# Midwest ISO Transmission Owners v. Federal Energy Regulatory Commission

373 F.3d 1361 (D.C. Cir. 2004)

ROBERTS, Circuit Judge:

I.

1. In the bad old days, utilities were vertically integrated monopolies; electricity generation, transmission, and distribution for a particular geographic area were generally provided by and under the control of a single regulated utility. Sales of those services were "bundled," meaning consumers paid a single price for generation, transmission, and distribution. As the Supreme Court observed, with blithe understatement, "[c]ompetition among utilities was not prevalent." *New York v. FERC*, 535 U.S. 1, 5 (2002).

In its pathmarking Order No. 888, FERC required utilities that owned transmission facilities to guarantee all market participants non-discriminatory access to those facilities. See *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities*, FERC Stats. & Regs. ¶ 31,036, 31,635-36 (1996) (*Order No. 888*). That is, FERC required all transmission-owning utilities to provide transmission service for electricity generated by others on the same basis that they provided transmission service for the electricity they themselves generated. To effectuate this introduction of competition, FERC required public utilities to "functionally unbundle" their wholesale generation and transmission services by stating separate rates for each service in a single tariff and offering transmission service under that tariff on an open-access, non-discriminatory basis. See *New York*, 535 U.S. at 11, 122; see generally *California Indep. Sys. Operator Corp. v. FERC*, 372 F.3d 395, 397 (D.C. Cir. 2004).

As the next step toward the goal of a more competitive electricity marketplace, Order No. 888 encouraged—but did not require—the development of multi-utility regional transmission organizations (RTOs). The concern was that the segmentation of the transmission grid among different utilities, even if each had functionally unbundled transmission, contributed to inefficiencies that impeded free competition in the market for electric power. Combining the different segments and placing control of the grid in one entity—an RTO—was expected to overcome these inefficiencies and promote competition. Order No. 888 at 31,730-32; see also Public Util. Dist. No. 1 of Snohomish County v. FERC, 272 F.3d 607, 610-11 (D.C. Cir. 2001). Better still if the RTO were run by an independent system operator—an ISO. As envisioned by FERC, an ISO would assume operational control—but not ownership—of the transmission facilities owned by its member utilities, thereby "separat[ing] operation of the transmission grid and access to it from economic interests in generation." Order No. 888 at 31,654; see also id. at 31,730-32. The ISO would then provide open access to the regional transmission system to all electricity generators at rates established in "a single, unbundled, grid-wide tariff that applies to all eligible users in a

non-discriminatory manner." *Id.* at 31,731; see also *California Indep. Sys. Operator Corp.*, at 397. FERC called this type of separation of generation and transmission "operational unbundling," a step beyond "functional unbundling." *Order No. 888* at 31,654. Although several parties to the 1996 rulemaking had requested that FERC require "operational unbundling" or even divestiture of transmission assets, it was FERC's considered judgment that "the less intrusive functional unbundling approach ... is all that we must require at this time." *Id.* at 31,655.

By 1999, FERC had come to a less sanguine view of the curative powers of functional unbundling. In FERC's view, inefficiencies in the transmission grid and lingering opportunities for transmission owners to discriminate in their own favor remained obstacles to robust competition in the wholesale electricity market. FERC concluded that these problems could be remedied through the establishment of RTOs, explaining that "better regional coordination in areas such as maintenance of transmission and generation systems and transmission planning and operation" was necessary to address regional reliability concerns and to foster regional competition. See Regional Transmission Organizations, Order No. 2000, FERC Stats. & Regs. ¶ 31,089, 30,999 (1999) (Order No. 2000) (codified at 18 C.F.R. § 35.34) (citing Staff Report to FERC on the Causes of Wholesale Electric Pricing Abnormalities in the Midwest During June 1998, at 5-8 (Sept. 22, 1998)). FERC concluded that RTOs would: "(1) improve efficiencies in transmission grid management; (2) impose grid reliability; (3) remove remaining opportunities for discriminatory transmission practices; (4) improve market performance; and (5) facilitate lighter handed regulation." Order No. 2000 at 30,993; Public Util. Dist. No. 1, 272 F.3d at 611. To further encourage RTO development, FERC directed transmission-owning utilities either to participate in an RTO or to explain their refusal to do so. Public Util. Dist. No. 1, 272 F.3d at <u>612</u>. Importantly, though, *Order No. 2000* still did not *require* utilities to join RTOs; participation remained voluntary. See *id.* at 616.

For those utilities opting to join an RTO, *Order No. 2000* retained a flexible approach, allowing the RTOs to employ a variety of ownership and operational structures, so long as the RTO established that it had certain required characteristics and functional capabilities. *Id.* at 611. FERC required, *inter alia*, that an RTO be regional in scope, 18 C.F.R. § 35.34(j)(2); "have operational authority for all transmission facilities under its control," *id.* § 35.34(j)(3); "be the only provider of transmission service over the facilities under its control," *id.* § 35.34(k)(1)(i); and "have the sole authority to receive, evaluate, and approve or deny all requests for transmission service," *id.* Thus, whatever its structure, once a utility made the decision to surrender operational control of its transmission facilities to an RTO, any transmissions across those facilities were subject to the control of that RTO.

2. In January 1998 (more than a year before Order No. 2000), several transmission-owning utilities in the Midwest sought FERC's approval for the transfer of operational control of their transmission facilities to an ISO known as Midwest ISO (MISO), which would be organized as a non-profit, non-stock corporation. *See* 

Midwest Indep. Transmission Sys. Operator, Inc., 84 FERC ¶ 61,231, 62,138-39 (1998) (MISO Initial Approval). MISO would link up the transmission lines of the member transmission-owning utilities (MISO Owners) into a single interconnected grid stretching across the northern border of the U.S. from Michigan to eastern Montana, and reaching as far south as Kansas City, Missouri and Louisville, Kentucky. Under the MISO proposal, the MISO Owners would retain ownership of and physically operate and maintain their transmission facilities, subject to MISO's instructions. MISO would have functional control of the transmission system, with responsibility for calculating available transmission capability; receiving, approving, and scheduling transmission service requests; and providing or arranging for ancillary services under the tariff. MISO would also serve as the system security coordinator for the MISO Owners.

The MISO Owners concurrently applied for approval of MISO's open access transmission tariff. See id. at 62,166. Under the tariff, all customers would pay a single rate to use the entire MISO transmission system, based on the volume of power the customer carried on the system. The MISO Owners did not, however, propose to bring all of their own transmission loads immediately under that new open access tariff. Several of the MISO Owners were required to provide bundled retail service (generation and transmission) to consumers at rates frozen by state legislation, state regulatory agencies, or legal settlements. The MISO Owners proposed that such bundled retail loads be brought under the MISO tariff at the end of a six-year transition period, unless the state regulatory authorities unbundled those loads sooner. See id. at 62,167. Also, some MISO Owners had pre-existing bilateral agreements with other utilities to provide wholesale transmission service at fixed rates. The MISO Owners proposed that loads under such grandfathered agreements also remain outside of the tariff until the end of the transition period. Thus, only new wholesale and unbundled retail transmission loads would be immediately subject to the MISO tariff.

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# Illinois Commerce Commission v. Federal Energy Regulatory Commission

721 F.3d 764 (7th Cir. 2013)

POSNER, Circuit Judge: Control of more than half the nation's electrical grid is divided among seven Regional Transmission Organizations, as shown in Figure 1. These are voluntary associations of utilities that own electrical transmission lines interconnected to form a regional grid and that agree to delegate operational control of the grid to the association. See 18 C.F.R. § 35.34(j), (k)(1)(i); *Midwest ISO Transmission Owners v. FERC*, 373 F.3d 1361, 1363-65 (D.C. Cir. 2004). Power plants that do not own any part of the grid but generate electricity transmitted by it are also

members of these associations, as are other electrical companies involved in one way or another with the regional grid.

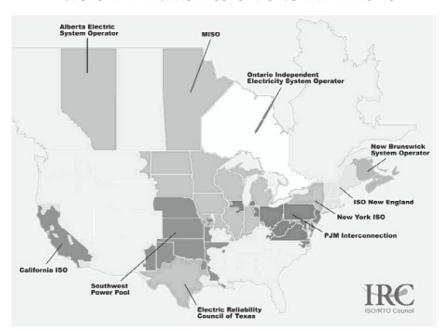


FIGURE 1
REGIONAL TRANSMISSION ORGANIZATIONS

The RTOs play a key role in the effort by the Federal Energy Regulatory Commission "to promote competition in those areas of the industry amenable to competition, such as the segment that generates electric power, while ensuring that the segment of the industry characterized by natural monopoly—namely, the transmission grid that conveys the generated electricity—cannot exert monopolistic influence over other areas.... To further pry open the wholesale-electricity market and to reduce technical inefficiencies caused when different utilities operate different portions of the grid independently, the Commission has encouraged transmission providers to establish 'Regional Transmission Organizations'—entities to which transmission providers would transfer operational control of their facilities for the purpose of efficient coordination ... [and] has encouraged the management of those entities by 'Independent System Operators,' not-for-profit entities that operate transmission facilities in a nondiscriminatory manner." *Morgan Stanley Capital Group, Inc. v. Public Utility District No. 1*, 554 U.S. 527, 536-37 (2008).

Two Regional Transmission Organizations are involved in this case—Midwest Independent Transmission System Operator, Inc. (MISO) and PJM Interconnection, LLC (PJM). As shown in Figure 1, MISO operates in the midwest and in the Great Plains states while PJM operates in the mid-Atlantic region but has midwestern enclaves in and surrounding Chicago and in southwestern Michigan.

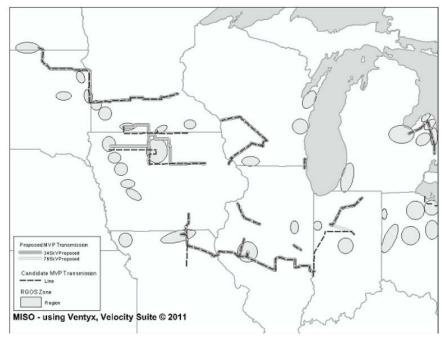
Each RTO is responsible for planning and directing expansions and upgrades of its grid. It finances these activities by adding a fee to the price of wholesale electricity transmitted on the grid. 18 C.F.R. § 35.34(k)(1), (7). The Federal Power Act requires that the fee be "just and reasonable," 16 U.S.C. § 824d(a), and therefore at least roughly proportionate to the anticipated benefits to a utility of being able to use the grid. *Illinois Commerce Commission v. FERC*, 576 F.3d 470, 476 (7th Cir. 2009); *Pacific Gas & Electric Co. v. FERC*, 373 F.3d 1315, 1320-21 (D.C. Cir. 2004). Thus "all approved rates [must] reflect to some degree the costs actually caused by the customer who must pay them." *K N Energy, Inc. v. FERC*, 968 F.2d 1295, 1300 (D.C. Cir. 1992). Courts "evaluate compliance [with this principle, which is called 'cost causation'] by comparing the costs assessed against a party to the burdens imposed or benefits drawn by that party." *Midwest ISO Transmission Owners v. FERC*, supra, 373 F.3d at 1368.

MISO began operating in 2002 and soon grew to have 130 members. (Unfortunately, the voluminous briefs say little about the association's governance structure.) In 2010 it sought FERC's approval to impose a tariff on its members to fund the construction of new high-voltage power lines that it calls "multi-value projects" (MVPs), beginning with 16 pilot projects. The tariff is mainly intended to finance the construction of transmission lines for electricity generated by remote wind farms. Every state in MISO's region except Kentucky (which is barely in the region, see Figure 1) encourages or even requires utilities to obtain a specified percentage of their electricity supply from renewable sources, mainly wind farms. Indiana, North Dakota, and South Dakota have aspirational goals; the rest have mandates. The details vary but most of the states expect or require utilities to obtain between 10 and 25 percent of their electricity needs from renewable sources by 2025—and by then there may be federal renewable energy requirements as well.

"The dirty secret of clean energy is that while generating it is getting easier, moving it to market is not.... Achieving [a 20% renewable energy quota] would require moving large amounts of power over long distances, from the windy, lightly populated plains in the middle of the country to the coasts where many people live... The grid's limitations are putting a damper on such projects already." Matthew L. Wald, "Wind Energy Bumps into Power Grid's Limits," *New York Times*, Aug. 27, 2008, p. A1. MISO aims to overcome these limitations.

To begin with, it has identified what it believes to be the best sites in its region for wind farms that will meet the region's demand for wind power. They are the shaded ovals in Figure 2. Most are in the Great Plains, because electricity produced by wind farms there is cheaper despite the longer transmission distance; the wind flow is stronger and steadier and land is cheaper because population density is low (wind farms require significant amounts of land).

FIGURE 2
WIND DEVELOPMENT ZONES AND MVP PROJECTS (dashed lines are initial proposals, solid lines approved projects)



MISO has estimated that the cost of the transmission lines necessary both to bring electricity to its urban centers from the Great Plains and to integrate the existing wind farms elsewhere in its region with transmission lines from the Great Plains—transmission lines that the multi-value projects will create—will be more than offset by the lower cost of electricity produced by western wind farms. The new transmission lines will also increase the reliability of the electricity supply in the MISO region and thus reduce brownouts and outages, and also increase the efficiency with which electricity is distributed throughout the region.

The cost of the multi-value projects is to be allocated among utilities drawing power from MISO's grid in proportion to each utility's share of the region's total whole-sale consumption of electricity. Before 2010, MISO allocated the cost of expanding or upgrading the transmission grid to the utilities nearest a proposed transmission line, on the theory that they would benefit the most from the new line. But wind farms in the Great Plains can generate far more power than that sparsely populated region needs. So MISO decided to allocate MVP costs among all utilities drawing power from the grid according to the amount of electrical energy used, thus placing most of those costs on urban centers, where demand for energy is greatest.

FERC approved (with a few exceptions, one discussed later in this opinion) MISO's rate design and pilot projects in two orders (for simplicity we'll pretend they're just one), precipitating the petitions for review that we have consolidated.

Six issues are presented: the proportionality of benefits to costs; the procedural adequacy of the Commission's treatment of proportionality; the propriety of apportioning the cost of the multi-value projects among utilities on the basis of their total power consumption while allocating no MVP costs to the plants that generate the power; whether MISO should be permitted to add the MVP fee to electricity transmitted to utilities that belong to the PJM Regional Transmission Organization rather than to MISO; whether MISO should be permitted to assess some of the multi-value projects' costs on departing members of MISO; and whether the Commission's approval of the MVP tariff—which if implemented will influence decisions by state utility commissions regarding the siting of transmission lines—violates the Tenth Amendment to the Constitution by invading state prerogatives.

The Tenth Amendment. The last issue is frivolous, so we dispatch it first. FERC approved the MVP tariff pursuant to its statutory authority to regulate interstate electrical rates, 16 U.S.C. § 824(a), but (unlike the regulation of natural gas, a field in which FERC has jurisdiction both over pricing and over the siting of interstate lines, see 15 U.S.C. § 717f(c)) the states retain authority over the location and construction of electrical transmission lines. 16 U.S.C. § 824(b)(1); New York v. FERC, 535 U.S. 1, 24 (2002). Some of the petitioners complain that FERC's approval of the MVP tariff coerces each state to approve all MVPs proposed within its territory. They argue that since the costs of each project are distributed among all MISO utilities while any local benefits will be retained in the state in which the project is located, a state will deprive itself of the local benefits of a project subsidized by other utilities if it refuses to approve an MVP project.

But this is just to say that the tariff provides a carrot that states won't be able to resist eating; to obtain the benefits of the MVP program each state's MISO members may have to shoulder costs of some specific projects that they'd prefer not to support. But that's a far cry from the federal government's conscripting a state government into federal service. That it may not do. *National Federation of Independent Business v. Sebelius*, \_\_\_\_\_ U.S. \_\_\_\_ (2012); *New York v. United States*, 505 U.S. 144, 149 (1992); *Printz v. United States*, 521 U.S. 898, 935 (1997). This it may do. Cf. *National Ass'n of Regulatory Utility Commissioners v. FERC*, 475 F.3d 1277, 1282-83 (D.C. Cir. 2007). It's not as if FERC were ordering states to build transmission lines that the federal government wants to use for its own purposes. And to glance ahead a bit, there is nothing to prevent a member of MISO from withdrawing from the association and joining another Regional Transmission Organization.

Five issues remain; we discuss them in the order in which we listed them, beginning with—

Proportionality and Procedure (best discussed together). MISO used to allocate the cost of an upgrade to its grid to the local area ("pricing zone") in which the upgrade was located. (There are 24 pricing zones in MISO.) But those were upgrades to low-voltage lines, which transmit power short distances and thus benefit only the local area served by the lines. MISO contends (and FERC agrees) that the multi-value pro-

jects, which involve high-voltage lines that transmit electricity over long distances, will benefit all members of MISO and so the projects' costs should be shared among all members.

The petitioners' objections fall into two groups. One consists of objections lodged by the Michigan utilities and their regulator (we'll call this set of objectors "Michigan"), the other of objections by other petitioners led by the Illinois Commerce Commission. We'll call these objectors "Illinois," though they include other state utilities and regulators; and we'll begin with their objections.

Illinois contends that the criteria for determining what projects are eligible to be treated as MVPs are too loose and as a result all MISO members will be forced to contribute to the cost of projects that benefit only a few. To qualify as an MVP a project must have an expected cost of at least \$20 million, must consist of high-voltage transmission lines (at least 100kV), and must help MISO members meet state renewable energy requirements, fix reliability problems, or provide economic benefits in multiple pricing zones. None of these eligibility criteria ensures that every utility in MISO's vast region will benefit from every MVP project, let alone in exact proportion to its share of the MVP tariff. For example, Illinois power cooperatives are exempt from the state's renewable energy requirements, 83 Ill. Adm.Code 455.100; 20 ILCS 3855/1-75(c), and so would not benefit from MVPs that help utilities meet state renewable energy requirements. But FERC expects them to benefit by virtue of the criteria for MVP projects relating to reliability and to the provision of benefits across pricing zones.

Bear in mind that every multi-value project is to be large, is to consist of high-voltage transmission (enabling power to be transmitted efficiently across pricing zones), and is to help utilities satisfy renewable energy requirements, improve reliability (which benefits the entire regional grid by reducing the likelihood of brownouts or outages, which could occur anywhere on it, *Illinois Commerce Commission v. FERC*, *supra*, 576 F.3d at 477), facilitate power flow to currently underserved areas in the MISO region, or attain several of these goals at once. The 16 projects that have been authorized are just the beginning. And FERC has required MISO to provide annual updates on the status of those projects. Should the reports show that the benefits anticipated by MISO and FERC are not being realized, the Commission can modify or rescind its approval of the MVP tariff.

Illinois also complains that MISO has failed to show that the multi-value projects as a whole will confer benefits greater than their costs, and it complains too about FERC's failure to determine the costs and benefits of the projects subregion by subregion and utility by utility. But Illinois's briefs offer no estimates of costs and benefits either, whether for the MISO region as a whole or for particular subregions or particular utilities. And in complaining that MISO and the Commission failed to calculate the full financial incidence of the MVP tariff, Illinois ignores the limitations on calculability that the uncertainty of the future imposes. MISO did estimate that there would be cost savings of some \$297 million to \$423 million annually because

western wind power is cheaper than power from existing sources, and that these savings would be "spread almost evenly across all Midwest ISO Planning Regions." *Midwest Independent Transmission System Operator, Inc.*, 133 FERC 61221, ¶ 34 (2010). It also estimated that the projected high-voltage lines would reduce losses of electricity in transmission by \$68 to \$104 million, and save another \$217 to \$271 million by reducing "reserve margin losses." *Id.* That term refers to electricity generated in excess of demand and therefore (because it can't be stored) wasted. Fewer plants will have to be kept running in reserve to meet unexpected spikes in demand if by virtue of longer transmission lines electricity can be sent from elsewhere to meet those unexpected spikes. It's impossible to allocate these cost savings with any precision across MISO members.

The promotion of wind power by the MVP program deserves emphasis. Already wind power accounts for 3.5 percent of the nation's electricity, U.S. Energy Information Administration, "What is U.S. Electricity Generation by Source?" May 9, 2013, www.eia.gov/tools/faqs/faq.cfm? id=427 & t=3 (visited May 29, 2013), and it is expected to continue growing despite the downsides of wind power that we summarized in Muscarello v. Winnebago County Board, 702 F.3d 909, 910-11 (7th Cir. 2012). The use of wind power in lieu of power generated by burning fossil fuels reduces both the nation's dependence on foreign oil and emissions of carbon dioxide. And its cost is falling as technology improves. No one can know how fast wind power will grow. But the best guess is that it will grow fast and confer substantial benefits on the region served by MISO by replacing more expensive local wind power, and power plants that burn oil or coal, with western wind power. There is no reason to think these benefits will be denied to particular subregions of MISO. Other benefits of MVPs, such as increasing the reliability of the grid, also can't be calculated in advance, especially on a subregional basis, yet are real and will benefit utilities and consumers in all of MISO's subregions.

It's not enough for Illinois to point out that MISO's and FERC's attempt to match the costs and the benefits of the MVP program is crude; if crude is all that is possible, it will have to suffice. As we explained in *Illinois Commerce Commission v. FERC*, *su-pra*, 576 F.3d at 477, if FERC "cannot quantify the benefits [to particular utilities or a particular utility]... but it has an articulable and plausible reason to believe that the benefits are at least roughly commensurate with those utilities' share of total electricity sales in [the] region, then fine; the Commission can approve [the pricing scheme proposed by the Regional Transmission Organization for that region] ... on that basis. For that matter it can presume [as it did in this case] that new transmission lines benefit the entire network by reducing the likelihood or severity of outages."

Illinois can't counter FERC without presenting evidence of imbalance of costs and benefits, which it hasn't done. When we pointed this out at oral argument, Illinois's lawyer responded that he could not obtain the necessary evidence without pretrial discovery and that FERC had refused to grant his request for an evidentiary hearing even though the Commission's rules make the grant of such a hearing a precondition

to discovery. 18 C.F.R. § 385.504(b)(5). FERC refused because it already had voluminous evidentiary materials, including MISO's elaborate quantifications of costs and benefits—and these were materials to which the petitioners had access as well; they are, after all, members of MISO. The only information MISO held back was the production costs of particular power plants, which it deemed trade secrets and anyway are only tenuously related to the issue of proportionality. The need for discovery has not been shown; and for us to order it without a compelling reason two and a half years after the Commission rendered its exhaustive decision (almost 400 pages long) would create unconscionable regulatory delay.

Michigan (which is to say Michigan utilities plus the state's electric power regulatory agency) argues that unique features of the state's power system will cause Michigan utilities to pay a share of the MVP tariff greatly disproportionate to the benefits they will derive from the multi-value projects. A Michigan statute, Mich. Comp. L. 460.1029(1), forbids Michigan utilities to count renewable energy generated outside the state toward satisfying the requirement in the state's "Clean, Renewable, and Efficient Energy Act" of 2008 that they obtain at least 10 percent of their electrical power needs from renewable sources by 2015. Michigan further argues that it won't benefit from any multi-value projects constructed in other states because its utilities draw very little power from the rest of the MISO grid, as a consequence of the limited capacity to transmit electricity from Indiana to Michigan. It argues that for these reasons it should be required to contribute only to the costs of multi-value projects built in Michigan.

The second argument founders on the fact that the construction of high-voltage lines from Indiana to Michigan is one of the multi-value projects and will enable more electricity to be transmitted to Michigan at lower cost. Michigan's first argument—that its law forbids it to credit wind power from out of state against the state's required use of renewable energy by its utilities—trips over an insurmountable constitutional objection. Michigan cannot, without violating the commerce clause of Article I of the Constitution, discriminate against out-of-state renewable energy. See *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93, 100-01 (1994); *Wyoming v. Oklahoma*, 502 U.S. 437, 454-55 (1992); *Alliance for Clean Coal v. Miller*, 44 F.3d 591, 595-96 (7th Cir.1995).

Like Illinois, Michigan objects to the Commission's refusal to conduct an evidentiary hearing. It wants an opportunity to present evidence in a trial-type proceeding involving cross-examination of expert witnesses. (All direct testimony at FERC's evidentiary hearings is presented in writing; only cross-examination is oral.) It also wants pretrial discovery, like Illinois. But unlike Illinois it didn't raise the issue until its reply brief, which is too late.

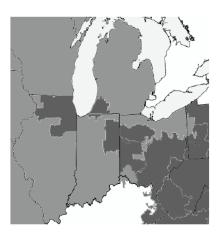
FERC need not conduct an oral hearing if it can adequately resolve factual disputes on the basis of written submissions. Considering the highly technical character of the data and analysis required to match costs and benefits of transmission projects, the technical knowledge and experience of FERC's members and staff, and the petition-

ers' access to MISO's studies, we would be creating gratuitous delay to insist at this late date on the Commission's resorting to litigation procedures designed long ago for run-of-the-mine legal disputes. Michigan has failed to indicate what evidence that it might present in an evidentiary hearing would contribute to the data and analysis in the record already before the Commission.

A further answer to both the substantive and procedural questions about proportionality is that MISO members who think they're being mistreated by the MVP tariff can vote with their feet. Membership in an RTO is voluntary and though there's a "departure fee" (discussed later in this opinion), it is an unexceptionable feature of membership in a voluntary association, designed to prevent a departing member from reaping a windfall by leaving costs for which it is properly liable to be borne by the remaining members. A departure fee, which if properly calculated just deters windfalls, will not prevent a discontented MISO member from decamping to an adjacent RTO. As shown in the right-hand panel of Figure 3, Michigan abuts the border between MISO (light gray) and PJM (dark gray) and has claimed that 96.5 percent of its external grid connections are with PJM. It should therefore be able without great difficulty to quit MISO and join PJM. It doesn't want to do that; so far as appears, it is objecting to the MVP program only in the hope of getting better terms.

FIGURE 3: MISO-PJM BORDER REGION (MISO to left, PJM to right)

2004 2013





Allocation of cost on the basis of peak load versus total electricity consumption. Because a power grid must be built to handle peak loads (the amount of electricity transmitted when demand is greatest, as on hot summer days), some of the petitioners argue that the MVP surcharge should be allocated according to each utility's contribution to peak demand. The peak demanders would be paying for facilities built to accommodate that demand and thus minimize brownouts and outages. Instead MISO allo-

cates the surcharge by the total amount of electricity that each utility receives over the MISO grid. A higher share of MVP costs is thus allocated to utilities receiving electricity to meet continuous demands, such as the demand by a factory for electricity much of which it uses in off-peak periods.

The objection to MISO's allocating costs by total rather than peak demand is refuted by the fact that a primary goal of the MVPs is to increase the supply of wind-powered energy. The electricity generated by wind farms varies with the amount of wind rather than with demand and therefore is not a reliable source of energy to meet peak demand. That is why the states' renewable energy standards are couched in terms of total energy rather than peak load. See, e.g., 20 ILCS 3855/1-75(c)(2); Wis. Stat. § 196.378(1)(fm); Minn.Stat. § 216B.1691 subd. 2a(a). Furthermore, long-distance power transmission will enable fewer power plants to serve the grid's off-peak demand. True, the projects are also intended to increase the grid's reliability, which is challenged mainly by peak load (which is why outages are more frequent on hot summer days, when everyone is running his air conditioner at the same time). But MISO and FERC were entitled to conclude that the benefits of more and cheaper wind power predominate over the benefits of greater reliability brought about by improvement in meeting peak demand.

Allocation of cost between power plants and the wholesale buyers of the power. Petitioners complain about MISO's decision to allocate all MVP costs to the utilities that buy electricity from its grid and none to the power plants that generate that electricity. Because the power plants are required to pay for connecting to the grid and the multivalue projects will shorten the interconnection distance and thus reduce the cost to the power plants of connecting, the petitioners argue that the power plants should pay part of the MVP tariff. But the utilities benefit from cheaper power generated by efficiently sited wind farms whose development the multi-value projects will stimulate. The MVP tariff allocates to the wholesale buyers some of the costs of conferring these benefits on those buyers, though competition might do the same thing without the tariff because the power plants would pass some of their higher costs on to their customers, the wholesale buyers.

An important consideration is that when wind farms are built in remote areas (which are the best places to site them), the costs of connecting them to the grid are very high, and by reducing those costs the multi-value projects, financed by the MVP tariff, facilitate siting wind farms at the best locations in MISO's region rather than at inefficient ones that are however closer to the existing grid and so would be preferred by the wind-farm developers if they had to pay for the connection. See *California Independent System Operator Corp.*, 119 F.E.R.C. 61061, ¶¶ 64-67 (2007); *Southwest Power Pool, Inc.*, 127 FERC 61283, ¶¶ 5, 11, 28 (2009).

Export charges to PJM. An issue that unlike the previous ones finds MISO and FERC at loggerheads is whether the Commission is unreasonable in prohibiting MISO from adding the MVP surcharge to electricity transmitted from its grid to the

grid of PJM, an adjoining Regional Transmission Organization. The Commission permits MISO to charge for transmission to other RTOs.

The prohibition arises from a concern with what in FERC-speak is called "rate pancaking" but is more transparently described as exploiting a locational monopoly by charging a toll. It is illustrated by Henrich von Kleist's classic German novella *Mi*chael Kohlhaas. When the book was published in 1810, what is now Germany was divided into hundreds of independent states. A road from Munich to Berlin, say, would cross many boundaries, and each state that the road entered could charge a toll as a condition for allowing entry. The toll would be limited not by the cost imposed on the state by the traveler, in wear and tear on the road or traffic congestion, but by the cost to the traveler of using a less direct alternative route. Like early nineteenthcentury Germany, the American electric grid used to be divided among hundreds of independent utilities, each charging a separate toll for the right to send electricity over its portion of the grid. The multiple charges imposed on long-distance transmission discouraged such transmission. FERC promoted the creation of the Regional Transmission Organizations as a way of eliminating these locational monopolies. Wabash Valley Power Ass'n v. FERC, 268 F.3d 1105, 1116 (D.C. Cir. 2001). For it required that the RTOs embrace coherent geographic regions and that each RTO charge a single fee for use of its entire grid. 18 C.F.R. § 35.34(j)(2), (k)(1)(ii).

In the early 2000s Commonwealth Edison and American Electric Power had requested FERC's permission to join PJM despite being inside MISO's region (around Chicago and in southwestern Michigan, respectively). The Commission approved their requests yet was concerned that the irregular border (seen in the left-hand panel of Figure 3) between the two regions, by creating PJM enclaves in MISO's region, violated the requirement that RTOs embrace coherent regions. The Commission was concerned for example with Michigan utilities' having to pay PJM charges on power sent from elsewhere in MISO (such as Wisconsin), because those transmissions, though beginning and ending in MISO territory, traversed a PJM enclave—the area served by Commonwealth Edison.

The Commission had another concern with the irregular border, what we'll call the "power routing" concern. Notice in the left-hand panel of Figure 3 the MISO utilities that lie (or rather lay, as of 2004) on a south to north diagonal in Kentucky and Ohio. Imagine a wholesale buyer of electricity located on the diagonal. It would be more efficient for it to draw electricity from the PJM transmission lines to its immediate west or east than from the MISO lines that snake to the northeast and thus bring electricity from a great distance. But the buyer might be deflected from the most efficient routing option because buying from PJM would cross both MISO and PJM territory and thus require paying a double toll.

So in 2003 FERC forbade export charges between MISO and PJM and ordered the two RTOs to negotiate a joint rate that would divide the costs of the cross-border transmissions between them, much as with "divisions" of railroad rates for shipments in which more than one railroad participates. The Commission didn't require a simi-

lar negotiation between MISO and the other RTOs that MISO abuts because no enclave or power-routing problem was created by transmission to those RTOs; there were no enclaves or highly irregular borders.

The two RTOs negotiated a joint rate designed to share the costs of some transmission upgrades with crossborder benefits—but have not negotiated a joint rate for multi-value projects. MISO argues that the Commission should have reconsidered its 2003 prohibition of export charges to PJM and permitted such charges for multivalue projects that benefit electricity customers in PJM, in light of the changes (seen in the right-hand panel of Figure 3) in the MISO-PJM border between 2003-2004 and 2013. Those changes have straightened out the border and by doing so should have lessened the Commission's concern that "the elongated and highly irregular seam between MISO and PJM....would subject a large number of transactions in the region to continued rate pancaking." Midwest Independent Transmission System Operator, Inc., 137 FERC 61074, ¶ 264 (2011). No longer are any parts of Ohio in MISO. True, there still are PJM enclaves. For example, a transmission from a PJM enclave in northern Illinois or southwestern Michigan to Ohio or Pennsylvania runs through MISO lines in Indiana. But with the disappearance of the MISO diagonal that we mentioned, the power-routing problem, at least, appears to have been solved, though FERC wants more data from MISO to demonstrate this.

A further concern about the continued validity of the 2003 order prohibiting tolls on transmissions between MISO and PJM is that the order was issued at a time when all of MISO's transmission projects were local and therefore provided only local benefits, so that an export charge would have shifted costs to PJM utilities that derived few or even no benefits from the projects. A related consideration behind the 2003 order was that export charges would not finance projects, but would merely operate as a toll exploiting a locational advantage. Cf. *Illinois Commerce Commission v. FERC*, supra, 576 F.3d at 473-74. The multi-value projects are new projects, not yet paid for, and since they will benefit electricity users in PJM, those users should contribute to the costs.

The MVPs also are not local. They will "support all uses of the system, including transmission on the system that is ultimately used to deliver to an external load," and "benefit all users of the integrated transmission system, regardless of whether the ultimate point of delivery is to an internal or external load." *Midwest Independent Transmission System Operator, Inc.*, 133 FERC 61221, ¶ 439 (2010). (By "external" read PJM or any other recipient of electricity that is outside MISO.) That is an argument for shifting some of the costs of the system to PJM utilities. The requirement of proportionality between costs and benefits requires that all beneficiaries—which the Commission has determined include all users of the MISO grid, including users in PJM—shoulder a reasonable portion of MVP costs.

MISO and PJM may eventually negotiate an allocation agreement, as they did in the pre-MVP era, but the rest of the grid is left to pay for PJM's share unless and until they do so. So far as we can tell, the Commission is being arbitrary in continuing to prohibit MISO from charging anything for exports of energy to PJM enabled by the multi-value projects while permitting it to charge for exports of energy to all the other RTOs. The Commission must determine in light of current conditions what if any limitation on export pricing to PJM by MISO is justified. This part of the Commission's decision must therefore be vacated.

The departers. Two former members of MISO, FirstEnergy and Duke Energy, which lie on the diagonal that had created the power-routing problem, announced their intention to quit MISO before the MVP tariff was announced. MISO wants nevertheless to allocate some MVP costs to them. FERC has ruled that allocation to departing utilities is proper in principle. But it has not yet determined which if any costs may be allocated to the two utilities in particular. That determination FERC has ruled to be outside the scope of the present proceeding, the proceeding before us. Midwest Independent Transmission System Operator, Inc., 133 FERC 61221, ¶ 472 (2010). FirstEnergy and Duke respond that they can't be made liable for any such costs because their membership contract with MISO does not provide for the imposition of such costs.

When a firm withdraws from an association owing money to it, its withdrawal does not terminate its liability; an example is an employer who withdraws from a multiemployer ERISA plan. The same may be true of withdrawal from a Regional Transmission Organization. If MISO began to incur costs relating to the MVPs (including the pilot projects) before the departing members announced their departure, those utilities may be liable for some of those costs. MISO contends that they are liable, but the Commission has reserved the question for a separate proceeding, see FirstEnergy Service Co. v. Midwest Independent Transmission System Operator, Inc., 138 FERC 61140, ¶ 74 (2012), as it is authorized to do. Mobil Oil Exploration & Producing Southeast Inc. v. United Distribution Cos., 498 U.S. 211, 230 (1991). That proceeding is pending.

The departing members' attack on an order that amounts to a truism—that amounts to saying that if they're liable they're liable—is premature, and must therefore be dismissed for want of a final administrative decision on the matter.

In summary, the challenged orders are affirmed, except that the challenge by the departing MISO members is dismissed as premature and the determination regarding export pricing to PJM is remanded for further analysis by the Commission in light of the discussion of the issue in this opinion.

# **DVD Joint Licensing of Patents Request Letter**

July 29, 1998

Honorable Joel I. Klein, Esq.,

Assistant Attorney General,

Antitrust Division,

United States Department of Justice,

10th Street and Constitution Avenue, N.W.,

Washington, D.C. 20530.

Re: Request for Business Review Letter Regarding the Licensing of Patents Essential to DVD-Video and DVD-ROM

Dear Mr. Klein:

On behalf of Koninklijke Philips Electronics, N.V. ("Philips"), Sony Corporation of Japan ("Sony"), and Pioneer Electronic Corporation of Japan ("Pioneer") (and their affiliates which are involved in the patent licensing program described below) we submit this request for a Business Review pursuant to 28 C.F.R. § 50.6 regarding the proposed arrangement under which certain patents essential to the manufacture and use of DVD-Video and DVD-ROM will be licensed on reasonable and non-discriminating terms (the "Proposed Licensing Program").

DVD (or Digital Versatile Discs) refers to a high density CD-sized optical disc in which signals are encoded and stored in digital form and are then read and reproduced by players using an optical read out beam. Relying on basic CD technology, the DVD discs and players allow for an increase of approximately sixty times the storage capacity of a typical CD or CD-ROM. DVD-Video and DVD-ROM are two formats relating to high density optical discs which have been described by Philips, Sony, Pioneer and several other companies in the DVD-Specification for Read Only Disc version 1.0 dated August 1996 and in several updates thereto (a copy of the specification is set forth in Exhibit A hereto).

A single DVD format for video and ROM was defined in an open process by participating companies over the course of several years at the request of various industries—particularly the computer industry—which asserted that multiple DVD formats would delay introduction of this new and beneficial product, increase costs, and much like the incompatible BETA and VHS formats, result in losses to consumers who purchased products based on a format which quickly became obsolete. In defining the DVD-Video and DVD-ROM formats, input was solicited and received from a variety of industries and an even wider variety of companies throughout the world.

As the format was developed and refined, it became clear that numerous independent companies had been granted patents which were relevant to DVD-Video and DVD-ROM. The three companies submitting this request actively sought to join the licensing of their patents with the patents of other companies which also claimed to have patents which are essential to DVD-Video and DVD-ROM. To date, those ef-

forts have not resulted in any other companies joining the Proposed Licensing Program. Philips, Sony and Pioneer, however, remain willing to include others having essential patents in the licensing program described below.

The companies submitting this request firmly believe that, in the near future, DVD products will be widely marketed by a wide variety of companies. We are also convinced that, once these products are manufactured and distributed in volume, there will be great consumer demand for them. We anticipate that the producers and sellers of DVD discs and players will largely be the companies that currently manufacture and sell CDs and the equipment that plays CDs and CD ROMs. Thus, prospective licensees include manufacturers of consumer audio equipment and computer disc drives. Typically, licensees to manufacture DVD discs will be replicators, as is the case with CDs. In sum, the DVD licenses will be offered to the same classes of sophisticated licensees as are CD licenses, and there is every reason to expect that the transfer of this valuable DVD technology will have the same beneficial effects upon the relevant industries that CD licenses had upon the recorded music industry 15 years ago.

In one respect, licensors of DVD technology face risks and uncertainties that were not faced 15 years ago by the creators of CD technology. During the past year, several different formats have been announced that will compete with various applications of DVD for the favor of consumers. For example, Circuit City and others have developed Digital Video Express (DIVX), a pay-per-play system that allows consumers who have purchased a DIVX-compliant player to purchase a disc at a lower price and to play that disc for a limited period of time without having to return the disc when finished. The disc may later be "re-activated" for additional plays upon payment of additional fees. Various companies have announced that they will offer DIVX discs, including Twentieth Century Fox, the Walt Disney Company, Paramount Pictures, Universal Studios and Dream Works. It is our understanding that DIVX discs will not play on non-DIVX DVD players. In addition, NEC, one of Japan's largest electronics manufacturers, has announced its intention to introduce Multimedia Video File (MMDF), an optical disc format which is expected to compete directly with certain applications of DVD technology. Other new announced products include TeraStor's Near Field Recording (NFR) technology and Advanced Storage Magneto-Optical (ASMO). In short, this is an area in which several well-financed suppliers are prepared to compete aggressively with DVD products. Obviously, there also will be competition among those selling DVD products.

Offering a patent license for all essential patents of the three companies under the Proposed Licensing Program will provide several pro-competitive benefits, including (1) reducing the uncertainty of the availability of patent licenses so that those who require a license to manufacture or use a DVD-Video or DVD-ROM product are aware that a license from the three companies easily can be obtained; (2) reducing the royalties that likely would be payable if the three companies licensed their essential patents on their own; (3) reducing the cost for each prospective licensee of determin-

ing on its own the identities of owners of essential patents and the entities from which licenses which must be obtained; (4) reducing other transaction costs of licensees having to negotiate and execute separate licenses; (5) reducing the transaction costs of essential patent holders offering separate licenses thereby allowing for a reduction in the price of the license; and (6) offering the same royalty rate and other conditions to all interested licensees so that no entity manufacturing or selling a DVD-Video or DVD-ROM product will have a price advantage over any other such entity as a result of entering into a license for the essential patents of Philips, Sony and Pioneer.

The Proposed Licensing Program will be structured to avoid any countervailing aspects that may be deemed anticompetitive. For example, each patent holder will retain the right to license its patents outside the Proposed Licensing Program under whatever terms and conditions it reaches with any prospective licensee, and each prospective licensee will be informed in writing of its option to negotiate such an individual license under reasonable terms and conditions. The Philips personnel who are responsible for the Proposed Licensing Program will play no role in the marketing of DVD products. An independent expert in the art has been retained to insure that the portfolio of patents that will be licensed under the Program includes only those patents which are essential to DVD-Video and DVD-ROM products. Although Philips, Sony and Pioneer have not been successful in having other companies join their licensing program, they remain willing to include any others having essential patents who wish to join. There will be no royalty payable by the licensee unless a licensed patent would be infringed but for the license, information which the licensee may be required to disclose to monitor infringement and royalty payments will not be disclosed to any of the licensors, but only to a third party expert retained by the licensors, patents included in the licenses will be specifically identified in appendices to the license, and Philips, Sony and Pioneer will commit to licensing to any licensee any essential patent rights they may acquire subsequent to the date specified in the license.

Set forth below is a fuller description of the proposed licensing terms and the agreements among the licensors.

# The Proposed Patent License

Two licenses (Appended hereto as Exhibits B and C) will be offered, both in substantially the same form. One is for DVD players, the other for DVD discs. A three page "Agreement" sets forth a few basic terms of the license and also specifically incorporates the "Conditions" of the license which are appended to the Agreement.

On the first page of the Agreement, it is specifically noted that Philips, Sony and Pioneer are each willing to license their respective patent rights for optical disc or player manufacturing whether within or outside the standard DVD specifications on reasonable terms and conditions. Thus, any prospective licensee who is dissatisfied with the terms of the Proposed Licensing Program is assured of this alternative.

Article 2 of the Conditions sets forth the terms of the license grant, and provides for a license under Licensed Patents which are defined in Article 1.07 as all patent rights pertinent to DVD discs or players which Philips has acquired the right to license, which have or are entitled to a priority date prior to January 1, 1997, and which are essential to DVD discs or players. Article 1.07 goes on to define as "essential" those patents which are necessary as a practical matter for compliance with the DVD-Video or DVD-ROM specifications. The license, therefore, includes not only all patents technically necessary to manufacture a product to the standard specifications, but also those which a typical licensee is likely to require. For example, it may be theoretically possible to design around a particular patent at significant additional cost (and without additional benefit), but few, if any, licensees who pay the standard royalty rate for other essential patents would want such patent excluded from the license. Indeed, it is fair to say that most, if not all, licensees would want such patents included.

Article 2.07 describes the method by which patents are selected for the portfolio license. The prospective licensee is specifically informed that Philips has appointed an independent patent expert to evaluate the patents of the three licensors for "essentiality" and that the portfolio included in the license may be amended from time to time based on the results of that evaluation.<sup>1</sup>

In Article 2.03, each licensor agrees to grant a license to each licensee under any essential patent which Philips, Sony or Pioneer acquire the right to license in the future. Thus, to the extent any of the licensors are issued essential patents in the future or other companies join the proposed licensing program, all licensees are guaranteed a license under any such essential patent.

Articles 2.05 and 2.06 set forth the terms of the licensees' grant of patent rights. For the identical term of the license granted by Philips, Sony and Pioneer, the licensee agrees to grant to the licensors and other licensees (who also agree to the terms of the grant back) a royalty bearing license on essential patents. Thus, the scope of the grant back is virtually identical to the scope of the license itself. The grant back would not create any disincentive to innovate as it specifically allows the licensee to charge a royalty for its grant of a license and would only prevent a particular patent holder from deciding to use its after-acquired patent position to completely block others from competing in a business in which they already have invested substantial resources.

Article 4 sets forth the royalty payments to be made by licensees. The license provides for a \$10,000 payment upon execution of the license (\$5,000 of which may be

<sup>&</sup>lt;sup>1</sup> Philips has appointed Kenneth Rubenstein, a member of Proskauer Rose LLP of New York, to determine which patents are essential and should be included in the license. Dr. Rubenstein received his Ph.D in plasma physics from the Massachusetts Institute of Technology in 1975 and his J.D. cum laude from New York Law School in 1982. Dr. Rubenstein previously performed a similar function for the licensing of patents essential to MPEG-2 technology and he continues this work.

credited to royalty payments) and a running royalty of \$.05 per disc or 3.5% of the net selling price of a player, with a minimum player payment of \$7.00 until January 1, 2000 and a minimum of \$5.00 thereafter.<sup>2</sup>

Article 4 makes plain that no royalties are due unless "a Licensed Patent is utilized" and, therefore, there are no royalty paying obligations regardless of whether the 10-year license is in effect if the licensee has adopted new or different technology that does not utilize any of the patents in the portfolio.

Articles 4.09 and 4.10 provide that licensees must maintain and furnish certain information relevant to issues of infringement and appropriate royalty payments, but specify that such information shall be provided to independent experts rather than to any licensor itself.

The licenses provide for "most favorable nations" terms under which each licensee is assured of receiving the most favorable royalty rate granted any other portfolio licensee under the conditions specified in Article 5. Thus, no similarly situated licensee is given a competitive advantage by the license over any other such licensee.

Article 10.05 gives each licensor the right to withdraw its own patents from the portfolio license with respect to any licensee which both (1) brings a lawsuit against the licensor for infringement of an essential DVD patent and (2) refuses to license such patents to the licensor on fair and reasonable terms. This provision is necessary to prevent portfolio licensees from taking unreasonable and unfair advantage of the fact that each portfolio licensor already has agreed to license its patent on the open, fair and non-discriminatory terms provided in the portfolio license at royalty rates that are likely considerably lower than what would be payable if patents were licensed individually outside the portfolio license.

Without the provisions of Article 10.05, a portfolio licensee could—while enjoying the considerable benefits of the portfolio license—attempt to extract unreasonable terms for licensing its patents as a result of already being licensed under the portfolio license. Article 10.05 merely "evens the playing field," returns the parties to the bargaining position each would have been in but for the portfolio license, and creates no competitive issues. This is particularly so in light of each portfolio licensors' undertaking to license its patents outside the portfolio license. Thus, a licensee who subjects itself to the provision of Article 10.05 by filing suit and refusing to grant a license on fair and reasonable terms is not denied the right to a license for essential patents, just to a license for essential patents on the favorable terms of the portfolio license.

Finally, Article 11.04 provides that any disputes involving the license shall be submitted to arbitration in New York and resolved under New York law. This provides for a certain and cost effective method to resolve disputes.

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<sup>&</sup>lt;sup>2</sup> Widespread public reports have suggested that the typical disc will retail for approximately \$20-25. The per disc royalty thus amounts to approximately. 22% of the retail price of discs, although the royalty typically will be payable by the disc replicator.

# Agreement Among Licensors

The agreements among Philips, Sony and Pioneer relating to the Proposed Licensing Program are set forth in two bilateral Agreements and Amendment No. 1 thereto, one between Sony and Philips and one identical agreement between Pioneer and Philips. The Agreements and Amendments are appended hereto as Exhibit D.

The Agreements basically set forth the terms under which Philips shall license the three companies' essential patents and set out many of the same terms which are incorporated in the licenses itself and are discussed above. The Agreements make plain that the Proposed Licensing Program does not in any way impede the companies' ability to license their patents on their own under any conditions they may negotiate.

Article 2.01 of the Agreement provides that Philips shall offer the portfolio license to "all interested third parties." Article 5 of Amendment No. 1 further specifies that Philips shall grant licenses "to all interested parties and shall not discriminate against or among potential licensees" although Philips is entitled to seek financial guarantees on royalty payments when required. The Agreements also set out various terms for the collection and distribution of royalties. Although Article 4.03 provides that each party may consult with the others in the event of a good faith belief that an act of infringement has occurred, Article 4.04 provides that each party retains the right to enforce its patents as it sees fit.

Article 7 of Amendment No. 1 sets forth the details of the procedure by which Philips shall retain an independent expert to assure that all patents in the portfolio are essential, and provides the procedure under which patents may be added to the Proposed Licensing Program.

#### Conclusion

It is anticipated that DVD-Video and DVD-ROM applications will gain widespread acceptance among consumers in the United States and throughout the world. Intellectual property rights granted by the United States and other sovereign nations to numerous unrelated entities could seriously delay if not block the introduction of this new and significant technology. The Proposed Licensing Program described above eliminates one potential impediment to the implementation of DVD-Video and DVD-ROM by allowing all essential patents of Philips, Sony and Pioneer to be offered in a single, non-discriminatory, fair and cost effective licensing program. The Proposed Licensing Program has been carefully crafted in an effort to avoid any competition concerns which may arise from the combining of patents belonging to independent entities within a single license. We respectfully submit that the Proposed Licensing Program has successfully addressed any competition concerns, and that the pro-competitive aspects of the program far outweigh any potential competition issues which may remain.

We will be available at your convenience to provide any further information you may require. We very much appreciate the Division's attention to this matter.

Respectfully,

Garrard R. Beeney

for Koninklijke Philips Electronics, N.V.; Sony Corporation of Japan and Pioneer Electronic Corporation of Japan

# **DVD Business Review Letter Response**

December 16, 1998

VIA FAX

Garrard R. Beeney, Esq.

Sullivan & Cromwell

125 Broad Street

New York, New York 10004-2498

Dear Mr. Beeney:

This letter is in response to your request on behalf of Koninklijke Philips Electronics, N.V. ("Philips"), Sony Corporation of Japan ("Sony") and Pioneer Electronic Corporation of Japan ("Pioneer") for the issuance of a business review letter pursuant to the Department of Justice's Business Review Procedure, 28 C.F.R. ¶ 50.6. You have requested a statement of the Department of Justice's antitrust enforcement intentions with respect to a proposed arrangement pursuant to which Philips will assemble and offer a package license under the patents of Philips, Sony and Pioneer (collectively, the "Licensors") that are "essential," as defined below, to manufacturing Digital Versatile Discs (DVDs) and players in compliance with the DVD-ROM and DVD-Video formats, and will distribute royalty income among the Licensors.

#### I. The DVD-ROM and DVD-Video Formats

The Standard Specifications for the DVD-ROM and DVD-Video formats describe the physical and technical parameters for DVDs for read-only-memory and video applications, respectively, and "rules, conditions and mechanisms" for player units for the two formats. In either format, the DVD offers storage capacity more than seven times that of a compact disc; a single-layer, single-sided DVD, for example, can store 4.7 billion bytes (4.38 GB) of information including audio, video, text, and data. Employing compression technology, a DVD-Video disc can hold a 135-minute feature film on a single side.

The Licensors, along with a number of other producers of consumer electronics hardware, software, or both,<sup>2</sup> established the Standard Specifications.<sup>3</sup> These Stand-

<sup>&</sup>lt;sup>1</sup> DVD Specifications for Read-Only Disc (the "Standard Specifications"), Part 3: Video Specifications, Version 1.1 (December 1997), § 3.3.1. You have attached the Standard Specifications as Exhibit A to your letter. DVD-Video, which is described in Part 3 of the Standard Specifications, appears to be a subunit of the DVD-ROM format. The DVD-Video specifications indicate that DVD-Video discs shall comply with Parts 1 and 2 of the Standard Specifications, which describe the disc's physical and file-system characteristics, respectively. Id., § 1.1.

<sup>&</sup>lt;sup>2</sup> Each of the Licensors is a leading manufacturer of consumer electronics equipment and software,

ard Specifications appear to implicate the intellectual property rights of numerous firms.

# II. The Proposed Arrangement

The proposed arrangement is embodied in two pairs of licenses: two separate but substantially identical licenses to Philips from Sony and Pioneer (the "DVD-Video and DVD-ROM Agreement"); and a pair of standard licenses from Philips to DVD makers (the "Disc License") and player manufacturers (the "Player License"). <sup>5</sup> Through these two sets of licenses, Philips aggregates the Licensors' patents and will disseminate them to users of the DVD-ROM and DVD-Video formats.

# A. The patents to be licensed

Under the proposed arrangement, Philips is licensing from the other Licensors those patents that: (i) they owned or controlled as of specific dates in 1997; (ii) are entitled to a priority date before December 31, 1996;<sup>7</sup> and (iii) are "essential," which is defined as "necessary (as a practical matter) for compliance with the DVD Video or DVD-ROM Standard Specifications." In turn, Philips will sublicense those patents, along with its own patents that meet the same criteria, in the Portfolio Licenses for use in making discs or players, respectively, that comply with either of those formats.

Initially, each Licensor has designated its "essential" patents for inclusion in the Portfolio Licenses; there are 115 patents in all for the manufacture of DVD players, and 95 for the manufacture of the discs themselves. However, the Licensors have re-

including both DVD-Video discs and DVD players, and a producer of content, such as feature-length motion pictures, that can be incorporated in DVDs. Upon the completion of the pending sale of its PolyGram N.V. subsidiary to The Seagram Co., Ltd., however, Philips will no longer have a substantial presence in any market for recorded music, film, or other entertainment software, or the production of content for such software.

- <sup>3</sup> In addition to the Licensors, the publishers of the DVD-ROM Specifications are: Hitachi, Ltd.; Matsushita Electric Industrial Co., Ltd.; Mitsubishi Electric Corporation; Thomson Multimedia; Time Warner Inc.; Toshiba Corp.; and Victor Company of Japan, Ltd. While your letter includes information concerning the process by which these formats were established, you have not requested, and this letter does not offer, an opinion on any competitive issues presented by the development of these formats or any other DVD-related format.
- <sup>5</sup> You have attached the Player License as Exhibit B to your letter, and the Disc License as Exhibit C. I will refer to the Disc and Player Licenses collectively as the "Portfolio Licenses."
- <sup>7</sup> DVD-Video and DVD-ROM Agreement, Arts. 1.06-1.07. You have confirmed that the term "priority date" means, for any given patent in the Portfolio License, the first date on which the application for that patent, or for a patent on the same invention in an another country, was filed. See 35 U.S.C. § 119.
- <sup>8</sup> We understand this definition to encompass patents which are technically essential—*i.e.*, inevitably infringed by compliance with the specifications—and those for which existing alternatives are economically unfeasible. As discussed below, a less concrete definition of the term "as a practical matter" could give rise to difficult competitive issues. Neither Sony's and Pioneer's licenses to Philips nor the Portfolio Licenses convey rights to patents that are "essential" by virtue of the DVD formats' incorporation of MPEG-2 video compression technology.

tained a patent expert to review the designated United States patents and make an independent determination as to their "essentiality." His determination, reflecting his "best independent judgment," is to be based on information he obtains from the Licensors, others in the industry, and the advice of technical experts he may retain. The review, which is already underway, will not entail an examination of validity. Should the expert determine that a patent initially designated as "essential" is not, Philips will exclude it from the Portfolio Licenses. However, licensees that have already taken the Disc or Player License shall have the option to retain their licenses to the newly excluded patent.

While one of the license documents indicates that the patent expert is to be "appointed" by Philips, the letters that the Licensors will send to the expert state that all of them are retaining him. Further, the letters state that the expert's conclusions will have no bearing on either his compensation or any Licensor's future retention of him or his law firm.

As noted above, the DVD-Video and DVD-ROM Agreements ensure only that the Licensors' "essential" patents with filing dates before December 31, 1996, and which were owned or controlled by the Licensors as of November 24, 1997 (or, in Pioneer's case, October 1, 1997) will be part of the Portfolio Licenses. You have stated to us that, as of December 1, 1998, no Licensor has indicated that it owns or controls an "essential" patent that falls outside these bounds. Should such a patent emerge, however, the DVD-Video and DVD-ROM Agreements commit the Licensors to licensing it, "at fair and reasonable conditions," to any licensee under the Portfolio Licenses, either through Philips or individually.

#### B. The joint licensing arrangement

### 1. The licenses from Sony and Pioneer to Philips

Sony and Pioneer have granted Philips nonexclusive, sublicensable licenses on their "essential" patents to enable Philips to grant licenses "to all interested parties . . . to manufacture, have made, have manufactured components of, use and sell or otherwise dispose of" discs and players that conform to the Standard Specifications. The licenses obligate Philips to grant licenses on the "essential" patents for use in conformity with the specifications nondiscriminatorally to all interested third-parties. All three Licensors, however, remain free to license their "essential" patents independently of the Portfolio Licenses, including for uses outside the DVD-ROM and DVD-Video formats.

The licenses from Sony and Pioneer also establish the Portfolio Licenses' royalty rates. The Player License per-unit royalty is to be 3.5% of the net selling price for each player sold, subject to a minimum fee of \$7 per unit, which drops to \$5 as of January 1, 2000. The Disc License royalty is to be \$.042 per disc sold. In addition, each Portfolio License requires a \$10,000 initial payment, half of which is creditable against the per-unit royalties. Philips' licenses from Sony and Pioneer separately set the latter two firms' share of these royalties, again on a per-unit basis. The allocation

of royalties among the Licensors is not a function of the number of patents contributed to the pool. To ensure the receipt of their agreed royalties, Sony's and Pioneer's independent auditors may audit Philips' books and records up to once a year.

While each of the Licensors retains sole discretion to pursue infringers, the licenses from Sony and Pioneer require each Licensor to notify the others before initiating any enforcement action and provide for sharing of joint infringement litigation expenses.

#### 2. The Portfolio Licenses

As authorized by its licenses from Sony and Pioneer, Philips' licenses to disc and player manufacturers will be for use in conformity with the Standard Specifications. However, the Portfolio Licenses will notify potential licensees that all the Licensors are "willing to license their respective patent rights for optical disc manufacturing, whether within or outside of the DVD-Video and DVD-ROM Standard Specifications . . . on reasonable terms and conditions." They will warn potential licensees that licensees from other intellectual property owners may be necessary for compliance with the formats. A "Most Favourable Conditions" clause will entitle the licensee to the benefit of any lower royalty rate Philips grants to another licensee under "otherwise similar and substantially the same conditions."

Each Portfolio License will have a term of ten years from the license's effective date, subject to termination for a limited number of reasons.<sup>37</sup> To verify royalties owed and paid, Philips may appoint an independent accountant to audit its licensees' books and records up to once a year and may require licensees to provide the accountant with additional information for that purpose. The Portfolio Licenses also require licensees to provide, on request, information for review by a patent expert to determine whether a particular product infringes any of the licensed patents and, thus, triggers royalty obligations. The licensees' obligation to provide information to the independent accountant and patent expert extends only to the information necessary to determine the amount of royalties owed or whether they are owed at all.

One of the grounds on which Philips may terminate a license relates to the licensees' grantback obligation: Portfolio licensees must grant the Licensors and fellow licensees a license, "on reasonable, non-discriminatory conditions comparable to those set forth herein," on any patents they own or control that are "essential" to either disc or player manufacture in conformity with the Standard Specifications. As noted above, this obligation is reinforced by Philips' right to terminate without notice the license of any licensee that, after having refused to grant a Licensor a license on an "essential" patent it owns, sues that Licensor for infringement of that patent.

<sup>&</sup>lt;sup>37</sup> Philips or its licensee may terminate the license on 30 days' notice for the other party's default. Philips also may terminate for licensee bankruptcy, failure to pay royalties, and without notice in response to a licensee's lawsuit against any Licensor for infringement of an "essential" patent that licensee owns or controls, after the licensee has refused that Licensor's request for a license.

#### III. Analysis

As with any aggregation of patent rights for the purpose of joint package licensing, commonly known as a patent pool, an antitrust analysis of this proposed licensing program must examine both the pool's expected competitive benefits and its potential competitive hazards. In particular, one expects that a patent pool "may provide competitive benefits by integrating complementary technologies, reducing transaction costs, clearing blocking positions, and avoiding costly infringement litigation." At the same time, "some patent pools can restrict competition, whether among intellectual property rights within the pool or downstream products incorporating the pooled patents or in innovation among parties to the pool." Accordingly, the following analysis addresses (i) whether the proposed licensing program is likely to integrate complementary patent rights and (ii), if so, whether the resulting competitive benefits are likely to be outweighed by competitive harm posed by other aspects of the program.

A fundamental premise of the following analysis is that the patents to be licensed are valid. This is a legitimate presumption with any patent. 46 On the other hand, persuasive evidence to the contrary would undermine virtually any licensing arrangement: "A licensing scheme premised on invalid or expired intellectual property rights will not withstand antitrust scrutiny." 47 Unaccompanied by legitimate intellectual property rights, restrictions on licensors or licensees are highly likely to be anticompetitive. None of the information that you have provided us warrants abandonment of the presumption of validity as to any of the patents to be licensed. 48 Should the Department subsequently receive information that undercuts this presumption, its enforcement intentions as to the proposed arrangement might be very different.

<sup>44</sup> Department of Justice-Federal Trade Commission, Antitrust Guidelines for the Licensing of Intellectual Property ("IP Guidelines"), § 5.5.

<sup>&</sup>lt;sup>45</sup> Letter from Joel I. Klein to Gerrard [sic] R. Beeney, Esq., June 26, 1997 ("MPEG-2 Business Review Letter"), 9 (citing *IP Guidelines*, § 5.5).

<sup>&</sup>lt;sup>46</sup> See 35 U.S.C. § 282 (in an action for infringement, "[a] patent shall be presumed valid"); Genentech, Inc. v. Novo Nordisk, A/S, 108 F.3d 1361, 1364 n.2 (Fed. Cir. 1997).

<sup>&</sup>lt;sup>47</sup> MPEG-2 Business Review Letter, 9 (citing *United States v. Pilkington plc*, 1994 Trade Cas. (CCH) ¶ 70,842 (D. Ariz. 1994)).

<sup>&</sup>lt;sup>48</sup> At the same time, it is worth noting that the pool does not seem well equipped internally to eliminate any patents whose validity becomes dubious. The proposed arrangement provides no internal screen for catching those patents, either at the outset of the pool or thereafter. The expert's role, for example, is to assess essentiality, not validity. Nor is there a mechanism for weeding out patents later held invalid. In contrast, the pool established for the joint licensing of patents essential to the MPEG-2 compression standard automatically excludes patents conclusively held invalid or unenforceable. Since the Licensors here are not allocating royalties on a per-patent basis, no Licensor has an incentive to challenge the validity of any particular patent of another.

# A. Integration of Complementary Patent Rights

If the Licensors owned patent rights that could be licensed and used in competition with each other, they might have an economic incentive to utilize a patent pool to eliminate competition among them. A pool that served that purpose "would raise serious competitive concerns." In combining such substitute patents, the pool could serve as a price-fixing mechanism, ultimately raising the price of products and services that utilize the pooled patents. If, on the other hand, the pool were to bring together complementary patent rights, it could be "an efficient and procompetitive method of disseminating those rights to would-be users." By reducing what would otherwise be three licensing transactions to one, the pool would reduce transactions costs for Licensors and licensees alike. By ensuring that each Licensor's patents will not be blocked by those of the other two, the pool would enhance the value of all three Licensors' patents.

One way to ensure that the proposed pool will integrate only complementary patent rights is to limit the pool to patents that are essential to compliance with the Standard Specifications. Essential patents by definition have no substitutes; one needs licenses to each of them in order to comply with the standard. At the same time, they are complementary to each other; a license to one essential patent is more valuable if the licensee also has licenses to use other essential patents.

A broader inclusion criterion than essentiality carries with it two anticompetitive risks, both arising from the possibility that there may be substitutes for patents included in the pool. Consider, for example, a situation where there are several patented methods for placing DVD-ROMs into packaging—each a useful complement to DVD-ROM manufacturing technology, but not essential to the standard. A DVD-ROM maker needs to license only one of them; they are substitutes for each other. Inclusion in the pool of two or more of those patents would risk turning the pool into a price-fixing mechanism. Inclusion in the pool of one of the patents, which the pool would convey along with the essential patents, could in certain cases unreasonably foreclose the competing patents from use by manufacturers; because the manufacturers would obtain a license to the one patent with the pool, they might choose not to license any of the competing patents, even if they otherwise would regard the competitive patents as superior. Limiting a pool to essential patents ensures that neither of these concerns will arise; rivalry is foreclosed neither among patents within the pool nor between patents in the pool and patents outside it.

If our understanding of the criterion "necessary (as a practical matter)" is correct, then it appears that the Licensors intend to license through the pool only complementary patents for which there are no substitutes for the purposes of compliance with the Standard Specifications. Some uncertainty arises from this definition's im-

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<sup>&</sup>lt;sup>49</sup> MPEG-2 Business Review Letter, 9.

<sup>&</sup>lt;sup>50</sup> Id.

precision: Unlike the MPEG-2 pool, which required actual technical essentiality for eligibility, this pool introduces the concept of necessity "as a practical matter." On its face, this latter standard is inherently more susceptible to subjective interpretation. An excessively liberal interpretation of it could lead to the inclusion of patent rights for which there were viable substitutes. In that event, the pool could injure competition by foreclosing such substitutes.

Based on what you have told us, however, the definition of "necessary (as a practical matter)" that the expert will be employing is sufficiently clear and demanding that the portfolio is unlikely to contain patents for which there are economically viable substitutes. Thus, so long as the patent expert applies this criterion scrupulously and independently, it is reasonable to expect that the Portfolio will combine complementary patent rights while not limiting competition between them and other patent rights for purposes of the licensed applications.

The structure of this pool, however, creates some concern about the expert's ability to apply this criterion entirely independent of the Licensors. While you have stated that the patent expert will be "independent" and demonstrated that his independence is a term of the licenses from Sony and Pioneer to Philips, the expert is being retained directly by the Licensors, who have an incentive to combine in the pool any of their competing DVD-related patents and to foreclose others' competing patents.<sup>56</sup> Without more, there would be justifiable skepticism that this structure would ensure a disinterested review of the "essentiality" of the patent rights put forward.

However, in furtherance of the provision for independence in the licenses from Sony and Pioneer to Philips, each Licensor has assured the U.S. expert in writing that the expert's compensation and future retention will not be affected by his determinations as to essentiality; the same assurance will go to the Japanese patent expert as well. These assurances, of course, are no guarantee. Their continuing fulfillment is necessary to the expert's independence and, consequently, to the likelihood that the portfolio will contain only complementary patents without foreclosing competition. Whether they will be sufficient as well as necessary remains to be seen.

Although the patent-expert mechanism is flawed, the Department is willing to base its present enforcement intentions on your representation that the combination of the Licensors' contractual commitment to independence and their written assurances to the expert will insulate him from their interests sufficiently to ensure that the Portfolio Licenses will contain only those patent rights of the Licensors that all DVD-Video and DVD-ROM licensees will need. In that case, the proposed arrangement

<sup>&</sup>lt;sup>56</sup> Because the royalty allocation is unaffected by each Licensor's share of the patents in the Portfolio License, the Licensors have no financial incentive to exclude each other's non-essential patents. In the MPEG-2 pool, in contrast, the joint licensor, which retained the expert, was an entity separate from the patent owners with no intellectual property of its own at stake. Moreover, the pool members themselves had a strong incentive to exclude non-essential patents, since their share of the royalties was a direct function of the number of essential patents they held.

would serve the procompetitive purpose of combining complementary technologies into a package that will be likely to lower costs to makers of DVD-Video and DVD-ROM discs and players. If, nevertheless, these assurances prove insufficient either to ensure the expert's ability to function independently and objectively or to ensure that the pool will contain only essential patents, the Department's enforcement intentions as to the proposed arrangement might be very different.

#### B. Foreclosure of Competition in Related Markets

As mentioned above, the Licensors are competitors in markets vertically related to the licensed technology—not only in "downstream" markets such as the manufacture of DVD discs and players, but also in the creation of content, such as feature-length films, that is incorporated in DVD discs. Consequently, the question arises whether this pool is likely to impede competition in any of those markets, not only between any given Licensor and licensees, but also among the Licensors themselves.

Based upon what you have told us, the proposed licensing program does not appear to have any such anticompetitive potential in the markets in which the licensed technology will be used. First, the agreed royalty is sufficiently small relative to the total costs of manufacture that it is unlikely to enable collusion among sellers of DVD players or discs. Second, the proposed program should enhance rather than limit access to the Licensors' "essential" patents. Because Philips must license on a nondiscriminatory basis to all interested parties, it cannot impose disadvantageous terms on competitors, let alone refuse to license them altogether. Should the agreed pool royalty prove economically unrealistic, each Licensor's ability to grant licenses on its own to users of the Standard Specifications provides a backstop. Third, the extent of Philips' ability to audit licensees, through independent accountants, is unlikely to afford it anticompetitive access to competitively sensitive proprietary information, such as cost data. Sony's and Pioneer's similarly limited right to an annual audit of Philips' conduct as joint licensor should not create any greater likelihood of collusion. Nor does there seem to be any facet of the proposed program that would facilitate collusion or dampen competition among the Licensors in the creation of content for software.

# C. Effect on Innovation

Because only already-filed "essential" patents and patent applications are required for inclusion in the Portfolio, the program does not discourage the Licensors from continuing research and development that may relate to the standard.<sup>58</sup> Further, the Li-

<sup>&</sup>lt;sup>58</sup> At the same time, the exclusion of patents with a priority date of December 31, 1996 or later, and those acquired by a Licensor only after November 24, 1997 (October 1, 1997 for Pioneer), could create anticompetitive costs for Portfolio licensees if any Licensor did not honor its commitment to make such patents available at reasonable rates. Transaction costs to licensees would almost certainly be somewhat lower if these later patents were included in the pool, instead of being subject to separate negotiations. However, the fact that this pool might not enable the realization of all potential efficiencies of pooling patents in this area does not mean that the efficiencies that it does create are insubstan-

censors are free to license their "essential" patents for purposes that compete with the DVD-Video and DVD-ROM standards.

Ordinarily, patent license grantback provisions might be expected to raise the question whether, by reducing licensees' incentives to innovate, they threaten competitive harm that outweighs their procompetitive effects. Here, however, the proposed grantback provisions are so narrow that they are unlikely to raise significant issues. Their scope is commensurate with that of the Licenses: They cover only "essential" patents. A licensee's non-"essential" improvements remain its own and may be licensed or not, as the licensee wishes. Thus, the grantback obligation seems unlikely to apply to further innovation within the DVD-ROM and DVD-Video formats. Instead, it is far more likely to force cross-licenses, on "reasonable, non-discriminatory conditions comparable to those" of the Portfolio Licenses, from owners of already extant "essential" patents. In requiring licensees to offer the Licensors and fellow licensees access, on reasonable terms, to whatever "essential" patents they own or control, the Portfolio Licenses ensure that no licensee may take advantage of the benefits of the pool while exploiting its own market power over users of the Standard Specifications. The grantback provision is likely simply to bring other "essential" patents into the Portfolio, thereby limiting holdouts' ability to exact a supracompetitive toll from Portfolio licensees and further lowering licensees' costs in assembling the patent rights essential to their compliance with the Standard Specifications. While easing, though not altogether eliminating, the holdout problem, 60 the grantback should not create any disincentive among licensees to innovate.

In the current circumstances, the proposed ten-year term of the license does not pose significant concerns. The Portfolio Licenses authorize only a limited field of use for the licensed technology—the manufacture and sale of products that comply with the Standard Specifications; they do not limit licensees' other options. Licensees may seek presently unknown methods of complying with these standards, or they may support altogether different product standards. The absence of any renewal clause puts potential licensees on notice that they will be facing a new market-based negotiation for access to the technology on the expiration of the Portfolio Licenses ten years hence. The uncertainty of market conditions at that time makes it impossible to speculate on the degree of power, if any, the Licensors will hold over any future technology licensing market.

#### IV. Conclusion

Based on the information and assurances that you have provided us, it appears that the proposed arrangement is likely to combine complementary patent rights, thereby lowering the costs of manufacturers that need access to them in order to produce discs and players in conformity with the DVD-Video and DVD-ROM formats. Your

tial or that the arrangement is anticompetitive or unlawful.

<sup>&</sup>lt;sup>60</sup> Any non-manufacturing owner of an "essential" patent, in contrast, can still be a holdout, having no need for either Portfolio License.

assurances and information indicate that the proposed arrangement is not likely to impede competition, either in the licensing or development of technology for use in making DVDs, players, or products that conform to alternative formats, or in the markets in which DVDs and players compete.

For these reasons, the Department is not presently inclined to initiate antitrust enforcement action against the conduct you have described. This letter, however, expresses the Department's current enforcement intention. In accordance with our normal practices, the Department reserves the right to bring an enforcement action in the future if the actual operation of the proposed conduct proves to be anticompetitive in purpose or effect.

This statement is made in accordance with the Department's Business Review Procedure, 28 C.F.R. ¶ 50.6. Pursuant to its terms, your business review request and this letter will be made publicly available immediately, and any supporting data will be made publicly available within 30 days of the date of this letter, unless you request that part of the material be withheld in accordance with Paragraph 10(c) of the Business Review Procedure.

Sincerely,

/ s / Joel I. Klein

# Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal co-operation agreements Text with EEA relevance

Official Journal C 011, 14/01/2011

#### 1. INTRODUCTION

# 1.1. Purpose and scope

- 1. These guidelines set out the principles for the assessment under Article 101 of the Treaty on the Functioning of the European Union ("Article 101") of agreements between undertakings, decisions by associations of undertakings and concerted practices (collectively referred to as "agreements") pertaining to horizontal co-operation. Co-operation is of a "horizontal nature" if an agreement is entered into between actual or potential competitors. In addition, these guidelines also cover horizontal co-operation agreements between non-competitors, for example, between two companies active in the same product markets but in different geographic markets without being potential competitors.
- 2. Horizontal co-operation agreements can lead to substantial economic benefits, in particular if they combine complementary activities, skills or assets. Horizontal co-operation can be a means to share risk, save costs, increase investments, pool know-how, enhance product quality and variety, and launch innovation faster.
- 3. On the other hand, horizontal co-operation agreements may lead to competition problems. This is, for example, the case if the parties agree to fix prices or output or to share markets, or if the co-operation enables the parties to maintain, gain or increase market power and thereby is likely to give rise to negative market effects with respect to prices, output, product quality, product variety or innovation. ...

# 7. STANDARDISATION AGREEMENTS

#### 7.1. Definition

#### Standardisation agreements

- 257. Standardisation agreements have as their primary objective the definition of technical or quality requirements with which current or future products, production processes, services or methods may comply. Standardisation agreements can cover various issues, such as standardisation of different grades or sizes of a particular product or technical specifications in product or services markets where compatibility and interoperability with other products or systems is essential. The terms of access to a particular quality mark or for approval by a regulatory body can also be regarded as a standard. Agreements setting out standards on the environmental performance of products or production processes are also covered by this chapter.
- 258. The preparation and production of technical standards as part of the execution of public powers are not covered by these guidelines. The European standardisation bodies recognised under Directive 98/34/EC of the European Parliament and of the Council of 22 June 1998 laying down a procedure for the provision of infor-

mation in the field of technical standards and regulations and on rules on Information Society services are subject to competition law to the extent that they can be considered to be an undertaking or an association of undertakings within the meaning of Articles 101 and 102. Standards related to the provision of professional services, such as rules of admission to a liberal profession, are not covered by these guidelines.

#### Standard terms

- 259. In certain industries companies use standard terms and conditions of sale or purchase elaborated by a trade association or directly by the competing companies ("standard terms"). Such standard terms are covered by these guidelines to the extent that they establish standard conditions of sale or purchase of goods or services between competitors and consumers (and not the conditions of sale or purchase between competitors) for substitute products. When such standard terms are widely used within an industry, the conditions of purchase or sale used in the industry may become de facto aligned. Examples of industries in which standard terms play an important role are the banking (for example, bank account terms) and insurance sectors.
- 260. Standard terms elaborated individually by a company solely for its own use when contracting with its suppliers or customers are not horizontal agreements and are therefore not covered by these guidelines.

#### 7.2. Relevant markets

- 261. Standardisation agreements may produce their effects on four possible markets, which will be defined according to the Market Definition Notice. First, standard-setting may have an impact on the product or service market or markets to which the standard or standards relates. Second, where the standard-setting involves the selection of technology and where the rights to intellectual property are marketed separately from the products to which they relate, the standard can have effects on the relevant technology market. Third, the market for standard-setting may be affected if different standard-setting bodies or agreements exist. Fourth, where relevant, a distinct market for testing and certification may be affected by standard-setting.
- 262. As regards standard terms, the effects are, in general, felt on the downstream market where the companies using the standard terms compete by selling their product to their customers.
- 7.3. Assessment under Article 101(1)
- 7.3.1. Main competition concerns

#### Standardisation agreements

263. Standardisation agreements usually produce significant positive economic effects, for example by promoting economic interpenetration on the internal market and encouraging the development of new and improved products or markets and improved supply conditions. Standards thus normally increase competition and lower output and sales costs, benefiting economies as a whole. Standards may maintain and

enhance quality, provide information and ensure interoperability and compatibility (thus increasing value for consumers).

264. Standard-setting can, however, in specific circumstances, also give rise to restrictive effects on competition by potentially restricting price competition and limiting or controlling production, markets, innovation or technical development. This can occur through three main channels, namely reduction in price competition, foreclosure of innovative technologies and exclusion of, or discrimination against, certain companies by prevention of effective access to the standard.

265. First, if companies were to engage in anti-competitive discussions in the context of standard-setting, this could reduce or eliminate price competition in the markets concerned, thereby facilitating a collusive outcome on the market.

266. Second, standards that set detailed technical specifications for a product or service may limit technical development and innovation. While a standard is being developed, alternative technologies can compete for inclusion in the standard. Once one technology has been chosen and the standard has been set, competing technologies and companies may face a barrier to entry and may potentially be excluded from the market. In addition, standards requiring that a particular technology is used exclusively for a standard or preventing the development of other technologies by obliging the members of the standard-setting organisation to exclusively use a particular standard, may lead to the same effect. The risk of limitation of innovation is increased if one or more companies are unjustifiably excluded from the standard-setting process.

267. In the context of standards involving intellectual property rights ("IPR"), three main groups of companies with different interests in standard-setting can be distinguished in the abstract. First, there are upstream-only companies that solely develop and market technologies. Their only source of income is licensing revenue and their incentive is to maximise their royalties. Secondly, there are downstream-only companies that solely manufacture products or offer services based on technologies developed by others and do not hold relevant IPR. Royalties represent a cost for them, and not a source of revenue, and their incentive is to reduce or avoid royalties. Finally, there are vertically integrated companies that both develop technology and sell products. They have mixed incentives. On the one hand, they can draw licensing revenue from their IPR. On the other hand, they may have to pay royalties to other companies holding IPR essential to the standard. They might therefore cross-license their own essential IPR in exchange for essential IPR held by other companies.

268. Third, standardisation may lead to anti-competitive results by preventing certain companies from obtaining effective access to the results of the standard-setting process (that is to say, the specification and/or the essential IPR for implementing the standard). If a company is either completely prevented from obtaining access to the result of the standard, or is only granted access on prohibitive or discriminatory terms, there is a risk of an anti-competitive effect. A system where potentially relevant

IPR is disclosed up-front may increase the likelihood of effective access being granted to the standard since it allows the participants to identify which technologies are covered by IPR and which are not. This enables the participants to both factor in the potential effect on the final price of the result of the standard (for example choosing a technology without IPR is likely to have a positive effect on the final price) and to verify with the IPR holder whether they would be willing to license if their technology is included in the standard.

269. Intellectual property laws and competition laws share the same objectives of promoting innovation and enhancing consumer welfare. IPR promote dynamic competition by encouraging undertakings to invest in developing new or improved products and processes. IPR are therefore in general pro-competitive. However, by virtue of its IPR, a participant holding IPR essential for implementing the standard, could, in the specific context of standard-setting, also acquire control over the use of a standard. When the standard constitutes a barrier to entry, the company could thereby control the product or service market to which the standard relates. This in turn could allow companies to behave in anti-competitive ways, for example by "holding-up" users after the adoption of the standard either by refusing to license the necessary IPR or by extracting excess rents by way of excessive royalty fees thereby preventing effective access to the standard. However, even if the establishment of a standard can create or increase the market power of IPR holders possessing IPR essential to the standard, there is no presumption that holding or exercising IPR essential to a standard equates to the possession or exercise of market power. The question of market power can only be assessed on a case by case basis.

#### Standard terms

- 270. Standard terms can give rise to restrictive effects on competition by limiting product choice and innovation. If a large part of an industry adopts the standard terms and chooses not to deviate from them in individual cases (or only deviates from them in exceptional cases of strong buyer-power), customers might have no option other than to accept the conditions in the standard terms. However, the risk of limiting choice and innovation is only likely in cases where the standard terms define the scope of the end-product. As regards classical consumer goods, standard terms of sale generally do not limit innovation of the actual product or product quality and variety.
- 271. In addition, depending on their content, standard terms might risk affecting the commercial conditions of the final product. In particular, there is a serious risk that standard terms relating to price would restrict price competition.
- 272. Moreover, if the standard terms become industry practice, access to them might be vital for entry into the market. In such cases, refusing access to the standard terms could risk causing anti-competitive foreclosure. As long as the standard terms remain effectively open for use for anyone that wishes to have access to them, they are unlikely to give rise to anti-competitive foreclosure.

## 7.3.2. Restrictions of competition by object

#### Standardisation agreements

- 273. Agreements that use a standard as part of a broader restrictive agreement aimed at excluding actual or potential competitors restrict competition by object. For instance, an agreement whereby a national association of manufacturers sets a standard and puts pressure on third parties not to market products that do not comply with the standard or where the producers of the incumbent product collude to exclude new technology from an already existing standard would fall into this category.
- 274. Any agreements to reduce competition by using the disclosure of most restrictive licensing terms prior to the adoption of a standard as a cover to jointly fix prices either of downstream products or of substitute IPR or technology will constitute restrictions of competition by object.

#### Standard terms

- 275. Agreements that use standard terms as part of a broader restrictive agreement aimed at excluding actual or potential competitors also restrict competition by object. An example would be where a trade association does not allow a new entrant access to its standards terms, the use of which is vital to ensure entry to the market.
- 276. Any standard terms containing provisions which directly influence the prices charged to customers (that is to say, recommended prices, rebates, etc.) would constitute a restriction of competition by object.

### 7.3.3. Restrictive effects on competition

#### Standardisation agreements

Agreements normally not restrictive of competition

- 277. Standardisation agreements which do not restrict competition by object must be analysed in their legal and economic context with regard to their actual and likely effect on competition. In the absence of market power, a standardisation agreement is not capable of producing restrictive effects on competition. Therefore, restrictive effects are most unlikely in a situation where there is effective competition between a number of voluntary standards.
- 278. For those standard-setting agreements which risk creating market power, paragraphs 280 to 286 set out the conditions under which such agreements would normally fall outside the scope of Article 101(1).
- 279. The non-fulfilment of any or all of the principles set out in this section will not lead to any presumption of a restriction of competition within Article 101(1). However, it will necessitate a self-assessment to establish whether the agreement falls under Article 101(1) and, if so, if the conditions of Article 101(3) are fulfilled. In this context, it is recognised that there exist different models for standard-setting and that competition within and between those models is a positive aspect of a market economy. Therefore, standard-setting organisations remain entirely free to put in place

rules and procedures that do not violate competition rules whilst being different to those described in paragraphs 280 to 286.

- 280. Where participation in standard-setting is unrestricted and the procedure for adopting the standard in question is transparent, standardisation agreements which contain no obligation to comply with the standard and provide access to the standard on fair, reasonable and non-discriminatory terms will normally not restrict competition within the meaning of Article 101(1).
- 281. In particular, to ensure unrestricted participation the rules of the standard-setting organisation would need to guarantee that all competitors in the market or markets affected by the standard can participate in the process leading to the selection of the standard. The standard-setting organisations would also need to have objective and non-discriminatory procedures for allocating voting rights as well as, if relevant, objective criteria for selecting the technology to be included in the standard.
- 282. With respect to transparency, the relevant standard-setting organisation would need to have procedures which allow stakeholders to effectively inform themselves of upcoming, on-going and finalised standardisation work in good time at each stage of the development of the standard.
- 283. Furthermore, the standard-setting organisation's rules would need to ensure effective access to the standard on fair, reasonable and non discriminatory terms.
- 284. In the case of a standard involving IPR, a clear and balanced IPR policy, adapted to the particular industry and the needs of the standard-setting organisation in question, increases the likelihood that the implementers of the standard will be granted effective access to the standards elaborated by that standard-setting organisation.
- 285. In order to ensure effective access to the standard, the IPR policy would need to require participants wishing to have their IPR included in the standard to provide an irrevocable commitment in writing to offer to license their essential IPR to all third parties on fair, reasonable and non-discriminatory terms ("FRAND commitment"). That commitment should be given prior to the adoption of the standard. At the same time, the IPR policy should allow IPR holders to exclude specified technology from the standard-setting process and thereby from the commitment to offer to license, providing that exclusion takes place at an early stage in the development of the standard. To ensure the effectiveness of the FRAND commitment, there would also need to be a requirement on all participating IPR holders who provide such a commitment to ensure that any company to which the IPR owner transfers its IPR (including the right to license that IPR) is bound by that commitment, for example through a contractual clause between buyer and seller.
- 286. Moreover, the IPR policy would need to require good faith disclosure, by participants, of their IPR that might be essential for the implementation of the standard under development. This would enable the industry to make an informed choice of technology and thereby assist in achieving the goal of effective access to the standard.

Such a disclosure obligation could be based on ongoing disclosure as the standard develops and on reasonable endeavours to identify IPR reading on the potential standard. It is also sufficient if the participant declares that it is likely to have IPR claims over a particular technology (without identifying specific IPR claims or applications for IPR). Since the risks with regard to effective access are not the same in the case of a standard-setting organisation with a royalty-free standards policy, IPR disclosure would not be relevant in that context.

#### FRAND Commitments

287. FRAND commitments are designed to ensure that essential IPR protected technology incorporated in a standard is accessible to the users of that standard on fair, reasonable and non-discriminatory terms and conditions. In particular, FRAND commitments can prevent IPR holders from making the implementation of a standard difficult by refusing to license or by requesting unfair or unreasonable fees (in other words excessive fees) after the industry has been locked-in to the standard or by charging discriminatory royalty fees.

288. Compliance with Article 101 by the standard-setting organisation does not require the standard-setting organisation to verify whether licensing terms of participants fulfil the FRAND commitment. Participants will have to assess for themselves whether the licensing terms and in particular the fees they charge fulfil the FRAND commitment. Therefore, when deciding whether to commit to FRAND for a particular IPR, participants will need to anticipate the implications of the FRAND commitment, notably on their ability to freely set the level of their fees.

289. In case of a dispute, the assessment of whether fees charged for access to IPR in the standard-setting context are unfair or unreasonable should be based on whether the fees bear a reasonable relationship to the economic value of the IPR. In general, there are various methods available to make this assessment. In principle, cost-based methods are not well adapted to this context because of the difficulty in assessing the costs attributable to the development of a particular patent or groups of patents. Instead, it may be possible to compare the licensing fees charged by the company in question for the relevant patents in a competitive environment before the industry has been locked into the standard (ex ante) with those charged after the industry has been locked in (ex post). This assumes that the comparison can be made in a consistent and reliable manner.

290. Another method could be to obtain an independent expert assessment of the objective centrality and essentiality to the standard at issue of the relevant IPR portfolio. In an appropriate case, it may also be possible to refer to ex ante disclosures of licensing terms in the context of a specific standard-setting process. This also assumes that the comparison can be made in a consistent and reliable manner. The royalty rates charged for the same IPR in other comparable standards may also provide an indication for FRAND royalty rates. These guidelines do not seek to provide an exhaustive list of appropriate methods to assess whether the royalty fees are excessive.

291. However, it should be emphasised that nothing in these Guidelines prejudices the possibility for parties to resolve their disputes about the level of FRAND royalty rates by having recourse to the competent civil or commercial courts.

Effects based assessment for standardisation agreements

- 292. The assessment of each standardisation agreement must take into account the likely effects of the standard on the markets concerned. The following considerations apply to all standardisation agreements that depart from the principles as set out in paragraphs 280 to 286.
- 293. Whether standardisation agreements may give rise to restrictive effects on competition may depend on whether the members of a standard-setting organisation remain free to develop alternative standards or products that do not comply with the agreed standard. For example, if the standard-setting agreement binds the members to only produce products in compliance with the standard, the risk of a likely negative effect on competition is significantly increased and could in certain circumstances give rise to a restriction of competition by object. In the same vein, standards only covering minor aspects or parts of the end-product are less likely to lead to competition concerns than more comprehensive standards.
- 294. The assessment whether the agreement restricts competition will also focus on access to the standard. Where the result of a standard (that is to say, the specification of how to comply with the standard and, if relevant, the essential IPR for implementing the standard) is not at all accessible, or only accessible on discriminatory terms, for members or third parties (that is to say, non-members of the relevant standard-setting organisation) this may discriminate or foreclose or segment markets according to their geographic scope of application and thereby is likely to restrict competition. However, in the case of several competing standards or in the case of effective competition between the standardised solution and non-standardised solution, a limitation of access may not produce restrictive effects on competition.
- 295. If participation in the standard-setting process is open in the sense that it allows all competitors (and/or stakeholders) in the market affected by the standard to take part in choosing and elaborating the standard, this will lower the risks of a likely restrictive effect on competition by not excluding certain companies from the ability to influence the choice and elaboration of the standard. The greater the likely

<sup>&</sup>lt;sup>118</sup> See Commission Decision in Case IV/29/151, Philips/VCR, OJ L 47, 18.2.1978, p. 42, paragraph 23: "As these standards were for the manufacture of VCR equipment, the parties were obliged to manufacture and distribute only cassettes and recorders conforming to the VCR system licensed by Philips. They were prohibited from changing to manufacturing and distributing other video cassette systems ... This constituted a restriction of competition under Article 85(1)(b)".

<sup>&</sup>lt;sup>120</sup> In Commission Decision in Case IV/31.458, X/Open Group, OJ L 35, 6.2.1987, p. 36, the Commission considered that even if the standards adopted were made public, the restricted membership policy had the effect of preventing non-members from influencing the results of the work of the group and from getting the know-how and technical understanding relating to the standards which the members were likely to acquire. In addition, non-members could not, in contrast to the members, implement the standard before it was adopted (see paragraph 32). The agreement was therefore in

market impact of the standard and the wider its potential fields of application, the more important it is to allow equal access to the standard-setting process. However, if the facts at hand show that there is competition between several such standards and standard-setting organisations (and it is not necessary that the whole industry applies the same standards) there may be no restrictive effects on competition. Also, if in the absence of a limitation on the number of participants it would not have been possible to adopt the standard, the agreement would not be likely to lead to any restrictive effect on competition under Article 101(1). In certain situations the potential negative effects of restricted participation may be removed or at least lessened by ensuring that stakeholders are kept informed and consulted on the work in progress. The more transparent the procedure for adopting the standard, the more likely it is that the adopted standard will take into account the interests of all stakeholders.

296. To assess the effects of a standard-setting agreement, the market shares of the goods or services based on the standard should be taken into account. It might not always be possible to assess with any certainty at an early stage whether the standard will in practice be adopted by a large part of the industry or whether it will only be a standard used by a marginal part of the relevant industry. In many cases the relevant market shares of the companies having participated in developing the standard could be used as a proxy for estimating the likely market share of the standard (since the companies participating in setting the standard would in most cases have an interest in implementing the standard). However, as the effectiveness of standardisation agreements is often proportional to the share of the industry involved in setting and/or applying the standard, high market shares held by the parties in the market or markets affected by the standard will not necessarily lead to the conclusion that the standard is likely to give rise to restrictive effects on competition.

297. Any standard-setting agreement which clearly discriminates against any of the participating or potential members could lead to a restriction of competition. For example, if a standard-setting organisation explicitly excludes upstream only companies (that is to say, companies not active on the downstream production market), this could lead to an exclusion of potentially better technologies.

298. As regards standard-setting agreements with different types of IPR disclosure models from the ones described in paragraph 286, it would have to be assessed on a case by case basis whether the disclosure model in question (for example a disclosure model not requiring but only encouraging IPR disclosure) guarantees effective access to the standard. In other words, it needs to be assessed whether, in the specific context, an informed choice between technologies and associated IPR is in practice not prevented by the IPR disclosure model.

299. Finally, standard-setting agreements providing for ex ante disclosures of most restrictive licensing terms, will not, in principle, restrict competition within the meaning of Article 101(1). In that regard, it is important that parties involved in the

selection of a standard be fully informed not only as to the available technical options and the associated IPR, but also as to the likely cost of that IPR. Therefore, should a standard-setting organisation's IPR policy choose to provide for IPR holders to individually disclose their most restrictive licensing terms, including the maximum royal-ty rates they would charge, prior to the adoption of the standard, this will normally not lead to a restriction of competition within the meaning of Article 101(1). Such unilateral ex ante disclosures of most restrictive licensing terms would be one way to enable the standard-setting organisation to take an informed decision based on the disadvantages and advantages of different alternative technologies, not only from a technical perspective but also from a pricing perspective.

#### Standard terms

- 300. The establishment and use of standard terms must be assessed in the appropriate economic context and in the light of the situation on the relevant market in order to determine whether the standard terms at issue are likely to give rise to restrictive effects on competition.
- 301. As long as participation in the actual establishment of standard terms is unrestricted for the competitors in the relevant market (either by participation in the trade association or directly), and the established standard terms are non-binding and effectively accessible for anyone, such agreements are not likely to give rise to restrictive effects on competition (subject to the caveats set out in paragraphs 303, 304, 305 and 307).
- 302. Effectively accessible and non-binding standard terms for the sale of consumer goods or services (on the presumption that they have no effect on price) thus generally do not have any restrictive effect on competition since they are unlikely to lead to any negative effect on product quality, product variety or innovation. There are, however, two general exceptions where a more in-depth assessment would be required.
- 303. Firstly, standard terms for the sale of consumer goods or services where the standard terms define the scope of the product sold to the customer, and where therefore the risk of limiting product choice is more significant, could give rise to restrictive effects on competition within the meaning of Article 101(1) where their common application is likely to result in a de facto alignment. This could be the case when the widespread use of the standard terms de facto leads to a limitation of innovation and product variety. For instance, this may arise where standard terms in insurance contracts limit the customer's practical choice of key elements of the contract, such as the standard risks covered. Even if the use of the standard terms is not compulsory, they might undermine the incentives of the competitors to compete on product diversification.
- 304. When assessing whether there is a risk that the standard terms are likely to have restrictive effects by way of a limitation of product choice, factors such as existing competition on the market should be taken into account. For example if there is

a large number of smaller competitors, the risk of a limitation of product choice would seem to be less than if there are only a few bigger competitors. The market shares of the companies participating in the establishment of the standard terms might also give a certain indication of the likelihood of uptake of the standard terms or of the likelihood that the standard terms will be used by a large part of the market. However, in this respect, it is not only relevant to analyse whether the standard terms elaborated are likely to be used by a large part of the market, but also whether the standard terms only cover part of the product or the whole product (the less extensive the standard terms, the less likely that they will lead, overall, to a limitation of product choice). Moreover, in cases where in the absence of the establishment of the standard terms it would not have been possible to offer a certain product, there would not be likely to be any restrictive effect on competition within the meaning of Article 101(1). In that scenario, product choice is increased rather than decreased by the establishment of the standard terms.

305. Secondly, even if the standard terms do not define the actual scope of the end-product they might be a decisive part of the transaction with the customer for other reasons. An example would be online shopping where customer confidence is essential (for example, in the use of safe payment systems, a proper description of the products, clear and transparent pricing rules, flexibility of the return policy, etc). As it is difficult for customers to make a clear assessment of all those elements, they tend to favour widespread practices and standard terms regarding those elements could therefore become a de facto standard with which companies would need to comply to sell in the market. Even though non-binding, those standard terms would become a de facto standard, the effects of which are very close to a binding standard and need to be analysed accordingly.

306. If the use of standard terms is binding, there is a need to assess their impact on product quality, product variety and innovation (in particular if the standard terms are binding on the entire market).

307. Moreover, should the standard terms (binding or non-binding) contain any terms which are likely to have a negative effect on competition relating to prices (for example terms defining the type of rebates to be given), they would be likely to give rise to restrictive effects on competition within the meaning of Article 101(1).

7.4. Assessment under Article 101(3)

7.4.1. Efficiency gains

Standardisation agreements

308. Standardisation agreements frequently give rise to significant efficiency gains. For example, Union wide standards may facilitate market integration and allow companies to market their goods and services in all Member States, leading to increased consumer choice and decreasing prices. Standards which establish technical interoperability and compatibility often encourage competition on the merits between technologies from different companies and help prevent lock-in to one particular suppli-

- er. Furthermore, standards may reduce transaction costs for sellers and buyers. Standards on, for instance, quality, safety and environmental aspects of a product may also facilitate consumer choice and can lead to increased product quality. Standards also play an important role for innovation. They can reduce the time it takes to bring a new technology to the market and facilitate innovation by allowing companies to build on top of agreed solutions.
- 309. To achieve those efficiency gains in the case of standardisation agreements, the information necessary to apply the standard must be effectively available to those wishing to enter the market.
- 310. Dissemination of a standard can be enhanced by marks or logos certifying compliance thereby providing certainty to customers. Agreements for testing and certification go beyond the primary objective of defining the standard and would normally constitute a distinct agreement and market.
- 311. While the effects on innovation must be analysed on a case-by-case basis, standards creating compatibility on a horizontal level between different technology platforms are considered to be likely to give rise to efficiency gains.

#### Standard terms

- 312. The use of standard terms can entail economic benefits such as making it easier for customers to compare the conditions offered and thus facilitate switching between companies. Standard terms might also lead to efficiency gains in the form of savings in transaction costs and, in certain sectors (in particular where the contracts are of a complex legal structure), facilitate entry. Standard terms may also increase legal certainty for the contract parties.
- 313. The higher the number of competitors on the market, the greater the efficiency gain of facilitating the comparison of conditions offered.

#### 7.4.2. Indispensability

314. Restrictions that go beyond what is necessary to achieve the efficiency gains that can be generated by a standardisation agreement or standard terms do not fulfil the criteria of Article 101(3).

#### Standardisation agreements

315. The assessment of each standardisation agreement must take into account its likely effect on the markets concerned, on the one hand, and the scope of restrictions that possibly go beyond the objective of achieving efficiencies, on the other. 127

<sup>&</sup>lt;sup>127</sup> In Case IV/29/151, Philips/VCR, compliance with the VCR standards led to the exclusion of other, perhaps better systems. Such exclusion was particularly serious in view of the pre-eminent market position enjoyed by Philips "... [R]restrictions were imposed upon the parties which were not indispensable to the attainment of these improvements. The compatibility of VCR video cassettes with the machines made by other manufacturers would have been ensured even if the latter had to accept no more than an obligation to observe the VCR standards when manufacturing VCR equipment" (paragraph 31).

- 316. Participation in standard-setting should normally be open to all competitors in the market or markets affected by the standard unless the parties demonstrate significant inefficiencies of such participation or recognised procedures are foreseen for the collective representation of interests.
- 317. As a general rule standardisation agreements should cover no more than what is necessary to ensure their aims, whether this is technical interoperability and compatibility or a certain level of quality. In cases where having only one technological solution would benefit consumers or the economy at large that standard should, be set on a non-discriminatory basis. Technology neutral standards can, in certain circumstances, lead to larger efficiency gains. Including substitute IPR as essential parts of a standard while at the same time forcing the users of the standard to pay for more IPR than technically necessary would go beyond what is necessary to achieve any identified efficiency gains. In the same vein, including substitute IPR as essential parts of a standard and limiting the use of that technology to that particular standard (that is to say, exclusive use) could limit inter-technology competition and would not be necessary to achieve the efficiencies identified.
- 318. Restrictions in a standardisation agreement making a standard binding and obligatory for the industry are in principle not indispensable.
- 319. In a similar vein, standardisation agreements that entrust certain bodies with the exclusive right to test compliance with the standard go beyond the primary objective of defining the standard and may also restrict competition. The exclusivity can, however, be justified for a certain period of time, for example by the need to recoup significant start-up costs. The standardisation agreement should in that case include adequate safeguards to mitigate possible risks to competition resulting from exclusivity. This concerns, inter alia, the certification fee which needs to be reasonable and proportionate to the cost of the compliance testing.

#### Standard terms

320. It is generally not justified to make standard terms binding and obligatory for the industry or the members of the trade association that established them. The possibility cannot, however, be ruled out that making standard terms binding may, in a specific case, be indispensable to the attainment of the efficiency gains generated by them.

#### 7.4.3. Pass-on to consumers

#### Standardisation agreements

321. Efficiency gains attained by indispensable restrictions must be passed on to consumers to an extent that outweighs the restrictive effects on competition caused by a standardisation agreement or by standard terms. A relevant part of the analysis of likely pass-on to consumers is which procedures are used to guarantee that the interests of the users of standards and end consumers are protected. Where standards facilitate technical interoperability and compatibility or competition between new

and already existing products, services and processes, it can be presumed that the standard will benefit consumers.

#### Standard terms

- 322. Both the risk of restrictive effects on competition and the likelihood of efficiency gains increase with the companies' market shares and the extent to which the standard terms are used. Hence, it is not possible to provide any general "safe harbour" within which there is no risk of restrictive effects on competition or which would allow the presumption that efficiency gains will be passed on to consumers to an extent that outweighs the restrictive effects on competition.
- 323. However, certain efficiency gains generated by standard terms, such as increased comparability of the offers on the market, facilitated switching between providers, and legal certainty of the clauses set out in the standard terms, are necessarily beneficial for the consumers. As regards other possible efficiency gains, such as lower transaction costs, it is necessary to make an assessment on a case-by-case basis and in the relevant economic context whether these are likely to be passed on to consumers.

## 7.4.4. No elimination of competition

324. Whether a standardisation agreement affords the parties the possibility of eliminating competition depends on the various sources of competition in the market, the level of competitive constraint that they impose on the parties and the impact of the agreement on that competitive constraint. While market shares are relevant for that analysis, the magnitude of remaining sources of actual competition cannot be assessed exclusively on the basis of market share except in cases where a standard becomes a de facto industry standard. In the latter case competition may be eliminated if third parties are foreclosed from effective access to the standard. Standard terms used by a majority of the industry might create a de facto industry standard and thus raise the same concerns. However, if the standard or the standard terms only concern a limited part of the product or service, competition is not likely to be eliminated.

#### 7.5. Examples

325. Setting standards competitors cannot satisfy

## Example 1

Situation: A standard-setting organisation sets and publishes safety standards that are widely used by the relevant industry. Most competitors of the industry take part in the setting of the standard. Prior to the adoption of the standard, a new entrant has developed a product which is technically equivalent in terms of the performance and functional requirements and which is recognised by the technical committee of the standard-setting organisation. However, the technical specifications of the safety standard are, without any objective justification, drawn up in such a way as to not allow for this or other new products to comply with the standard.

Analysis: This standardisation agreement is likely to give rise to restrictive effects on competition within the meaning of Article 101(1) and is unlikely to meet the criteria of Article 101(3). The members of the standards development organisation

have, without any objective justification, set the standard in such a way that products of their competitors which are based on other technological solutions cannot satisfy it, even though they have equivalent performance. Hence, this standard, which has not been set on a non-discriminatory basis, will reduce or prevent innovation and product variety. It is unlikely that the way the standard is drafted will lead to greater efficiency gains than a neutral one.

326. Non-binding and transparent standard covering a large part of the market Example 2

Situation : A number of consumer electronics manufacturers with substantial market shares agree to develop a new standard for a product to follow up the DVD.

Analysis: Provided that (a) the manufacturers remain free to produce other new products which do not conform to the new standard, (b) participation in the standard-setting is unrestricted and transparent, and (c) the standardisation agreement does not otherwise restrict competition, Article 101(1) is not likely to be infringed. If the parties agreed to only manufacture products which conform to the new standard, the agreement would limit technical development, reduce innovation and prevent the parties from selling different products, thereby creating restrictive effects on competition within the meaning of Article 101(1).

# 327. Standardisation agreement without IPR disclosure Example 3

Situation: A private standard-setting organisation active in standardisation in the ICT (information and communication technology) sector has an IPR policy which neither requires nor encourages disclosures of IPR which could be essential for the future standard. The standard-setting organisation took the conscious decision not to include such an obligation in particular considering that in general all technologies potentially relevant for the future standard are covered by many IPR. Therefore the standard-setting organisation considered that an IPR disclosure obligation would, on the one hand, not lead to the benefit of enabling the participants to choose a solution with no or little IPR and, on the other, would lead to additional costs in analysing whether the IPR would be potentially essential for the future standard. However, the IPR policy of the standard-setting organisation requires all participants to make a commitment to license any IPR that might read on the future standard on FRAND terms. The IPR policy allows for opt-outs if there is specific IPR that an IPR holder wishes to put outside the blanket licensing commitment. In this particular industry there are several competing private standard-setting organisations. Participation in the standard-setting organisation is open to anyone active in the industry.

Analysis: In many cases an IPR disclosure obligation would be pro-competitive by increasing competition between technologies ex ante. In general, such an obligation allows the members of a standard-setting organisation to factor in the amount of IPR reading on a particular technology when deciding between competing technologies (or even to, if possible, choose a technology which is not covered by IPR). The

amount of IPR reading on a technology will often have a direct impact on the cost of access to the standard. However, in this particular context, all available technologies seem to be covered by IPR, and even many IPR. Therefore, any IPR disclosure would not have the positive effect of enabling the members to factor in the amount of IPR when choosing technology since regardless of what technology is chosen, it can be presumed that there is IPR reading on that technology. IPR disclosure would be unlikely to contribute to guaranteeing effective access to the standard which in this scenario is sufficiently guaranteed by the blanket commitment to license any IPR that might read on the future standard on FRAND terms. On the contrary, an IPR disclosure obligation might in this context lead to additional costs for the participants. The absence of IPR disclosure might also, in those circumstances, lead to a quicker adoption of the standard which might be important if there are several competing standard-setting organisations. It follows that the agreement is unlikely to give rise to any negative effects on competition within the meaning of Article 101(1).

# 328. Standards in the insurance sector

# Example 4

Situation: A group of insurance companies comes together to agree non-binding standards for the installation of certain security devices (that is to say, components and equipment designed for loss prevention and reduction and systems formed from such elements). The non-binding standards set by the insurance companies (a) are agreed in order to address a specific need and to assist insurers to manage risk and offer risk-appropriate premiums; (b) are discussed with the installers (or their representatives) and their views are taken on board prior to finalisation of the standards; (c) are published by the relevant insurance association on a dedicated section of its website so that any installer or other interested party can access them easily.

Analysis: The process for setting these standards is transparent and allows for the participation of interested parties. In addition, the result is easily accessible on a reasonable and non-discriminatory basis for anyone that wishes to have access to it. Provided that the standard does not have negative effects on the downstream market (for example by excluding certain installers through very specific and unjustified requirements for installations) it is not likely to lead to restrictive effects on competition. However, even if the standards led to restrictive effects on competition, the conditions set out in Article 101(3) would seem to be fulfilled. The standards would assist insurers in analysing to what extent such installation systems reduce relevant risk and prevent losses so that they can manage risks and offer risk-appropriate premiums. Subject to the caveat regarding the downstream market, they would also be more efficient for installers, allowing them to comply with one set of standards for all insurance companies rather than be tested by every insurance company separately. They could also make it easier for consumers to switch between insurers. In addition, they could be beneficial for smaller insurers who may not have the capacity to test separately. As regards the other conditions of Article 101(3), it seems that the nonbinding standards do not go beyond what is necessary to achieve the efficiencies in question, that benefits would be passed on to the consumers (some would even be directly beneficial for the consumers) and that the restrictions would not lead to an elimination of competition.

#### 329. Environmental standards

#### Example 5

Situation: Almost all producers of washing machines agree, with the encouragement of a public body, to no longer manufacture products which do not comply with certain environmental criteria (for example, energy efficiency). Together, the parties hold 90 % of the market. The products which will be thus phased out of the market account for a significant proportion of total sales. They will be replaced by more environmentally friendly, but also more expensive products. Furthermore, the agreement indirectly reduces the output of third parties (for example, electric utilities and suppliers of components incorporated in the products phased out). Without the agreement, the parties would not have shifted their production and marketing efforts to the more environmentally friendly products.

Analysis: The agreement grants the parties control of individual production and concerns an appreciable proportion of their sales and total output, whilst also reducing third parties' output. Product variety, which is partly focused on the environmental characteristics of the product, is reduced and prices will probably rise. Therefore, the agreement is likely to give rise to restrictive effects on competition within the meaning of Article 101(1). The involvement of the public authority is irrelevant for that assessment. However, newer, more environmentally friendly products are more technically advanced, offering qualitative efficiencies in the form of more washing machine programmes which can be used by consumers. Furthermore, there are cost efficiencies for the purchasers of the washing machines resulting from lower running costs in the form of reduced consumption of water, electricity and soap. Those cost efficiencies are realised on markets which are different from the relevant market of the agreement. Nevertheless, those efficiencies may be taken into account as the markets on which the restrictive effects on competition and the efficiency gains arise are related and the group of consumers affected by the restriction and the efficiency gains is substantially the same. The efficiency gains outweigh the restrictive effects on competition in the form of increased costs. Other alternatives to the agreement are shown to be less certain and less cost-effective in delivering the same net benefits. Various technical means are economically available to the parties in order to manufacture washing machines which do comply with the environmental characteristics agreed upon and competition will still take place for other product characteristics. Therefore, the criteria of Article 101(3) would appear to be fulfilled.

#### 330. Government encouraged standardisation

#### Example 6

Situation: In response to the findings of research into the recommended levels of fat in certain processed food conducted by a government-funded think tank in one

Member State, several major manufacturers of the processed foods in the same Member State agree, through formal discussions at an industry trade association, to set recommended fat levels for the products. Together, the parties represent 70 % of sales of the products within the Member State. The parties' initiative will be supported by a national advertising campaign funded by the think tank highlighting the dangers of a high fat content in processed foods.

Analysis: Although the fat levels are recommendations and therefore voluntary, as a result of the wide publicity resulting from the national advertising campaign, the recommended fat levels are likely to be implemented by all manufacturers of the processed foods in the Member State. It is therefore likely to become a de facto maximum fat level in the processed foods. Consumer choice across the product markets could therefore be reduced. However, the parties will be able to continue to compete with regard to a number of other characteristics of the products, such as price, product size, quality, taste, other nutritional and salt content, balance of ingredients, and branding. Moreover, competition regarding the fat levels in the product offering may increase where parties seek to offer products with the lowest levels. The agreement is therefore unlikely to give rise to restrictive effects on competition within the meaning of Article 101(1).

# 331. Open standardisation of product packaging Example 7

Situation: The major manufacturers of a fast-moving consumer product in a competitive market in a Member State – as well as manufacturers and distributors in other Member States who sell the product into the Member State ("importers") – agree with the major packaging suppliers to develop and implement a voluntary initiative to standardise the size and shape of the packaging of the product sold in that Member State. There is currently a wide variation in packaging sizes and materials within and across the Member States. This reflects the fact that the packaging does not represent a high proportion of total production costs and that switching costs for packaging producers are not significant. There is no actual or pending European standard for the packaging. The agreement has been entered into by the parties voluntarily in response to pressure from the Member State's government to meet environmental targets. Together, the manufacturers and importers represent 85 % of sales of the product within the Member State. The voluntary initiative will give rise to a uniform-sized product for sale within the Member State that uses less packaging material, occupies less shelf space, has lower transport and packaging costs, and is more environmentally friendly through reduced packaging waste. It also reduces the recycling costs of producers. The standard does not specify that particular types of packaging materials must be used. The specifications of the standard have been agreed between manufacturers and importers in an open and transparent manner, with the draft specifications having been published for open consultation on an industry website in a timely manner prior to adoption. The final specifications adopted are also published on an industry trade association website that is freely accessible to any potential entrants, even if they are not members of the trade association.

Analysis: Although the agreement is voluntary, the standard is likely to become a de facto industry practice because the parties together represent a high proportion of the market for the product in the Member State and retailers are also being encouraged by the government to reduce packaging waste. As such, the agreement could in theory create barriers to entry and give rise to potential anti-competitive foreclosure effects in the Member State market. This would in particular be a risk for importers of the product in question who may need to repackage the product to meet the de facto standard in order to sell in the Member State if the pack size used in other Member States does not meet the standard. However, significant barriers to entry and foreclosure are unlikely to occur in practice because (a) the agreement is voluntary, (b) the standard has been agreed with major importers in an open and transparent manner, (c) switching costs are low, and (d) the technical details of the standard are accessible to new entrants, importers and all packaging suppliers. In particular, importers will have been aware of potential changes to packaging at an early stage of development and will have had the opportunity through the open consultation on the draft standards to put forward their views before the standard was eventually adopted. The agreement therefore may not give rise to restrictive effects on competition within the meaning of Article 101(1).

In any event, it is likely that the conditions of Article 101(3) will be fulfilled in this case: (i) the agreement will give rise to quantitative efficiencies through lower transport and packaging costs, (ii) the prevailing conditions of competition on the market are such that these costs reductions are likely to be passed on to consumers, (iii) the agreement includes only the minimum restrictions necessary to achieve the packaging standard and is unlikely to result in significant foreclosure effects and (iv) competition will not be eliminated in a substantial part of the products in question.

# 332. Closed standardisation of product packaging

#### Example 8

Situation: The situation is the same as in Example 7, paragraph 331, except the standard is agreed only between manufacturers of the fast-moving consumer product located within the Member State (who represent 65 % of the sales of the product in the Member State), there was no open consultation on the specifications adopted (which include detailed standards on the type of packaging material that must be used) and the specifications of the voluntary standard are not published. This resulted in higher switching costs for producers in other Member States than for domestic producers.

Analysis: Similar to Example 7, paragraph 331, although the agreement is voluntary, it is very likely to become de facto standard industry practice since retailers are also being encouraged by the government to reduce packaging waste and the domestic manufacturers account for 65 % of sales of the product within the Member State.

The fact that relevant producers in other Member States were not consulted resulted in the adoption of a standard which imposes higher switching costs on them compared to domestic producers. The agreement may therefore create barriers to entry and give rise to potential anti-competitive foreclosure effects on packaging suppliers, new entrants and importers – all of whom were not involved in the standard-setting process – as they may need to repackage the product to meet the de facto standard in order to sell in the Member State if the pack size used in other Member States does not meet the standard.

Unlike in Example 7, paragraph 331, the standardisation process has not been carried out in an open and transparent manner. In particular, new entrants, importers and packaging suppliers have not been given the opportunity to comment on the proposed standard and may not even be aware of it until a late stage, creating the possibility that they may not be able to change their production methods or switch suppliers quickly and effectively. Moreover, new entrants, importers and packaging suppliers may not be able to compete if the standard is unknown or difficult to comply with. Of particular relevance here is the fact that the standard includes detailed specifications on the packaging materials to be used which, because of the closed nature of the consultation and the standard, importers and new entrants will struggle to comply with. The agreement may therefore restrict competition within the meaning of Article 101(1). This conclusion is not affected by the fact the agreement has been entered into in order to meet underlying environmental targets agreed with the Member State's government.

It is unlikely that the conditions of Article 101(3) will be fulfilled in this case. Although the agreement will give rise to similar quantitative efficiencies as arise under Example 7, paragraph 331, the closed and private nature of the standardisation agreement and the non-published detailed standard on the type of packaging material that must be used are unlikely to be indispensable to achieving the efficiencies under the agreement.

# 333. Non-binding and open standard terms used for contracts with end-users Example 9

Situation: A trade association for electricity distributors establishes non-binding standard terms for the supply of electricity to end-users. The establishment of the standard terms is made in a transparent and non-discriminatory manner. The standard terms cover issues such as the specification of the point of consumption, the location of the connection point and the connection voltage, provisions on service reliability as well as the procedure for settling the accounts between the parties to the contract (for example, what happens if the customer does not provide the supplier with the readings of the measurement devices). The standard terms do not cover any issues relating to prices, that is to say, they contain no recommended prices or other clauses related to price. Any company active within the sector is free to use the standard

terms as it sees fit. About 80 % of the contracts concluded with end-users in the relevant market are based on these standard terms.

Analysis: These standard terms are not likely to give rise to restrictive effects on competition within the meaning of Article 101(1). Even if they have become industry practice, they do not seem to have any appreciable negative impact on prices, product quality or variety.

334. Standard terms used for contracts between companies Example 10

Situation: Construction companies in a certain Member State come together to establish non-binding and open standard terms and conditions for use by a contractor when submitting a quotation for construction work to a client. A form of quotation is included together with terms and conditions suitable for building or construction. Together, the documents create the construction contract. Clauses cover such matters as contract formation, general obligations of the contractor and the client and non-price related payment conditions (for example, a provision specifying the contractor's right to give notice to suspend the work for non-payment), insurance, duration, handover and defects, limitation of liability, termination, etc. In contrast to Example 9, paragraph 333, these standard terms would often be used between companies, one active upstream and one active downstream.

Analysis: These standard terms are not likely to have restrictive effects on competition within the meaning of Article 101(1). There would normally not be any significant limitation in the customer's choice of the end-product, namely the construction work. Other restrictive effects on competition do not seem likely. Indeed, several of the clauses above (handover and defects, termination, etc.) would often be regulated by law.

335. Standard terms facilitating the comparison of different companies' products Example 11

Situation: A national association for the insurance sector distributes non-binding standard policy conditions for house insurance contracts. The conditions give no indication of the level of insurance premiums, the amount of the cover or the excesses payable by the insured. They do not impose comprehensive cover including risks to which a significant number of policyholders are not simultaneously exposed and do not require the policyholders to obtain cover from the same insurer for different risks. While the majority of insurance companies use standard policy conditions, not all their contracts contain the same conditions as they are adapted to each client's individual needs and therefore there is no de facto standardisation of insurance products offered to consumers. The standard policy conditions enable consumers and consumer organisations to compare the policies offered by the different insurers. A consumer association is involved in the process of laying down the standard policy conditions. They are also available for use by new entrants, on a non-discriminatory basis.

Analysis: These standard policy conditions relate to the composition of the final insurance product. If the market conditions and other factors would show that there might be a risk of limitation in product variety as a result of insurance companies using such standard policy conditions, it is likely that such possible limitation would be outweighed by efficiencies such as facilitation of comparison by consumers of conditions offered by insurance companies. Those comparisons in turn facilitate switching between insurance companies and thus enhance competition. Furthermore the switching of providers, as well as market entry by competitors, constitutes an advantage for consumers. The fact that the consumer association has participated in the process could, in certain instances, increase the likelihood of those efficiencies which do not automatically benefit the consumers being passed on. The standard policy conditions are also likely to reduce transaction costs and facilitate entry for insurers on a different geographic and/or product markets. Moreover, the restrictions do not seem to go beyond what is necessary to achieve the identified efficiencies and competition would not be eliminated. Consequently, the criteria of Article 101(3) are likely to be fulfilled.

# Statement of the Federal Trade Commission Regarding Google's Search Practices In the Matter of Google Inc. FTC File Number 111-0163

January 3, 2013

The Federal Trade Commission has today completed a wide-ranging investigation of alleged anticompetitive conduct by Google Inc. ("Google"). We issue this Statement to explain the Commission's unanimous decision to close the portion of its investigation relating to allegations that Google unfairly preferences its own content on the Google search results page and selectively demotes its competitors' content from those results. Some parties refer to this alleged practice as "search bias."

The Commission conducted a comprehensive investigation of the search bias allegations against Google. Commission staff reviewed over nine million pages of documents from Google and other relevant parties. Staff interviewed numerous industry participants and conducted many investigational hearings of key Google executives. Staff economists conducted empirical analyses to investigate the impact of Google's design changes on search engine traffic and user click-through behavior. The Commission also considered the many white papers, letters, and presentations made by industry participants, consumer organizations, and other stakeholders. In addition, we worked closely with, and had the active assistance of, five state attorneys general, who conducted parallel investigations into Google's search practices.

## I. Overview of the Search Bias Allegations

As is well known, when a user types a word or words into a Google search box, Google, guided by proprietary algorithms, searches its index of the Internet and assembles a ranked listing of relevant websites, known as "organic" search results. These organic results – together with advertising, links to Google products, and other information judged to be relevant to the user's query – are returned to the user as the Google search results page. Google is a "horizontal," or general purpose, search engine because it seeks to cover the Internet as completely as possible, delivering a comprehensive list of results to any query. General purpose search engines are distinct from "vertical" search engines, which focus on narrowly defined categories of content such as shopping or travel. Although vertical search engines are not wholesale substitutes for general purpose search engines, they present consumers with an alternative to Google for specific categories of searches.

Some vertical websites alleged that Google unfairly promoted its own vertical properties through changes in its search results page, such as the introduction of the "Universal Search" box, which prominently displayed Google vertical search results in response to certain types of queries, including shopping and local. Prominent display of Google's proprietary content had the collateral effect of pushing the "ten blue links" of organic search results that Google had traditionally displayed farther down the search results page. Complainants also charged that

<sup>&</sup>lt;sup>1</sup> Although Commissioner Rosch concurs in the decision to close the investigation, he does not join this Statement and has issued a separate statement expressing his views.

Google manipulated its search algorithms in order to demote vertical websites that competed against Google's own vertical properties.

# II. The Commission's Investigation

The Commission may intervene and challenge business practices if it has reason to believe that such practices violate Section 5's prohibition on unfair methods of competition, and create a likelihood of significant injury to competition, including monopolization or attempted monopolization actionable under Section 2 of the Sherman Act. To determine whether Google violated Section 5 with respect to these search bias allegations, the Commission considered whether Google manipulated its search algorithms and search results page in order to impede a competitive threat posed by vertical search engines.

A key issue for the Commission was to determine whether Google changed its search results primarily to exclude actual or potential competitors and inhibit the competitive process, or on the other hand, to improve the quality of its search product and the overall user experience. The totality of the evidence indicates that, in the main, Google adopted the design changes that the Commission investigated to improve the quality of its search results, and that any negative impact on actual or potential competitors was incidental to that purpose. While some of Google's rivals may have lost sales due to an improvement in Google's product, these types of adverse effects on particular competitors from vigorous rivalry are a common byproduct of "competition on the merits" and the competitive process that the law encourages.

While Google's prominent display of its own vertical search results on its search results page had the effect in some cases of pushing other results "below the fold," the evidence suggests that Google's primary goal in introducing this content was to quickly answer, and better satisfy, its users' search queries by providing directly relevant information. Notably, the documents, testimony and quantitative evidence the Commission examined are largely consistent with the conclusion that Google likely benefited consumers by prominently displaying its vertical content on its search results page. For example, contemporaneous evidence demonstrates that Google would typically test, monitor, and carefully consider the effect of introducing its vertical content on the quality of its general search results, and would demote its own content to a less prominent location when a higher ranking adversely affected the user experience. Analyses of "click through" data showing how consumers reacted to the proprietary content displayed by Google also suggest that users benefited from these changes to Google's search results. We also note that other competing general search engines adopted many similar design changes, suggesting that these changes are a quality improvement with no necessary connection to the anticompetitive exclusion of rivals.

We nonetheless recognize that some of Google's algorithm and design changes resulted in the demotion of websites that could, collectively, be considered threats to Google's search business. For example, for shopping queries, Google demoted all but one or two comparison shopping properties from the first page of Google's search results to a later page. Demoting comparison shopping properties had the effect of elevating to page one certain merchant and other websites. These changes resulted in significant traffic loss to the demoted comparison shopping properties, arguably weakening those websites as rivals to Google's own shopping

vertical. On the other hand, these changes to Google's search algorithm could reasonably be viewed as improving the overall quality of Google's search results because the first search page now presented the user with a greater diversity of websites.

Product design is an important dimension of competition and condemning legitimate product improvements risks harming consumers. Reasonable minds may differ as to the best way to design a search results page and the best way to allocate space among organic links, paid advertisements, and other features. And reasonable search algorithms may differ as to how best to rank any given website. Challenging Google's product design decisions in this case would require the Commission – or a court – to second-guess a firm's product design decisions where plausible procompetitive justifications have been offered, and where those justifications are supported by ample evidence. Based on this evidence, we do not find Google's business practices with respect to the claimed search bias to be, on balance, demonstrably anticompetitive, and do not at this time have reason to believe that these practices violate Section 5.<sup>2</sup>

#### III. Conclusion

In sum, we find that the evidence presented at this time does not support the allegation that Google's display of its own vertical content at or near the top of its search results page was a product design change undertaken without a legitimate business justification. Rather, we conclude that Google's display of its own content could plausibly be viewed as an improvement in the overall quality of Google's search product. Similarly, we have not found sufficient evidence that Google manipulates its search algorithms to unfairly disadvantage vertical websites that compete with Google-owned vertical properties. Although at points in time various vertical

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While Commissioner Ramirez is pleased that Google has decided to change certain of its practices, she objects to the form of the commitments made by Google.

Chairman Leibowitz and Commissioner Brill support the enforceable commitments made by Google. In this case, the commitments made by Google are appropriate and consistent with past practice at the Commission. See Statement of Commissioners Orson Swindle and Thomas B. Leary, In re General Mills, Inc./Diageo plc/Pillsbury Co. FTC File No. 001-0213, available at <a href="http://www.ftc.gov/os/2001/10/gmstmtswinleary.htm">http://www.ftc.gov/os/2001/10/gmstmtswinleary.htm</a>. Chairman Leibowitz and Commissioner Brill expect the Commission to enforce vigorously Google's commitments with respect to scraping and API restrictions.

<sup>&</sup>lt;sup>2</sup> The Commission also investigated allegations that Google had unfairly "scraped," or misappropriated, the content of certain competing websites, passed this content off as its own, and then threatened to delist these rivals entirely from Google's search results when they protested the misappropriation of their content. The Commission considered whether this conduct could have diminished the incentive of Google's rivals to invest in bringing new and innovative content and services to the Internet in the future or reduced Google's own incentive to innovate in the relevant markets, and if so whether this conduct was actionable as an unfair method of competition within the meaning of Section 5 of the FTC Act, 15 U.S.C. § 45. Chairman Leibowitz, Commissioner Brill and Commissioner Ramirez found the record evidence to support strong concerns about Google's conduct in this regard, and Google has committed to refrain from this conduct in the future. In addition, the Commission investigated allegations that Google placed unreasonable restrictions on the ability of advertisers to simultaneously advertise on Google and competing search engines, or "multihome." The Commission considered whether these restrictions raised the cost of dealing with Google's rivals for advertisers, particularly small businesses who might multihome less due to the restrictions, whether these effects were material, and if so whether this conduct was actionable as an unfair method of competition under Section 5. Chairman Leibowitz and Commissioner Brill found the record evidence to support strong concerns about Google's conduct in this regard, and Google has committed to refrain from this conduct in the future.

websites have experienced demotions, we find that this was a consequence of algorithm changes that also could plausibly be viewed as an improvement in the overall quality of Google's search results.

Although our careful review of the evidence in this matter supports our decision to close this investigation, we will remain vigilant and continue to monitor Google for conduct that may harm competition and consumers.

# ANALYSIS OF PROPOSED CONSENT ORDER TO AID PUBLIC COMMENT

## In the Matter of Motorola Mobility LLC and Google Inc., File No. 121-0120

The Federal Trade Commission ("Commission") has accepted, subject to final approval, an Agreement Containing Consent Order ("Agreement") with Motorola Mobility LLC (formerly Motorola Mobility, Inc. ("Motorola"), a wholly-owned subsidiary of Respondent Google Inc.), and Google Inc. ("Google"), which is designed to settle allegations that Motorola and Google violated Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45, by engaging in unfair methods of competition and unfair acts or practices relating to the licensing of standard essential patents ("SEPs") for cellular, video codec, and wireless LAN standards. The Complaint alleges that, after committing to license the SEPs on fair, reasonable, and non-discriminatory ("FRAND") terms Motorola sought injunctions and exclusion orders against willing licensees, undermining the procompetitive standard-setting process. After purchasing Motorola for \$12.5 billion in June 2012, Google continued Motorola's anticompetitive behavior.

The Proposed Consent Order has been placed on the public record for thirty (30) days for comments by interested persons. Comments received during this period will become part of the public record. After thirty (30) days, the Commission will again review the Agreement and the comments received and will decide whether it should withdraw from the Agreement or make final the Agreement's Proposed Consent Order.

The purpose of this analysis is to facilitate comments on the Proposed Consent Order. This analysis does not constitute an official interpretation of the Proposed Consent Order, and does not modify its terms in any way. The Agreement has been entered into for settlement purposes only and does not constitute an admission by Motorola or Google that the law has been violated as alleged or that the facts alleged, other than jurisdictional facts, are true.

#### **Background**

American consumers rely on standardized technology for the interoperability of consumer electronics and other products. Manufacturers of these products participate in standard-setting organizations ("SSOs") such as the European Telecommunications Standards Institute ("ETSI"), the Institute of Electrical and Electronics Engineers ("IEEE"), and the International Telecommunication Union ("ITU") that agree upon and develop standards based on shared technologies that incorporate patents. SSOs and the standards they promulgate have procompetitive benefits; they encourage common technological platforms that many different manufacturers ultimately incorporate into their respective products. Standards foster competition among these manufacturers' products and facilitate the entry of related products. Overall, standards benefit the market by encouraging compatibility among all products,

<sup>&</sup>lt;sup>1</sup> As the Supreme Court has recognized, when properly formulated standards "can have significant procompetitive advantages." *Allied Tube & Conduit Corp. v. Indian Head, Inc.*, 486 U.S. 492, 501 (1988).

promoting interoperability of competing devices, and lowering the costs of products for consumers.

Many SSOs require that a firm make a licensing commitment, such as a FRAND commitment, in order for its patented technology to be included in a standard. SSOs have this policy because the incorporation of patented technology into a standard induces market reliance on that patent and increases its value. After manufacturers implement a standard, they can become "locked-in" to the standard and face substantial switching costs if they must abandon initial designs and substitute different technologies. This allows SEP holders to demand terms that reflect not only "the value conferred by the patent itself," but also "the additional value—the hold-up value—conferred by the patent's being designated as standard-essential." The FRAND commitment is a promise intended to mitigate the potential for patent hold-up. In other words, it restrains the exercise of market power gained by a firm when its patent is included in a standard and the standard is widely adopted in the market.

Despite the significant procompetitive benefits of standard setting, particularly the interoperability of technology that arises from efficient and effective standards, standard setting is a collaborative process among competitors that often displaces free market competition in technology platforms. FRAND commitments by SSO members are critical to offsetting the potential anticompetitive effects of such agreements while preserving the procompetitive aspects of standard setting.

Seeking and threatening injunctions against willing licensees of FRAND-encumbered SEPs undermines the integrity and efficiency of the standard-setting process and decreases the incentives to participate in the process and implement published standards. Such conduct reduces the value of standard setting, as firms will be less likely to rely on the standard-setting process. Implementers wary of the risk of patent hold-up may diminish or abandon entirely their participation in the standard-setting process and their reliance on standards. If firms forego participation in the standard-setting process, consumers will no longer enjoy the benefits of interoperability that arise from standard setting, manufacturers have less incentive to innovate

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<sup>&</sup>lt;sup>2</sup> Apple, Inc. v. Motorola, Inc., 869 F. Supp. 2d 901, 913 (N.D. Ill. 2012) (Posner, J., sitting by designation).

<sup>&</sup>lt;sup>3</sup> As the Commission explained in its unanimous filing before the United States International Trade Commission ("ITC"), incorporating patented technologies into standards without safeguards risks distorting competition because it enables SEP owners to negotiate high royalty rates and other favorable terms, after a standard is adopted, that they could not credibly demand beforehand. The exercise of this leverage is known as patent hold-up. See Third Party United States Federal Trade Commission's Statement on the Public Interest filed on June 6, 2012 in *In re Certain Wireless Communication Devices, Portable Music & Data Processing Devices, Computers and Components Thereof*, Inv. No. 337-TA-745, available at www.ftc.gov/os/2012/06/1206ftcwirelesscom.pdf; *In re Certain Gaming and Entertainment\ Consoles, Related Software, and Components Thereof*, Inv. No. 337-TA-752, available at <a href="http://www.ftc.gov/os/2012/06/1206ftcgamingconsole.pdf">http://www.ftc.gov/os/2012/06/1206ftcgamingconsole.pdf</a>.

<sup>&</sup>lt;sup>4</sup> As the Ninth Circuit recently stated, a FRAND commitment is "a guarantee that the patent-holder will not take steps to keep would-be users from using the patented material, such as seeking an injunction, but will instead proffer licenses consistent with the commitment made." *Microsoft Corp. v. Motorola, Inc.*, 696 F.3d 872, 884 (9th Cir. 2012) (citing *Apple*, 869 F. Supp. 2d at 914).

and differentiate product offerings, and new manufacturers will be deterred from entering the market.

## **The Proposed Complaint**

Motorola sought to exploit the market power that it acquired through the standard-setting process by breaching its promises to license its SEPs on FRAND terms. ETSI, ITU, and IEEE require that firms disclose whether they will commit to license their SEPs on FRAND terms in order for the SSO to decide if the patents should be included in the relevant cellular, video codec, or wireless LAN standards. Motorola promised to license its patents essential to these standards on FRAND terms, inducing ETSI, ITU, and IEEE to include its patents in cellular, video codec, and wireless LAN standards. These commitments created express and implied contracts with the SSOs and their members. In acquiring Motorola and its patent portfolio, Google affirmatively declared that it would honor Motorola's FRAND commitments.<sup>5</sup>

Relying on Motorola's promise to license its SEPs on FRAND terms, electronic device manufacturers implemented the relevant standards and were locked-in to using Motorola's patents. Motorola then violated the FRAND commitments made to ETSI, ITU, and IEEE by seeking, or threatening, to enjoin certain competitors from marketing and selling products compliant with the relevant standards, like the iPhone and the Xbox, from the market unless the competitor paid higher royalty rates or made other concessions. At all times relevant to the allegations in the Proposed Complaint, these competitors – Microsoft and Apple – were willing to license Motorola's SEPs on FRAND terms.

Specifically, Motorola threatened exclusion orders and injunctions in various forums against these willing licensees. Motorola filed patent infringement claims at the ITC where the only remedy for patent infringement is an exclusion order. Because of the ITC's remedial structure, filing for an exclusion order before the ITC on a FRAND-encumbered SEP significantly raises the risk of patent hold-up in concurrent licensing negotiations because an exclusion order may be entered by the ITC before a FRAND rate is reached. Motorola also filed for injunctive relief in various federal district courts, which also raises the risk of patent hold-up.

Had Google been successful in obtaining either an injunction or exclusion order against its competitors' products, it could have imposed a wide variety of costs to consumers and competition. These products could have been kept off the market entirely, diminishing competition and denying consumers access to products they wish to purchase, such as the iPhone and Xbox. Alternatively, Google's conduct might have increased prices because manufacturers, when faced with the threat of an injunction, are likely to surrender to higher royalty rates for SEPs. Other manufacturers, deterred by increased licensing fees, might exit the market altogether, or limit their product lines. In the end, prices would likely rise both because of higher

<sup>&</sup>lt;sup>5</sup> See Letter from Allen Lo, Deputy General Counsel, Google, to Luis Jorge Romero Saro, Director-General, ETSI (Feb. 8, 2012); Letter from Allen Lo, Deputy General Counsel, Google, to Gordon Day, President, IEEE (Feb. 8, 2012) available at

http://static.googleusercontent.com/external\_content/untrusted\_dlcp/www.google.com/en/us/press/motorola/pdf/ssoletter.pdf; Letter from Allen Lo, Deputy General Counsel, Google, to Hamadoun Toure, Secretary-General, ITU (Feb. 8, 2012).

royalties and because of less product-market competition. Ultimately, end consumers may bear some share of these higher costs, either in the form of higher prices or lower quality products.

Consumers would also suffer to the extent that Google's conduct impaired the efficacy of the standard-setting process or diminished the willingness of firms to participate in standard-setting processes. Relatedly, such FRAND violations may diminish the interest of SSOs in using new patented technologies – a step that could reduce the technical merit of those standards as well as their ultimate value to consumers. This could result in increased costs or inferior standards. Innovation by implementers would suffer and consumers would lose the benefits of lower costs, interoperability, and rapid technological development that efficient standard-setting enables.

The Proposed Complaint alleges that Motorola and Google's conduct violates Section 5 of the FTC Act, both as an unfair method of competition and an unfair act or practice.

#### 1. Unfair Method of Competition

Google and Motorola's conduct constitute an unfair method of competition and harms competition by threatening to undermine the integrity and efficiency of the standard-setting process. FRAND commitments help ensure the efficacy of the standard-setting process and that the outcome of that process is procompetitive. Conversely, that process is undermined when those promises are reneged. Motorola's conduct threatens to increase prices and reduce the quality of products on the market and to deter firms from entering the market. Moreover, Motorola's conduct threatens to deny consumers the many procompetitive benefits that standard setting makes possible. Motorola's conduct may deter manufacturers from participating in the standard setting process and relying on standards, and SSOs from adopting standards that incorporate patented technologies.

Consistent with these principles, courts have found that patent holders may injure competition by breaching FRAND commitments they made to induce SSOs to standardize their patented technologies. Each of these cases, brought under Section 2 of the Sherman Act, involved allegations of bad faith or deceptive conduct by the patent holder before the standard was adopted. However, under its stand-alone Section 5 authority, the Commission can reach opportunistic conduct that takes place after a standard is adopted that tends to harm consumers and undermine the standard-setting process." For example, in *Negotiated Data Solutions, LLC* 

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<sup>&</sup>lt;sup>6</sup> See Broadcom Corp. v. Qualcomm, Inc., 501 F.3d 297, 313-15 (3d Cir. 2007); In re Rambus, Inc., No. 9302, 2006 WL 2330117 (F.T.C. Aug. 2, 2006), available at http://www.ftc.gov/os/adjpro/d9302/060802commissionopinion.pdf, rev'd on other grounds Rambus v. F.T.C., 522

F.3d 456 (D.C. Cir. 2008); Research in Motion, Ltd. v. Motorola, Inc., 644 F. Supp. 2d 788, 796-97 (N.D. Tex. 2008); Apple Inc. v. Samsung Elecs. Co., No. 11-CV-01846, 2012 U.S. Dist. LEXIS 67102, at \*27-28 (N.D. Cal. May 14, 2012).

<sup>&</sup>lt;sup>7</sup> The Commission's investigation did not give it reason to believe that Motorola acted with bad faith or an intent to deceive at the time it first made these FRAND commitments to IEEE, ETSI, and ITU.

("*N-Data*"),<sup>8</sup> the Commission condemned similar conduct as "inherently 'coercive' and 'oppressive." The respondent, N-Data, acquired SEPs from a patent holder that had committed to license them to any requesting party for a one-time flat fee of \$1,000. After it acquired these SEPs, N-Data reneged on this licensing commitment. "Instead, N-Data threatened to initiate, and in some cases prosecuted, legal actions against companies refusing to pay its royalty demands, which [were] far in excess of [the \$1,000 one-time flat fee]." The Commission found that N-Data's "efforts to exploit the power it enjoy[ed] over those practicing the [relevant] standard and lacking any practical alternatives" were inherently "coercive" and "oppressive" as these firms were, "as a practical matter, locked into [the] standard." As here, the Commission found that N-Data's opportunistic breach of its licensing commitment had the tendency of leading to higher prices for consumers and undermining the standard-setting process.

Google and MMI's opportunistic violations of their FRAND commitments have the potential to harm consumers by excluding products from the market as a result of an injunction or by leading to higher prices because manufacturers are forced, by the threat of an injunction, to pay higher royalty rates. As explained in *N-Data*, courts have traditionally viewed opportunistic breaches as conduct devoid of countervailing benefits. As Judge Posner has explained, when a promisor breaches opportunistically, "we might as well throw the book at the promisor. . . . Such conduct has no economic justification and ought simply to be deterred." As in *N-Data*, "the context here is in standard-setting," and "[a] mere departure from a previous licensing commitment is unlikely to constitute an unfair method of competition under Section 5." <sup>14</sup>

<sup>&</sup>lt;sup>8</sup> In re Negotiated Data Solutions LLC (N-Data), File No. 051-0094, 2008 WL 258308 (FTC Jan. 22, 2008).

<sup>&</sup>lt;sup>9</sup> N-Data, 2008 WL 258308, at \*37 (analysis to aid public comment).

<sup>&</sup>lt;sup>10</sup> *Id.* at \*34–36.

<sup>&</sup>lt;sup>11</sup> Id. at \*37. Both Section 5 and common law precedents support the conclusion that parties engage in coercive and oppressive conduct when they breach commitments after those commitments have induced others to make relationship-specific investments and forego otherwise available alternatives. In Holland Furnace Co. v. FTC, 295 F.2d 302 (7th Cir. 1961), the Commission found a Section 5 violation when furnace salesmen dismantled furnaces for cleaning and inspection and refused to reassemble them until customers agreed to buy additional parts or services. Id. at 305. In Alaska Packers' Ass'n v. Domenico, 117 F. 99 (9th Cir. 1902), the Ninth Circuit likewise found that seamen acted coercively by threatening to strike unless the owners of a fishing vessel agreed to pay them wages higher than those they had negotiated before the vessel set sail. Id. at 102-03. In each case, the victims could have turned to alternatives ex ante (before their furnaces had been dismantled or their vessel had set sail for remote waters), but were "locked in," and therefore vulnerable to exploitation, ex post. Id. at 102 (explaining that, "at a time when it was impossible for the [vessel owners] to secure other men in their places," the seamen "refused to continue the services they were under contract to perform unless the [owners] would consent to pay them more money"); Neil W. Averitt, The Meaning of "Unfair Acts or Practices" in Section 5 of the Federal Trade Commission Act, 70 Geo. L.J. 225, 253 (1981) (observing that the consumers in Holland Furnace, because they "could not escape the need to restore their units to service, ... willingly or not, ... often had to purchase replacements from the respondent").

<sup>&</sup>lt;sup>12</sup> N-Data, 2008 WL 258308, at \*38 (Analysis to Aid Public Comment).

<sup>&</sup>lt;sup>13</sup> Richard A. Posner, Economic Analysis of Law 130 (5th ed. 1998).

<sup>&</sup>lt;sup>14</sup> N-Data, 2008 WL 258308, at \*37 (Analysis to Aid Public Comment).

#### 2. Unfair Act or Practice

Google and Motorola's violations of their FRAND commitments also constitute unfair acts or practices under Section 5 because they are "likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition." <sup>15</sup> If these practices continue, consumers will likely pay higher prices because many consumer electronics manufacturers will pass on some portion of unreasonable or discriminatory royalties they agree to pay to avoid an injunction or exclusion order. Consumers will not be able to avoid this injury, due to the industry-wide lock-in induced by Motorola's FRAND commitments. Moreover, this practice has no apparent "countervailing benefits," either to those upon whom demands have been made, or to ultimate consumers, or to competition. <sup>16</sup>

#### **The Proposed Consent**

The Proposed Consent Order is tailored to prevent Google – through its wholly owned subsidiary, Motorola – from using injunctions or threats of injunctions against current or future potential licensees who are willing to accept a license on FRAND terms. Under this Order, before seeking an injunction on FRAND-encumbered SEPs, Google must: (1) provide a potential licensee with a written offer containing all of the material license terms necessary to license its SEPs, and (2) provide a potential licensee with an offer of binding arbitration to determine the terms of a license that are not agreed upon. Furthermore, if a potential licensee seeks judicial relief for a FRAND determination, Google must not seek an injunction during the pendency of the proceeding, including appeals. Nothing in the Order limits Google or a potential licensee from challenging the validity, essentiality, claim of infringement or value of the patents at issue, and either party may object to a court action on jurisdictional or justiciability grounds, or on the ground that an alternative forum would be more appropriate. The Proposed Consent Order also does not prevent Google from pursuing legal claims regarding its FRANDencumbered SEPs other than a claim for injunctive relief, such as an action seeking damages for patent infringement. The Order does not define FRAND but requires Google to offer, and follow, specific procedures that will lead to that determination.

The Proposed Consent Order prohibits Google from revoking or rescinding any FRAND commitment that it has made or assumed unless the relevant standard no longer exists, Google no longer owns the SEPs encumbered by the FRAND commitment, or such SEPs are no longer enforceable. Motorola made FRAND commitments on the understanding that they were irrevocable, and Google, in acquiring Motorola's FRAND-encumbered SEPs, must continue to honor those agreements.

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<sup>&</sup>lt;sup>15</sup> 15 U.S.C. § 45(n) (1992). Section 45(n) codified limiting principles set forth in the 1980 FTC Policy Statement on Unfairness. *See* Letter from Federal Trade Commission to Senators Ford and Danforth (Dec. 17, 1980), *reprinted in* H.R. Rep. No. 156, Pt. 1, 98th Cong., 1st Sess. 33-40 (1983), *available at* <a href="http://www.ftc.gov/bcp/policystmt/ad-unfair.htm">http://www.ftc.gov/bcp/policystmt/ad-unfair.htm</a>, appended to the Commission's decision in *International Harvester*, 104 F.T.C. at 949, 1061 (1984).

<sup>&</sup>lt;sup>16</sup> N-Data, 2008 WL 258308, at \*38 (Analysis to Aid Public Comment).

The Proposed Consent Order further prohibits Google and Motorola from continuing or enforcing existing claims for injunctive relief based on FRAND-encumbered SEPs. Google and Motorola are similarly prohibited from bringing future claims for injunctive relief based on FRAND-encumbered SEPs. For both current and future claims for injunctive relief, Google and Motorola must follow specific negotiation procedures, described below, that are intended to protect the interests of potential willing licensees while allowing Google and Motorola to seek injunctions only after the licensee refuses to engage in the negotiation process. However, if a potential licensee indisputably demonstrates that it is not willing to pay Google a reasonable fee for use of Google's FRAND-encumbered SEPs, Google is permitted by this Order to seek injunctive relief.

Outside the processes outlined in the Order, Google is permitted to seek injunctive relief only in the following four narrowly-defined circumstances: (1) the potential licensee is not subject to United States jurisdiction; (2) the potential licensee has stated in writing or in sworn testimony that it will not accept a license for Google's FRAND-encumbered SEPs on any terms; (3) the potential licensee refuses to enter a license agreement for Google's FRAND-encumbered SEPs on terms set for the parties by a court or through binding arbitration; or (4) the potential licensee fails to assure Google that it is willing to accept a license on FRAND terms. The Proposed Consent Order provides Google with a form letter, attached to the Proposed Consent Order as Exhibit B, for requesting a potential licensee to affirm that it is willing to pay a FRAND rate for Google's FRAND-encumbered SEPs, and Google must provide a copy of the Proposed Consent Order along with the form letter. Google may not, however, seek an injunction simply because the potential licensee challenges the validity, value, infringement or essentiality of Google's FRAND-encumbered patents.

The Proposed Consent Order provides potential licensees with two avenues for resolving licensing disputes that involve Google's FRAND-encumbered SEPs. The first is a framework for resolution that a potential licensee may voluntarily elect. Under this path, Google and the potential licensee agree to negotiate the terms of the license for at least six (6) months (unless a license agreement is reached sooner); after the negotiation period concludes, Google may offer a license agreement, or, if the potential licensee requests a license after this negotiation period, Google must provide a proposed license within two months of the request. Google's proposed license agreement must be a binding, written offer that contains all material terms and limitations. Under this procedure, the potential licensee either accepts the proposed license or informs Google of the terms that it accept and the terms that it believes are inconsistent with Google's FRAND commitments; for each term that it disagrees with, the potential licensee must provide an alternative term that it believes is consistent with Google's FRAND commitment. The potential licensee may then go to court for a FRAND determination or propose binding arbitration to resolve the disputed provisions of Google's proposed license agreement. If a court decides that it cannot resolve the disputed terms, the parties are to go to binding arbitration to finalize the terms of the license agreement.

In the event that the potential licensee does not choose to pursue the path set forth above for resolving the licensing dispute, Google is nevertheless prohibited from seeking injunctive relief unless it takes the following steps. At least six months before seeking an injunction,

Google must provide the potential licensee with the Proposed Consent Order and an offer to license Google's FRAND-encumbered patents containing all material terms; Google's offer may require that the potential licensee in turn offer Google a license for the potential licensee's FRAND-encumbered SEPs within the same standard. If no agreement is reached, at least sixty days before initiating a claim for injunctive relief, Google must offer the potential licensee the option to enter binding arbitration to determine the terms of a license agreement between the parties. The Proposed Consent Order describes the terms and conditions that Google must follow should the potential licensee accept the offer for binding arbitration, although the parties are free to agree to their own terms. Google's license offers will be irrevocable until it makes the offer to arbitrate, and Google's offers to arbitrate will be irrevocable until thirty (30) days after Google files for injunctive relief.

Under these provisions, if the potential licensee seeks a court's determination of a FRAND-license-rate between the parties instead of accepting Google's offer to arbitrate, Google may not file for injunctive relief as long as the potential licensee goes to court within seven (7) months of Google providing a license offer, or within three months of Google's offer to arbitrate. But the potential licensee must, in connection with its court action, provide Google with assurances that it will abide by the license terms set by the court and pay royalties based on a final court determination or Google will be free to seek injunctive relief. The Proposed Consent Order provides Google with a form letter, attached as Exhibit A, for requesting that the potential licensee agree to be bound by the court's FRAND determination.

Under the terms of the Proposed Consent Order, Google retains the option to file for injunctive relief against a potential licensee that itself files a claim for injunctive relief against Google based on the potential licensee's FRAND-encumbered SEPs, unless that potential licensee has followed the procedures similar to those set out by the Proposed Consent Order for Google.

Finally, the Proposed Consent Order prohibits Google from selling or assigning its FRAND-encumbered SEPs to third parties unless those parties agree to assume Google's FRAND commitments, abide by the terms of the Proposed Consent Order, and condition any further sale or assignment of Google's FRAND-encumbered SEPs on the same.

In sum, the Proposed Consent Order improves upon the commitments made by Google in February 2012 to ETSI, IEEE, and ITU to honor Motorola's prior FRAND assurances and limit its pursuit of injunctive relief in connection with Motorola's SEPs by providing clear mechanisms for Google to do so. The Order also clarifies and defines Google's FRAND commitments by prohibiting Google from seeking injunctive relief against implementers who are willing to license Google's SEPs. The Proposed Consent Order also contains standard reporting, notification, and access provisions designed to allow the Commission to monitor compliance. It terminates ten (10) years after the date the Order becomes final.

# UNITED STATES DEPARTMENT OF JUSTICE AND UNITED STATES PATENT & TRADEMARK OFFICE

# POLICY STATEMENT ON REMEDIES FOR STANDARDS-ESSENTIAL PATENTS SUBJECT TO VOLUNTARY F/RAND COMMITMENTS

January 8, 2013

The U.S. Department of Justice, Antitrust Division (DOJ), and the U.S. Patent & Trademark Office (USPTO), an agency of the U.S. Department of Commerce, provide the following perspectives on a topic of significant interest to the patent and standards-setting communities: whether injunctive relief in judicial proceedings or exclusion orders in investigations under section 337 of the Tariff Act of 1930<sup>1</sup> are properly issued when a patent holder seeking such a remedy asserts standards-essential patents that are encumbered by a RAND or FRAND licensing commitment.<sup>2</sup>

The patent system promotes innovation and economic growth by providing incentives to inventors to apply their knowledge, take risks, and make investments in research and development and by publishing patents so that others can build on the disclosed knowledge with further innovations. These efforts, in turn, benefit society as a whole by disseminating knowledge and by providing new and valuable technologies,

<sup>&</sup>lt;sup>1</sup> Although the focus of the present policy statement is on exclusion orders issued pursuant to 19 U.S.C. § 1337, similar principles apply to the granting of injunctive relief in U.S. federal courts, which is governed by the standards set forth by the U.S. Supreme Court in *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388 (2006). The present policy statement is not, however, intended to be a complete legal analysis of injunctive relief under the *eBay* standard.

<sup>&</sup>lt;sup>2</sup> For purposes of this statement, a patent is RAND- or FRAND-encumbered where a patent holder has voluntarily agreed to license the patent on reasonable and non-discriminatory (RAND) terms or fair, reasonable, and non-discriminatory (FRAND) terms while participating in standards-setting activities at a standards-developing organization (SDO). In the United States, SDO members may commit to license all of their patents that are essential to the SDO standard on RAND terms. In other jurisdictions, SDO members may commit to license such patents on FRAND terms. For the purposes of this letter, F/RAND refers to both types of licensing commitments. Commentators frequently use the terms interchangeably to denote the same substantive type of commitment.

lower prices, improved quality, and increased consumer choice.<sup>3</sup> The DOJ and USPTO recognize that the right of a patent holder to exclude others from practicing patented inventions is fundamental to obtaining these benefits. It is incorporated into section 337 of the Tariff Act of 1930 itself, which forbids the unlawful "importation into the United States . . . of articles that . . . infringe a valid and enforceable United States patent." As noted in the Administration's 2010 Joint Strategic Plan on Intellectual Property Enforcement, "[s]trong enforcement of intellectual property rights is an essential part of the Administration's efforts to promote innovation and ensure that the U.S. is a global leader in creative and innovative industries." Accordingly, as historically has been the case, exclusion typically is the appropriate remedy when an imported good infringes a valid and enforceable U.S. patent.

Standards, and particularly voluntary consensus standards set by standardsdeveloping organizations (SDOs), have come to play an increasingly important role in our economy.<sup>6</sup> Voluntary consensus standards, i.e., agreements containing technical

<sup>&</sup>lt;sup>3</sup> See, e.g., Office of the U.S. Intellectual Prop. Enforcement Coordinator, Office of Mgmt. & Budget, Exec. Office of the President, 2010 Joint Strategic Plan on Intellectual Prop. Enforcement 3 (2010) [hereinafter 2010 Joint Strategic Plan], http://www.whitehouse.gov/sites/default/files/omb/assets/intellectualproperty/intellectualproperty strategic

http://www.whitehouse.gov/sites/default/files/omb/assets/intellectualproperty/intellectualproperty strategic\_plan.pdf. ("Enforcement of intellectual property rights is a critical and efficient tool we can use, as a government, to strengthen the economy, support jobs and promote exports. Intellectual property supports jobs across all industries, and in particular where there is a high degree of creativity, research and innovation.").

<sup>&</sup>lt;sup>4</sup> 19 U.S.C. § 1337(a)(1)(B)(i) (2006).

<sup>&</sup>lt;sup>5</sup> 2010 JOINT STRATEGIC PLAN, *supra* note 3, at 4.

<sup>&</sup>lt;sup>6</sup> Congress and the Executive Branch have recognized the benefits of voluntary consensus standards. SDOs play an essential role in the development of such standards. See, e.g., National Technology Transfer and Advancement Act of 1995, Pub. L. No. 104-113 § 12(d), 110 Stat. 775, 783 (1996), 15 U.S.C. § 272 note (2006)); OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, OMB CIRCULAR A-119, FED. PARTICIPATION IN THE DEV. AND USE OF VOLUNTARY CONSENSUS STANDARDS AND IN CONFORMITY ASSESSMENT ACTIVITIES (1998), www.whitehouse.gov/omb/circulars a119; see also Mem. from the Exec.

specifications or other criteria, are generally produced by private-sector organizations engaged in the development of standards.<sup>7</sup>

Voluntary consensus standards serve the public interest in a variety of ways, from helping protect public health and safety to promoting efficient resource allocation and production by facilitating interoperability among complementary products. 

Interoperability standards have paved the way for moving many important innovations into the marketplace, including the complex communications networks and sophisticated mobile computing devices that are hallmarks of the modern age. Indeed, voluntary consensus standards, whether mechanical, electrical, computer-related, or communications-related, have incorporated important technical advances that are

Office of the President on the Principles for Fed. Engagement in Standards Activities to Address Nat'l Priorities for the Heads of Exec. Dep'ts and Agencies (Jan. 17, 2012), <a href="http://www.whitehouse.gov/sites/default/files/omb/memoranda/2012/m-12-08">http://www.whitehouse.gov/sites/default/files/omb/memoranda/2012/m-12-08</a> 1.pdf.

<sup>&</sup>lt;sup>7</sup> Participation in their development is optional and the resulting standards are generally intended for voluntary use. U.S. Dep't of Commerce, Standards and Competitiveness: Coordinating for Results 5 (2004), <a href="http://www.ita.doc.gov/td/standards/pdf%20files/Standards%20and%20Competitiveness.pdf">http://www.ita.doc.gov/td/standards/pdf%20files/Standards%20and%20Competitiveness.pdf</a>. In the United States alone, there are approximately 50,000 private-sector voluntary standards developed by more than 600 organizations. *See Overview of the U.S. Standardization System*, Am. Nat'l Standards Inst., <a href="http://www.standardsportal.org/usa-en/standards-system.aspx">http://www.standardsportal.org/usa-en/standards-system.aspx</a> (last visited Dec. 7, 2012). The U.S. standards system is tremendously diverse, resulting in a system that is largely sectoral in focus. This is a logical approach because SDOs developing standards for use in each industrial sector, such as the information technology, telecommunications, automotive, medical devices, and building technology sectors, are most likely to understand that sector's needs and to know what standards best meet those needs. Many products, including those in the telecommunications sector, are based on multiple voluntary consensus standards developed by a number of different SDOs with different patent-licensing policies.

<sup>&</sup>lt;sup>8</sup> Due to the important role of F/RAND-licensed intellectual property in the standards process, we understand that the National Science and Technology Council Subcommittee on Standards, which includes broad representation from stakeholder agencies, plans to study this issue to explore any broader potential impacts of this, and other, related policies.

fundamental to the interoperability of many of the products on which consumers have come to relv.<sup>9</sup>

However, collaborative standards setting does not come without some risks. For example, when a standard incorporates patented technology owned by a participant in the standards-setting process, and the standard becomes established, it may be prohibitively difficult and expensive to switch to a different technology within the established standard or to a different standard entirely. As a result, the owner of that patented technology may gain market power and potentially take advantage of it by engaging in patent hold-up, which entails asserting the patent to exclude a competitor from a market or obtain a higher price for its use than would have been possible before the standard was set, when alternative technologies could have been chosen. This type of patent hold-up can cause other problems as well. For example, it may induce prospective implementers to postpone or avoid making commitments to a standardized technology or to make inefficient investments in developing and implementing a standard in an effort to protect themselves. Consumers of products implementing the standard could also be harmed to the extent that the hold-up generates unwarranted higher royalties and those royalties are passed on to consumers in the form of higher prices. 10

<sup>&</sup>lt;sup>9</sup> See Subcomm. On Standards, Nat'l Sci. & Tech. Council, Office of Sci. & Tech. Policy, Exec. Office of the President, Fed. Engagement in Standards Activities to Address Nat'l Priorities: Background and Proposed Policy Recommendations 1 (Oct. 10, 2011), <a href="http://standards.gov/upload/Federal">http://standards.gov/upload/Federal</a> Engagement in Standards Activities October12 final.pdf.

<sup>&</sup>lt;sup>10</sup> See U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, ANTITRUST ENFORCEMENT AND INTELLECTUAL PROPERTY RIGHTS: PROMOTING INNOVATION AND COMPETITION 35-36 (2007), <a href="http://www.justice.gov/atr/public/hearings/ip/222655">http://www.justice.gov/atr/public/hearings/ip/222655</a> htm.

In an effort to reduce the occurrences of opportunistic conduct in the adoption of voluntary consensus standards, while encouraging participants to include the best available technology in standards, some SDOs have relied on voluntary licensing commitments by their participants, including commitments to license the patents they own that are essential to the standard on F/RAND terms. SDOs and their members rely on these voluntary F/RAND commitments to facilitate the bilateral licensing negotiations necessary for successful widespread adoption of a standard and to provide assurances to implementers of the standard that the patented technologies will be available to parties seeking to license them.<sup>11</sup>

In making such voluntary F/RAND licensing commitments, patent holders that also sell products and services related to the standard benefit from expanded marketing opportunities, and patent holders that focus on licensing their inventions benefit from an expanded source of revenues. These incentives encourage patent holders to contribute their best technology to the standardization process. F/RAND commitments may also contribute to increased follow-on innovation by allowing non-discriminatory access to networks both to new entrants and to established market participants to introduce new generations of network-operable devices. <sup>12</sup> In light of these and other potential benefits, the United States continues to encourage systems that support voluntary F/RAND licensing—both domestically and abroad—rather than the imposition of one-size-fits-all

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<sup>&</sup>lt;sup>11</sup> By participating in the standards-setting activities at the SDO and by voluntarily making a F/RAND licensing commitment under the SDO's policies, the patent holder may be implicitly acknowledging that money damages, rather than injunctive or exclusionary relief, is the appropriate remedy for infringement in certain circumstances, as discussed below.

<sup>&</sup>lt;sup>12</sup> See Letter from Thomas O. Barnett, Assistant Att'y Gen., U.S. Dep't of Justice, to Robert A. Skitol, Esq. 7 (Oct. 30, 2006), <a href="http://www.usdoj.gov/atr/public/busreview/219380.pdf">http://www.usdoj.gov/atr/public/busreview/219380.pdf</a>.

mandates for royalty-free or below-market licensing, which would undermine the effectiveness of the standardization process and incentives for innovation.

A patent owner's voluntary F/RAND commitments may also affect the appropriate choice of remedy for infringement of a valid and enforceable standardsessential patent. In some circumstances, the remedy of an injunction or exclusion order may be inconsistent with the public interest. This concern is particularly acute in cases where an exclusion order based on a F/RAND-encumbered patent appears to be incompatible with the terms of a patent holder's existing F/RAND licensing commitment to an SDO. A decision maker could conclude that the holder of a F/RAND-encumbered, standards-essential patent had attempted to use an exclusion order to pressure an implementer of a standard to accept more onerous licensing terms than the patent holder would be entitled to receive consistent with the F/RAND commitment—in essence concluding that the patent holder had sought to reclaim some of its enhanced market power over firms that relied on the assurance that F/RAND-encumbered patents included in the standard would be available on reasonable licensing terms under the SDO's policy. 13 Such an order may harm competition and consumers by degrading one of the tools SDOs employ to mitigate the threat of such opportunistic actions by the holders of F/RAND-encumbered patents that are essential to their standards.

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<sup>&</sup>lt;sup>13</sup> Moreover, this type of hold-up may be exacerbated when patents are sold or otherwise transferred by their owners. If F/RAND licensing obligations do not travel with a transferred patent, the potential for hold-up from the network effects of a standard may be substantially increased. For this reason, we believe that F/RAND commitments should bind subsequent patent transferees. *See* Renata B. Hesse, Deputy Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice, Six "Small" Proposals for SSOs before Lunch: Remarks as Prepared for the ITU-T Patent Roundtable (Oct. 10, 2012), <a href="http://www.justice.gov/atr/public/speeches/287855.pdf">http://www.justice.gov/atr/public/speeches/287855.pdf</a>.

This is not to say that consideration of the public interest factors set out in the statute would always counsel against the issuance of an exclusion order to address infringement of a F/RAND-encumbered, standards-essential patent. An exclusion order may still be an appropriate remedy in some circumstances, such as where the putative licensee is unable or refuses to take a F/RAND license and is acting outside the scope of the patent holder's commitment to license on F/RAND terms. <sup>14</sup> For example, if a putative licensee refuses to pay what has been determined to be a F/RAND royalty, or refuses to engage in a negotiation to determine F/RAND terms, an exclusion order could be appropriate. Such a refusal could take the form of a constructive refusal to negotiate, such as by insisting on terms clearly outside the bounds of what could reasonably be considered to be F/RAND terms in an attempt to evade the putative licensee's obligation to fairly compensate the patent holder. 15 An exclusion order also could be appropriate if a putative licensee is not subject to the jurisdiction of a court that could award damages. This list is not an exhaustive one. Rather, it identifies relevant factors when determining whether public interest considerations should prevent the issuance of an exclusion order

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<sup>&</sup>lt;sup>14</sup> As courts have found, when a holder of a standards-essential patent makes a commitment to an SDO to license such patents on F/RAND terms, it does so for the intended benefit of members of the SDO and third parties implementing the standard. These putative licensees are beneficiaries with rights to sue for breach of that commitment. *See Microsoft Corp. v. Motorola, Inc.*, 864 F. Supp. 2d 1023, 1030-33 (W.D. Wash. 2012); *Microsoft Corp. v. Motorola, Inc.*, 854 F. Supp. 2d 993, 999-1001 (W.D. Wash. 2012); *see also Microsoft Corp. v. Motorola, Inc.*, 696 F.3d 872, 884 (9th Cir. 2012) (holding that the "district court's conclusions that Motorola's RAND declarations to the ITU created a contract enforceable by Microsoft as a third-party beneficiary (which Motorola concedes), and that this contract governs in some way what actions Motorola may take to enforce its ITU standard-essential patents (including the patents at issue in the German suit), were not legally erroneous"); *Apple, Inc. v. Motorola Mobility, Inc.*, --- F. Supp. 2d ---, No. 11-cv-178bbc, 2012 WL 3289835, at \*21-22 (W.D. Wis. Aug. 10, 2012); *Apple, Inc. v. Motorola Mobility, Inc.*, No. 11-cv-178bbc, 2011 WL 7324582, at \*7-11 (W.D. Wis. June 10, 2011).

<sup>&</sup>lt;sup>15</sup> We recognize that the risk of a refusal to license decreases where the putative licensee perceives a cost associated with delay and increases where the putative licensee believes its worst-case outcome after litigation is to pay the same amount it would have paid earlier for a license.

based on infringement of a F/RAND-encumbered, standards-essential patent or when shaping such a remedy.

Voluntary consensus standards-setting activities benefit consumers and are in the public interest. Although we recommend caution in granting injunctions or exclusion orders based on infringement of voluntarily F/RAND-encumbered patents essential to a standard, DOJ and USPTO strongly support the protection of intellectual property rights and believe that a patent holder who makes such a F/RAND commitment should receive appropriate compensation that reflects the value of the technology contributed to the standard. It is important for innovators to continue to have incentives to participate in standards-setting activities and for technological breakthroughs in standardized technologies to be fairly rewarded. By providing these views on ways in which opportunistic conduct by patent holders and putative licensees may be mitigated, the DOJ and USPTO seek to ensure that there is greater certainty concerning the meaning of a F/RAND commitment so that incentives to participate in voluntary consensus standards-setting activities continue to be strong.

The DOJ is the executive-branch agency charged with protecting U.S. consumers by promoting and protecting competition. The USPTO, an agency of the Department of Commerce, is the executive-branch agency charged with responsibility for examining patent applications, issuing patents, and—through the Secretary of Commerce—advising the President on domestic and certain international issues of intellectual property policy. The DOJ and USPTO are concerned about the potential impact of exclusion

<sup>&</sup>lt;sup>16</sup> See 35 U.S.C. §§ 1, 2 (2006).

orders on "competitive conditions in the United States" and "United States consumers" in some cases involving F/RAND-encumbered patents that are essential to a standard, and the conditions under which they may be denied. <sup>17</sup> Although, as described above, an exclusion order for infringement of F/RAND-encumbered patents essential to a standard may be appropriate in some circumstances, we believe that, depending on the facts of individual cases, the public interest may preclude the issuance of an exclusion order in cases where the infringer is acting within the scope of the patent holder's F/RAND commitment and is able, and has not refused, to license on F/RAND terms.

The approach the U.S. International Trade Commission (USITC) adopts in cases involving voluntarily F/RAND-encumbered patents that are essential to a standard will be important to the continued vitality of the voluntary consensus standards-setting process and thus to competitive conditions and consumers in the United States. In an era where competition and consumer welfare thrive on interconnected, interoperable network platforms, the DOJ and USPTO<sup>18</sup> urge the USITC to consider whether a patent holder has acknowledged voluntarily through a commitment to license its patents on F/RAND terms that money damages, rather than injunctive or exclusionary relief, is the appropriate remedy for infringement.

The USITC has a mandate to consider the "effect of such exclusion upon the public health and welfare, competitive conditions in the United States economy, the

<sup>&</sup>lt;sup>17</sup> 19 U.S.C. § 1337(d)(1) (2006).

<sup>&</sup>lt;sup>18</sup> See 19 U.S.C. § 1337(b)(2) (2006) (directing the USITC to consult with the Department of Justice and "other departments and agencies as it considers appropriate").

production of like or directly competitive articles in the United States, and United States consumers." As the USITC has observed, these public interest factors "are not meant to be given mere lip service," but rather "public health and welfare and the assurance of competitive conditions in the United States economy must be the <u>overriding</u> considerations in the administration of this statute."

The USITC may conclude, after applying its public interest factors, that exclusion orders are inappropriate in the circumstances described in more detail above.

Alternatively, it may be appropriate for the USITC, as it has done for other reasons in the past, to delay the effective date of an exclusion order for a limited period of time to provide parties the opportunity to conclude a F/RAND license.

Finally, determinations on the appropriate remedy in cases involving F/RAND-encumbered, standards-essential patents should be made against the backdrop of promoting both appropriate compensation to patent holders and strong incentives for innovators to participate in standards-setting activities.

<sup>&</sup>lt;sup>19</sup> 19 U.S.C. § 1337(d)(1).

<sup>&</sup>lt;sup>20</sup> Certain Inclined Field Acceleration Tubes & Components Thereof, Inv. No. 337-TA-67, USITC Pub. 1119, Comm'n Op., at 22 (Dec. 1980) (emphasis in original) (quoting S. REP. 93-1298, at 197 (1974), reprinted in 1974 U.S.C.C.A.N. 7186, 7330).

## Act of March 3, 1845

2 Stat. 732 (28th Congress, 2d Session)

CHAP. XLIII..—An Act to reduce the rates of postage, to limit the use and correct the abuse of the franking privilege, and for the prevention of frauds on the revenues of the Post Office Department.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That, from and after the first day of July next, members of Congress and delegates from Territories, may receive letters, not exceeding two ounces in weight, free of postage, during the recess of Congress, anything to the contrary in this act notwithstanding; and the same franking privilege which is granted by the act to the members of the two Houses of Congress, is hereby extended to the Vice President of the United States; and in lieu of the rates of postage now established by law, there shall be charged the following rates, viz: For every single letter, in manuscript, or paper of any kind by or upon which information shall be asked for or communicated in writing, or by marks and signs, conveyed in the mail, for any distance under 300 miles, five cents; and for any distance over 300 miles, ten cents: and for a double letter there shall be charged double these rates; and for a treble letter, treble these rates; and for a quadruple letter, quadruple these rates; and every letter or parcel not exceeding half an ounce in weight shall be deemed a single letter, and every additional weight of half an ounce, or additional weight of less than half an ounce, shall be charged with an additional single postage. And all drop letters, or letters placed in any post office, not for transmission by mail, but for delivery only, shall be charged with postage at the rate of two cents each. And all letters which shall hereafter be advertised as remaining over in any post office shall, when delivered out, be charged with the costs of advertising the same in addition to the regular postage, both to be accounted for as other postages now are.

SEC 2. "And be it further enacted, That all newspapers of no greater size or superficies than nineteen hundred square inches may be transmitted through the mail by the editors or publishers thereof, to all subscribers or other persons within thirty miles of the city, town, or other place in which the paper is or may be printed, free of any charge for postage whatever; and all newspapers of and under the size aforesaid, which shall be conveyed in the mail any distance beyond thirty miles from the place at which the same may be printed, shall be subject to the rates of postage chargeable upon the same under the thirtieth section of the act of Congress approved the third of March, one thousand eight hundred and twenty-five, entitled "An act to reduce into one the several acts for establishing and regulating the Post Office Department;" and upon all newspapers of greater size or superficial extent than nineteen hundred square inches, there shall be charged and collected the same rates of postage as are prescribed by this act to be charged on magazines and pamphlets.

SEC. 3. And be it further enacted, That all printed or lithographed circulars and handbills or advertisements, printed or lithographed on quarto post or single cap pa-

per, or paper not larger than single cap, folded, directed, and unsealed, shall be charged with postage at the rate of two cents for each sheet, and no more, whatever be the distance the same may be sent; and all pamphlets, magazines, periodicals, and every other kind and description of printed or other matter, (except newspapers,) which shall be unconnected with any manuscript communication whatever, and which it is or may be lawful to transmit by the mail of the United States, shall be charged with postage at the rate of two and a half cents for each copy sent, of no greater weight than one ounce, and one cent additional shall be charged for each additional ounce of the weight of every such pamphlet, magazine, matter, or thing, which may be transmitted through the mail, whatever be the distance, the same may be transported; and any fractional excess of not less than one-half of an ounce, in the weight of any such matter or thing, above one or more ounces, shall be charged for as if said excess amounted to a full ounce.

SEC. 4. And be it further enacted, That the Postmaster General be and he is hereby, authorized, upon all mail routes over or upon which the amount of matter usually transported, or which may be offered or deposited in the post office or post offices for transportation, is or may become so great as to threaten materially to retard the progress or endanger the security of the letter mail, or to cause any considerable augmentation of the cost of transporting the whole mail at the present rate of speed, to provide for the separate and more secure conveyance of the letter mail, at a speed at least equal to that at which the mail is now transported over such route, taking care to allow in no case of any greater delay, in the transportation of the other matters and things to be transported in the mail on any such route, than may appear to be absolutely necessary, regard being had to the cost of expediting its transportation, and the means at his disposal or under his control for effecting the same.

SEC. 5. And be it further enacted, That the twenty-seventh section of the act of Congress entitled "An act to reduce into one the several acts for establishing and regulating the Post Office Department," approved and sigued the third day of March, in the year one thousand eight hundred and twenty-five, and all other acts, and parts of acts granting and conferring upon any person whatsoever the right or privilege to receive and transmit through the mail, free of postage, letters, packets, newspapers, periodicals, or other matters, be, and the same are hereby, utterly abrogated, and repealed.

SEC. 6. And be it further enacted, That from and after the passage of this act, all officers of the Government of the United States, heretofore having the franking privilege, shall be authorized and required to keep an account of all postage charged to and payable by them, respectively, upon letters, packages, or other matters received through the mail, touching the duties or business of their respective offices; and said accounts for postage, upon being duly verified by said officers, respectively, shall be allowed and paid quarter yearly, out of the contingent fund of the bureau or department to which the officers aforesaid may respectively belong or be attached. And the three Assistant Postmasters General shall be entitled to have remitted by the postmas-

ter in Washington all postage charged upon letters, packages, or other matter, received by them, respectively, through the mail, touching the business of the Post Office Department or the particular branch of that business committed to them, respectively, and each of the said Assistant Postmasters General shall be, and hereby is, authorized to transmit through the mail, free of postage, any letters, packages, or other matters relating exclusively to his official duties, or to the business of the Post Office Department; but he shall, in every such case, endorse on the back of the letter or package so to be sent free of postage, over his own signature, the words "official business." And for any such endorsement falsely made, the person so offending shall forfeit and pay three hundred dollars. And the several deputy postmasters throughout the United States shall be authorized to charge, and have allowed to them in the settlement of their accounts with the Post Office Department all postage which they may have paid or had charged to them, respectively, for letters, packages, or other matters, received by them on the business of their respective offices or of the Post Office Department, upon a verification on oath of their accounts for the same, and the transmission of the charged letters as vouchers; and the said several deputy postmasters shall be, and hereby are, authorized to send through the mail, free of postage, all letters, and packages, which it may be their duty, or they may have occasion, to transmit to any person or place, and which shall relate exclusively to the business of their respective offices, or to the business of the Post Office Department, but in every such case, the deputy postmaster sending any such letter or package shall endorse thereon, over his own signature, the words "Post Office business." And for any and every such endorsement falsely made, the person making the same shall forfeit and pay three hundred dollars. And when the commissions of any postmaster amount to less than twenty-five dollars per annum, it shall be lawful for the Postmaster General to increase the rate of his commissions, provided that they do not exceed fifty per cent. On letter postage accruing at such office, and the Postmaster General is hereby required to cause accounts to be kept of the postage that would be chargeable at the rates prescribed in this act upon all matter passing free through the mail according to the provisions of this act; and the sums thus chargeable shall be paid to the Post Office Department from the contingent funds of the two Houses of Congress and of the other Departments of the Government for which such mail service may have been performed, and where there is no such fund, that they be paid out of the Treasury of the United States.

SEC. 7. And be it further enacted, That the act of Congress entitled "An act authorizing the Governors of the several States to transmit by mail certain books and documents," approved June the thirtieth, one thousand eight hundred and thirty-four, shall remain and continue in full force, any thing hereinbefore to the contrary not-withstanding; and the Members of Congress, the Delegates from Territories, the Secretary of the Senate, and the Clerk of the House of Representatives, shall be, and they are hereby, authorized to transmit, free of postage, to any post office within the United States, or the Territories thereof, any documents which have been or may be

printed by order of either House of Congress, any thing in this law to the contrary notwithstanding.

SEC. 8. And be it further enacted, That each member of the Senate, each member of the house of Representatives, and each Delegate from a Territory of the United States, the Secretary of the Senate, and the Clerk of the House of Representatives, may, during each session of Congress, and for a period of thirty days before the commencement and thirty days after the end of each and every session of Congress, send and receive through the mail, free of postage, any letter, newspaper, or packet, not exceeding two ounces in weight; and all postage charged upon any letters, packages, petitions, memorials, or other matters or things, received during any session of Congress, by any Senator, Member or Delegate of the House of Representatives, touching his official or legislative duties, by reason of any excess of weight, above two ounces, of the matter or thing so received, shall be paid out of the contingent fund of the House of which the person receiving the same may be a member. And they shall have the right to frank written letters from themselves during the whole year, as now authorized by law.

SEC. 9. And be it further enacted, That it shall not be lawful for any person or persons to establish any private express or expresses for the conveyance, nor in any manner to cause to be conveyed, or provide for the conveyance or transportation by regular trips, or at stated periods or intervals, from one city, town, or other place, to any other city, town, or place in the United States, between and from and to which cities, towns, or other places the United States mail is regularly transported, under the authority of the Post Office Department, of any letters, packets, or packages of letters, or other matter properly transmittable in the United States mail, except newspapers, pamphlets, magazines and periodicals; and each and every person offending against this provision, or aiding and assisting therein, or acting as such private express, shall, for each time any letter or letters, packet or packages, or other matter properly transmittable by mail, except newspapers, pamphlets, magazines, periodicals, shall or may be, by him, her, or them, or though his, her, or their means or instrumentality, in whole or in part, conveyed or transported, contrary to the true intent, spirit, and meaning of this section, forfeit and pay the sum of one hundred and fifty dollars.

SEC. 10. And be it further enacted, That it shall not be lawful for any stage-coach, railroad car, steamboat, packet boat, or other vehicle or vessel, nor any of the owners, managers, servants, or crews of either, which regularly performs trips at stated periods on a post route, or between two or more cities, towns, or other places, from one to the other of which the United States mail is regularly conveyed under the authority of the Post Office Department, to transport or convey, otherwise than in the mail, any letter or letters, packet or packages of letters, or other mailable matter whatsoever, except such as may have relation to some part of the cargo of such steamboat, packet boat, or other vessel, or to some article at the same time conveyed by the same stage-coach, railroad car, or other vehicle, and excepting also, newspapers, pamphlets, magazines, and periodicals; and for every such offence, the owner or owners of the

stage-coach, railroad car, steamboat, packet boat, or other vehicle or vessel, shall forfeit and pay the sum of one hundred dollars, and the driver, captain, conductor, or person having charge of any such stage-coach, railroad car, steamboat, packet boat, or other vehicle or vessel, at the time of the commission of any such offence, and who shall not at that time be the owner thereof, in whole nor in part, shall, in like manner, forfeit and pay, in every such case of offence, the sum of fifty dollars.

SEC. 11. And be it further enacted, That the owner of owners of every stage-coach, railroad car, steamboat, or other vehicle or vessel, which shall, with the knowledge or connivance of the driver, conductor, captain, or other person having charge of any such stage-coach, railroad car, steamboat, or other vessel or vehicle, convey or transport any person or persons acting or employed as a private express for the conveyance of letters, packets, or packages of letters, or other mailable matter, and actually in possession of such mailable matter, for the purpose of transportation, contrary to the spirit, true intent, and meaning of the preceding sections of this law, shall be subject to the like fines and penalties as are hereinbefore provided and directed in the case of persons acting as such private expresses, and of persons employing the same; but nothing in this act contained shall be construed to prohibit the conveyance or transmission of letters, packets, or packages, or other matter, to any part of the United States, by private hands, no compensation being tendered or received therefor in any way, or by a special messenger employed only for the single particular occasion.

SEC. 12. And be it further enacted, That all persons whatsoever who shall, after the passage of this act, transmit by any private express, or other means by this act declared to be unlawful, any letter or letters, package or packages, or other mailable matter, excepting newspapers, pamphlets, magazines, and periodicals, or who shall place or cause to be deposited at any appointed place, for the purpose of being transported by such unlawful means, any matter or thing properly transmittable, by mail, excepting newspapers, pamphlets, magazines and periodicals, or who shall deliver any such matter, excepting newspapers, pamphlets, magazines and periodicals for transmission to any agent or agents of such unlawful expresses, shall, for each and every offence, forfeit and pay the sum of fifty dollars.

SEC. 13. And be it further enacted, That nothing in this act contained shall have the effect, or be construed to prohibit the conveyance or transportation of letters by steamboats, as authorized by the sixth section of the act entitled "An act to reduce into one the several acts for establishing and regulating the Post Office Department, approved the third of March, 1825." Provided, That the requirements of said sixth section of said act be strictly complied with, by the delivery, within the time specified by said act, of all letters so conveyed, not relating to the cargo, or some port thereof, to the postmaster or other authorized agent of the Post Office Department at the port or place to which said letters may be directed, or intended to be delivered over from said boat; and the postmaster or other agent of the Post Office Department shall charge and collect upon all letters or other mailable matter, so delivered to him, except newspapers, pamphlets, magazines, and periodicals, the same rates of postage

as would have been charged upon said letters had they been transmitted by mail from the port of place at which they were placed on board the steamboat from which they were received; but it is hereby expressly provided, that all the pains and penalties provided by this act, for any violation of the provisions of the eleventh section of this act, shall attach in every case to any steamboat, or to the owners and persons having charge thereof, the captain or other person having charge of which shall not, as aforesaid, comply with the requirements of the sixth section of the said law of 1825. And no postmaster shall receive, to be conveyed by the mail, any packet which shall weigh more than three pounds.

SEC. 14. And be it further enacted, That the Postmaster General shall have power, and he is hereby authorized, to contract with the owners or commanders of any steamboat plying upon the Western or other waters of the United States, for the transportation of the mail for any length of time or number of trips, less than the time for which contracts for transporting the mail of the United States are now usually made under existing laws, and without the previous advertisements now required before entering into such contracts, whenever in his opinion the public interest and convenience will be promoted thereby: *Provided*, That the price to be paid for such service shall in no case be greater than the average rate paid for transporting the mail upon the route he may so for a less time contract for the transportation of the mail upon.

SEC. 15. And be it further enacted, That "mailable matter," and "matter properly transmittable by mail," shall be deemed and taken to mean, all letters and newspapers, and all magazines and pamphlets periodically published, or which may be published in regular series or in successive numbers, under the same title, though at irregular intervals, and all other written or printed matter whereof each copy or number shall not exceed eight ounces in weight, except bank notes, sent in packages or bundles, without written letters accompanying them; but bound books, of any size, shall not be held to be included within the meaning of these terms. And any packet or packets, of whatever size or weight, being made up of any such mailable matter, shall subject all persons concerned in transporting the same to all the penalties of this law equally as if it or they were not so made up into a packet or packages. But nothing in this act contained shall be so construed as to prohibit any person whatsoever from transporting, or causing to be transported, over any mail route, or any road or way parallel thereto, any books, magazines, or pamphlets, or newspapers, not marked, directed, or intended for immediate distribution to subscribers or others, but intended for sale as merchandise, and transported in the usual mode of transporting merchandise over the particular route used, and sent or consigned to some bona fide dealer or agent for the sale thereof; nor shall any thing herein be construed to interfere with the right of any traveller to have and take with him or her, for his or her own use, any book, pamphlet, magazine or newspaper.

SEC. 16. And be it further enacted, That the term "newspaper," hereinbefore used, shall be, and the same is hereby defined to be, any printed publication, issued in

numbers, consisting of not more than two sheets, and published at short stated intervals of not more than one month, conveying intelligence of passing events, and bona fide extras and supplements of any such publication. And nothing herein contained shall be so construed as to prevent the free exchange of newspapers between the publishers thereof, as provided for under the twenty-ninth section of the act entitled, "An act to reduce into one the several acts for establishing and regulating the Post Office Department, approved the third day of March, 1825."

SEC. 17. And be it further enacted, That all pecuniary penalties and forfeitures, incurred under this act, shall be one half the use of the person or persons informing and prosecuting the same, and the other half to the use of the United States and shall be paid over to the Postmaster General and accounted for by him as other moneys of the department; and all causes of action arising under this act, may be sued, and all offenders against this act may be prosecated before the justices of the peace, magistrates, or other judicial courts of the several States and of the several Territories of the United States, they having competent jurisdiction, by the laws of such States or Territories, to the trial of claims and demands of as great value, and of the prosecutions, where the punishments are of as great extent; and such justices, magistrates, or judiciary, shall take cognizance thereto and proceed to judgment and execution as in other cases.

SEC. 18. And be it further enacted, That it shall be the duty of the Postmaster General in all future lettings of contracts for the transportation of the mail, to let the same, in every case, to the lowest bidder, tendering sufficient guarantees for faithful performance, without other reference to the mode of such transportation than may be necessary to provide for the due celerity, certainty, and security of such transportation; nor shall any new contractor hereafter be required to purchase out, or take at a valuation, the stock or vehicles of any previous contractor for the same route And all advertisements made under the orders of the Postmaster General, in a newspaper or newspapers, of letters uncalled for in any post office, shall be inserted in the paper or papers, of the town or place where the office advertising may be situated, having the largest circulation, provided the editor or editors of such paper or papers shall agree to insert the same for a price not greater than that now fixed by law; and in case of question or dispute as to the amount of the circulation of any papers the editors of which may desire this advertising, it shall be the duty of the postmaster to receive evidence and decide upon the fact.

SEC. 19. And it shall be further enacted, That to insure, as far as may be practicable, an equal and just rate of compensation, according to the service performed, among the several railroad companies in the United States, for the transportation of the mail, it shall be the duty of the Postmaster General to arrange and divide the railroad routes, including those in which the service is partly by railroad and partly by steamboats, into three classes according to the size of the mails the speed with which they are conveyed, and the importance of the service; and it shall be lawful for him to contract for conveying the mail with any such railroad company, either with or without

advertising for such contract: *Provided*, That, for the conreyance of the mail on any railroad of the first class, he shall not pay a higher rate of compensation than is now allowed by law; nor for carrying the mail on any railroad of the second class, a greater compensation than one hundred dollars per mile per annum; nor for carrying the mail on any railroad of the third class, a greater compensation than fifty dollars per mile annum. And in case the Postmaster General shall not be able to conclude a contract for carrying the mail on any of such railroad routes at a compensation not exceeding the aforesaid maximum rates, or for what he may deem a reasonable and fair compensation for the service to be performed, it shall be lawful for him to separate the letter mail from the residue of the mail and to contract, either with or without advertising, for conveying the letter mail over such route, by horse express or otherwise, at the greatest speed that can reasonably be obtained; and also to contract for carrying over such route the residue of the mail, in wagons or otherwise, at a slower rate of speed, *Provided*, That if one-half of the service, on any railroad, is required to be performed in the night season, it shall be lawful for the Postmaster General to pay twenty-five per cent in addition to the aforesaid maximum rates of allowance: And provided further, That if it shall be found necessary to convey over any railroad route more than two mails daily, it shall be lawful for the Postmaster General to pay such additional compensation as he may think just and reasonable, having reference to the service performed and the maximum rate of allowance established by this act.

SEC. 20. And be it further enacted, That all causes of action arising under this act may be sued, and all offenders against this act may be prosecuted, before any circuit or district court of the United States, of the District of Columbia or of the Territories of the United States.

SEC. 21. And be it further enacted, That for the purpose of guarding against the possibility of any embarrassment in the operations of the Post Office Department consequent upon any deficiency of the revenues of said department which may be occasioned by the reduction of the rates of postage by this act made, there be, and hereby is, appropriated the sum of seven hundred and fifty thousand dollars, to be paid out of any money in the Treasury not otherwise appropriated, and to be placed to the credit of the Post Office Department in the Treasury of the United States, to be applied, under the direction of the Postmaster General, to supply any deficiency in the regular revenues from postage, in the same manner as the revenues of said department are now by law applied.

SEC. 22. And be it further enacted, That in case the amount of postages collected from the rates of postage prescribed by this act, with the annual appropriation from the treasury of seven hundred and fifty thousand dollars herein granted, shall prove insufficient to defray the expense of the mail service throughout the United States to an extent equal to what is now enjoyed by the public, and also the expense of extending and enlarging the same in due proportion with the increase and expansion of the population, particularly in the new States and Territories, the deficiency that may so arise shall be paid out of any moneys in the Treasury not otherwise appropriated:

*Provided*, That the amount of expenditure for the Post Office Department shall not in the entire aggregate, exclusive of salaries of officers, clerks, and messengers, of the General Post Office, and the contingent fund of the same, exceed the annual amount of four million five hundred thousand dollars.

SEC. 23. And be it further enacted, That nothing in this act contained shall be construed to repeal the laws heretofore enacted, granting the franking privilege to the President of the United States when in office, and to all ex-Presidents, and to the widows of the former Presidents Madison and Harrison.

APPROVED, March 3, 1845.

## U.S. Postal Service v. Council of Greenburgh Civic Associations

453 U.S. 114 (1981)

Justice REHNQUIST delivered the opinion of the Court: We noted probable jurisdiction to decide whether the United States District Court for the Southern District of New York correctly determined that 18 U.S.C. § 1725, which prohibits the deposit of unstamped "mailable matter" in a letterbox approved by the United States Postal Service, unconstitutionally abridges the First Amendment rights of certain civic associations in Westchester County, N.Y., 449 U.S. 1076 (1981). \*\*\*

I

Appellee Council of Greenburgh Civic Associations (Council) is an umbrella organization for a number of civic groups in Westchester County, N.Y. Appellee Saw Mill Valley Civic Association is one of the Council's member groups. In June 1976, the Postmaster in White Plains, N.Y., notified the Chairman of the Saw Mill Valley Civic Association that the association's practice of delivering messages to local residents by placing unstamped notices and pamphlets in the letterboxes of private homes was in violation of 18 U.S.C. § 1725, which provides:

"Whoever knowingly and willfully deposits any mailable matter such as statements of accounts, circulars, sale bills, or other like matter, on which no postage has been paid, in any letter box established, approved, or accepted by the Postal Service for the receipt or delivery of mail matter on any mail route with intent to avoid payment of lawful postage thereon, shall for each such offense be fined not more than \$300."

Saw Mill Valley Civic Association and other Council members were advised that if they continued their practice of placing unstamped notices in the letterboxes of private homes it could result in a fine not to exceed \$300.

In February 1977, appellees filed this suit in the District Court for declaratory and injunctive relief from the Postal Service's threatened enforcement of § 1725. Appellees contended that the enforcement of § 1725 would inhibit their communication

with residents of the town of Greenburgh and would thereby deny them the freedom of speech and freedom of the press secured by the First Amendment.

\*\*\* [T]he Postal Service offered three general justifications for § 1725: (1) that § 1725 protects mail revenues; (2) that it facilitates the efficient and secure delivery of the mails; and (3) that it promotes the privacy of mail patrons. More specifically, the Postal Service argued that elimination of § 1725 could cause the overcrowding of mailboxes due to the deposit of civic association notices. Such overcrowding would in turn constitute an impediment to the delivery of the mails. Testimony was offered that § 1725 aided the investigation of mail theft by restricting access to letterboxes, thereby enabling postal investigators to assume that anyone other than a postal carrier or a householder who opens a mailbox may be engaged in the violation of the law. On this point, a postal inspector testified that 10% of the arrests made under the external mail theft statute, 18 U.S.C. § 1708, resulted from surveillance-type operations which benefit from enforcement of § 1725. Testimony was also introduced that § 1725 has been particularly helpful in the investigation of thefts of government benefit checks from letterboxes.

The Postal Service introduced testimony that it would incur additional expense if § 1725 were either eliminated or held to be inapplicable to civic association materials. If delivery in mailboxes were expanded to permit civic association circulars—but not other types of nonmailable matter such as commercial materials—mail carriers would be obliged to remove and examine individual unstamped items found in letterboxes to determine if their deposit there was lawful. Carriers would also be confronted with a larger amount of unstamped mailable matter which they would be obliged to separate from outgoing mail. The extra time resulting from these additional activities, when computed on a nationwide basis, would add substantially to the daily cost of mail delivery.

The final justification offered by the Postal Service for § 1725 was that the statute provided significant protection for the privacy interests of postal customers. Section 1725 provides postal customers the means to send and receive mails without fear of their correspondence becoming known to members of the community.

The Postal Service also argued at trial that the enforcement of § 1725 left appellees with ample alternative means of delivering their message. The appellees can deliver their messages either by paying postage, by hanging their notices on doorknobs, by placing their notices under doors or under a doormat, by using newspaper or nonpostal boxes affixed to houses or mailbox posts, by telephoning their constituents, by engaging in person-to-person delivery in public areas, by tacking or taping their notices on a door post or letterbox post, or by placing advertisements in local newspapers. A survey was introduced comparing the effectiveness of certain of these alternatives which arguably demonstrated that between 70-75% of the materials placed under doors or doormats or hung from doorknobs were found by the homeowner whereas approximately 82% of the items placed in letterboxes were found. This incidental difference, it was argued, cannot be of constitutional significance.

The District Court found the above arguments of the Postal Service insufficient to sustain the constitutionality of § 1725 at least as applied to these appellees. \*\*\*

II

The present case is a good example of Justice Holmes' aphorism that "a page of history is worth a volume of logic." *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921). For only by review of the history of the postal system and its present statutory and regulatory scheme can the constitutional challenge to § 1725 be placed in its proper context.

By the early 18th century, the posts were made a sovereign function in almost all nations because they were considered a sovereign necessity. Government without communication is impossible, and until the invention of the telephone and telegraph, the mails were the principal means of communication. Kappel Commission, Toward Postal Excellence, Report of the President's Commission on Postal Organization 47 (Comm. Print 1968). Little progress was made in developing a postal system in Colonial America until the appointment of Benjamin Franklin, formerly Postmaster at Philadelphia, as Deputy Postmaster General for the American Colonies in 1753. In 1775, Franklin was named the first Postmaster General by the Continental Congress, and, because of the trend toward war, the Continental Congress undertook its first serious effort to establish a secure mail delivery organization in order to maintain communication between the States and to supply revenue for the Army. D. Adie, An Evaluation of Postal Service Wage Rates 2 (American Enterprise Institute, 1977).

Given the importance of the post to our early Nation, it is not surprising that when the United States Constitution was ratified in 1789, Art. I, § 8, provided Congress the power "To establish Post Offices and post Roads" and "To make all Laws which shall be necessary and proper" for executing this task. The Post Office played a vital yet largely unappreciated role in the development of our new Nation. Stagecoach trails which were improved by the Government to become post roads quickly became arteries of commerce. Mail contracts were of great assistance to the early development of new means of transportation such as canals, railroads, and eventually airlines. During this developing stage, the Post Office was to many citizens situated across the country the most visible symbol of national unity.

The growth of postal service over the past 200 years has been remarkable. Annual revenues increased from less than \$40 million in 1790 to close to \$200 million in 1829 when the Postmaster General first became a member of the Cabinet. However, expenditures began exceeding revenues as early as the 1820's as the postal structure struggled to keep pace with the rapid growth of the country westward. Because of this expansion, delivery costs to the South and West raised average postal costs nationally. To prevent competition from private express services, Congress passed the Postal Act of 1845, which prohibited competition in letter mail and established what is today referred to as the "postal monopoly."

More recently, to deal with the problems of increasing deficits and shortcomings in the overall management and efficiency of the Post Office, Congress passed the Postal Reorganization Act of 1970. This Act transformed the Post Office Department into a Government-owned corporation called the United States Postal Service. The Postal Service today is among the largest employers in the world, with a work force nearing 700,000 processing 106.3 billion pieces of mail each year. The Postal Service is the Nation's largest user of floor space, and the Nation's largest nonmilitary purchaser of transport, operating more than 200,000 vehicles. Its rural carriers alone travel over 21 million miles each day and its city carriers walk or drive another million miles a day. Its operating budget in fiscal 1980 exceeded \$17 billion.

Not surprisingly, Congress has established a detailed statutory and regulatory scheme to govern this country's vast postal system. See 39 U.S.C. § 401 et seq. and the Domestic Mail Manual (DMM), which has been incorporated by reference in the Code of Federal Regulations, 39 CFR pt. 3 (1980). Under 39 U.S.C. § 403(a), the Postal Service is directed to "plan, develop, promote, and provide adequate and efficient postal services at fair and reasonable rates and fees." Section 403(b)(1) similarly directs the Postal Service "to maintain an efficient system of collection, sorting, and delivery of the mail nationwide," and under 39 U.S.C. § 401 the Postal Service is broadly empowered to adopt rules and regulations designed to accomplish the above directives.

Acting under this authority, the Postal Service has provided by regulation that both urban and rural postal customers must provide appropriate mail receptacles meeting detailed specifications concerning size, shape, and dimensions. By regulation, the Postal Service has also provided that "[e]very letter box or other receptacle intended or used for the receipt or delivery of mail on any city delivery route, rural delivery route, highway contract route, or other mail route is designated an authorized depository for mail within the meaning of 18 U.S.C. [§] 1725." DMM 151.1. A letterbox provided by a postal customer which meets the Postal Service's specifications not only becomes part of the Postal Service's nationwide system for the receipt and delivery of mail, but is also afforded the protection of the federal statutes prohibiting the damaging or destruction of mail deposited therein. See 18 U.S.C. §§ 1702, 1705, and 1708.

It is not without irony that this elaborate system of regulation, coupled with the historic dependence of the Nation on the Postal Service, has been the causal factor which led to this litigation. For it is because of the very fact that virtually every householder wishes to have a mailing address and a receptacle in which mail sent to that address will be deposited by the Postal Service that the letterbox or other mail receptacle is attractive to those who wish to convey messages within a locality but do not wish to purchase the stamp or pay such other fee as would permit them to be transmitted by the Postal Service. To the extent that the "alternative means" eschewed by the appellees and found to be inadequate alternatives by the District Court are in fact so, it is in no small part attributable to the fact that the typical mail

patron first looks for written communications from the "outside world" not under his doormat, or inside the screen of his front door, but in his letterbox. Notwith-standing the increasing frequency of complaints about the rising cost of using the Postal Service, and the uncertainty of the time which passes between mailing and delivery, written communication making use of the Postal Service is so much a fact of our daily lives that the mail patron watching for the mailtruck, or the jobholder returning from work looking in his letterbox before he enters his house, are commonplaces of our society. Indeed, according to the appellees the receptacles for mailable matter are so superior to alternative efforts to communicate printed matter that all other alternatives for deposit of such matter are inadequate substitutes for postal letterboxes.

Postal Service regulations, however, provide that letterboxes and other receptacles designated for the delivery of mail "shall be used exclusively for matter which bears postage." DMM 151.2. Section 1725 merely reinforces this regulation by prohibiting, under pain of criminal sanctions, the deposit into a letterbox of any mailable matter on which postage has not been paid. \*\*\*

Section 1725 was enacted in 1934 "to curb the practice of depositing statements of accounts, circulars, sale bills, etc., in letter boxes established and approved by the Postmaster General for the receipt or delivery of mail matter without payment of postage thereon by making this a criminal offense." H.R. Rep. No. 709, 73d Cong., 2d Sess., 1 (1934). Both the Senate and House Committees on Post Offices and Post Roads explained the principal motivation for § 1725 as follows:

"Business concerns, particularly utility companies, have within the last few years adopted the practice of having their circulars, statements of account, etc., delivered by private messenger, and have used as receptacles the letter boxes erected for the purpose of holding mail matter and approved by the Post Office Department for such purpose. This practice is depriving the Post Office Department of considerable revenue on matter which would otherwise go through the mails, and at the same time is resulting in the stuffing of letter boxes with extraneous matter." *Ibid.*; S. Rep. No. 742, 73d Cong., 2d Sess., 1 (1934).

Nothing in any of the legislation or regulations recited above requires any person to become a postal customer. Anyone is free to live in any part of the country without having letters or packages delivered or received by the Postal Service by simply failing to provide the receptacle for those letters and packages which the statutes and regulations require. Indeed, the provision for "General Delivery" in most post offices enables a person to take advantage of the facilities of the Postal Service without ever having provided a receptacle at or near his premises conforming to the regulations of the Postal Service. What the legislation and regulations do require is that those persons who *do* wish to receive and deposit their mail at their home or business do so under the direction and control of the Postal Service.

#### Ш

As early as the last century, this Court recognized the broad power of Congress to act in matters concerning the posts:

"The power vested in Congress 'to establish post-offices and post-roads' has been practically construed, since the foundation of the government, to authorize not merely the designation of the routes over which the mail shall be carried, and the offices where letters and other documents shall be received to be distributed or forwarded, but the carriage of the mail, and all measures necessary to secure its safe and speedy transit, and the prompt delivery of its contents. The validity of legislation describing what should be carried, and its weight and form, and the charges to which it should be subjected, has never been questioned.... The power possessed by Congress embraces the regulation of the entire Postal System of the country. The right to designate what shall be carried necessarily involves the right to determine what shall be excluded." Ex parte Jackson, 96 U.S. 727, 732 (1878).

However broad the postal power conferred by Art. I may be, it may not of course be exercised by Congress in a manner that abridges the freedom of speech or of the press protected by the First Amendment to the Constitution. In this case we are confronted with the appellees' assertion that the First Amendment guarantees them the right to deposit, without payment of postage, their notices, circulars, and flyers in letterboxes which have been accepted as authorized depositories of mail by the Postal Service. \*\*\*

What is at issue in this case is solely the constitutionality of an Act of Congress which makes it unlawful for persons to use, without payment of a fee, a letterbox which has been designated an "authorized depository" of the mail by the Postal Service. As has been previously explained, when a letterbox is so designated, it becomes an essential part of the Postal Service's nationwide system for the delivery and receipt of mail. In effect, the postal customer, although he pays for the physical components of the "authorized depository," agrees to abide by the Postal Service's regulations in exchange for the Postal Service agreeing to deliver and pick up his mail.

Appellees' claim is undermined by the fact that a letterbox, once designated an "authorized depository," does not at the same time undergo a transformation into a "public forum" of some limited nature to which the First Amendment guarantees access to all comers. There is neither historical nor constitutional support for the characterization of a letterbox as a public forum. Letterboxes are an essential part of the nationwide system for the delivery and receipt of mail, and since 1934 access to them has been unlawful except under the terms and conditions specified by Congress and the Postal Service. As such, it is difficult to accept appellees' assertion that because it may be somewhat more efficient to place their messages in letterboxes there is a First Amendment right to do so. \*\*\*

Indeed, it is difficult to conceive of any reason why this Court should treat a letterbox differently for First Amendment access purposes than it has in the past treated the military base in *Greer v. Spock*, 424 U.S. 828 (1976), the jail or prison in *Adderley v. Florida*, 385 U.S. 39 (1966), and *Jones v. North Carolina Prisoners' Union*, 433 U.S. 119 (1977), or the advertising space made available in city rapid transit cars in *Lehman v. City of Shaker Heights*, 418 U.S. 298 (1974). In all these cases, this Court recognized that the First Amendment does not guarantee access to property simply because it is owned or controlled by the government. In *Greer v. Spock, supra*, the Court cited approvingly from its earlier opinion in *Adderley v. Florida, supra*, wherein it explained that "[t]he State, no less than a private owner of property, has power to preserve the property under its control for the use to which it is lawfully dedicated." 424 U.S., at 836.

This Court has not hesitated in the past to hold invalid laws which it concluded granted too much discretion to public officials as to who might and who might not solicit individual homeowners, or which too broadly inhibited the access of persons to traditional First Amendment forums such as the public streets and parks. But it is a giant leap from the traditional "soapbox" to the letter-box designated as an authorized depository of the United States mails, and we do not believe the First Amendment requires us to make that leap.

IV

It is thus unnecessary for us to examine § 1725 in the context of a "time, place, and manner" restriction on the use of the traditional "public forums" referred to above. This Court has long recognized the validity of reasonable time, place, and manner regulations on such a forum so long as the regulation is content-neutral, serves a significant governmental interest, and leaves open adequate alternative channels for communication. But since a letterbox is not traditionally such a "public forum," the elaborate analysis engaged in by the District Court was, we think, unnecessary. \*\*\*

V

From the time of the issuance of the first postage stamp in this country at Brattleboro, Vt., in the fifth decade of the last century, through the days of the governmentally subsidized "Pony Express" immediately before the Civil War, and through the less admirable era of the Star Route Mail Frauds in the latter part of that century, Congress has actively exercised the authority conferred upon it by the Constitution "to establish Post Offices and Post Roads" and "to make all laws which shall be necessary and proper" for executing this task. While Congress, no more than a suburban township, may not by its own *ipse dixit* destroy the "public forum" status of streets and parks which have historically been public forums, we think that for the reasons stated a letterbox may not properly be analogized to streets and parks. It is enough for our purposes that neither the enactment nor the enforcement of § 1725 was geared in any way to the content of the message sought to be placed in the letterbox. The judgment of the District Court is accordingly

Reversed.

[Omitted opinions: Justice Brennan, concurring in the judgment; Justice White, concurring in the judgment; Justice Marshall, dissenting; and Justice Stevens, dissenting]

## Advanced Television Systems and their Impact upon the Existing Television Broadcast Service: Fourth Report and Order

FCC 96-493 (Dec. 27, 1996)

#### I. Introduction

1. In this, the Fourth Report and Order in our digital television ("DTV") proceeding, we adopt a standard for the transmission of digital television. This standard is a modification of the ATSC DTV Standard proposed in the Fifth Further Notice of Proposed Rule Making and is consistent with a consensus agreement voluntarily developed by a broad cross-section of parties, including the broadcasting, consumer equipment manufacturing and computer industries. As explained below, the Standard we adopt does not include requirements with respect to scanning formats, aspect ratios, and lines of resolution. For clarity, we will refer to this modified standard as the "DTV Standard." \*\*\*

## II. Background

- 4. This proceeding began in 1987, when we issued our first inquiry into the potential for advanced television ("ATV") services. \*\*\* In the fall of 1987, a few months after initiating this rulemaking proceeding, we established the Advisory Committee on Advanced Television Service ("Advisory Committee" or "ACATS") to provide recommendations concerning technical, economic and public policy issues associated with the introduction of ATV service. Early in the process we decided that no additional spectrum would be allocated for television broadcasting, but that existing broadcasters should be permitted to upgrade their transmission technology so long as the public remains served throughout any transition period. We later decided "that an ATV system that transmits the increased information of an ATV signal in a separate 6 MHz channel independent from an existing NTSC channel will allow for ATV introduction in the most non-disruptive and efficient manner." As the proceeding progressed, all-digital advanced television systems were developed and we began to refer to advanced television as digital television ("DTV") in recognition that, with the development of the technology, it was decided any ATV system was certain to be digital. In February of 1993, the Advisory Committee reported that a digital HDTV system was achievable, but that all four competing digital systems then under consideration would benefit significantly from further development and none would be recommended over the others at that time. In May of 1993, seven companies and institutions that had been proponents of the four tested digital ATV systems, joined together in a "Grand Alliance" to develop a final digital ATV system for the standard. Over the next two-and-a-half years, that system was developed, extensively tested, and is documented in the ATSC DTV Standard. On November 28, 1995, the Advisory Committee voted to recommend the Commission's adoption of the ATSC DTV Standard.
- 5. The system described by the ATSC DTV Standard is generally recognized to represent a significant technological breakthrough. It includes discrete subsystem de-

scriptions, or "layers," for video source coding and compression, audio source coding and compression, service multiplex and transport, and RF/transmission. In addition to being able to broadcast one, and under some circumstances two, high definition television ("HDTV") programs, the Standard allows for multiple streams, or "multicasting," of Standard Definition Television ("SDTV") programming at a visual quality better than the current analog signal. Utilizing this Standard, broadcasters can transmit three, four, five, or more such program streams simultaneously. The Standard allows for the broadcast of literally dozens of CD-quality audio signals. It permits the rapid delivery of large amounts of data; an entire edition of the local daily newspaper could be sent, for example, in less than two seconds. Other material, whether it be telephone directories, sports information, stock market updates, information requested concerning certain products featured in commercials, computer software distribution, interactive education materials, or virtually any other type of information access can also be provided. It allows broadcasters to send, video, voice and data simultaneously and to provide a range of services dynamically, switching easily and quickly from one type of service to another. For example, a broadcaster could transmit a news program consisting of four separate, simultaneous SDTV program streams for local news, national news, weather and sports; then transmit an HDTV commercial with embedded data about the product; then transmit a motion picture in an HDTV format simultaneously with unrelated data. As stated by the HDTV Grand Alliance:

The ATSC DTV Standard based on the Grand Alliance system represents by far the world's best digital broadcast television system, with unmatched flexibility and unprecedented ability to incorporate future improvements. Implementing this technology will dramatically increase the technical quality of broadcast television, helping to preserve for consumers and for our democratic society the benefits of a vibrant and healthy free over-the-air television service in the future. In addition, deploying this technology will give consumers access to a host of potential information services that can help meet pressing needs in health care, education and other areas....

\*\*\* 7. \*\*\* On November 25, 1996, representatives of a broad cross section of the broadcast, computer and receiver manufacturing industries reached an agreement ("the Agreement") and, the following day, submitted it to the Commission. The Agreement stated that the FCC should adopt the voluntary ATSC DTV Standard \*\*\*. On November 27, 1996, the Commission released a Public Notice soliciting comment on the Agreement. Comments were filed December 6, 1996.

### III. Comments

8. Technical Standards for DTV. \*\*\* There is widespread agreement among commenters that selection of a DTV standard should be analyzed in terms of network effects, that is the indirect benefits that accrue to other DTV users when any particular user adopts DTV. Broadcasters, computer interests and cable interests agree that broadcasting is a network product; that issues surrounding selection of a DTV stand-

ard are influenced by network effects; and that in order to evaluate the various alternatives, it is important to understand how network effects will operate. While commenters agreed on a common analytical framework, they disagreed on the relative severity of the startup, coordination and potential splintering problems facing digital broadcast television. Startup refers to the situation where everyone would be better off adopting DTV technology but no one has the incentive to move first. Coordination is the collaborative effort by broadcasters, consumer equipment manufacturers, and program producers that is necessary to introduce DTV. Splintering refers to the breakdown of the consensus or agreement to use the DTV Standard.

- 9. Commenters also disagreed on the availability and effectiveness of market-based mechanisms to solve these problems and to facilitate the goals and objectives established in this proceeding. Broadcasters, equipment manufacturers and some consumer groups contend that DTV has startup, coordination and splintering problems that are more severe than those of other network industries and that a DTV standard adopted by the Commission is needed to overcome these problems. In contrast, cable and computer interests contend that all sectors of the broadcast industry have significant incentives to reach a consensus on transmission and reception standards without a government mandate.
- 10. Broadcasters warn that a market-driven selection of a standard would result in barriers to the introduction of DTV if different incompatible systems develop. Under a market-based approach, for example, broadcasters in the same community could select different and incompatible transmission systems so that consumers would only be able to obtain service from those television stations using the system that is compatible with the receiver they have purchased and be denied access to those using another transmission system. Broadcasters maintain that a government-mandated standard is essential to ensure a universally available, advertiser-supported over-the-air digital broadcast service in the future. In contrast, cable interests do not agree that there are unique characteristics or public policy goals attendant to broadcast DTV, or that there would be a market failure unless a mandatory transmission standard is adopted. \*\*\*

## IV. The Digital Television Standard \*\*\*

31. In the Fifth Further Notice, we proposed to adopt the ATSC DTV Standard. In addition to requesting comment on our proposal, we requested comment on alternative approaches to requiring a standard and specifically mentioned two options previously identified by the Commission: 1) authorizing use of a standard and prohibiting interference to it, but not requiring the use of that standard; and 2) adopting a standard for allocation and assignment purposes only. We also sought comment on requiring use of some layers of the ATSC DTV Standard but making others optional. In this Report and Order, we decide to adopt this last alternative and to require the use of all layers of the ATSC DTV Standard, except the video format layer, which will remain optional.

- 32. Our decision today to adopt the ATSC DTV Standard, as modified, is based on a careful weighing and balancing of the various goals and objectives outlined in this proceeding. We conclude that adopting the DTV Standard will fulfill the four objectives set out in the Fifth Further Notice.
- 33. First, we conclude that the DTV Standard will serve our goal of ensuring that all affected parties have sufficient confidence and certainty in order to promote the smooth introduction of a free and universally available digital broadcast television service. As we have recognized before, broadcast television is unique. It is free, available to nearly every American, and many Americans rely on broadcast television programming as a primary source of information and entertainment. Because of these characteristics, we stated that the goals of certainty and reliability take on special significance and strengthen the case for our adoption of a DTV standard. The DTV Standard we adopt today will help ensure that broadcast television remains available to all Americans in the digital era.
- 34. Many commenters argued that startup, coordination and potential splintering problems are so severe in digital broadcast television that they cannot be adequately solved without the Commission adopting a single DTV standard. We recognize that these problems may be more troublesome for digital broadcast television than cable, DBS, MMDS and other subscription video services which have a greater degree of control over the equipment used by their customers. While we are not convinced that these problems are so severe that they would absolutely preclude us from allowing the market to operate without a set standard, we are concerned that market solutions may result in more than one sustainable transmission standard. Such an outcome might result in compatibility problems and increase the risk that consumer DTV equipment purchased in one city would not work well in another city; that a receiver would not display all the broadcast channels in a city; or that a digital television set purchased one year might not work several years later. Such results would hurt consumers and make it more difficult to preserve a universally available broadcast television service.
- 35. More than one transmission standard could also cause some consumers and licensees to postpone purchasing DTV equipment, because they do not wish to take the risk of investing in what may soon become obsolete technology, or because they believe better technologies will soon become available. This could slow investment during the early stages of the transition to DTV and, thereby, slow the transition to DTV.
- 36. In addition, more than one transmission standard would make it more difficult to facilitate an efficient allotment of broadcast channels and protect against interference. Determining interference performance becomes more complicated as the number of transmission systems increases, because each system's interference characteristics must be tested against every other system. This could complicate moving some licensees to new channels following the conversion to DTV and decrease the amount of spectrum recovered.

- 37. For all of these reasons, we believe that adopting the DTV Standard provides additional certainty that the public policy goals unique to broadcast DTV are realized. Simply protecting a standard, or using a standard for allocation purposes would not address our concerns with "wait-and-see" behavior and preserving a universally available broadcast television service. We also reject the argument that the Agreement is too restrictive and still includes too many mandatory aspects of the DTV Standard. As more fully explained below, we believe that the entire DTV Standard is needed to achieve our goals.
- 38. Second, we conclude that adopting the DTV Standard will increase the availability of new products and services for consumers. The DTV Standard is flexible and extensible and permits data broadcasting as well as new services. With respect to data broadcasting, the DTV Standard provides for multiple 19 Mega (Million) bits per second ("Mbps") digital pipelines directly into the home of every American. While we would anticipate that licensees would, at the very least, continue to provide tomorrow what consumers have come to expect today—that is, at least one free program per 6 MHz channel—we also expect to authorize its use to transmit, for example, newspapers, stock market or sports data and, perhaps of greatest significance, software applications directly to computing devices.
- 39. Third, we conclude that incorporating the DTV Standard into our Rules will encourage technological innovation and competition. In particular, we conclude that our decision not to specify video formats will result in greater choice and diversity of equipment, allow computer equipment and software firms more opportunity to compete by promoting interoperability, and result in greater consumer benefits by allowing an increase in the availability of new products and services. By not adopting video formats, we are allowing consumers to choose which formats are most important to them. Thus, we avoid the possibility that we could inhibit development of services which might, in fact, draw consumers more readily to embrace digital broadcasting and thus, hasten its adoption. By not specifying video formats in this respect we foster competition among those aspects of the technology where we are least able to predict the outcome, choosing instead to rely upon the market and consumer demand.
- 40. Moreover, the DTV Standard itself is highly extensible. The DTV Standard remains fully digital and incorporates packet identifiers ("PIDs") which provide a large amount of "headroom" for further development without requiring changes to the DTV Standard. We note that ATSC is already at work on technical standards to facilitate data broadcasting with DTV systems. It has formed a new ATSC Specialist Group on Data Broadcasting to develop data broadcasting standards that "will provide the mechanism for distribution of computer files including programs (executable code) and data."
- 41. Furthermore, there is little risk in such extensibility making obsolete consumer investment in digital receivers or decoders. While not all receivers would be capable of interpreting new PIDs, we are satisfied that, "[b]ackward compatibility is assured

when new bit streams are introduced into the transport system as existing decoders will automatically ignore new PIDs" and continue to decode and display the intended material. The resultant conditions would be reminiscent of the introduction of color or stereo sound to the NTSC system. Earlier equipment continued to work unimpaired even as newer equipment provided additional or improved features.

42. Finally, we conclude that adopting this Standard provides for the minimum of regulation needed to provide for a smooth transition. At the same time, we provide the certainty needed for the transition. The DTV Standard eliminates an unnecessary government requirement by not specifying video formats. A key point of contention throughout this proceeding has been the migration to progressive scan transmission formats. While almost all parties agree that, ultimately, progressive scanning is superior to interlaced across a variety of dimensions, the record has been marked by dissent and contradiction about the desirability of allowing both interlaced and progressive scanning, given the over-the-air bandwidth limitation of 6 MHz. Adoption of the DTV Standard, which will allow video formats to be tested and decided by the market, avoids the risk of a mistaken government intervention in the market and is consistent with the deregulatory direction of the Telecommunications Act of 1996.

44. We recognize that although there was substantial praise among members of the broadcasting, equipment manufacturing and computer industries, support for the Agreement was not unanimous. The Coalition of Film Makers was party to the negotiations that resulted in the Agreement, but did not join in its support and opposes the Agreement because it does not require the display of films in the films' original aspect ratios. We note, however, that consistent with the Agreement, we are not adopting Table 3 of the ATSC DTV Standard as part of the DTV Standard, and thus not adopting any particular aspect ratio. This goes far in meeting the Film Makers' initially expressed concerns that by adopting Table 3 we might prevent films from being displayed in their original aspect ratio. We are sensitive to the concerns of film makers but note that the standard we adopt will allow pass-through of films in whatever format they are provided to broadcasters by distributors. The DTV Standard we are adopting not only does not impose any impediment to the display of films in their original aspect ratios, but to the extent that resolution of displays is improved and a wide aspect ratio is adopted by consumers, the display of films in their original aspect ratios might be promoted.

46. We are not persuaded by those who contend that not specifying video formats in the DTV Standard will inject uncertainty into the transition process and delay implementation of digital television. As explained above, we believe that by adopting a transmission standard, we are providing the appropriate level of certainty that the digital television market will need to move forward. Our belief in this regard is supported by the fact that the major industries affected by this decision have reached an agreement that video formats need not be part of the DTV Standard. The confidence expressed by these parties gives us reasonable assurance it is not necessary to require

video formats. We recognize that some parties contend that the Commission should not rely on the Agreement in considering an appropriate digital standard. As the analysis above shows, we are not relying solely on the fact that these parties reached agreement. Nevertheless, we believe the consensus flows from a sufficiently broad segment of the affected industries to warrant our recognition of the end result and factor it into our analysis. \*\*\*

## VI. Licensing Technology

54. In earlier phases of this proceeding we indicated that, in order for DTV to be successfully implemented, the patents on the technology would have to be licensed to other manufacturing companies on reasonable and nondiscriminatory terms. We noted that the system proponents that participated in the Advisory Committee's competitive testing process were required to submit a statement that they would comply with the ANSI patent policies. The proponents agreed to make any relevant patents that they owned available either free of charge or on a reasonable, nondiscriminatory basis and we stated that we intended to condition selection of a DTV system on such commitments. In the Fifth Further Notice, we sought additional comment on whether more detailed information on the specific terms of such patent licensing, how pending patents will be licensed, or any other intellectual property issues should be considered.

55. It appears that licensing of the patents for DTV technology will not be an impediment to the development and deployment of DTV products for broadcasters and consumers. We reiterate that adoption of this standard is premised on reasonable and nondiscriminatory licensing of relevant patents, but believe that greater regulatory involvement is not necessary at this time. We remain committed to this principle and if a future problem is brought to our attention, we will consider it and take appropriate action.

#### IX. Conclusion

61. This Report and Order is one of the crucial milestones in our effort to ensure that the benefits of digital technology are available to terrestrial television broadcasting and to the American public. We believe that the course we are taking will provide the certainty that many broadcasters, equipment manufacturers and consumers need to invest with confidence in new technology while at the same time preserving the flexibility to accommodate innovation and experimentation. In doing so, we believe our decision will provide many benefits to American consumers. We believe that the inter-industry agreement has provided us with a valuable roadmap to resolve seemingly conflicting goals. After thorough review of the record and reflection on these issues, we believe our decision strikes a proper balance in achieving all of our goals. Accordingly, we will incorporate into our Rules, by reference, the ATSC Digital Television Standard \*\*\*

# Advanced Television Systems and their Impact upon the Existing Television Broadcast Service: Fifth Report and Order

FCC 97-116 (April 21, 1997)

#### I. INTRODUCTION

- 1. Television has played a critical role in the United States in the second half of the twentieth century. A technological breakthrough—digital television—now offers the opportunity for broadcast television service to meet the competitive and other challenges of the twenty-first century.
- 2. The Telecommunications Act of 1996 ("1996 Act") provided that initial eligibility for any advanced television licenses issued by the Commission should be limited to existing broadcasters, conditioned on the eventual return of either the current 6 MHz channel or the new digital channel. Today we adopt rules to implement the statute. \*\*\*

#### II. ISSUE ANALYSIS

#### A. Goals

- \*\*\* 4. \*\*\* These goals can be distilled into the two essential objectives that underlie the decisions we make today.
- 5. First, we wish to promote and preserve free, universally available, local broadcast television in a digital world. Only if DTV achieves broad acceptance can we be assured of the preservation of broadcast television's unique benefit: free, widely accessible programming that serves the public interest. DTV will also help ensure robust competition in the video market that will bring more choices at less cost to American consumers. Particularly given the intense competition in video programming, and the move by other video programming providers to adopt digital technology, it is desirable to encourage broadcasters to offer digital television as soon as possible. We make decisions today designed to promote the viability of digital television services. Digital broadcasters must be permitted the freedom to succeed in a competitive market, and by doing so, attract consumers to digital. In addition, broadcasters' ability to adapt their services to meet consumer demand will be critical to a successful initiation of DTV.
- 6. Second, we wish to promote spectrum efficiency and rapid recovery of spectrum. Decisions that promote the success of digital television—our first goal—promote this goal as well. The more quickly that broadcasters and consumers move to digital, the more rapidly spectrum can be recovered and then be reallocated or reassigned, or both. The faster broadcasters roll out digital television, the earlier we can recover spectrum.
- 7. Our decisions today further these goals. They ensure that broadcasters have more flexibility in their business. Broadcasters will be able to experiment with innovative offerings and different service packages as they continue to provide at least one

free program service and meet their public-interest obligations. We choose to impose few restrictions on broadcasters and to allow them to make decisions that will further their ability to respond to the marketplace. We leave to broadcasters' business judgment such decisions as whether to provide high definition television or whether, initially, to simulcast the NTSC stream on DTV, and what and how many ancillary and supplementary services to provide. To aid the launch of digital services, we provide for a rapid construction of digital facilities by network-affiliated stations in the top markets, in order to expose a significant number of households, as early as possible, to the benefits of DTV. We require those most able to bear the risks of introducing digital television to proceed most quickly. Our decisions here will foster the swift development of DTV, which should enable us to meet our target of ending NTSC service by 2006. To permit careful monitoring of the development of digital television and an opportunity to reassess the decisions we make today, we intend to conduct a review of DTV every two years until the cessation of NTSC service.

#### B. Channel Bandwidth

- 8. <u>Background</u>. In the *Fourth Further Notice/Third Inquiry*, we noted that we had previously decided that DTV would be introduced by assigning existing broadcasters a temporary channel on which to operate a DTV station during the transition period. We also noted that the DTV transmission system was designed for a 6 MHz channel and added that "we continue to believe that providing 6 MHz channels for ATV purposes represents the optimum balance of broadcast needs and spectrum efficiency." \*\*\*
- 9. <u>Comments</u>. All broadcasters filing comments support affording a second 6 MHz channel per broadcaster for DTV. \*\*\*
- 10. However, Media Access Project, et al. ("MAP") argues that the Commission should provide broadcasters only enough spectrum to provide one "free" digital program service, either by allocating less than 6 MHz channels to broadcasters, by allocating the spectrum to others and only affording broadcasters "must carry" rights; or by allocating the spectrum to broadcasters but requiring them to lease out excess capacity to unaffiliated programmers. \*\*\*
- 11. <u>Decision</u>. We invited comment in the *Fourth Further Notice/Third Inquiry* on any means of achieving greater spectrum efficiency. Based on the comments, we continue to believe that providing 6 MHz channels for DTV purposes "represents the optimum balance of broadcast needs and spectrum efficiency." See Fourth Further Notice/Third Inquiry, supra, at 10543. We do not believe that greater spectrum efficiency can be achieved by adopting a different channel size. Indeed, use of 6 MHz channels would facilitate spectrum efficiency because making the DTV channel the same width as the analog channel will afford greater flexibility at the end of the transition in terms of the choice of channel the broadcaster retains for DTV purposes.
- 12. Moreover, contrary to those comments that disagreed with allotting 6 MHz channels for DTV, we believe that the use of 6 MHz channels is necessary to provide

viewers and consumers the full benefits of digital television made possible by the DTV Standard, including high definition television ("HDTV"), standard definition television, and other digital services. The DTV Standard was premised on the use of 6 MHz channels. To specify a different channel size at this late date would not promote our goals in adopting the DTV Standard and would prolong the conversion to DTV. Specifically, we believe that failing to specify a 6 MHz channel would undermine our goals, expressed in the *Fourth Report and Order*, of fostering an expeditious and orderly transition to digital technology and managing the spectrum to permit the recovery of contiguous blocks of spectrum and promote spectrum efficiency. The conversion to DTV would undoubtedly be significantly delayed if we set aside the longstanding expectations of the parties, on which they have based the technology and established their plans, and specified a different channel bandwidth. Accordingly, we reaffirm our earlier judgment and will allot 6 MHz channels for DTV.

## C. Eligibility

- 13. <u>Background</u>. We proposed to limit initial eligibility for DTV channels to existing broadcasters. Our proposed criteria for existing broadcasters included full-service television broadcast station licensees, permittees authorized as of October 24, 1991, and parties with applications for a construction permit on file as of October 24, 1991, who are ultimately awarded a full-service broadcast license. After release of the *Fourth Further Notice/Third Inquiry*, Congress statutorily addressed eligibility in the 1996 Act. Congress instructed the Commission to limit the initial eligibility for advanced television licenses to persons that, as of the date of the issuance of the licenses, are licensed to operate a television broadcast station or hold a permit to construct such a station. The 1996 Act did not change the fact that the Commission lacks statutory authority to auction broadcast spectrum. \*\*\*
- 17. <u>Decision</u>. In the 1996 Act, Congress specifically addressed the eligibility issue. Congress provided that the Commission "should limit the initial eligibility for [DTV] licenses to persons that, as of the date of such issuance, are licensed to operate a television broadcast station or hold a permit to construct a station (or both) . . ." 47 U.S.C. 336(a)(1). \*\*\* Following Congress' direction, we determine that initial eligibility should be limited to those broadcasters who, as of the date of issuance of the initial licenses, hold a license to operate a television broadcast station or a permit to construct such a station, or both. \*\*\*

### D. Definition of Service

#### 1. SPECTRUM USE

19. <u>Background</u>. The *Fourth Further Notice/Third Inquiry* reaffirmed our intention to preserve and promote universal, free, over-the-air television. We recognized that broadcast television has become an important part of American life and thus stated "we envision that the 6 MHz channel earmarked for [DTV] will be used for free, over-the-air broadcasting." We also recognized the increased flexibility that DTV offered broadcasters and noted that "allowing at least some level of flexibility would in-

crease the ability of broadcasters to compete in an increasingly competitive marketplace, and would allow them to serve the public with new and innovative services."

20. The DTV Standard, adopted by the Commission in the Fourth Report and Order, See 47 C.F.R. 73.682(d), permits broadcasters to offer a variety of services. It allows broadcasters to offer free television of higher resolution than analog technology. It allows the broadcast of at least one, and under some circumstances two, high definition television programs; and it allows "multicasting," the simultaneous transmission of three, four, five, or more digital programs. The Standard also allows for the broadcast of CD-quality audio signals. And it permits the rapid delivery of large amounts of data: an entire edition of the local newspaper in less than two seconds, sports information, computer software, telephone directories, stock market updates, interactive educational materials and, indeed, any information that can be translated into digital bits. In addition to allowing broadcasters to transmit video, voice, and data simultaneously, the DTV Standard allows broadcasters to do so dynamically, meaning that they can switch back and forth quickly and easily. For example, a broadcaster could transmit a news program consisting of four separate SDTV programs for local news, national news, weather and sports; while interrupting that programming with a single high definition television commercial with embedded data about the product; or transmit a motion picture in a high definition format, while simultaneously using the excess capacity for transmission of data unrelated to the movie. \*\*\*

- 27. <u>Decision</u>. As we have noted before, an overarching goal of this proceeding is to promote the success of a *free*, local television service using digital technology. \*\*\*
- 28. We expect that the fundamental use of the 6 MHz DTV license will be for the provision of free over-the-air television service. In order to ease the transition from our current analog broadcasting system to a digital system, we will require broadcasters to provide on their digital channel the free over-the-air television service on which the public has come to rely. Specifically, broadcasters must provide a free digital video programming service the resolution of which is comparable to or better than that of today's service and aired during the same time periods that their analog channel is broadcasting.
- 29. We wish to preserve for viewers the public good of free television that is widely available today. At the same time, we recognize the benefit of permitting broadcasters the opportunity to develop additional revenue streams from innovative digital services. This will help broadcast television to remain a strong presence in the video programming market that will, in turn, help support a free programming service. Thus, we will allow broadcasters flexibility to respond to the demands of their audience by providing ancillary and supplementary services that do not derogate the mandated free, over-the-air program service. Ancillary and supplementary services could include, but are not limited to, subscription television programming, computer software distribution, data transmissions, teletext, interactive services, audio signals, and any other services that do not interfere with the required free service. \*\*\*

33. Moreover, we believe that the approach we take here will serve the public interest by fostering the growth of innovative services to the public and by permitting the full possibilities of the DTV system to be realized. One of our goals is to promote spectrum efficiency. Encouraging an expeditious transition from analog to digital television and a quick recovery of spectrum will promote that goal. By permitting broadcasters to assemble packages of services that consumers desire, we will promote the swift acceptance of DTV and the penetration of DTV receivers and converters. That, in turn, will help promote the success of the free television service. As discussed above, digital television promises a wealth of possibilities in terms of the kinds and numbers of enhanced services that could be provided to the public. Indeed, we believe that giving broadcasters flexibility to offer whatever ancillary and supplementary services they choose may help them attract consumers to the service, which will, in turn, hasten the transition. In addition, the flexibility we authorize should encourage entrepreneurship and innovation. For example, it may encourage the development of compression technologies that could allow even more digital capacity on a 6 MHz channel, paving the way for multiple high definition programs and more free programming than would otherwise be offered. \*\*\*

#### 2. HIGH DEFINITION

- 37. <u>Background</u>. In the *Fourth Further Notice/Third Inquiry*, the Commission \*\*\* requested comment as to whether it should require broadcasters to provide a minimum amount of high definition television and, if so, what minimum amount should be required.
- 38. Comments. Many commenters are opposed to a minimum HDTV requirement. Commenters urging the Commission not to apply a minimum HDTV requirement but rather to leave that determination to the marketplace and thus to broadcasters and viewers include the National Association of Broadcasters ("NAB"), ALTV, the Benton Foundation, Microsoft Corporation, Telemundo Group, Inc. ("Telemundo"), and AAPTS/PBS. NAB notes that mandating a certain amount of HDTV could impair broadcasters' ability rapidly to fuel development of the DTV market with complementary program offerings and could prolong the transition to digital television. NAB states: "By providing maximum latitude, the Commission will encourage development of diverse new programming services that will facilitate the most rapid acceptance of ATV and lead to the most rapid return of NTSC spectrum." \*\*\* The Benton Foundation argues that mandating an HDTV minimum serves no public interest because it does not increase the number of voices in the marketplace or contribute to the civic discourse of democracy.
- 39. Support for a minimum HDTV requirement is expressed by three networks, HBO, NYNEX Corporation, receiver manufacturers, Viacom, Golden Orange Broadcasting Co., Inc. ("Golden Orange"), and the National Consumers League. Supporters of a minimum requirement generally argue that a requirement will help promote the early availability of HDTV programming, create demand for HDTV receivers, stimulate the market, and speed the transition. Golden Orange, for example,

notes that without HDTV, the public will not be motivated to buy receivers. HBO argues that the legal and policy principles that justify awarding incumbent broadcasters a second channel for DTV do not permit broadcasters to use this second channel for any thing other than HDTV programming, and, if the FCC allows other than HDTV programming, it should require that a substantial portion of the broadcast day, especially during dayparts and prime time, be devoted exclusively to HDTV. These commenters vary on the amount of HDTV programming that should be required and on how the minimum should be implemented.

- 41. <u>Decision</u>. Our decisions today, and our previous adoption of the DTV Standard, give broadcasters the opportunity to provide high definition television programming, but we decline to impose a requirement that broadcasters provide a minimum amount of such programming and, instead, leave this decision to the discretion of licensees. \*\*\*
- 42. Our decisions to adopt the DTV Standard and to use 6 MHz channels permit broadcasters to provide high definition television in response to viewer demand. If we do not mandate a minimum amount of high resolution television, we anticipate that stations may take a variety of paths: some may transmit all or mostly high resolution television programming, others a smaller amount of high resolution television, and yet others may present no HDTV, only SDTV, or SDTV and other services. We do not know what consumers may demand and support. Since broadcasters have incentives to discover the preferences of consumers and adapt their service offerings accordingly, we believe it is prudent to leave the choice up to broadcasters so that they may respond to the demands of the marketplace. A requirement now could stifle innovation as it would rest on a priori assumptions as to what services viewers would prefer. Broadcasters can best stimulate consumers' interest in digital services if able to offer the most attractive programs, whatever form those may take, and it is by attracting consumers to digital, away from analog, that the spectrum can be freed for additional uses. Further, allowing broadcasters flexibility as to the services they provide will allow them to offer a mix of services that can promote increased consumer acceptance of digital television, which, in turn, will increase broadcasters' profits, which, in turn, will increase incentives to proceed faster with the transition.
- 44. We note that some commenters argued that a high definition television mandate is necessary to give program producers and equipment manufacturers the necessary incentives to support high resolution television, and to provide viewers and consumers enough high resolution television programming to foster demand for such programming and to drive DTV receiver purchases. To the contrary, however, we believe that a minimum high definition television requirement is unnecessary to achieve these goals. We note in this regard that broadcasters and networks have emphasized their commitment to high definition television. We find nothing in the record that identifies a market failure or other reason to impose a governmental requirement for high definition television. High definition television will afford broadcasters an important tool in the increasingly competitive video programming market.

There is no reason to believe that a government mandate is necessary to ensure that high definition television gets a fair chance in the marketplace.

## E. Public Interest Obligations

- 45. <u>Background</u>. As we stated in the *Fourth Further Notice*, the rules imposing public interest obligations on broadcast licensees originate in the statutory mandate that broadcasters serve the "public interest, convenience, and necessity," as well as other provisions of the Communications Act. \*\*\*
- 48. <u>Decision</u>. In this proceeding we seek to promote the successful transition of analog broadcast television into a digital broadcast television service that serves the public interest. Broadcasters have long been subject to the obligation to serve the "public interest, convenience and necessity." 47 U.S.C. 307(a), 309(a). In the 1996 Act, Congress provided that broadcasters' public interest obligations extend into the digital environment:
  - "(d) Public Interest Requirement. --Nothing in this section shall be construed as relieving a television broadcasting station from its obligation to serve the public interest, convenience, and necessity. In the Commission's review of any application for renewal of a broadcast license for a television station that provides ancillary or supplementary services, the television licensee shall establish that all of its program services on the existing or advanced television spectrum are in the public interest."
- 47 U.S.C. 336(d). In enacting this provision, Congress clearly provided that broadcasters have public interest obligations on the program services they offer, regardless of whether they are offered using analog or digital technology. \*\*\*
- 50. Some argue that broadcasters' public interest obligations in the digital world should be clearly defined and commensurate with the new opportunities provided by the digital channel broadcasters are receiving. Others contend that our current public interest rules need not change simply because broadcasters will be using digital technology to provide the same broadcast service to the public. We are not resolving this debate today. Instead, at an appropriate time, we will issue a Notice to collect and consider all views. \*\*\* Thus as to the public interest, our action today forecloses nothing from our consideration.

#### F. Transition

## 1. SIMULCAST

51. <u>Background</u>. In our 1992 *Second Report/Further Notice*, we determined that DTV licensees should simulcast on their NTSC channel the programming offered on their DTV channel. Specifically, we adopted, as a preliminary matter, a 50 percent simulcasting requirement, beginning one year after the six-year application and construction period, increasing to 100 percent two years later. Our early simulcast decisions were based on the expectation that DTV would primarily consist of the broadcast of a single HDTV program service. However, as DTV technology developed, we learned that DTV would be able to do much more than we initially expected and

that it would be possible to transmit multiple simultaneous SDTV program services on a single 6 MHz channel. Recognizing that a licensee would be unable to simulcast multiple program services on its NTSC channel, we stated in the *Fourth Further Notice* that our simulcast requirement must be revisited and we must consider alternatives. In addition, we stated that we still perceived a need for a simulcast requirement, albeit different from that first envisioned, and proposed to require the simulcast of all material being broadcast on the licensee's NTSC channel on a program service of the DTV channel. \*\*\*

- 54. <u>Decision</u>. We decline to adopt a simulcast requirement for the early years of the transition. In order to help reclaim spectrum at the end of the transition period, however, we adopt by the sixth year from the date of adoption of this *Report and Order* a requirement of 50% simulcasting of the video programming of the analog channel on the DTV channel; by the seventh year, a 75% simulcasting requirement; by the eighth year, a 100% simulcasting requirement, until the analog channel is terminated and that spectrum returned.
- 55. We have previously recognized the need to afford broadcasters flexibility to program their DTV channels to attract consumers, especially during the critical launch phase of DTV. We do not adopt a simulcast requirement during the early years of the transition in order to give broadcasters the ability to experiment with program and service offerings. We are convinced by commenters who argue that many consumers' decisions to invest in DTV receivers will depend on the programs, enhanced features, and services that are not available on the NTSC service, and a simulcast requirement might limit broadcasters' ability to experiment with the full range of digital capabilities. Because the DTV channels represent valuable resources with large opportunity costs, we believe licensees will have economic incentives to provide programming and services that will attract consumers to DTV. In any event, a simulcast requirement during this initial transition phase appears to be unnecessary because the record suggests that marketplace forces will ensure that the best NTSC programming will be simulcast on the digital channel and broadcasters have indicated that they will simulcast NTSC programs on the DTV channel even in the absence of a requirement.
- 56. While we believe that a simulcast requirement is not warranted during the early years of the transition, there are benefits to a simulcast requirement near the end of the transition period. Such a requirement will help ensure that consumers will enjoy continuity of free over-the-air program service when we reclaim the analog spectrum at the conclusion of the transition period. It may be difficult to terminate analog broadcast service if broadcasters show programs on their analog channels but not on their digital channels. We believe that it will be easier to terminate analog services and reclaim the spectrum at the end of the transition if most broadcast households are capable of receiving DTV signals and these households do not suffer the loss of a current program service only offered on analog channels. Thus, we will require a phased-in simulcasting requirement as follows: By the sixth year from the date of

adoption of this *Report and Order*, we adopt a 50% simulcasting requirement; by the seventh year, we adopt a 75% simulcasting requirement; by the eighth year, we adopt a 100% simulcasting requirement which will continue until the analog channel is terminated and the analog spectrum returned. We recognize that we will need to define clearly "simulcasting" in the context of DTV and will do so as part of our two-year reviews or other appropriate proceeding. \*\*\*

## G. Application/Construction Period

- 61. <u>Background</u>. The *Second Report/Further Notice* adopted a two year application period and an additional three years for construction of a DTV facility. We were concerned that without a specific timetable, some parties might delay construction while waiting for others to take the lead, to the detriment of our goal of expeditious DTV implementation. We clarified that broadcasters who did not apply and construct within the established time period (and who failed to obtain an extension of time) would lose their initial eligibility for a DTV frequency. \*\*\*
- 62. In the *Third Report/Further Notice*, we adjusted the application deadline from a two-year to a three-year period, and provided for a total six-year application and construction period with those applying early having a longer portion of the six-year period to devote to construction of DTV facilities. \*\*\*
- 63. The Fourth Further Notice/Third Inquiry proposed a procedure by which broadcasters would have six months in which to make an election and confirm to the Commission that they want a DTV license. After that, they would have the remainder of the three-year period in which to supply any required supporting data, and a total of six years to complete construction. If they would elect not to construct a DTV facility, or would elect but then fail to construct, their NTSC licenses would expire at the end of the DTV conversion period, and they would be required to cease broadcasting. \*\*\*
- 76. Construction Schedule. We have decided to adopt the following construction requirements. Stations affiliated with ABC, CBS, Fox and NBC must build digital facilities in the ten largest television markets by May 1, 1999. Stations affiliated with ABC, CBS, Fox and NBC in the top 30 television markets, not included above, must construct DTV facilities by November 1, 1999. All other commercial stations must construct DTV facilities by May 1, 2002. All noncommercial stations must construct their DTV facilities by May 1, 2003. We note that 24 stations in the top ten markets have voluntarily committed in writing to the Commission to building DTV facilities within 18 months. \*\*\*
- 79. Our earlier preliminary decision to provide for an across-the-board six-year application/construction schedule is no longer appropriate. We now believe that a general six-year construction schedule would unnecessarily delay the realization of our goals of free, universal DTV service and spectrum recovery. A six-year construction schedule for all commercial stations anticipated neither the rapid development of digital technologies nor the ability of manufacturers and suppliers to provide DTV

equipment. In light of these changes, we now believe that the six-year construction period is too long. Instead, we believe that an aggressive construction schedule should be implemented for several reasons.

- 80. First, digital broadcast television stands a risk of failing unless it is rolled out quickly. Many operators in other media such, as DBS, cable, and wireless cable use or plan to use digital technology. Unless digital television broadcasting is available quickly, other digital services may achieve levels of penetration that could preclude the success of over-the-air, digital television. Viewers who have leased or purchased digital set-top boxes from competing digital media may be less likely to purchase DTV receivers or converters. If digital, over-the-air television does not succeed, however, viewers will be without a free, universally available digital programming service.
- 82. Third, an aggressive construction schedule helps to offset possible disincentives that any individual broadcaster may have to begin digital transmissions quickly, as well as the possible absence of market forces that might themselves ensure rapid construction. We recognize that an individual broadcaster may consider implementation of DTV to require it to invest funds in order to capture viewers for which it is already receiving advertising revenue. Such a broadcaster might prefer to wait until others have converted to digital for a number of reasons, including lower equipment costs. On the other hand, a broadcaster may recognize first-mover advantages, such as being first to market with programs in higher definition or with ancillary data services. Our schedule ensures rapid construction in major markets.
- 83. Fourth, a rapid build-out works to ensure that recovery of broadcast spectrum occurs as quickly as possible. As we discuss in the *Sixth Report and Order*, at the end of the transition we plan to recover 78 MHz of clear spectrum in addition to the 60 MHz of partially encumbered spectrum we plan to recover in the near future from channels 60-69. We will also recover at the end of the transition that spectrum within channels 60-69 that is still needed for analog and digital television broadcasting during the transition.
- 84. By adopting construction requirements, we hope to give the various industries involved the certainty to move forward. Penetration of color television sets, for example, was limited until the three major networks began transmitting prime time programming in color. This provides evidence that consumers may not purchase great numbers of DTV sets or converters until multiple stations in their market are transmitting DTV, and that we therefore should adopt construction requirements that ensure that there are multiple digital television broadcasters operating. Television manufacturers plan to have the first digital television sets ready for purchase by the public by mid-1998. The construction schedule set forth here provides that multiple stations in most of the top ten markets are operating at roughly that time.
- 85. Our construction schedule will facilitate our goal of having at least 40 facilities affiliated with the four top networks in the top 10 markets transmitting DTV by

May 1, 1999. Within roughly 24 months in each of the top 10 markets, which cover approximately 30 percent of U.S. television households, viewers will have DTV transmissions available from multiple stations. These signals will come from network affiliates, which are generally the stations with the highest ratings in the market. In the top 30 markets, network-affiliated stations must construct digital facilities by November 1, 1999. These markets include 53 percent of U.S. television households. Stations in the second category will benefit from the success of the stations in the first category, as word spreads from the largest markets to those medium-sized markets. The May 1, 1999, requirement applies to only 40 of the country's approximately 1200 commercial television stations, and only 80 additional stations will be affected by the November 1, 1999, deadline. Over one thousand commercial stations will have until May 1, 2002, to plan for and implement their DTV facilities. Noncommercial stations will have until May 1, 2003, to construct. \*\*\*

### H. Recovery Date

- 94. <u>Background</u>. Earlier in this proceeding, the Commission made the preliminary decision to establish a recovery date 15 years from the date of the adoption of an ATV system or the date a final Table of ATV Allotments is effective, whichever is later. At the end of this period, all analog broadcast would cease, and the spectrum used for NTSC would be returned to the Commission. The Commission emphasized that, given the uncertainties surrounding the conversion process and the possible changes in the data on which we relied, setting the recovery date at 15 years was necessarily preliminary. \*\*\*
- 97. <u>Decision</u>. One of our overarching goals in this proceeding is the rapid establishment of successful digital broadcast services that will attract viewers from analog to DTV technology, so that the analog spectrum can be recovered. Accomplishment of this goal requires that the NTSC service be shut down at the end of the transition period and that spectrum be surrendered to the Commission. Indeed, Congress required the Commission to condition the grant of a digital license on the Commission's recovery of 6 MHz from each licensee. The Act provides:
  - "(c) RECOVERY OF LICENSE. --If the Commission grants a license for advanced television services to a person that, as of the date of such issuance, is licensed to operate a television broadcast station or holds a permit to construct such a station (or both), the Commission shall, as a condition of such license, require that either the additional license or the original license held by the licensee be surrendered to the Commission for reallocation or reassignment (or both) pursuant to Commission regulation."

The question we face is at what point in time the surrender should occur.

98. We continue to believe that it is desirable to identify a target end-date of NTSC service. Doing so will lend certainty to the introduction of digital by making clear to the public that analog television service will indeed cease on a date certain. A

target will provide broadcasters and manufacturers with a defined planning horizon that will help them gauge their business plans to the introduction of DTV.

99. While the Commission has previously considered a 15-year end-point for NTSC service, we now believe that broadcasters should be able to convert to digital broadcast much more rapidly. Specifically, we believe that a target of 2006 for the cessation of analog service is reasonable. As the Fourth Further Notice/Third Inquiry explained, as digital technology has developed, we have had reason to expect that DTV may be adopted more quickly than originally anticipated. Competitors in the video programming market, such as DBS, cable, and wireless cable, have aggressively pursued the potential of digital technology. This competitive pressure has lent urgency to the need for broadcasters to convert rapidly. Furthermore, technological advances have worked to lower the introductory costs to broadcasters; for example, new technology may allow many broadcasters to use existing towers for digital transmission, thus easing the expense of converting to digital equipment. And, due to the introduction of other services, broadcasters who need new towers, will be able to lease space on their new towers to mobile service providers, further lowering the costs of converting. On the viewers' side, technological advances in converter-box technology will lower the consumer costs of the introduction of digital technology. The dramatic drop anticipated in converter-box prices will permit consumers inexpensively to continue to use existing equipment, thus easing the introduction of digital services. Based on our current information, we believe 2006 is a reasonable target.

100. As we discuss below, we will conduct reviews of the progress of DTV every two years. This will allow us to monitor the progress of DTV and to make adjustments to the 2006 target, if necessary. In evaluating the appropriateness of the 2006 target date, key factors for consideration will include viewer acceptance of digital television, penetration of digital receivers and digital-to-analog converter set-top boxes, the availability of digital-to-analog conversion by retransmission media such as cable, DBS, and wireless cable, and generally the number of television households that continue to rely solely on over-the-air analog broadcasting. We emphasize, as we have throughout this proceeding, that at the designated date, broadcasters who do not receive extensions must return one of their two channels. \*\*\*

## J. Must-Carry and Retransmission Consent

105. In the Fourth Further Notice/Third Inquiry, we requested comment on questions relating to the issues of what must-carry obligations and retransmission consent provisions should apply to DTV stations, both during the transition and as a consequence of DTV having replaced NTSC broadcasting. We received comments on these issues from several entities. Subsequent to the issuance of the Fourth Further Notice/Third Inquiry, Congress, in the 1996 Act, gave the Commission some direction as to the scope of must-carry, indicating that no ancillary or supplementary DTV services should have must-carry rights.

106. On March 31, 1997, the Supreme Court upheld the constitutionality of the must-carry provisions contained in the Cable Television Consumer Protection and Competition Act of 1992, in *Turner Broadcasting System, Inc. v. FCC* ("*Turner II*"). In upholding the constitutionality of must-carry, the Court emphasized that preserving the benefits of free, over-the-air broadcast television and promoting the wide-spread dissemination of information from a multiplicity of sources were important governmental interests. The *Turner II* case did not expressly address the issue of must-carry of digital television signals. In order to obtain a full and updated record on the applicability of the must-carry and retransmission consent provisions in the digital context, particularly in light of the *Turner II* decision, we intend to issue a Notice to seek additional comments on these issues.

### K. All-Channel Receiver Issues

- 107. <u>Background</u>. Traditionally, we have not regulated broadcast receivers except insofar as they incidentally radiate energy. However, the All Channel Receiver Act authorizes us to require that television receivers "be capable of adequately receiving all frequencies allocated by the Commission to television broadcasting." While we require that all TV broadcast receivers be capable of adequately receiving all channels allocated by the Commission to the television broadcast service, we previously determined in this proceeding that the All Channel Receiver Act does not mandate the manufacture of dual-mode (DTV and NTSC) receivers. \*\*\*
- 109. <u>Comments</u>. Most broadcasters support a requirement that all DTV receivers and set-top converters be able to receive and display NTSC signals, and receive all DTV signals included in the DTV transmission standard and display them in the highest quality format which the particular set is designed to accommodate.
- 110. While most broadcasters and Motorola favor regulations governing how DTV signals are displayed on DTV receivers, most equipment manufacturers and other commenters favor a market-driven approach. \*\*\*
- 111. <u>Decision</u>. The digital broadcast transmission standard which we adopted in the *Fourth Report and Order* differed from the standard we proposed in the *Fifth Further Notice*. Many of the comments we received in response to the *Fifth Further Notice* assumed that the Commission would adopt a DTV transmission standard that included specific video formats. However, the standard we adopted in the *Fourth Report and Order* did not specify video formats. We chose instead to allow video formats to be determined by the market and consumer demand. Because of this important modification, we believe that some of the arguments made by the commenters on specific all-channel receiver issues are no longer applicable.
- 112. We have decided that, at this time, equipment manufacturers should have maximum latitude to determine which video formats DTV equipment will receive. We believe that it is likely that market forces will provide incentives for broadcasters and equipment manufacturers to work closely together to produce the receiver and converter designs most valued by consumers.

- 113. We do not believe that our goals would be advanced by mandating that all digital receivers receive and display NTSC signals and DTV signals, regardless of format, aspect ratio, or progressive or interlaced scanning, as broadcasters argue. We expect that equipment manufacturers will make available to consumers digital receivers that receive both NTSC and DTV signals. However, we will not preclude equipment manufacturers from designing digital receivers that do not receive NTSC signals. In addition, we believe that equipment manufacturers should be allowed to offer lower-cost, digital receivers that receive only progressive scan or SDTV formats. Our two-year reviews will give us an opportunity to monitor DTV receiver designs and address any problems that may arise.
- 114. We have decided to postpone any decision concerning a labeling requirement. We are providing broadcasters flexibility in their choice of video formats and equipment manufacturers flexibility in their choice of receiver designs and we are hopeful that this will result in products and services that draw consumers to DTV. At this early stage of the transition process, we will rely on consumer electronics manufacturers and retailers to provide the information necessary for consumers to make informed choices. Should problems arise, and consumers become confused, as the transition moves forward, we will have opportunity to revisit labeling requirement issues through our review process. Finally, we recognize that there is an enormous embedded base of video cassette recorders, cable decoder boxes, laser disc players, and other video equipment that use NTSC receivers for non-broadcast purposes. This suggests that there may be a continuing market for the sale of NTSC display devices, even after the conversion to DTV. Therefore, we decline to limit the sale of NTSC-only display devices.

# Sec. 3003 of the Balanced Budget Act of 1997

P.L. 103-33 (Aug. 5, 1997)

47 USC \$309(j)(14) Auction of recaptured broadcast television spectrum.

- (A) Limitations on terms of terrestrial television broadcast licenses. A television broadcast license that authorizes analog television service may not be renewed to authorize such service for a period that extends beyond December 31, 2006.
- (B) Extension. The Commission shall extend the date described in subparagraph (A) for any station that requests such extension in any television market if the Commission finds that—
  - (i) one or more of the stations in such market that are licensed to or affiliated with one of the four largest national television networks are not broadcasting a digital television service signal, and the Commission finds that each such station has exercised due diligence and satisfies the conditions for an extension of the Commission's applicable construction deadlines for digital television service in that market;

- (ii) digital-to-analog converter technology is not generally available in such market; or
- (iii) in any market in which an extension is not available under clause (i) or (ii), 15 percent or more of the television households in such market—
  - (I) do not subscribe to a multichannel video programming distributor (as defined in section 602) that carries one of the digital television service programming channels of each of the television stations broadcasting such a channel in such market; and
    - (II) do not have either—
  - (a) at least one television receiver capable of receiving the digital television service signals of the television stations licensed in such market; or
  - (b) at least one television receiver of analog television service signals equipped with digital-to-analog converter technology capable of receiving the digital television service signals of the television stations licensed in such market.
- (C) Spectrum reversion and resale.
  - (i) The Commission shall—
  - (I) ensure that, as licenses for analog television service expire pursuant to subparagraph (A) or (B), each licensee shall cease using electromagnetic spectrum assigned to such service according to the Commission's direction; and
  - (II) reclaim and organize the electromagnetic spectrum in a manner consistent with the objectives described in paragraph (3) of this subsection.
- (ii) Licensees for new services occupying spectrum reclaimed pursuant to clause (i) shall be assigned in accordance with this subsection. \*\*\*

## **Deficit Reduction Act of 2005**

Pub. L. 109-171 (Feb. 8, 2006)

\*\*\* III—Digital Television Transition and Public Safety

Sec. 3001. Short Title: Definition.

- (a) Short Title.—This title may be cited as the "Digital Television Transition and Public Safety Act of 2005".
- (b) Definition.—As used in this Act, the term "Assistant Secretary" means the Assistant Secretary for Communications and Information of the Department of Commerce.

Sec. 3002. Analog Spectrum Recovery: Firm Deadline.

- (a) Amendments.—Section 309(j)(14) of the Communications Act of 1934 (47 U.S.C. 309(j)(14)) is amended—
  - (1) in subparagraph (A)—
    - (A) by inserting "full-power" before "television broadcast license"; and
    - (B) by striking "December 31, 2006" and inserting "February 17, 2009";

- (2) by striking subparagraph (B);
- (3) in subparagraph (C)(i)(I), by striking "or (B)";
- (4) in subparagraph (D), by striking "subparagraph (C)(i)" and inserting "subparagraph (B)(i)"; and
- (5) by redesignating subparagraphs (C) and (D) as subparagraphs (B) and (C), respectively. \*\*\*

Sec. 3005. Digital-To-Analog Converter Box Program.

- (a) Creation of Program.—The Assistant Secretary shall—
- (1) implement and administer a program through which households in the United States may obtain coupons that can be applied toward the purchase of digital-to-analog converter boxes; and
- (2) make payments of not to exceed \$990,000,000, in the aggregate, through fiscal year 2009 to carry out that program from the Digital Television Transition and Public Safety Fund established under section 309(j)(8)(E) of the Communications Act of 1934 (47 U.S.C. 309(j)(8)(E)). \*\*\*
- (c) Program Specifications.—
  - (1) Limitations.—
  - (A) Two-per-household maximum.—A household may obtain coupons by making a request as required by the regulations under this section between January 1, 2008, and March 31, 2009, inclusive. The Assistant Secretary shall ensure that each requesting household receives, via the United States Postal Service, no more than two coupons.
  - (B) No combinations of coupons.—Two coupons may not be used in combination toward the purchase of a single digital-to-analog converter box.
    - (C) Duration.—All coupons shall expire 3 months after issuance. \*\*\*

## National Cable & Telecommunications Ass'n v. Brand X Internet Services

545 U.S. 967 (2005)

Justice THOMAS delivered the opinion of the Court: Title II of the Communications Act of 1934, 48 Stat. 1064, as amended, 47 U.S.C. § 151 et seq., subjects all providers of "telecommunications servic[e]" to mandatory common-carrier regulation, § 153(44). In the order under review, the Federal Communications Commission concluded that cable companies that sell broadband Internet service do not provide "telecommunications servic[e]" as the Communications Act defines that term, and hence are exempt from mandatory common-carrier regulation under Title II. We must decide whether that conclusion is a lawful construction of the Communications Act under Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984), and the Administrative Procedure Act, 5 U.S.C. § 555 et seq. We hold that it is.

I

The traditional means by which consumers in the United States access the network of interconnected computers that make up the Internet is through "dial-up" connections provided over local telephone facilities. See 345 F.3d 1120, 1123-1124 (C.A.9 2003) (cases below); In re Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities, 17 FCC Rcd. 4798, 4802-4803, ¶ 9, 2002 WL 407567 (2002) (hereinafter *Declaratory Ruling*). Using these connections, consumers access the Internet by making calls with computer modems through the telephone wires owned by local phone companies. See Verizon Communications Inc. v. FCC, 535 U.S. 467, 489-490 (2002) (describing the physical structure of a local telephone exchange). Internet service providers (ISPs), in turn, link those calls to the Internet network, not only by providing a physical connection, but also by offering consumers the ability to translate raw Internet data into information they may both view on their personal computers and transmit to other computers connected to the Internet. See In re Federal-State Joint Board on Universal Service, 13 FCC Rcd. 11501, 11531, ¶ 63, 1998 WL 166178 (1998) (hereinafter *Universal Service Report*); P. Huber, M. Kellogg, & J. Thorne, Federal Telecommunications Law 988 (2d ed. 1999) (hereinafter Huber). Technological limitations of local telephone wires, however, retard the speed at which data from the Internet may be transmitted through end users' dial-up connections. Dial-up connections are therefore known as "narrowband," or slower speed, connections.

"Broadband" Internet service, by contrast, transmits data at much higher speeds. There are two principal kinds of broadband Internet service: cable modem service and Digital Subscriber Line (DSL) service. Cable modem service transmits data between the Internet and users' computers via the network of television cable lines owned by cable companies. DSL service provides high-speed access using the local telephone wires owned by local telephone companies. Cable companies and tele-

phone companies can either provide Internet access directly to consumers, thus acting as ISPs themselves, or can lease their transmission facilities to independent ISPs that then use the facilities to provide consumers with Internet access. Other ways of transmitting high-speed Internet data into homes, including terrestrial- and satellite-based wireless networks, are also emerging.

II

At issue in these cases is the proper regulatory classification under the Communications Act of broadband cable Internet service. The Act, as amended by the Telecommunications Act of 1996, defines two categories of regulated entities relevant to these cases: telecommunications carriers and information-service providers. The Act regulates telecommunications carriers, but not information-service providers, as common carriers. Telecommunications carriers, for example, must charge just and reasonable, nondiscriminatory rates to their customers, 47 U.S.C. § \$201-209, design their systems so that other carriers can interconnect with their communications networks, § 251(a)(1), and contribute to the federal "universal service" fund, § 254(d). These provisions are mandatory, but the Commission must forbear from applying them if it determines that the public interest requires it. § \$160(a), (b). Information-service providers, by contrast, are not subject to mandatory common-carrier regulation under Title II, though the Commission has jurisdiction to impose additional regulatory obligations under its Title I ancillary jurisdiction to regulate interstate and foreign communications, see § \$151-161.

These two statutory classifications originated in the late 1970's, as the Commission developed rules to regulate data-processing services offered over telephone wires. That regime, the "Computer II" rules, distinguished between "basic" service (like telephone service) and "enhanced" service (computer-processing service offered over telephone lines). In re Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), 77 F.C.C.2d 384, 417-423, ¶ \$86-101 (1980) (hereinafter Computer II Order). The Computer II rules defined both basic and enhanced services by reference to how the consumer perceives the service being offered.

In particular, the Commission defined "basic service" as "a pure transmission capability over a communications path that is virtually transparent in terms of its interaction with customer supplied information." *Id.*, at 420, ¶ 96. By "pure" or "transparent" transmission, the Commission meant a communications path that enabled the consumer to transmit an ordinary-language message to another point, with no computer processing or storage of the information, other than the processing or storage needed to convert the message into electronic form and then back into ordinary language for purposes of transmitting it over the network—such as via a telephone or a facsimile. Basic service was subject to common-carrier regulation.

"[E]nhanced service," however, was service in which "computer processing applications [were] used to act on the content, code, protocol, and other aspects of the subscriber's information," such as voice and data storage services, *id.*, at 420-421, ¶ 97,

as well as "protocol conversion" (*i.e.*, ability to communicate between networks that employ different data-transmission formats), *id.*, at 421-422, ¶ 99. By contrast to basic service, the Commission decided not to subject providers of enhanced service, even enhanced service offered via transmission wires, to Title II common-carrier regulation. The Commission explained that it was unwise to subject enhanced service to common-carrier regulation given the "fast-moving, competitive market" in which they were offered. *Id.*, at 434, ¶ 129.

The definitions of the terms "telecommunications service" and "information service" established by the 1996 Act are similar to the *Computer II* basic- and enhanced-service classifications. "Telecommunications service"—the analog to basic service—is "the offering of telecommunications for a fee directly to the public ... regardless of the facilities used." 47 U.S.C. § 153(46). "Telecommunications" is "the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received." § 153(43). "Telecommunications carrier[s]"—those subjected to mandatory Title II common-carrier regulation—are defined as "provider[s] of telecommunications services." § 153(44). And "information service"—the analog to enhanced service—is "the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information via telecommunications ..." § 153(20).

In September 2000, the Commission initiated a rulemaking proceeding to, among other things, apply these classifications to cable companies that offer broadband Internet service directly to consumers. In March 2002, that rulemaking culminated in the Declaratory Ruling under review in these cases. In the Declaratory Ruling, the Commission concluded that broadband Internet service provided by cable companies is an "information service" but not a "telecommunications service" under the Act, and therefore not subject to mandatory Title II common-carrier regulation. In support of this conclusion, the Commission relied heavily on its *Universal Service Report*. See Declaratory Ruling 4821-4822, ¶ ¶ 36-37 (citing Universal Service Report or Report). The Universal Service Report classified "non-facilities-based" ISPs—those that do not own the transmission facilities they use to connect the end user to the Internet—solely as information-service providers. Unlike those ISPs, cable companies own the cable lines they use to provide Internet access. Nevertheless, in the Declaratory Ruling, the Commission found no basis in the statutory definitions for treating cable companies differently from non-facilities-based ISPs: Both offer "a single, integrated service that enables the subscriber to utilize Internet access service ... and to realize the benefits of a comprehensive service offering." Declaratory Ruling 4823, ¶ 38. Because Internet access provides a capability for manipulating and storing information, the Commission concluded that it was an information service.

The integrated nature of Internet access and the high-speed wire used to provide Internet access led the Commission to conclude that cable companies providing Internet access are not telecommunications providers. This conclusion, the Commission reasoned, followed from the logic of the *Universal Service Report*. The *Report* had concluded that, though Internet service "involves data transport elements" because "an Internet access provider must enable the movement of information between customers' own computers and distant computers with which those customers seek to interact," it also "offers end users information-service capabilities inextricably intertwined with data transport." *Universal Service Report* 11539-11540, ¶ 80. ISPs, therefore, were not "offering … telecommunications … directly to the public," § 153(46), and so were not properly classified as telecommunications carriers, see *id.*, at 11540, ¶ 81. In other words, the Commission reasoned that consumers use their cable modems not to transmit information "transparently," such as by using a telephone, but instead to obtain Internet access.

The Commission applied this same reasoning to cable companies offering broadband Internet access. Its logic was that, like non-facilities-based ISPs, cable companies do not "offe[r] telecommunications service to the end user, but rather ... merely us[e] telecommunications to provide end users with cable modem service." *Declaratory Ruling* 4824, ¶ 41. Though the Commission declined to apply mandatory Title II common-carrier regulation to cable companies, it invited comment on whether under its Title I jurisdiction it should require cable companies to offer other ISPs access to their facilities on common-carrier terms. Numerous parties petitioned for judicial review, challenging the Commission's conclusion that cable modem service was not telecommunications service. By judicial lottery, the Court of Appeals for the Ninth Circuit was selected as the venue for the challenge.

The Court of Appeals granted the petitions in part, vacated the *Declaratory Ruling* in part, and remanded to the Commission for further proceedings. In particular, the Court of Appeals vacated the ruling to the extent it concluded that cable modem service was not "telecommunications service" under the Communications Act. It held that the Commission could not permissibly construe the Communications Act to exempt cable companies providing Internet service from Title II regulation. Rather than analyzing the permissibility of that construction under the deferential framework of *Chevron*, 467 U.S. 837, however, the Court of Appeals grounded its holding in the *stare decisis* effect of *AT&T Corp. v. Portland*, 216 F.3d 871 (C.A.9 2000). *Portland* held that cable modem service was a "telecommunications service," though the court in that case was not reviewing an administrative proceeding and the Commission was not a party to the case. Nevertheless, *Portland's* holding, the Court of Appeals reasoned, overrode the contrary interpretation reached by the Commission in the *Declaratory Ruling*. \*\*\*

We granted certiorari to settle the important questions of federal law that these cases present. 543 U.S. 1018, (2004).

III

We first consider whether we should apply *Chevron's* framework to the Commission's interpretation of the term "telecommunications service." We conclude that we

should. We also conclude that the Court of Appeals should have done the same, instead of following the contrary construction it adopted in *Portland.* \*\*\*

IV

We next address whether the Commission's construction of the definition of "telecommunications service," 47 U.S.C. § 153(46), is a permissible reading of the Communications Act under the *Chevron* framework. *Chevron* established a familiar two-step procedure for evaluating whether an agency's interpretation of a statute is lawful. At the first step, we ask whether the statute's plain terms "directly addres[s] the precise question at issue." 467 U.S., at 843. If the statute is ambiguous on the point, we defer at step two to the agency's interpretation so long as the construction is "a reasonable policy choice for the agency to make." *Id.*, at 845. The Commission's interpretation is permissible at both steps.

Α

We first set forth our understanding of the interpretation of the Communications Act that the Commission embraced. The issue before the Commission was whether cable companies providing cable modem service are providing a "telecommunications service" in addition to an "information service."

The Commission first concluded that cable modem service is an "information service," a conclusion unchallenged here. The Act defines "information service" as "the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information via telecommunications ...." § 153(20). Cable modem service is an information service, the Commission reasoned, because it provides consumers with a comprehensive capability for manipulating information using the Internet via high-speed telecommunications. That service enables users, for example, to browse the World Wide Web, to transfer files from file archives available on the Internet via the "File Transfer Protocol," and to access email and Usenet newsgroups. Declaratory Ruling 4821, ¶ 37; Universal Service Report 11537, ¶ 76. Like other forms of Internet service, cable modem service also gives users access to the Domain Name System (DNS). DNS, among other things, matches the Web page addresses that end users type into their browsers (or "click" on) with the Internet Protocol (IP) addresses of the servers containing the Web pages the users wish to access. Declaratory Ruling 4821- 4822, ¶ 37. All of these features, the Commission concluded, were part of the information service that cable companies provide consumers.

At the same time, the Commission concluded that cable modem service was not "telecommunications service." "Telecommunications service" is "the offering of telecommunications for a fee directly to the public." 47 U.S.C. § 153(46). "Telecommunications," in turn, is defined as "the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received." § 153(43). The Commission conceded that, like all information-service providers, cable companies use "tele-

communications" to provide consumers with Internet service; cable companies provide such service via the high-speed wire that transmits signals to and from an end user's computer. *Declaratory Ruling* 4823, ¶ 40. For the Commission, however, the question whether cable broadband Internet providers "offer" telecommunications involved more than whether telecommunications was one necessary component of cable modem service. Instead, whether that service also includes a telecommunications "offering" "tur[ned] on the nature of the functions the *end user* is offered," *id.*, at 4822, ¶ 38 (emphasis added), for the statutory definition of "telecommunications service" does not "res[t] on the particular types of facilities used," *id.*, at 4821, ¶ 35; see § 153(46) (definition of "telecommunications service" applies "regardless of the facilities used").

Seen from the consumer's point of view, the Commission concluded, cable modem service is not a telecommunications offering because the consumer uses the high-speed wire always in connection with the information-processing capabilities provided by Internet access, and because the transmission is a necessary component of Internet access: "As provided to the end user the telecommunications is part and parcel of cable modem service and is integral to its other capabilities." *Declaratory Ruling* 4823, ¶ 39. The wire is used, in other words, to access the World Wide Web, newsgroups, and so forth, rather than "transparently" to transmit and receive ordinary-language messages without computer processing or storage of the message. The integrated character of this offering led the Commission to conclude that cable modem service is not a "stand-alone," transparent offering of telecommunications.

В

This construction passes *Chevron's* first step. Respondents argue that it does not, on the ground that cable companies providing Internet service necessarily "offe[r]" the underlying telecommunications used to transmit that service. The word "offering" as used in § 153(46), however, does not unambiguously require that result. Instead, "offering" can reasonably be read to mean a "stand-alone" offering of telecommunications, *i.e.*, an offered service that, from the user's perspective, transmits messages unadulterated by computer processing. That conclusion follows not only from the ordinary meaning of the word "offering," but also from the regulatory history of the Communications Act.

1

Cable companies in the broadband Internet service business "offe[r]" consumers an information service in the form of Internet access and they do so "via telecommunications," § 153(20), but it does not inexorably follow as a matter of ordinary language that they also "offe[r]" consumers the high-speed data transmission (telecommunications) that is an input used to provide this service, § 153(46). We have held that where a statute's plain terms admit of two or more reasonable ordinary usages, the Commission's choice of one of them is entitled to deference. See *Verizon*, 535 U.S., at 498 (deferring to the Commission's interpretation of the term "cost" by ref-

erence to an alternative linguistic usage defined by what "[a] merchant who is asked about 'the cost of providing the goods' " might "reasonably" say). The term "offe[r]" as used in the definition of telecommunications service, 47 U.S.C. § 153(46), is ambiguous in this way.

It is common usage to describe what a company "offers" to a consumer as what the consumer perceives to be the integrated finished product, even to the exclusion of discrete components that compose the product, as the dissent concedes. One might well say that a car dealership "offers" cars, but does not "offer" the integrated major inputs that make purchasing the car valuable, such as the engine or the chassis. It would, in fact, be odd to describe a car dealership as "offering" consumers the car's components in addition to the car itself. Even if it is linguistically permissible to say that the car dealership "offers" engines when it offers cars, that shows, at most, that the term "offer," when applied to a commercial transaction, is ambiguous about whether it describes only the offered finished product, or the product's discrete components as well. It does not show that no other usage is permitted.

The question, then, is whether the transmission component of cable modem service is sufficiently integrated with the finished service to make it reasonable to describe the two as a single, integrated offering. We think that they are sufficiently integrated, because "[a] consumer uses the high-speed wire always in connection with the information-processing capabilities provided by Internet access, and because the transmission is a necessary component of Internet access." Supra. In the telecommunications context, it is at least reasonable to describe companies as not "offering" to consumers each discrete input that is necessary to providing, and is always used in connection with, a finished service. We think it no misuse of language, for example, to say that cable companies providing Internet service do not "offer" consumers DNS, even though DNS is essential to providing Internet access. Declaratory Ruling 4810, n. 74, 4822-4823, ¶ 38. Likewise, a telephone company "offers" consumers a transparent transmission path that conveys an ordinary-language message, not necessarily the data transmission facilities that also "transmi[t] ... information of the user's choosing," § 153(43), or other physical elements of the facilities used to provide telephone service, like the trunks and switches, or the copper in the wires. What cable companies providing cable modem service and telephone companies providing telephone service "offer" is Internet service and telephone service respectively—the finished services, though they do so using (or "via") the discrete components composing the end product, including data transmission. Such functionally integrated components need not be described as distinct "offerings."

In response, the dissent argues that the high-speed transmission component necessary to providing cable modem service is necessarily "offered" with Internet service because cable modem service is like the offering of pizza delivery service together with pizza, and the offering of puppies together with dog leashes. The dissent's appeal to these analogies only underscores that the term "offer" is ambiguous in the way that we have described. The entire question is whether the products here are functionally

integrated (like the components of a car) or functionally separate (like pets and leashes). That question turns not on the language of the Act, but on the factual particulars of how Internet technology works and how it is provided, questions *Chevron* leaves to the Commission to resolve in the first instance. As the Commission has candidly recognized, "the question may not always be straightforward whether, on the one hand, an entity is providing a single information service with communications and computing components, or, on the other hand, is providing two distinct services, one of which is a telecommunications service." *Universal Service Report* 11530, ¶ 60. Because the term "offer" can sometimes refer to a single, finished product and sometimes to the "individual components in a package being offered" (depending on whether the components "still possess sufficient identity to be described as separate objects"), the statute fails unambiguously to classify the telecommunications component of cable modem service as a distinct offering. This leaves federal telecommunications policy in this technical and complex area to be set by the Commission, not by warring analogies.

We also do not share the dissent's certainty that cable modem service is so obviously like pizza delivery service and the combination of dog leashes and dogs that the Commission could not reasonably have thought otherwise. For example, unlike the transmission component of Internet service, delivery service and dog leashes are not integral components of the finished products (pizzas and pet dogs). One can pick up a pizza rather than having it delivered, and one can own a dog without buying a leash. By contrast, the Commission reasonably concluded, a consumer cannot purchase Internet service without also purchasing a connection to the Internet and the transmission always occurs in connection with information processing. In any event, we doubt that a statute that, for example, subjected offerors of "delivery" service (such as Federal Express and United Parcel Service) to common-carrier regulation would unambiguously require pizza-delivery companies to offer their delivery services on a common carrier basis.

2

The Commission's traditional distinction between basic and enhanced service, see *su-pra*, also supports the conclusion that the Communications Act is ambiguous about whether cable companies "offer" telecommunications with cable modem service. Congress passed the definitions in the Communications Act against the background of this regulatory history, and we may assume that the parallel terms "telecommunications service" and "information service" substantially incorporated their meaning, as the Commission has held. The regulatory history in at least two respects confirms that the term "telecommunications service" is ambiguous.

First, in the *Computer II Order* that established the terms "basic" and "enhanced" services, the Commission defined those terms functionally, based on how the consumer interacts with the provided information, just as the Commission did in the order below. As we have explained, Internet service is not "transparent in terms of its interaction with customer-supplied information," *Computer II Order* 420, ¶ 96; the

transmission occurs in connection with information processing. It was therefore consistent with the statute's terms for the Commission to assume that the parallel term "telecommunications service" in 47 U.S.C. § 153(46) likewise describes a "pure" or "transparent" communications path not necessarily separately present, from the end user's perspective, in an integrated information-service offering.

The Commission's application of the basic/enhanced service distinction to nonfacilities-based ISPs also supports this conclusion. The Commission has long held that "all those who provide some form of transmission services are not necessarily common carriers." Computer II Order 431, ¶ 122. For example, the Commission did not subject to common-carrier regulation those service providers that offered enhanced services over telecommunications facilities, but that did not themselves own the underlying facilities—so-called "non-facilities-based" providers. Examples of these services included database services in which a customer used telecommunications to access information, such as Dow Jones News and Lexis, as well as "value added networks," which lease wires from common carriers and provide transmission as well as protocol-processing service over those wires. These services "combin[ed] communications and computing components," yet the Commission held that they should "always be deemed enhanced" and therefore not subject to common-carrier regulation. Following this traditional distinction, the Commission in the *Universal* Service Report classified ISPs that leased rather than owned their transmission facilities as pure information-service providers.

Respondents' statutory arguments conflict with this regulatory history. They claim that the Communications Act unambiguously classifies as telecommunications carriers all entities that use telecommunications inputs to provide information service. As respondent MCI concedes, this argument would subject to mandatory common-carrier regulation all information-service providers that use telecommunications as an input to provide information service to the public. For example, it would subject to common-carrier regulation non-facilities-based ISPs that own no transmission facilities. Those ISPs provide consumers with transmission facilities used to connect to the Internet, and so, under respondents' argument, necessarily "offer" telecommunications to consumers. Respondents' position that all such entities are necessarily "offering telecommunications" therefore entails mandatory common-carrier regulation of entities that the Commission never classified as "offerors" of basic transmission service, and therefore common carriers, under the *Computer II* regime.<sup>2</sup> We doubt that the parallel term "telecommunications service" unambiguously worked this abrupt shift in Commission policy.

<sup>&</sup>lt;sup>2</sup> The dissent attempts to escape this consequence of respondents' position by way of an elaborate analogy between ISPs and pizzerias. This analogy is flawed. A pizzeria "delivers" nothing, but ISPs plainly provide transmission service directly to the public in connection with Internet service. For example, with dial-up service, ISPs process the electronic signal that travels over local telephone wires, and transmit it to the Internet. The dissent therefore cannot deny that its position logically would require applying presumptively mandatory Title II regulation to all ISPs.

Respondents' analogy between cable companies that provide cable modem service and facilities-based enhanced-service providers—that is, enhanced-service providers who own the transmission facilities used to provide those services— fares no better. Respondents stress that under the *Computer II* rules the Commission regulated such providers more heavily than non-facilities-based providers. The Commission required, for example, local telephone companies that provided enhanced services to offer their wires on a common-carrier basis to competing enhanced-service providers. See, *e.g.*, *In re Amendment of Sections 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry)*, 104 F.C.C.2d 958, 964, ¶ 4 (1986) (hereinafter *Computer III Order*). Respondents argue that the Communications Act unambiguously requires the same treatment for cable companies because cable companies also own the facilities they use to provide cable modem service (and therefore information service).

We disagree. We think it improbable that the Communications Act unambiguously freezes in time the Computer II treatment of facilities-based information-service providers. The Act's definition of "telecommunications service" says nothing about imposing more stringent regulatory duties on facilities-based information-service providers. The definition hinges solely on whether the entity "offer[s] telecommunications for a fee directly to the public," 47 U.S.C. § 153(46), though the Act elsewhere subjects facilities-based carriers to stricter regulation, see § 251(c) (imposing various duties on facilities-based local telephone companies). In the Computer II rules, the Commission subjected facilities-based providers to common-carrier duties not because of the nature of the "offering" made by those carriers, but rather because of the concern that local telephone companies would abuse the monopoly power they possessed by virtue of the "bottleneck" local telephone facilities they owned. See Computer II Order 474-475, ¶ ¶ 229, 231; Computer III Order 968-969, ¶ 12; Verizon, 535 U.S., at 489-490 (describing the naturally monopolistic physical structure of a local telephone exchange). The differential treatment of facilities-based carriers was therefore a function not of the definitions of "enhanced-service" and "basic service," but instead of a choice by the Commission to regulate more stringently, in its discretion, certain entities that provided enhanced service. The Act's definitions, however, parallel the definitions of enhanced and basic service, not the facilities-based grounds on which that policy choice was based, and the Commission remains free to impose special regulatory duties on facilities-based ISPs under its Title I ancillary jurisdiction. In fact, it has invited comment on whether it can and should do so.

In sum, if the Act fails unambiguously to classify non-facilities-based information-service providers that use telecommunications inputs to provide an information service as "offer[ors]" of "telecommunications," then it also fails unambiguously to classify facilities-based information-service providers as telecommunications-service offerors; the relevant definitions do not distinguish facilities-based and non-facilities-based carriers. That silence suggests, instead, that the Commission has the discretion to fill the consequent statutory gap.

C

We also conclude that the Commission's construction was "a reasonable policy choice for the [Commission] to make" at *Chevron's* second step. 467 U.S., at 845.

Respondents argue that the Commission's construction is unreasonable because it allows any communications provider to "evade" common-carrier regulation by the expedient of bundling information service with telecommunications. Respondents argue that under the Commission's construction a telephone company could, for example, offer an information service like voice mail together with telephone service, thereby avoiding common-carrier regulation of its telephone service.

We need not decide whether a construction that resulted in these consequences would be unreasonable because we do not believe that these results follow from the construction the Commission adopted. As we understand the *Declaratory Ruling*, the Commission did not say that any telecommunications service that is priced or bundled with an information service is automatically unregulated under Title II. The Commission said that a telecommunications input used to provide an information service that is not "separable from the data-processing capabilities of the service" and is instead "part and parcel of [the information service] and is integral to [the information service's] other capabilities" is not a telecommunications offering. *Declaratory Ruling* 4823, ¶ 39; see *supra*, at 2703-2704.

This construction does not leave all information service offerings exempt from mandatory Title II regulation. "It is plain," for example, that a local telephone company "cannot escape Title II regulation of its residential local exchange service simply by packaging that service with voice mail." Universal Service Report 11530, ¶ 60. That is because a telephone company that packages voice mail with telephone service offers a transparent transmission path—telephone service—that transmits information independent of the information-storage capabilities provided by voice mail. For instance, when a person makes a telephone call, his ability to convey and receive information using the call is only trivially affected by the additional voice-mail capability. Equally, were a telephone company to add a time-of-day announcement that played every time the user picked up his telephone, the "transparent" information transmitted in the ensuing call would be only trivially dependent on the information service the announcement provides. By contrast, the high-speed transmission used to provide cable modem service is a functionally integrated component of that service because it transmits data only in connection with the further processing of information and is necessary to provide Internet service. The Commission's construction therefore was more limited than respondents assume.

Respondents answer that cable modem service does, in fact, provide "transparent" transmission from the consumer's perspective, but this argument, too, is mistaken. Respondents characterize the "information-service" offering of Internet access as consisting only of access to a cable company's e-mail service, its Web page, and the ability it provides consumers to create a personal Web page. When a consumer goes be-

yond those offerings and accesses content provided by parties other than the cable company, respondents argue, the consumer uses "pure transmission" no less than a consumer who purchases phone service together with voice mail.

This argument, we believe, conflicts with the Commission's understanding of the nature of cable modem service, an understanding we find to be reasonable. When an end user accesses a third-party's Web site, the Commission concluded, he is equally using the information service provided by the cable company that offers him Internet access as when he accesses the company's own Web site, its e-mail service, or his personal Web page. For example, as the Commission found below, part of the information service cable companies provide is access to DNS service. A user cannot reach a third-party's Web site without DNS, which (among other things) matches the Web site address the end user types into his browser (or "clicks" on with his mouse) with the IP address of the Web page's host server. It is at least reasonable to think of DNS as a "capability for ... acquiring ... retrieving, utilizing, or making available" Web site addresses and therefore part of the information service cable companies provide. 47 U.S.C. § 153(20). Similarly, the Internet service provided by cable companies facilitates access to third-party Web pages by offering consumers the ability to store, or "cache," popular content on local computer servers. See *Declaratory Ruling* 4810,  $\P$  17, and n. 76. Cacheing obviates the need for the end user to download anew information from third-party Web sites each time the consumer attempts to access them, thereby increasing the speed of information retrieval. In other words, subscribers can reach third-party Web sites via "the World Wide Web, and browse their contents, [only] because their service provider offers the 'capability for ... acquiring, [storing] ... retrieving [and] utilizing ... information.' " Universal Service Report 11538, ¶ 76 (quoting 47 U.S.C. § 153(20)). "The service that Internet access providers offer to members of the public is Internet access," Universal Service Report 11539, ¶ 79, not a transparent ability (from the end user's perspective) to transmit information. We therefore conclude that the Commission's construction was reasonable.

#### V

Respondent MCI, Inc., urges that the Commission's treatment of cable modem service is inconsistent with its treatment of DSL service and therefore is an arbitrary and capricious deviation from agency policy. See 5 U.S.C. § 706(2)(A). MCI points out that when local telephone companies began to offer Internet access through DSL technology in addition to telephone service, the Commission applied its *Computer II* facilities-based classification to them and required them to make the telephone lines used to transmit DSL service available to competing ISPs on nondiscriminatory, common-carrier terms. MCI claims that the Commission's decision not to regulate cable companies similarly under Title II is inconsistent with its DSL policy.

We conclude, however, that the Commission provided a reasoned explanation for treating cable modem service differently from DSL service. As we have already noted, the Commission is free within the limits of reasoned interpretation to change course

if it adequately justifies the change. It has done so here. The traditional reason for its *Computer II* common-carrier treatment of facilities-based carriers (including DSL carriers), as the Commission explained, was "that the *telephone network* [was] the primary, if not exclusive, means through which information service providers can gain access to their customers." *Declaratory Ruling* 4825, ¶ 44 (emphasis in original; internal quotation marks omitted). The Commission applied the same treatment to DSL service based on that history, rather than on an analysis of contemporaneous market conditions.

The Commission in the order under review, by contrast, concluded that changed market conditions warrant different treatment of facilities-based cable companies providing Internet access. Unlike at the time of *Computer II*, substitute forms of Internet transmission exist today: "[R]esidential high-speed access to the Internet is evolving over multiple electronic platforms, including wireline, cable, terrestrial wireless and satellite." *Declaratory Ruling* 4802, ¶ 6. The Commission concluded that "broadband services should exist in a minimal regulatory environment that promotes investment and innovation in a competitive market." *Declaratory Ruling* 4802, ¶ 5. This, the Commission reasoned, warranted treating cable companies unlike the facilities-based enhanced-service providers of the past. We find nothing arbitrary about the Commission's providing a fresh analysis of the problem as applied to the cable industry, which it has never subjected to these rules. This is adequate rational justification for the Commission's conclusions.

Respondents argue, in effect, that the Commission's justification for exempting cable modem service providers from common-carrier regulation applies with similar force to DSL providers. We need not address that argument. The Commission's decision appears to be a first step in an effort to reshape the way the Commission regulates information-service providers; that may be why it has tentatively concluded that DSL service provided by facilities-based telephone companies should also be classified solely as an information service. The Commission need not immediately apply the policy reasoning in the Declaratory Ruling to all types of information-service providers. It apparently has decided to revisit its longstanding Computer II classification of facilities-based information-service providers incrementally. Any inconsistency between the order under review and the Commission's treatment of DSL service can be adequately addressed when the Commission fully reconsiders its treatment of DSL service and when it decides whether, pursuant to its ancillary Title I jurisdiction, to require cable companies to allow independent ISPs access to their facilities. We express no view on those matters. In particular, we express no view on how the Commission should, or lawfully may, classify DSL service.

\* \* \*

The questions the Commission resolved in the order under review involve a "subject matter [that] is technical, complex, and dynamic." *Gulf Power*, 534 U.S., at 339. The Commission is in a far better position to address these questions than we are. Nothing in the Communications Act or the Administrative Procedure Act makes unlawful

the Commission's use of its expert policy judgment to resolve these difficult questions. The judgment of the Court of Appeals is reversed, and the cases are remanded for further proceedings consistent with this opinion.

It is so ordered.

are to be believed.

Ι

Justice SCALIA, with whom Justice SOUTER and Justice GINSBURG join as to Part I, dissenting: The Federal Communications Commission (FCC or Commission) has once again attempted to concoct "a whole new regime of regulation (or of free-market competition)" under the guise of statutory construction. *MCI Telecommunications Corp. v. American Telephone & Telegraph Co.*, 512 U.S. 218, 234 (1994). Actually, in these cases, it might be more accurate to say the Commission has attempted to establish a whole new regime of *non*-regulation, which will make for more or less free-market competition, depending upon whose experts are believed. The important fact, however, is that the Commission has chosen to achieve this through an implausible reading of the statute, and has thus exceeded the authority given it by Congress.

The first sentence of the FCC ruling under review reads as follows: "Cable modem service provides high-speed access to the Internet, as well as many applications or functions that can be used with that access, over cable system facilities." In re Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities, 17 FCC Rcd. 4798, 4799, ¶ 1, 2002 WL 407567 (2002) (hereinafter Declaratory Ruling) (emphasis added, footnote omitted). Does this mean that cable companies "offer" high-speed access to the Internet? Surprisingly not, if the Commission and the Court

It happens that cable-modem service is popular precisely because of the high-speed access it provides, and that, once connected with the Internet, cable-modem subscribers often use Internet applications and functions from providers other than the cable company. Nevertheless, for purposes of classifying what the cable company does, the Commission (with the Court's approval) puts all the emphasis on the rest of the package (the additional "applications or functions"). It does so by claiming that the cable company does not "offe[r]" its customers high-speed Internet access because it offers that access only in conjunction with particular applications and functions, rather than "separate[ly]," as a "stand-alone offering." *Id.*, at 4802, ¶ 7, 4823, ¶ 40.

The focus on the term "offer" appropriately derives from the statutory definitions at issue in these cases. Under the Telecommunications Act of 1996, 110 Stat. 56, " 'information service' "involves the capacity to generate, store, interact with, or otherwise manipulate "information via telecommunications." 47 U.S.C. § 153(20). In turn, "'telecommunications'" is defined as "the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received." § 153(43). Finally, "'telecommunications service'" is defined as "the offering of telecommunications for a

fee directly to the public ... regardless of the facilities used." § 153(46). The question here is whether cable-modem-service providers "offe[r] ... telecommunications for a fee directly to the public." If so, they are subject to Title II regulation as common carriers, like their chief competitors who provide Internet access through other technologies.

The Court concludes that the word "offer" is ambiguous in the sense that it has "alternative dictionary definitions'" that might be relevant. Ante (quoting National Railroad Passenger Corporation v. Boston & Maine Corp., 503 U.S. 407, 418 (1992)). It seems to me, however, that the analytic problem pertains not really to the meaning of "offer," but to the identity of what is offered. The relevant question is whether the individual components in a package being offered still possess sufficient identity to be described as separate objects of the offer, or whether they have been so changed by their combination with the other components that it is no longer reasonable to describe them in that way.

Thus, I agree (to adapt the Court's example, *ante*) that it would be odd to say that a car dealer is in the business of selling steel or carpets because the cars he sells include both steel frames and carpeting. Nor does the water company sell hydrogen, nor the pet store water (though dogs and cats are largely water at the molecular level). But what is sometimes true is not, as the Court seems to assume, *always* true. There are instances in which it is ridiculous to deny that one part of a joint offering is being offered merely because it is not offered on a "'stand-alone'" basis.

If, for example, I call up a pizzeria and ask whether they offer delivery, both common sense and common "usage," *ante*, would prevent them from answering: "No, we do not offer delivery—but if you order a pizza from us, we'll bake it for you and then bring it to your house." The logical response to this would be something on the order of, "so, you *do* offer delivery." But our pizza-man may continue to deny the obvious and explain, paraphrasing the FCC and the Court: "No, even though we bring the pizza to your house, we are not actually 'offering' you delivery, because the delivery that we provide to our end users is 'part and parcel' of our pizzeria-pizza-at-home service and is 'integral to its other capabilities." Cf. *Declaratory Ruling* 4823, ¶ 39.¹ Any reasonable customer would conclude at that point that his interlocutor was either crazy or following some too-clever-by-half legal advice.

In short, for the inputs of a finished service to qualify as the objects of an "offer" (as that term is reasonably understood), it is perhaps a sufficient, *but surely not a necessary*, condition that the seller offer separately "each discrete input that is necessary to providing ... a finished service." The pet store may have a policy of selling puppies only with leashes, but any customer will say that it *does* offer puppies—because a leashed puppy is still a puppy, even though it is not offered on a "stand-alone" basis.

<sup>&</sup>lt;sup>1</sup> The myth that the pizzeria does not offer delivery becomes even more difficult to maintain when the pizzeria advertises quick delivery as one of its advantages over competitors. That, of course, is the case with cable broadband.

Despite the Court's mighty labors to prove otherwise, the telecommunications component of cable-modem service retains such ample independent identity that it must be regarded as being on offer—especially when seen from the perspective of the consumer or the end user, which the Court purports to find determinative. The Commission's ruling began by noting that cable-modem service provides *both* "high-speed access to the Internet" *and* other "applications and functions," *Declaratory Ruling* 4799, ¶ 1, because that is exactly how any reasonable consumer would perceive it: as consisting of two separate things.

The consumer's view of the matter is best assessed by asking what other products cable-modem service substitutes for in the marketplace. Broadband Internet service provided by cable companies is one of the three most common forms of Internet service, the other two being dial-up access and broadband Digital Subscriber Line (DSL) service. In each of the other two, the physical transmission pathway to the Internet is sold—indeed, *is legally required* to be sold—separately from the Internet functionality. With dial-up access, the physical pathway comes from the telephone company and the Internet service provider (ISP) provides the functionality.

"In the case of Internet access, the end user utilizes two different and distinct services. One is the transmission pathway, a telecommunications service that the end user purchases from the telephone company. The second is the Internet access service, which is an enhanced service provided by an ISP .... Th[e] functions [provided by the ISP] are separate from the transmission pathway over which that data travels. The pathway is a regulated telecommunications service; the enhanced service offered over it is not." Oxman, The FCC and the Unregulation of the Internet, p. 13 (FCC, Office of Plans and Policy, Working Paper No. 31, July 1999), available at http://www.fcc.gov/ Bureaus/OPP/working\_papers/oppwp31.pdf (as visited June 24, 2005, and available in the Clerk of Court's case file).

As the Court acknowledges, DSL service has been similar to dial-up service in the respect that the physical connection to the Internet must be offered separately from Internet functionality.<sup>3</sup> Thus, customers shopping for dial-up or DSL service will not be able to use the Internet unless they get both someone to provide them with a physical connection and someone to provide them with applications and functions such as e-mail and Web access. It is therefore inevitable that customers will regard the competing cable-modem service as giving them *both* computing functionality *and* the physical pipe by which that functionality comes to their computer—both the pizza and the delivery service that nondelivery pizzerias require to be purchased from the cab company.<sup>4</sup>

<sup>&</sup>lt;sup>3</sup> In the DSL context, the physical connection is generally resold to the consumer by an ISP that has taken advantage of the telephone company's offer. The consumer knows very well, however, that the physical connection is a necessary component for Internet access which, just as in the dial-up context, is not provided by the ISP.

<sup>&</sup>lt;sup>4</sup> The Court contends that this analogy is inapposite because one need not have a pizza delivered,

Since the delivery service provided by cable (the broad-band connection between the customer's computer and the cable company's computer-processing facilities) is downstream from the computer-processing facilities, there is no question that it merely serves as a conduit for the information services that have already been "assembled" by the cable company in its capacity as ISP. This is relevant because of the statutory distinction between an "information service" and "telecommunications." The former involves the capability of getting, processing, and manipulating information. § 153(20). The latter, by contrast, involves no "change in the form or content of the information as sent and received." § 153(43). When cable-company-assembled information enters the cable for delivery to the subscriber, the information service is already complete. The information has been (as the statute requires) generated, acquired, stored, transformed, processed, retrieved, utilized, or made available. All that remains is for the information in its final, unaltered form, to be delivered (via telecommunications) to the subscriber.

This reveals the insubstantiality of the fear invoked by both the Commission and the Court: the fear of what will happen to ISPs that do not provide the physical pathway to Internet access, yet still use telecommunications to acquire the pieces necessary to assemble the information that they pass back to their customers. According to this reductio, if cable-modem-service providers are deemed to provide "telecommunications service," then so must all ISPs because they all "use" telecommunications in providing Internet functionality (by connecting to other parts of the Internet, including Internet backbone providers, for example). In terms of the pizzeria analogy, this is equivalent to saying that, if the pizzeria "offers" delivery, all restaurants "offer" delivery, because the ingredients of the food they serve their customers have come from other places; no matter how their customers get the food (whether by eating it at the restaurant, or by coming to pick it up themselves), they still consume a product for which delivery was a necessary "input." This is nonsense. Concluding that delivery of the finished pizza constitutes an "offer" of delivery does not require the conclusion that the serving of prepared food includes an "offer" of delivery. And that analogy does not even do the point justice, since "telecommunications service" is defined as "the offering of telecommunications for a fee directly to the public." 47 U.S.C. § 153(46) (emphasis added). The ISPs' use of telecommunications in their processing of information is not offered directly to the public.

The "regulatory history" on which the Court depends so much provides another reason why common-carrier regulation of all ISPs is not a worry. Under its *Computer* 

whereas one must purchase the cable connection in order to use cable's ISP functions. But the ISP functions provided by the cable company *can* be used without cable delivery—by accessing them from an Internet connection other than cable. The merger of the physical connection and Internet functions in cable's offerings has nothing to do with the "inextricably intertwined," nature of the two (like a car and its carpet), but is an artificial product of the cable company's marketing decision not to offer the two separately, so that the Commission could (by the *Declaratory Ruling* under review here) exempt it from common-carrier status.

Inquiry rules, which foreshadowed the definitions of "information" and "telecommunications" services, the Commission forbore from regulating as common carriers "value-added networks"—non-facilities-based providers who leased basic services from common carriers and bundled them with enhanced services; it said that they, unlike facilities-based providers, would be deemed to provide only enhanced services. That same result can be achieved today under the Commission's statutory authority to forbear from imposing most Title II regulations. 47 U.S.C. § 160. In fact, the statutory criteria for forbearance—which include what is "just and reasonable," "necessary for the protection of consumers," and "consistent with the public interest," § § 160(a)(1), (2), (3)—correspond well with the kinds of policy reasons the Commission has invoked to justify its peculiar construction of "telecommunications service" to exclude cable-modem service.

The Commission also says its *Computer Inquiry* rules should not apply to cable because they were developed in the context of telephone lines. Brief for Federal Petitioners 35-36. But to the extent that the statute imported the *Computer Inquiry* approach, there is no basis for applying it differently to cable than to telephone lines, since the definition of "telecommunications service" applies "regardless of the facilities used." 47 U.S.C. § 153(46).

The Court also puts great stock in its conclusion that cable-modem subscribers cannot avoid using information services provided by the cable company in its ISP capacity, even when they only click-through to other ISPs. For, even if a cable-modem subscriber uses e-mail from another ISP, designates some page not provided by the cable company as his home page, and takes advantage of none of the other standard applications and functions provided by the cable company, he will still be using the cable company's Domain Name System (DNS) server and, when he goes to popular Web pages, perhaps versions of them that are stored in the cable company's cache. This argument suffers from at least two problems. First, in the context of telephone services, the Court recognizes a de minimis exception to contamination of a telecommunications service by an information service. A similar exception would seem to apply to the functions in question here. DNS, in particular, is scarcely more than routing information, which is expressly excluded from the definition of "information service." 47 U.S.C. § 153(20). Second, it is apparently possible to sell a telecommunications service separately from, although in conjunction with, ISP-like services; that is precisely what happens in the DSL context, and the Commission does not contest that it *could* be done in the context of cable. The only impediment appears to be the Commission's failure to require from cable companies the unbundling that it required of facilities-based providers under its Computer Inquiry.

Finally, I must note that, notwithstanding the Commission's self-congratulatory paean to its deregulatory largesse, *e.g.*, Brief for Federal Petitioners 29-32, it concluded the *Declaratory Ruling* by asking, as the Court paraphrases, "whether under its Title I jurisdiction [the Commission] should require cable companies to offer other ISPs access to their facilities on common-carrier terms." *Ante*, see also Reply Brief for

Federal Petitioners 9; Tr. of Oral Arg. 17. In other words, what the Commission hath given, the Commission may well take away—unless it doesn't. This is a wonderful illustration of how an experienced agency can (with some assistance from credulous courts) turn statutory constraints into bureaucratic discretions. The main source of the Commission's regulatory authority over common carriers is Title II, but the Commission has rendered that inapplicable in this instance by concluding that the definition of "telecommunications service" is ambiguous and does not (in its current view) apply to cable-modem service. It contemplates, however, altering that (unnecessary) outcome, not by changing the law (i.e., its construction of the Title II definitions), but by reserving the right to change the facts. Under its undefined and sparingly used "ancillary" powers, the Commission might conclude that it can order cable companies to "unbundle" the telecommunications component of cable-modem service. And presto, Title II will then apply to them, because they will finally be "offering" telecommunications service! Of course, the Commission will still have the statutory power to forbear from regulating them under § 160 (which it has already tentatively concluded it would do, Declaratory Ruling 4847-4848, ¶ ¶ 94-95). Such Möbius-strip reasoning mocks the principle that the statute constrains the agency in any meaningful way.

After all is said and done, after all the regulatory cant has been translated, and the smoke of agency expertise blown away, it remains perfectly clear that someone who sells cable-modem service is "offering" telecommunications. For that simple reason set forth in the statute, I would affirm the Court of Appeals. \*\*\*

<sup>&</sup>lt;sup>7</sup> Under the Commission's assumption that cable-modem-service providers are not providing "tele-communications services," there is reason to doubt whether it can use its Title I powers to impose common-carrier-like requirements, since 47 U.S.C. § 153(44) specifically provides that a "telecommunications carrier shall be treated as a common carrier under this chapter *only to the extent* that it is engaged in providing telecommunications services" (emphasis added), and "this chapter" includes Titles I and II.