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**EX PARTE**

Chairman William Kennard  
Federal Communications Commission  
1919 M Street, N.W.  
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

**Re: Joint Application of AT&T/TCI for Transfer of Control of TCI  
Licenses to AT&T, CS Docket No. 98-178**

Dear Chairman Kennard:

Thank you again for the opportunity to appear at the Commission's recent en banc hearing to discuss the AT&T/TCI merger. We are excited by the prospects for facilities-based competition in local residential telephony and other services that the merger will make possible.

At the hearing, certain witnesses raised concerns that cable customers would somehow cross-subsidize AT&T's entry into the local telephone business. These concerns appear to be based on an unfounded fear that we will improperly raise cable prices to fund otherwise uneconomic local telephone entry. This will not occur.

As a matter of sound economics, AT&T/TCI will have neither the incentive nor the ability to engage in cross-subsidization. As of March 31, 1999, "upper-tier" cable programming services will not be subject to rate regulation at all. Congress' decision to sunset upper-tier cable price regulation reflected its well-grounded belief that market forces will effectively constrain prices for those services.<sup>1</sup> Moreover, even if a cable

<sup>1</sup> See 142 Cong. Rec. at S688 (Feb. 1, 1996) (statement of Sen. Hollings) ("By [March 31, 1999], we expect that competition from DBS and wireless cable, and perhaps from the telephone companies, will provide enough restraint on further cable rate increases."). And as the Commission recognized less than a month ago, all cable services are subject to increasing competition. See Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming, Fifth Annual Competition Report, FCC 98-335, CS Docket No. 98-102, ¶¶ 6-7, 62 (rel. Dec. 23, 1998) (noting that over 11 million consumers – approximately 15% of all MVPD subscribers nationwide – get programming from one of cable's competitors, and that two out of every three new subscribers chose DBS over cable last year).

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operator could charge supra-competitive prices for unregulated upper-tier services, the incentive to do so would exist regardless of any local telephony entry plans. Further, a cable operator that increased upper-tier cable prices would have no incentive to use those profits to support uneconomic telephony or other offerings, because the effect of doing so would be to make the combined enterprise less profitable.<sup>2</sup>

Moreover, the continued regulation of cable operators' "basic" tier of cable services rates does not give rise to cross-subsidy incentives. Regulatory incentives to cross-subsidize arise in the context of cost-based rate-of-return regulation, in which the regulated firm's rates are set at levels designed to produce revenues equal to total costs (including cost of capital or "profit"). Under this regime, the regulated firm has a clear incentive to misallocate costs from lines of business subject to competition to lines of business insulated from competition.<sup>3</sup>

But TCI's cable services are regulated based on a pure price cap model under which initial prices were determined by reference to prices charged by cable systems that were deemed by the Commission to be subject to "effective competition."<sup>4</sup> Under this basic tier price cap regulation, merely shifting "costs" among accounts does not produce price increases; rather, price increases may occur only for inflation, for increases in programming costs, and for certain other limited and regulatorily-defined "external costs" (such as state and local taxes and franchise fees).<sup>5</sup> This explains why no proponent of

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<sup>2</sup> See Implementation of Section 304 of the Telecommunications Act of 1996 Commercial Availability of Navigation Devices, Notice of Proposed Rulemaking, CS Docket No. 97-80, FCC 97-53, at ¶ 38 (1997) (even "if the MVPD is an unregulated monopolist serving both competitive and non-competitive markets with no limits on its profits, there is no incentive for it to 'cross-subsidize' costs, since such action would reduce the MVPD's monopoly profit.").

<sup>3</sup> See H. Averch and L.L. Johnson, "Behavior of the Firm under Regulatory Constraint," American Economic Review, 52, 1052-1069, 1962, pp. 1057-1058; A.E. Kahn, The Economics of Regulation, Volume 2, New York: John Wiley, 1971, p. 49.

<sup>4</sup> By contrast, the type of "price cap" regulation that typically applies to incumbent LECs' local exchange offerings "can best be regarded as a loose form of rate-of-return regulation with a formal time lag." See Johnson, Toward Competition in Cable Television, Cambridge: MIT Press 1994, at 78. Under this type of "price cap" regulation, cross-subsidy is still a serious concern. See id. See also In the Matter of Amendment of the Commission's Rules to Establish Competitive Service Safeguards for Local Exchange Carrier Provision of Commercial Mobile Radio Services; Implementation of Section 601(d) of the Telecommunications Act of 1996, Report and Order, 12 FCC Rcd. 15668, at ¶¶ 59-60 (1997).

<sup>5</sup> See 47 C.F.R. § 76.922; First Cable Rate Order at ¶¶ 171-257. Of course, the Commission's "basic" tier regulations leave open the possibility that a cable provider may choose to have its prices determined on the basis of costs (including an allowed rate of return). See First Cable Rate Order, 8 FCC Rcd. 5631, at ¶¶ 265-274 (1993). But the possibility that AT&T/TCI might some day elect that treatment somewhere surely cannot justify any across-the-board restrictions of

cable price merger conditions has supported allegations of potential cross-subsidy with any serious analysis of the relevant incentives and abilities.<sup>6</sup>

Moreover, whatever the Commission's ultimate view of these cross-subsidy arguments, there plainly is no legitimate basis to single out AT&T/TCI for additional regulatory burdens. Many other cable operators have already launched and have been offering telephone services over their cable plant for some time now.<sup>7</sup> Thus, the proper forum for airing any legitimate cross-subsidy concerns (and AT&T/TCI submit that there are none) is in an industry-wide rule-making proceeding, not a merger proceeding involving a single cable provider.<sup>8</sup> No commenter has identified anything about the AT&T/TCI merger that would justify unique restrictions on AT&T/TCI's cable prices.

In this regard, there is no merit to claims made at the en banc hearing that it is somehow "inconsistent" for AT&T/TCI to deny the incentive and ability to cross-subsidize but to oppose inclusion of a no-cross-subsidy provision in a LFA's order approving the transfer of a franchise from TCI to AT&T. Unnecessary regulation is burdensome and anticompetitive. Since, as shown above, there is no legitimate cross-subsidy concern here, the only consequence of imposing such a condition will be to invite needless and costly reviews of, and inquiries into, AT&T/TCI's pricing activities.<sup>9</sup> No consumer benefit would flow from such baseless inquiries, and, in fact, consumers would be harmed by the unnecessary diversion of corporate and government resources to such endeavors.

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AT&T/TCI cable prices. Further, in the event that AT&T/TCI did in the future seek to justify a basic tier cable price increase with a cost-of-service filing, AT&T/TCI would bear the burden of proving that it had reasonably estimated and allocated all relevant costs. See 47 C.F.R. §§ 76.922, 76.933.

<sup>6</sup> Nor has any party supplied any empirical evidence of cross-subsidy, notwithstanding that other cable operators have been providing telephony services for some time.

<sup>7</sup> See M. Jarman, "Cox to Offer Telephone Service in Phoenix," The Arizona Republic, Nov. 19, 1998; "MediaOne Bets Heavily on Cable Telephony," Communications Today, Aug. 19, 1998; D. Solomon, "Comcast Cable Debuts Long-Distance Phone Service in Detroit," Detroit Free Press, Mar. 21, 1998; "Special Report: Information Technology -- Hot CLECs Target Baby Bells," Rochester Business Journal, July 10, 1998.

<sup>8</sup> See, e.g., Application of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control of MCI Communications Corporation to WorldCom, Inc., Memorandum Opinion and Order, CC Docket No. 97-211 (rel. Sept. 14, 1998) ¶ 160 (holding that transfer of control proceeding was "not the appropriate forum" to address Internet cost-sharing because "this matter extends beyond the Applicants").

<sup>9</sup> See H.R. Rep. No. 102-628, 102d Cong. 2d Sess. (1992) at 83 ("The FCC should create a formula that is uncomplicated to implement, administer, and enforce, and should avoid creating the cable equivalent of a common carrier 'cost allocation manual'").

Finally, it is important to recognize that AT&T has no incentive to charge excessive prices for cable service. Our investment in TCI is driven by our desire to provide competitive local residential telephone service to TCI's customers. We thus have every incentive to retain and enlarge TCI's customer base, and no incentive to alienate TCI's customers by charging excessive prices for cable services.

We believe that the AT&T/TCI merger will fulfill the promise of the Telecommunications Act of 1996 by offering consumers a facilities-based alternative to the incumbent local telephone companies. We urge the Commission to approve the merger expeditiously and without conditions. Please do not hesitate to contact me if I can be of further assistance to you, your colleagues, or your staff on this matter.

Sincerely,

*Jim Cicconi (B013)*

cc: Commissioner Susan Ness  
Commissioner Harold Furchgott-Roth  
Commissioner Michael Powell  
Commissioner Gloria Tristani  
Deborah Lathen  
Thomas Krattenmaker  
Robert Pepper  
John Norton  
Royce Dickens