BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION

WASHINGTON, D.C. 20554

In the Matter of	)	
	)	
Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming	)))	CS Docket No. 01-129

COMMENTS OF AT&T CORP.

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AT&T Corp. ("AT&T"), by its attorneys, hereby files its comments in response to the Commission's Notice of Inquiry ("*Notice*") in the above-captioned proceeding.[1]

I. INTRODUCTION AND SUMMARY.

Marketplace evidence demonstrates that MVPD competition is significant and growing. In particular, non-cable MVPDs now account for approximately 23% of all multichannel video customers, a highly significant market penetration figure given that Congress has determined that a local franchise with 15% non-cable distribution is effectively competitive.[2] DBS alone serves over 18% of multichannel video customers, and DirecTV and EchoStar are the third and seventh largest MVPDs, respectively. Both companies continue to experience significant growth and industry experts predict this trend will continue, particularly in light of DBS's ability to offer

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1 *In re Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Notice of Inquiry, CS Docket No. 01-129, FCC 01-191 (rel. June 25, 2001) ("*Notice*").

2 *See* 47 U.S.C. § 543(l)(1)(B) (defining "effective competition").

local broadcast signals. Indeed, the Commission already has concluded that *DBS is an effective substitute for cable service*.

Moreover, economic theory and Commission precedent make plain that a static analysis of market share alone is not sufficient to establish market power. Rather, the Commission must assess an array of dynamic factors that affect the incentive and ability to control price or output. Applying these basic economic principles, it is apparent that the supply elasticity of DBS providers is sufficient to constrain any attempt by cable operators to exercise market power. Indeed, cable operators' continuing efforts to increase the amount and quality of video programming they offer and to provide innovative services like competitive telephony, while holding prices in line, confirms this conclusion.

Cable operators' efforts to cluster cable systems also reflect the competitive nature of the video marketplace. As the Commission and other governmental agencies have acknowledged, clustering provides efficiencies that enable cable operators to compete more effectively for video and non-video customers, by offering more programming at lower per unit prices, as well as providing better customer service, and delivering higher quality signals. Indeed, AT&T provided data to the Commission last year showing that clustering facilitated the rollout of digital video, telephony, and cable Internet services.[3]

Cable operators also lack market power in the *purchase* of video programming. A careful analysis of the market for wholesale purchase of video programming shows that

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[3] As AT&T indicated last year, the Commission's methodology for analyzing the effects of clustering on cable prices failed to weigh properly various factors. Although the Commission made some corrections to its methodology in response to AT&T's concerns, there still remain flaws that should be addressed.

numerous purchasers compete vigorously for access to video programming content. DBS is a leading competitor in this market, but there are others, many of whom the Commission has failed to take into account in its market analysis, including broadcast networks and stations, foreign video program distributors, and producers of videocassettes and DVDs. When making policy decisions that call for an assessment of the competitive status of cable operators in the program acquisition marketplace (*e.g.*, the cable horizontal ownership provisions), the Commission must consider *all* of these competing purchasers of video programming in order to accurately determine whether and to what extent individual purchasers can exercise market power in this marketplace.

Finally, competitive forces continue to drive AT&T's rollout of advanced digital services. AT&T has invested billions of dollars upgrading its networks to accommodate digital video as well as advanced services, such as telephony, cable Internet service, and interactive television. Likewise, in response to the aggressive bundling efforts of its competitors, AT&T is offering attractive broadband packages, including digital video, cable Internet service, and telephony, in numerous markets. Such packaged offerings afford consumers greater choice, lower prices, and better value.

In short, cable operators have been steadily increasing output, investing heavily in new service and technology innovations, and holding the line on prices. Stated another way, cable operators are acting precisely as one would expect companies subject to competition to act.

II. THE COMMISSION SHOULD ACKNOWLEDGE THAT THE VIDEO DISTRIBUTION INDUSTRY TODAY IS DRIVEN BY COMPETITIVE MARKET FORCES.

The MVPD marketplace is now unmistakably competitive. Accordingly, it is appropriate for the Commission to relax or eliminate existing cable regulations and avoid adopting new regulations that will reduce incentives for continued investment and innovation.

A. Market Data Confirm That Competition in the MVPD Marketplace Is Already Strong and Growing Stronger.

MVPD competition is robust. According to the most recent data, non-cable MVPDs now serve approximately 23% of multichannel video customers nationwide, up from 20% a year ago.[4] Indeed, since 1993, non-cable MVPD homes have increased at an average rate of 1.69 million new subscribers per year, many times greater than cable's growth rate.[5] Analysts agree that this trend will continue. Kagan Media, for example, estimates that non-cable distributors will account for 25% of the MVPD market in another year.[6] Likewise, the Strategis Group projects that by 2006 non-cable MVPD market share will have increased to 27% with revenues of approximately $20.5 billion, almost half of the revenue cable operators will realize.[7]

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4 *See Media Index Database*, Kagan Media Money, June 26, 2001, at 11.

5 *See* NCTA, *Cable & Telecommunications Industry Overview 2001*, at 12 (June 2001) ("*NCTA Cable Industry Overview*") (noting that the total number of non-cable MVPDs grew from 3.08 million in 1993 to 19.93 million (or 22.6% of all multichannel video subscribers) in March, 2001), *available at* http://www.ncta.com/docs/otherNews.cfm?PRid=156&showArticles=ok.

6 *See Media Index Database*, *supra* note 4, at 11.

7 *See* Charles Dorrier et al., The Strategis Group, *U.S. Digital Cable Market: Beyond IPGs and the 200 Channel Future* at 48, 50 (May 2001).

1. The Continued Explosive Growth of DBS Demonstrates That There Are Viable Alternative Sources of MVPD Services Available to Consumers Throughout the United States.

DBS continues to be cable's most vigorous competitor.[8] DirecTV and EchoStar now account for 18.2% of multichannel video customers, and rank today as the third and seventh largest MVPDs, respectively. DBS grew 20 times faster than cable last year, with both DirecTV and EchoStar experiencing significant subscriber growth.[9] DirecTV recently reported that it added 175,000 net customers in the second quarter of this year.[10] EchoStar fared even better, adding approximately 350,000 net new subscribers in the second quarter, and now exceeds 6 million total subscribers, a 41% increase over the last year.[11] Moreover, analysts estimate that

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8 *See In re Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Seventh Annual Report, 16 FCC Rcd. 6005, at ¶ 61 (rel. Jan. 8, 2001) ("*2000 Video Competition Report*") (noting that DBS, with its nationwide coverage area, is the "principal competitor" to cable). Overbuilders are also continuing to provide increased competition to cable companies. *See, e.g.*, Joe Estrella & Linda Haugsted, *Despite Some Losses, Overbuilds Persist*, Multichannel News, June 11, 2001, at 56 (describing service deployments of WideOpenWest, Seren, Knology, and other cable overbuilders); Press Release, RCN Corp., *RCN Announces Second Quarter Results* (Aug. 2, 2001) (announcing that RCN added 65,916 new subscribers in the second quarter of this year bringing its total to 606,429), *available at* http://www.rcn.com/investor/press/08-01/08-02-01/index.html; Linda Haugsted, *Knology 2Q Revenue Growth Robust*, Multichannel News, Aug. 2, 2001 (reporting that Knology reported an 8% increase in revenue for the second quarter of this year and that it "has 207,493 connections from 399,958 marketable passings"), *available at* http://www.tvinsite.com/multichannelnews/index.asp?layout=story&doc_id=39747&display=breakingNews.

9 *See 2000 Video Competition Report* at ¶ 14 (comparing 1.5% growth rate for cable with 29% growth rate for DBS).

10 *See* Press Release, Hughes Elecs. Corp., *Hughes Reports Second Quarter 2001 Financial Results* (July 16, 2001) ("DirecTV Press Release"), *available at* http://www.hughes.com/ir/pr/01_07_16_2nd_quarter.xml.

11 Press Release, EchoStar Communications Corp., *EchoStar Reports Positive Net Income, Record EBITDA and 50 Percent Revenue Growth in Second Quarter* (July 19, 2001) (also

(footnote continued…)

DBS will add another 3 million subscribers next year, bringing their total to 19 million,[12] and will eventually grow to 25 million by the end of 2005 and 27 million by 2008.[13]

The Commission has recognized the significant impact DBS has had on competition in the multichannel video distribution market. In its *2000 Price Report*, the Commission found for the first time that *DBS is a substitute for cable services*.[14] The Commission explained that the change in DBS's competitive status could be attributed to DBS's new ability to deliver to its customers local broadcast television signals.[15] In fact, DirecTV now provides local signals in 43

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reporting second quarter revenue of $966 million, a 49.5% increase over its second quarter 2000 revenue, and posting a profit for the first time), *available at* http://www.corporate-ir.net/ireye/ir_site.zhtml?ticker=dish&script=400.

12 *See Media Index Database*, *supra* note 4, at 11.

13 *See* Vijay Jayant et al., Morgan Stanley Dean Witter, *DBS: Undervalued as Story Transitions* at 5 (Jan. 22, 2001) (projecting 27 million subscribers by 2008); David B. Kestenbaum & Michael K. French, ING Barings, *The Impact of Interactive TV on DBS* at 10, 16 (Feb. 23, 2001) (projecting 13.6 million DirecTV and 12.5 million Echostar subscribers by 2005); Adam Simon & Barry A. Kaplan, Goldman Sachs, *Satellite Communications: DBS Operators* (Dec. 18, 2000) (projecting 27 million subscribers by 2010); Ryan Jones, The Yankee Group, *Direct Broadcast Satellite: Growth in New Directions* at 1 (Sept. 2000) (projecting 25 million DBS subscribers by the end of 2005).

14 *See In re Statistical Report on Average Rates for Basic Service, Cable Programming Services, and Equipment*, Report, 16 FCC Rcd. 4346 at ¶ 53 (Feb. 14, 2001) ("*2000 Price Report*"). The Justice Department previously reached the same conclusion. *See* Complaint, *United States v. Primestar, Inc.*, No. 1:98CV01193, at 63 (D.D.C. 1998) (noting that "consumers view [cable and DBS] as similar and to a large degree substitutable").

15 *See 2000 Price Report* at ¶ 53. *See also* Horowitz Associates, Inc., *Digital TV VII: A Survey of Consumers in Digital Cable Markets* at 17 (Apr. 2001) (noting positive effect of local channels on the market potential for DBS).

markets, and EchoStar in 36 markets,[16] and both providers have plans to expand this service into additional markets.[17] DirecTV's exclusive arrangements for key sports and entertainment programming have also given it a significant competitive advantage relative to cable.[18]

In addition, DBS is attracting new customers with a variety of advanced services, including high-speed Internet and interactive television ("ITV"). DirecTV, for example, is providing high-speed Internet to over 140,000 customers through its DSL and satellite offerings, a 50% increase over the last year.[19] Likewise, EchoStar recently announced that it is investing an additional $50 million in StarBand, a satellite broadband service, and will fund construction and launch of a new satellite to carry StarBand's broadband traffic.[20] Both DBS providers also

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16 *See* DirecTV, *Local Channels Are Now Available!*, *at* http://www.directv.com/howtoget/howtogetpages/0,1076,224,00.html; Echostar, *Programming -- Local Networks*, *at* http://www.dishnetwork.com/content/programming/locals/index.shtml.

17 *See, e.g.*, *DirecTV's Hartenstein: Over 10 Million Served*, Multichannel News, June 25, 2001, at 1, 14 (quoting DirecTV CEO Eddy Hartenstein as saying: "We'll get more [local] channels, more markets later this year when we get the first of our two spot-beam satellites up, and it will only keep getting better after that.").

18 *See, e.g.*, Press Release, DirecTV, *DirecTV Offers Last Six Weeks of 2000 NFL Sunday Ticket Free to New Residential Customers* (Nov. 6, 2000) (noting that NFL Sunday Ticket is not available on cable or any other DBS service in the United States); Press Release, DirecTV, *DirecTV Taps Rick Majerus to Promote 2001 Mega March Madness Package* (Feb. 27, 2001) (noting that package offering customers up to 37 out-of-market games from the first three rounds of the 2001 NCAA tournament is not available on cable); Press Release, DirecTV, *MCY Syndicates Exclusive Broadcast Rights for The Who Concert* (July 23, 2001) (noting that The Who's all-star charity concert is not available on any other multichannel service).

19 *DirecTV Press Release*, *supra* note 10.

20 *See* Press Release, StarBand Communications, *EchoStar Assumes Controlling Equity Stake in StarBand* (July 11, 2001) (noting that EchoStar's investment reflects its "strategy to offer a complete bundled package of Internet programming and interactive television services"), *available at* http://www.starband.com/whoweare/pr/071101.htm. In its first year of existence, StarBand has already installed over 40,000 modems in the United States. *See* Felicia Morton,
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are pursuing vigorously the development and deployment of ITV services, as documented in AT&T's comments in the ITV proceeding.[21] Industry analysts have remarked that these ITV offerings will "add[] substantially to DBS's value proposition to consumers, which will make their product more competitive with cable's,"[22] and that "the level of interactivity placed into the future [DBS] set top boxes will be more powerful than [was] originally anticipated, drawing more multichannel customers toward DBS than previously forecasted."[23]

In short, DBS is a powerful presence in the marketplace today. It has been well documented that 80% of the growth in multichannel video subscribership -- four out of every five new subscribers -- are going to DBS.[24] Indeed, DBS providers clearly view themselves as

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StarBand's Piece in the Satellite Internet Puzzle, Washtech.com, July 31, 2001, *at* http://www.washtech.com/cgi-bin/udt/WTW.PRINT.STORY?client=washtech-test&storyid=11584. Moreover, Microsoft is assisting StarBand "by configuring a desktop PC that includes a pre-installed transmitter and receiver card distributed via RadioShack." ISP Business News, *Broadband and Dial-Up Tug of War Rages On*, BIGPIPE.com, July 31, 2001, *available at* http://www.cabletoday.com/ct/996583575.html.

21 *See* AT&T Comments, filed in CS Docket No. 01-7, at 14-19 (Mar. 19, 2001).

22 Simon & Kaplan, *supra* note 13, at 28, 30 (also noting that DBS operators have "strong partners that offer technological expertise, content, and marketing"; a high-speed return path via satellite that will not tie up a subscriber's phone line; and a substantial opportunity to market their product in rural areas).

23 Marc E. Nabi et al., Merrill Lynch, *Direct Broadcast Satellite: TV Interactivity Produces Three Increases for 2001 -- Subscribers, Price Objectives and Acquisition Costs* at 2 (Sept. 26, 2000).

24 *See, e.g.*, NCTA Comments, filed in CS Dkt. No. 00-132, at 10 (Sept. 8, 2000). *See also Picture Quality Ranks High for DBS Subs*, SkyREPORT.com, July 23, 2001 (noting that multichannel video customers continue to choose DBS as an alternative to cable with almost half those polled expressing "dissatisfaction with cable" as an important reason for getting DBS), *at* http://www.skyreport.com/skyreport/july2001/072301.htm - three.

effective competitors to cable. As DirecTV's CEO noted in a recent interview, "We've always been a step ahead of cable. We are still ahead, and we'll leap-frog over them yet again when we complete our local channel build-out and add all these program-synchronous interactive services."[25] In these circumstances, the Commission plainly should acknowledge that competitive market forces are driving the video distribution market today, and should take the increasingly dynamic, highly competitive nature of the market into account in making policy decisions regarding future regulation of this industry.

B. Market Share Data Alone Significantly Understate the Current Impact of Market Forces in the Video Distribution Market.

It is a plain fact that cable's market share is dwindling steadily. Moreover, the Commission has recognized that market share is only the *beginning* of the analysis as to whether a particular competitor has market power. Under a dynamic analysis that accounts for *all* relevant criteria, the evidence is even more compelling that the growing strength of DBS constrains cable operators from exercising market power.

1. Commission Precedent Makes Plain That Market Share Alone Is Not Sufficient to Establish Market Power.

It is an economic commonplace that market share alone is not sufficient to establish market power.[26] Market share does not equate with market power because it is generally a

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[25] *DirecTV's Hartenstein: Over 10 Million Served*, *supra* note 17, at 14 (also quoting Eddy Hartenstein as saying that "the single feature about Hughes [(DirecTV's corporate parent)] that is the most exciting is the growth potential . . . not only on the television side, but on the satellite-delivered broadband side as well").

[26] *See, e.g.*, Phillip E. Areeda et al., *IIA Antitrust Law: An Analysis of Antitrust Principles and Their Application* ¶ 532 (1995); *United States v. General Dynamics Corp.*, 415 U.S. 486, 498 (1974); *United States v. Baker Hughes, Inc.*, 908 F.2d 981, 986 (D.C. Cir. 1990); *Broadway*

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measure of how successful a firm has been in the *recent past*. Market power, in contrast, reflects how consumers and alternative suppliers would respond *in the future* should a firm try to raise prices above competitive levels. Thus, as the U.S. Court of Appeals for the D.C. Circuit recently noted in its *Time Warner* decision, "a company's ability to exercise market power depends not only on its share of the market, but also on elasticities of supply and demand, which in turn are determined by the availability of competition."[27]

The Commission has followed this approach, noting that "[m]arket share alone is not necessarily a reliable measure of competition, particularly in markets with high supply and demand elasticities."[28] Rather, a determination of a firm's market power requires an assessment of an array of dynamic factors that affect the incentive and ability to control price or output. As the Commission has explained, "[e]ven a firm with a very large market share cannot automatically be presumed to have market power; more research would be needed regarding whether there are competitive factors such as ease of entry, excess capacity held by competitors, etc., that would defeat any attempt by the firm to exercise market power despite its very large market share."[29]

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Delivery Corp. v. United Parcel Serv. of Am., Inc., 651 F.2d 122, 127-30 (2d Cir. 1981); *Oahu Gas Serv., Inc. v. Pacific Res. Inc.*, 838 F.2d 360, 366-67 (9th Cir. 1988).

27 *Time Warner Entm't v. FCC*, 240 F.3d 1126, 1134 (2001) ("*Time Warner*").

28 *Competition in the Interstate Interexchange Marketplace*, 6 FCC Rcd. 5880, at ¶ 51 (1991).

29 *Prime Time Access Rule*, 11 FCC Rcd. 546, at ¶ 24 & n.44 (1995).

Thus, the Commission consistently has rejected market power claims that focus on static market shares, while failing to take into account dynamic considerations. For example, in *Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier*, the Commission rejected claims that AT&T could exercise market power in the domestic long distance market at a time when AT&T served significantly more than half of all long distance customers.[30] Despite AT&T's high market share, the Commission concluded that it lacked market power because other long distance providers could and would "expand to serve additional AT&T customers should AT&T attempt to charge a supra-competitive price."[31]

2. The Growing Strength of DBS, Together with Its Ability to Expand Output, Effectively Prevents Cable Operators from Exercising Market Power.

Through their ability to increase supply rapidly, DBS providers have the essential characteristics of firms that constrain or eliminate the market power of a firm with a substantial market share. First, DBS providers have virtually unlimited capacity to increase the number of customers they serve, and can rapidly expand output because their networks already provide 100% national coverage. Second, even at expanded service levels, the marginal cost of serving each additional DBS customer remains very low. The marginal cost of using the satellite to serve another customer is zero; the marginal cost of providing customers with reception equipment is small and falling; and the cost of providing programming services to additional customers is similar to that for a cable operator. Consequently, the supply elasticity of DBS

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[30] *Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier*, 11 FCC Rcd. 3271 (1995).

[31] *Id.* at ¶ 62. *See also id.* at ¶ 58; *LEC Provision of Interexchange Services*, 12 FCC Rcd. 15,756, at ¶ 28 (1997).

providers is sufficient to constrain any attempt by a cable operator to increase prices or otherwise exercise market power, notwithstanding that operator's current market share.[32] Indeed, in remanding the Commission's cable ownership rules, the *Time Warner* court noted that by failing to adequately consider these facts the Commission did not fully account for "the impact of DBS on [a cable operator's] market power."[33]

Cable operators' behavior reflects the significant marketplace constraints imposed by DBS. This is particularly true when one looks at the criteria which Chairman Powell has identified as indicating the presence or absence of a competitive market, including: (1) whether cable operators are imposing non-cost-based price increases; (2) whether cable operators are restricting output; and (3) whether cable operators are refraining from innovating.[34] The cable industry's conduct with respect to each of these criteria confirms that the MVPD marketplace is competitive.

Price increases are not evidence of a lack of competition unless they substantially exceed a firm's costs. In the case of video programming, the Commission has already found that cable operators' programming costs have increased dramatically (more than 10% over each of the last

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32 *See* NCTA Comments, filed in CS Dkt. No. 99-230, at Att. A-9-10 (Aug. 6, 1999) (Economists Incorporated, *FCC Video Competition Proceeding: Use and Limitations of Structural Indicia of Market Power*).

33 *Time Warner*, 240 F.3d at 1134.

34 *See In re Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Fifth Annual Report, 13 FCC Rcd. 24,284, 24,485-86 (1998) (Separate Statement of Commissioner Powell) ("*1998 Video Competition Report*").

two years) as have infrastructure expenses.[35] Yet, the cable industry has held the line on prices. Since 1986, the per channel price for cable has *decreased* when adjusted for inflation from 69¢ per channel to 66¢ per channel in spite of soaring programming costs.[36] The Commission's *2000 Price Report* also suggests competitive pressures are constraining cable prices. In particular, the Commission found that per channel rates were relatively unchanged over the last year, even when *not* accounting for inflation, and that average monthly rate increases for the basic service tier, cable programming service tier, and equipment were the same for cable systems subject to effective competition as those that were not.[37] Stated another way, the impact of DBS is felt even in systems that are *not* deemed "competitive" under the criteria established in the Commission's current rules.

Moreover, cable operators are not restricting output. Rather, they are responding to the competitive challenge from DBS by increasing the number of channels and programs available to consumers. In fact, over the last five years, cable operators have spent over $50 billion dollars, including $12.4 billion in 2000 alone, upgrading their facilities to provide new services to their customers.[38] Cable operators also are investing heavily in programming, spending over

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35 *See 2000 Video Competition Report* at ¶ 24 (noting that programming expenses rose 12.2% in 1999, and were projected to rise an additional 10.9% in 2000), ¶ 33 (estimating that capital expenditures increased 17% in 2000).

36 *See NCTA Cable Industry Overview* at 5.

37 *See 2000 Price Report* at ¶¶ 4, 8.

38 *See NCTA Cable Industry Overview* at 1-2; NCTA, *Cable Telephony: Offering Consumers Competitive Choice* at 1 (July 2001) ("*NCTA Cable Telephony Report*"), *available at* http://www.ncta.com/press/press.cfm?PRid=160&showArticles=ok. Analysts predict that, by the end of 2001, 60% of all cable homes will be passed by two-way cable plant capable of

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$26 billion over the past three years on video services, including many new digital networks.[39] The Commission's previous *Competition Reports* have confirmed that cable prices have increased modestly while cable's average channel capacity and the number of national programming services cable distributes have increased steadily.[40]

Further, cable companies have devoted billions of dollars to upgrading their cable facilities to provide customers with new digital services, including digital video, cable Internet service, and telephony. To take just one example, AT&T estimates that, since 1996, investments to upgrade its cable networks exceed $4 billion. In the past quarter alone, AT&T spent $871 million on cable network improvements.[41] AT&T's cumulative investment has resulted in the upgrade of over 71% of AT&T's cable plant to at least 550 MHz, with 56% of the network

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delivering ITV services, cable Internet service, and cable telephony. *NCTA Cable Industry Overview* at 2.

39 *See NCTA Cable Industry Overview* at 2 (also noting that the number of programming services has increased from 82 to 231 over the last ten years); NCTA, *Cable Television Handbook*, Jan. 2001, at 1-D-3, *available at* <http://www.ncta.com/industry_overvie w/aboutIND.cfm?indOverviewID=50&prevID=1>.

40 *See, e.g.*, *2000 Video Competition Report* at ¶¶ 9, 14, 20-25 (12% increase in programming costs, 3.8% increase in cable prices, channel capacity increased substantially, and national programming services decreased by less than 1%); *In re Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Sixth Annual Report, 15 FCC Rcd. 978 at ¶¶ 9, 15 (2000) ("*1999 Video Competition Report*") (programming costs increased by 15%, prices by 3.8%, channel capacity significantly, and national programming services by 16%). During the 2000-01 TV season, basic cable programmers received their *highest-ever* primetime viewership. *See NCTA Cable Industry Overview* at 2 (noting that basic cable finished the season with a 25.5 rating and a 41.7 share).

41 *See Second Quarter Earnings From Continuing Operations Were $0.04 Per Diluted Share*, AT&T Group Earnings Commentary, Quarterly Update -- Second Quarter 2001, July 23, 2001, at 11, *available at* http://www.att.com/ir/efr/ - commentary.

upgraded to 750 MHz. Because of these upgrades, AT&T can now offer digital video to the majority of its customers, broadband telephony to over six million homes, and cable Internet service to over 14 million homes.[42] And consumer demand for these new services has been remarkable. As of June 30, 2001, AT&T provided digital video service to 3.1 million customers, a 41% increase over the last year; telephony service to 848,000 customers, an increase of 183% from a year earlier; and cable Internet service to 1.3 million customers, a 92% increase over the last year.[43] AT&T is also test marketing other innovative services, including video-on-demand and personal video recorders.

In short, cable operators are exhibiting the very types of behaviors that signal a competitive market. In various proceedings, the Commission has acknowledged this evidence, and it should do so again here by concluding that the presence of DBS, and particularly its rapid growth, constrain cable operators from exercising market power, notwithstanding their current market share.

C. The Benefits Derived from the Clustering of Cable Systems Also Reflect the Impact of Competition in the Video Marketplace.

The Commission again invites comment on the effects of clustering of cable systems on consumer prices and the rollout of advanced services, including cable telephony and cable

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[42] *See id.* at 10.

[43] *See id.* For the cable industry as a whole, as of June 30, 2001, approximately 12 million cable customers subscribe to digital cable, over 1.3 million cable customers subscribe to cable telephony, and over 5 million cable customers subscribe to cable Internet service, with an additional 2.2. million expected to be added in the remainder of 2001. *See NCTA Cable Industry Overview* at 6-9; *NCTA Cable Telephony Report* at 1.

Internet service.[44] The *Notice* questions the benefits of clustering, noting that the *2000 Price Report* found that clustered systems had higher average prices than non-clustered systems and that clustered systems had similar rates of deployment for advanced services as compared to all systems (clustered and non-clustered).[45] As AT&T demonstrates below, however, clustering *does* provide substantial consumer benefits. Moreover, while the Commission has made certain helpful changes to its methodology for analyzing the effect of clustering on cable pricing, there remain flaws that should be addressed.

1. Clustering Enables Cable Operators to Compete More Effectively with DBS and Other Competitors.

As AT&T and other MSOs have demonstrated in previous filings, clustering provides the very types of benefits that enable cable operators to compete more effectively for video and non-video customers. In particular, clustering allows cable operators to: (1) spread costs over a number of systems and a larger subscriber base; (2) deliver a higher quality signal to consumers; (3) offer more local and regional programming; (4) provide better customer service and fewer outages; (5) create more interconnected networks which enhance educational and governmental uses; (6) develop more attractive joint consumer promotions and discounts with retailers and others; and (7) increase advertising revenues which can, in turn, be used to offset a portion of

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44 *See Notice* at ¶ 19.

45 *See id.*

programming and system upgrade expenses.[46] The Commission previously has acknowledged these benefits,[47] as have GAO and NTIA.[48]

As the econometric analysis included in AT&T's comments in last year's *2000 Video Competition* proceeding demonstrated, these benefits are not merely theoretical. AT&T noted that analysis of the data it provided the Commission as part of its *2000 Price Survey* confirmed that clustering facilitated the provision of advanced services, such as local telephony and cable Internet service, in direct competition with the LECs.[49] Moreover, AT&T's data also demonstrated that AT&T's clustered systems provided a greater number of activated channels and a greater number of digital video services than its non-clustered systems.[50] In short,

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[46] *See, e.g.*, AT&T Comments, filed in CS Dkt. No. 00-132, at 6-12 (Sept. 8, 2000) ("AT&T Video Competition Comments"); Comcast Reply Comments, filed in CS Dkt. No. 00-132, at 21-29 (Sept. 29, 2000).

[47] *See 2000 Video Competition Report* at ¶ 166 (noting that the 30% ownership limit "permits cable operators to acquire and cluster systems in order to gain efficiencies related to economies of scale and scope resulting in lower administrative costs, enhanced deployment of new technologies, and encouraging the extension into previously unserved areas"); *1999 Video Competition Report* at ¶¶ 161-165 (noting that clustering "can create greater economies of scale and size," thereby enabling "cable operators to offer a wider variety of broadband services at lower prices to customers in geographic areas that are larger than single cable franchise areas," and thus, "make cable operators more effective competitors to LECs whose local service areas are usually much larger than a single cable franchise area"); *1998 Video Competition Report* at ¶¶ 144-148.

[48] *See* General Accounting Office, *Telecommunications: The Changing Status of Competition to Cable Television* at 28 (July 1999); Letter from Larry Irving, Asst. Secretary of Commerce, to Janet D. Steiger, Chairman, Federal Trade Commission, Jan. 12, 1995, at 1.

[49] *See* AT&T Video Competition Comments at 7-10.

[50] *See id.* at 10.

clustering generated efficiencies and other benefits that have been instrumental in helping AT&T meet the competitive challenge from DBS and other distributors.[51]

2. There Are Flaws in the Commission's Methodology for Analyzing the Effect of Clustering on Cable Prices.

AT&T previously raised concerns with the methodology used by the Commission in its *1999 Price Report* to assess the effect of clustering on monthly cable prices.[52] The Commission responded by modifying its regression equation to include a subscriber variable (*i.e.*, reciprocal of system subscribers), but nonetheless concluded in its *2000 Video Competition Report* that the modified regression "again showed a positive relationship between clustering and average monthly rates" and that "while clustering may help reduce programming and other costs, [the Commission's] findings show that these lower costs are not being passed along to subscribers in the form of lower monthly rates."[53]

As AT&T previously indicated, there are a number of factors that explain why the Commission's analysis yielded the results that it did.[54] Although the Commission accounted for one of these factors in its modified regression, it did not address any of the other factors AT&T

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51 Aside from conflicting with AT&T's 2000 survey data, the Commission's conclusion in its *2000 Price Report* that "clustering did not lead to increases in the availability of Internet or telephony services," *2000 Price Report* at ¶ 9, may reflect temporary anomalies in other cable operators' rollout of cable Internet and telephony services; the relatively immature state of these markets; differences in the approach taken by individual operators in making the difficult technology choices associated with the deployment of still-developing cable Internet, cable telephony, and other advanced services; and the significant economic challenges faced by cable operators in attempting to compete with monopoly incumbent LECs.

52 *See* AT&T Video Competition Comments at 13-17.

53 *2000 Video Competition Report* at ¶ 155 & n.536.

54 *See* AT&T Video Competition Comments at 15-16.

identified. Specifically, the modified regression did not include variables for whether the system offers local telephony or Internet access, the number of subscribers in the franchise generally, or the number of subscribers to the specific package of services and equipment whose price was being analyzed in the regression. The Commission also did not respond to AT&T's concerns regarding the effects of programming costs on cable prices and did not take into consideration that clustering, by facilitating the offering and packaging of multiple video and non-video services, will yield lower *overall* prices for consumers that are not reflected in the Commission's analysis. In addition, the Commission made no mention of the fact that AT&T ran the Commission's own regression equation using AT&T's survey data for 2000, and found that the regression analysis disproved the Commission's claimed connection between clustering and higher cable prices.

In its *2000 Price Report*, which included similar results showing higher prices for clustered systems, the Commission acknowledged that its findings might be due to factors not reflected in its analysis, including: 1) the survey's failure to differentiate between integrated and non-integrated clustered systems; 2) the fact that the efficiencies of clustering may take some time to be realized; and 3) the fact that higher costs may be incurred in the early stages of the integration process.[55] At the very least, the fact that AT&T's analysis, using the Commission's own regression equation on AT&T's 2000 survey data, showed that clustering is *not* associated

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[55] *See 2000 Price Report* at ¶ 43. In an effort to address the first of these concerns, the Commission modified the definition of "clustered" systems for purposes of the 2001 price survey to exclude non-integrated systems. *See In re Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992: Statistical Report on Average Rates for Basic Service, Cable Programming Services and Equipment*, Order, MM Dkt No. 92-266, DA 01-1219, at App. (2001 Cable Price Survey, Question A11) (rel. May 17, 2001).

with higher cable prices seriously calls into question the validity of the Commission's contrary conclusion.[56]

III. THE COMMISSION SHOULD EXPAND ITS DEFINITION OF THE PROGRAM ACQUISITION MARKET TO INCLUDE PURCHASERS OF *ALL* VIDEO PROGRAMMING AND NOT JUST MULTICHANNEL VIDEO PROGRAMMING.

In its prior *Video Competition Reports*, the Commission focused primarily on the state of competition and the choices available to consumers in the video programming distribution market. As AT&T has already shown, a static analysis focusing on the cable industry's share of the video distribution market significantly understates the extent to which market forces currently serve to constrain any attempt by cable operators to exercise market power to the detriment of consumers.

Whatever its conclusions in this area, however, the Commission must take care not to confuse the issue of whether cable operators enjoy market power over consumers in the retail *distribution* of video programming (*i.e.*, *monopoly* power) with the separate issue of whether cable operators can exercise power over video programmers in the wholesale *purchase* of

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[56] Even assuming that the Commission's analysis were methodologically correct and properly took into account all relevant variables, the fact that the results might show higher prices for clustered systems than for non-clustered systems cannot be viewed as an indication that cable operators have market power. Assuming that there are in fact efficiencies of integration associated with the operation of clustered systems (a reasonable assumption, otherwise cable operators would not engage in clustering), under well-accepted economic theory, even a profit-maximizing monopolist would be expected to *share* such efficiencies with consumers in the form of lower rates and/or enhanced services. *See, e.g., Natural Gas Clearinghouse v. FERC*, 108 F.3d 397, 399 & n.1 (D.C. Cir. 1997). Under this scenario, then, the pricing pattern observed by the Commission must be the product of some factor *other than* the exercise of market power. The most logical explanation for such results would appear to be *competitive factors* (*e.g.*, supply and demand characteristics) specific to the markets surveyed. Indeed, in a competitive market, such factors would be expected to have a more significant impact on prices than cost factors.

programming (*i.e.*, *monopsony* power).[57] An analysis of the market for the wholesale purchase of video programming shows that numerous purchasers compete vigorously for access to video programming content, and accordingly constrain any power cable operators might have. As an initial matter, DBS and other MVPDs have a profound impact on the power of cable operators over the purchase of video programming.[58] But there are other competitors as well that are not currently taken into account in the Commission's market analysis.

In its *2000 Video Competition Report*, the Commission recognized that the market for the purchase of video programming is a separate and distinct market that exhibits structural characteristics that distinguish it from the video distribution market.[59] It further acknowledged that the "nationwide purchaser MVPD HHI" is at a level that is considered "unconcentrated" under the DOJ/FTC Merger Guidelines.[60] Even so, the Commission's analysis still overstated cable operators' market share in the program acquisition market. By limiting the relevant product market to include only the purchase of "multichannel video programming," the Commission improperly excluded other important purchasers of video programming, including

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57 *See* R. Lipsey et al., *Economics* 976 (7th ed. 1984) ("Monopsony and monopsony power are the equivalent on the buying side of monopoly and monopoly power on the selling side.").

58 Brief for Cable Operator Petitioners at 17-20, *Time Warner Entm't, L.P. v. FCC*, Case No. 94-1035 (D.C. Cir. March 7, 2000) ("AT&T Ownership Brief"). The success of Bloomberg Television and other programmers that have achieved significant subscribership primarily through DBS distribution is testament to the power of DBS in the video supply market. *See, e.g.*, Will Lee, *Bloomberg Jumps Ahead in Net Race*, Cableworld, July 23, 2001, at 1, 12 ("[Bloomberg Television] has been helped considerably by the growth of satellite services, which currently account for nearly two-thirds of its distribution.").

59 *See 2000 Video Competition Report* at ¶ 135.

60 *Id.* at ¶¶ 170-171.

broadcast networks, broadcast stations, foreign purchasers of video programming, and producers of videocassettes and DVDs.[61] The Commission should expand its definition of the program acquisition market to account for these various purchasers.

First, the exclusion of broadcast networks and stations from the relevant market is inconsistent with the Commission's own statement in its *2000 Video Competition Report* that "broadcast networks and stations are competitors to MVPDs in the advertising and program distribution markets."[62] Indeed, as a result of must-carry and retransmission consent arrangements, broadcast networks can effectively ensure ubiquitous, nationwide exposure for programs they purchase. Moreover, with the transition to digital broadcasting, broadcasters are able to multicast video programs and become even larger consumers of video programming. In short, broadcasters compete head-to-head with cable operators for the rights to programming, thereby constraining cable operators' power over programmers.

Second, the Commission's market analysis also ignores the impact of foreign video programming distributors, who purchase vast amounts of video programming. For example, among Viacom's stable of program networks, MTV reaches 370 million households in 140 countries; Nickelodeon is seen in over 300 million households worldwide; VH1 reaches 100 million households worldwide; and BET International reaches 30 countries in Europe and 36 Countries in Africa.[63] Similarly, Disney, Liberty Media, Fox, AOL Time Warner, MGM,

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61 *See* AT&T Ownership Brief at 21.

62 *2000 Video Competition Report* at ¶ 14.

63 Viacom Inc., *The Facts* (visited July 26, 2001), *at* http://www.viacom.com/thefacts.tin.

Universal, and Columbia, among others, sell their programming worldwide.[64] Indeed, with 280 million cable subscribers and 37 million DBS subscribers worldwide, as of the end of 2000, U.S. cable operators represent only 21% of the worldwide cable and DBS purchasers of multichannel video programming.[65] That figure is projected to decline to 16% by 2004.[66]

Finally, the Commission's analysis fails to take into account the purchases of video programming by producers of videocassettes and DVDs. The Commission has acknowledged that "video sales and rentals [are] part of the video marketplace" and that the "home video industry considers cable television, [DBS], and broadcast television as its competition."[67] Indeed, *the video retail industry is the largest source of revenue for movie studios*.[68] There is no logical basis to exclude producers of video cassettes and DVDs from an analysis of the market for the purchase of video programming.

The fact that programming purchased by cable operators and other video program consumers may be packaged and marketed differently does not mean that they do not compete

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64 *See, e.g.*, The Walt Disney Co., *2000 Annual Report* 3-8 (2000); Liberty Media Corp., *Investor Relations -- Liberty Affiliate List* (last visited July 25, 2001), *at* http://www.health-tv.com/investor_relations/03-index.html. *See also* Mike Farrell, *Redstone: Viacom Doesn't Need More Distribution*, Multichannel News, June 18, 2001 ("[Viacom Chairman and CEO Sumner Redstone] said that Viacom properties in Asia, Europe, and Japan have all experienced exponential growth . . . .").

65 Michelle Abraham & Mike Paxton, Cahners In-Stat Group, *Worldwide Digital Satellite and Cable TV Services* at 59, 67 (Dec. 2000).

66 *See id.* (predicting that, in 2004, worldwide DBS subscribers will grow to 95.5 million and cable subscribers will grow to 345.2 million).

67 *2000 Video Competition Report* at ¶ 114.

68 *See id.* at ¶ 116.

directly and vigorously in the program acquisition market. Indeed, from the program producers' perspective, it is the revenue stream available from these non-cable and foreign sources that affects their ability to create quality programming, not the method of packaging or marketing.

When making policy decisions that call for an assessment of the competitive status of cable operators in the program acquisition marketplace (*e.g.*, in implementing the horizontal ownership provisions of the Communications Act), the Commission clearly must consider all of these alternative consumers for video programming in order to accurately assess the degree of "market power," if any, that a cable operator has in the relevant market.[69] When the existence of these competing purchasers is taken into account, it is even more clear that cable operators lack the ability to exercise monopsony power over video programmers.[70]

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[69] Indeed, Section 613 of the Communications Act specifically requires the Commission to look at the market structure of the cable industry, the extent of any "market power" held by cable franchisees, and the "dynamic nature of the communications marketplace" in prescribing rules and regulations (*i.e.*, horizontal and vertical ownership rules). *See* 47 U.S.C. § 533(f)(2)(C), (E).

[70] *See United States v. Syufy Enters., Inc.*, 903 F.2d 659, 665-71 (9th Cir. 1990) (noting that a buyer cannot acquire monopsony power when sellers have meaningful alternative distribution channels for their products). AT&T's recent sale of its interest in several programmers (Speedvision, Food Network, and Outdoor Life) and its imminent spin-off of Liberty Media and sale of its interest in the Sunshine Network further undercut concerns about cable's power in the programming market. Moreover, since 1994, the percentage of vertically integrated programmers has decreased from 53% to 35% relative to the overall number of multichannel video programming services. *Compare In re Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, First Report, 9 FCC Rcd. 7442 at ¶ 161 (1994) (reporting that 53% (or 56 of 106) of national satellite-delivered programmers were vertically integrated), *with 2000 Video Competition Report* at ¶ 173 (noting that 35% (or 99 out of 281) were vertically integrated).

IV. IN RESPONSE TO COMPETITIVE PRESSURES AND CONSUMER DEMAND, AT&T IS CONTINUING TO OFFER ATTRACTIVE PACKAGES OF VIDEO AND NON-VIDEO SERVICES.

The *Notice* also invites comment on the extent to which video programming distributors are packaging video and non-video services.[71] As the Commission observed in the *AT&T/MediaOne Merger Order*, the packaging of services has the potential to provide substantial benefits for consumers, particularly in the form of enhanced choice and lower prices.[72]

AT&T agrees and continues to roll out broadband product packages in markets throughout the country. For example, in the Boston market, a customer can save up to $20.90 per month by subscribing to standard video, digital video, cable Internet service, and local phone service; up to $10.95 per month by subscribing to standard video, digital video, and phone service; and up to $4 per month by subscribing to two of the four services. Likewise, in the Atlanta and Portland markets, a subscriber to digital video, cable Internet service, and/or local phone service can receive a $5 credit for each service, up to $15 per month. In the Pittsburgh market, a customer that purchases digital video and cable Internet service can receive a free

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71 *See Notice* at ¶ 41.

72 *See In re Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from MediaOne Group, Inc. to AT&T Corp.*, MO&O, 15 FCC Rcd. 9816 at ¶ 141 (2000) ("[A] blanket condition prohibiting bundling of any form could have the unintended effect of denying consumers substantial benefits. The merged firm may well have lower costs in billing and servicing customers that subscribe to several of its offerings. In such a case, the merged firm could pass its cost savings to consumers in the form of lower prices. Purchasing the package of bundled services thus could be cheaper than the sum of purchasing each of the bundled services on a stand-alone basis."). *See also In re Applications for the Consent to Transfer of Control of Licenses and Section 214 Authorizations from Tele-Communications, Inc. to AT&T Corp.*, MO&O, 14 FCC Rcd. 3160 at ¶ 125 (1999) (same).

digital video package upgrade for twelve months, and in the San Francisco market, new cable Internet service customers can receive a free month of service when subscribing to phone service.[73] AT&T continues to experience strong consumer demand for these offerings, and is developing plans to market them more broadly.[74]

The recent proliferation of service packages by cable's competitors demonstrates that the competitive pressures to offer these products is not merely speculative. DBS providers are marketing packages of video and non-video services. EchoStar now offers a discount package that combines its "America's Top 150" video programming service with StarBand's satellite broadband access service for $99.00 per month.[75] Similarly, DirecTV offers a single satellite receiver that receives DirecWay/DirecPC, its satellite broadband service, and its programming service.[76]

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73 AT&T is also offering monthly promotions in the San Francisco market, including a plan launched this month that provides video customers with two $25 certificates to be used to credit their video bill when subscribing to cable Internet service.

74 Other cable operators also are marketing telephony to their video and cable modem customers. *See, e.g.*, *Cox Digital Telephone: Benefits and Features* (visited July 27, 2001) (noting 32% savings per month over PacBell for customers who have at least one other qualifying Cox Service), *at* http://www.cox.com/SanDiego/Telephone/benefits.asp.

75 *See* EchoStar, *StarBand Communications* (last visited July 25, 2001), *at* http://www.dishnetwork.com/content/promotions/starband/index.shtml.

76 *See DirecDUO: HNS' Satellite System That Provides Digital Satellite TV and DIRECWAY Broadband Services Using the Same Antenna* (visited Aug. 1, 2001), *at* http://www.hns.com/products/boxes/direcduo/direcduo.htm. DirecTV also offers consumers its DSL service at an introductory rate of $19.99 a month for the DSL service for the first three months. *See* DirecTV, *Introducing DirecTV DSL, The Joy of High-Speed Internet* (visited Aug. 1, 2001), *at* http://www.directvdsl.com/.

Cable overbuild competitors are also offering bundled services. For example, RCN offers its four ResiLink packages, including a Silver package that provides full basic cable service, expanded HBO, a digital set-top box, digital video and music services, local phone service, and an option to get discounted long distance service for approximately $80.00 per month.[77] For $130.00 per month, an RCN customer can get the Gold package that provides all of the Silver options plus Cinemax's premium channels, local phone service that includes ten call features (*e.g.*, voicemail, caller id, call waiting, etc.), and RCN's cable Internet service. Similarly, Knology, a major overbuilder in the Southeast, offers packages of bundled services that combine its telephone, Internet, and video programming services.[78]

The local phone companies are also marketing service packages to better compete against cable for high-speed Internet customers. For example, Qwest Communications now offers its "Total Package," which includes local phone service, wireless service, voice messaging, and Internet access,[79] and recently reported that "[m]ore than 30 percent of Qwest consumer customers subscribe to bundled services."[80] During the second quarter of 2001, Qwest and

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77 *See* RCN Communications, *RCN ResiLink -- Bundled Communications Services* (visited Aug. 1, 2001), *at* http://www.rcn.com/resilink/index.html.

78 *See* Knology, *Bundled Communications* (visited Aug. 1, 2001) (noting that Knology's "bundled packages let [consumers] purchase Telephone, Cable TV, and Internet from a single source, saving [them] money month after month, and giving [them] more choice, speed and service"), *at* http://www.knology.com/residential/index.cfm.

79 *See* Qwest Communications, *Value Packages* (visited Aug. 1, 2001), *at* http://www.qwest.com/pcat/for_home/product/1,1354,517_1_6,00.html.

80 Press Release, Qwest Communications Int'l Inc., *Qwest Communications Reports Strong Second Quarter 2001 Results* (July 24, 2001), *available at* http://www.qwest.com/about/media/pressroom/1,1720,713_current,00.html.

Microsoft formed a five-year strategic alliance to combine MSN Internet Access, content, and services with Qwest's broadband network and telecommunications services for 10 million homes in Qwest's service areas.[81] Likewise, SBC offers its "DSL Web Solution" package for approximately $90, which includes local and long distance service, Call Waiting ID, Voicemail, its inside wire maintenance plan, and DSL service.[82]

Again, the evidence demonstrates that the MVPD marketplace is competitive. Consumers have expressed strong interest in packages of video and non-video services. Cable and its competitors are competing vigorously to meet that demand. The result is greater choice, lower prices, and better value for consumers.

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81 *See id.*

82 *See* SBC Communications, *Money Savers: DSL Web Solution* (visited Aug. 1, 2001) (highlighting prices for Arkansas), *at* http://www.swbell.com/Products_Services/Residential/ProdInfo_1/1,1973,146-0-2-3-,00.html.

V. CONCLUSION

For the foregoing reasons, AT&T respectfully urges the Commission to adopt a report to Congress that reflects the current, highly-dynamic, vigorously competitive state of video distribution and program acquisition.

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