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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
	)	
Applications for Consent to the Transfer of Control of Licenses	)	
	)	
MediaOne Group, Inc., Transferor,	)	CS Docket No. 99-251
	)	
To	)	
	)	
AT&T Corp. Transferee.	)	

APPENDICES TO REPLY COMMENTS OF AT&T CORP. AND MEDIAONE GROUP, INC.

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September 17, 1999

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DECLARATION OF
JANUSZ A. ORDOVER
AND ROBERT D. WILLIG

I. QUALIFICATIONS

A. Professor Ordover

1. My name is Janusz A. Ordover. I am Professor of Economics and Director of the MA Program at New York University, which I joined in 1973. At New York University, I teach undergraduate and doctoral level courses in industrial organization economics, the field of economics concerned with competition among business firms and upon which "antitrust economics" is founded. I have devoted most of my professional life to the study and teaching of industrial organization economics and to its application through antitrust and regulatory law and policy.

2. In July 1991, President George Bush appointed me to the position of Deputy Assistant Attorney General for Economics in the Antitrust Division of the Untied States Department of Justice ("DOJ"). In this post, I participated in the drafting of the 1992 Horizontal Merger Guidelines,

which have been widely used by courts and antitrust enforcement agencies. In addition, I led many merger reviews that employed and developed methodologies to define relevant markets in merger and other cases. I returned to New York University in 1993.

3. I have been actively involved in the formulation of public policy in the telecommunications sector. In particular, I have submitted written and oral testimony for AT&T to the Federal Communications Commission and to the state regulatory commissions in the Midwest, New England, and New York on a number of issues, including the pricing of unbundled network elements and access to bottleneck facilities.

4. I have written extensively on a wide range of antitrust and telecommunications topics, such as mergers and joint ventures, predatory conduct and entry barriers. My antitrust articles have appeared in the *Yale Law Journal*, the *Harvard Law Review*, the *Columbia Law Review*, and many other journals, monographs and books, here and abroad. A full list of my articles and other professional publications and activities is presented in my *curriculum vitae*, which is attached as Exhibit 1.

5. I have lectured extensively on antitrust topics to the American Bar Association, the International Bar Association, and the Federal Trade Commission ("FTC"). I recently delivered lectures to the FTC during its hearings on the Future of Antitrust Enforcement, which were organized by FTC Chairman Robert Pitofsky. I have also lectured on antitrust policy at colleges and universities

in the United States and abroad, and at many conferences and meetings sponsored by various legal organizations.

6. I have acted as a consultant on antitrust and other competition matters to the DOJ, the FTC, and the post-communist governments of Poland, Russia, and Hungary. I have also consulted for the World Bank and the Organization for Economic Cooperation and Development in Paris. I have acted as a consultant in numerous antitrust lawsuits and investigations, including market definition and anti-competitive conduct matters for the FTC, DOJ and private clients in the United States, Australia, Germany and the European Union. I have extensive experience in the analysis of competitive effects of business strategies, including tying and bundling.

B. Professor Willig

7. My name is Robert D. Willig. I am Professor of Economics and Public Affairs at the Woodrow Wilson School and the Economics Department of Princeton University, a position I have held since 1978. Before that, I was Supervisor in the Economics Research Department of Bell Laboratories. My teaching and research have specialized in the fields of industrial organization, government-business relations and welfare theory.

8. I served as Deputy Assistant Attorney General of Economics in the Antitrust Division of the DOJ from 1989 to 1991. I also served on the Defense Science Board task force on the antitrust aspects of defense industry consolidation and on the Governor of New Jersey's task force on the market pricing of electricity.

9. I am the author of *Welfare Analysis of Policies Affecting Prices and Products*; *Contestable Markets and the Theory of Industry Structure* (with W. Baumol and J. Panzar), and numerous articles, including "Merger Analysis, IO theory, and Merger Guidelines." I am also a co-editor of *The Handbook of Industrial Organization*, and have served on the editorial boards of the *American Economic Review*, the *Journal of Industrial Economics* and the MIT Press Series on regulation. I am an elected Fellow of the Econometric Society and an associate of The Center for International Studies.

10. I have been active in both theoretical and applied analysis of telecommunications issues. Since leaving Bell Laboratories, I have been a consultant to AT&T, Bell Atlantic, Telstra and New Zealand Telecom, and have testified before the U.S. Congress, the Federal Communications Commission, and the public utility commissions of about a dozen states. I have been on government and privately supported missions involving telecommunications throughout South America, Canada, Europe, and Asia. I have written and testified on such subjects within telecommunications as the scope of competition, end-user service pricing and costing, unbundled access arrangements and pricing, the design of regulation and methodologies for assessing what activities should be subject to regulation, directory services, bypass arrangements, and network externalities and universal service. On other issues, I have worked as a consultant with the FTC, the Organization for Economic Cooperation and Development, the Inter-American Development Bank, the World Bank and various private clients. A full list of my articles and other professional publications and activities is presented in my *curriculum vitae*, which is attached as Exhibit 2.

II. PURPOSE OF STATEMENT

11. We have been asked to discuss two issues raised by opponents of the proposed merger. First, we respond to claims that the merger will not produce the public interest benefits projected by AT&T and MediaOne. For the reasons explained below, we believe that the merger is likely to produce immense public benefits from large-scale facilities-based bypass of the local telephone loop. These benefits have already begun to materialize in the anticipatory competitive responses of the incumbent providers, including their accelerated rollout of DSL and other advanced services. Neither the solo efforts of AT&T, MediaOne or other cable companies, nor joint ventures among these firms, are likely to produce comparable public benefits as quickly.

12. Second, we respond to proposals to impose broad new public-utility type requirements for forced access to the cable facilities built and owned by the combined entity. Prophylactic regulation of fledgling markets is warranted only if (1) the risk of monopoly power is great enough to warrant the costs and risks of regulation, and (2) the proposed regulatory standards will actually make consumers better off. Neither of these conditions is met here. The merger will neither create monopoly power in any relevant market, nor allow the combined firm to leverage monopoly power into any other market. Furthermore, the proponents of forced access have failed to show that it would make consumers better off. AT&T's business model – offering both editorial and advertising content, using content revenues to hold down subscription costs for consumers, and allowing consumers to access any other Internet site or service with a single click – is similar to the model favored by newspapers, magazines, radio and broadcast TV, and, more recently, other Internet-

related businesses in competitive markets. By contrast, any scheme of forced access is likely to be dysfunctional from the outset, and could ultimately lead to marketplace paralysis of some of the most dynamic technologies the world has ever seen.

III. THE MERGER OFFERS ENORMOUS PUBLIC INTEREST BENEFITS.

13. AT&T and MediaOne have explained in their Public Interest Statement why they believe that their merger will benefit the public. The Applicants are convinced that combining the complementary assets of their two firms will enable the merged firm to compete more effectively with the large incumbent local telephone monopolists, each of which currently dominates a service area of vast geographic scope and tens of millions of customers. That will produce immediate and enormous public interest benefits, AT&T and MediaOne claim, by breaking these incumbents' local telephone monopolies faster and more effectively than either firm could alone. Further, as technologies and service offerings continue to evolve and converge in an integrated world of telephony, video, data, online and other services, AT&T and MediaOne believe that the merger will enable them to offer a much more effective competitive counterweight to the significant threat that incumbent monopolists and other dominant providers of existing communications services will extend their dominance over nascent and future communications services.

14. Opponents of the merger challenge these public interest benefits from two directions. Some claim that the merged entity will not follow through on its announced plans to compete aggressively with dominant service providers. Others take the reverse tack, asserting that MediaOne and AT&T could compete with equal effectiveness as stand-alone firms or through

unspecified contractual arrangements short of a full merger. As explained below, we believe that the merger opponents' claims are misguided, and that the Commission should give great weight to the public interest benefits projected by AT&T and MediaOne.

15. The projected competitive benefits, if they occur, will be immense, achieving what no competitor or regulator has yet accomplished: large-scale facilities-based bypass of the bottleneck monopoly possessed by the incumbent telephone carriers in the local loop. The local telephone industry is among the largest remaining monopolies in the American economy. With over a hundred million captive consumers and many billions of dollars at stake annually, the local bottleneck unquestionably harms the public and exerts a substantial drag on the economy. But breaking the incumbent carriers' bottleneck stranglehold is more than just the longstanding goal of telephone regulation; it safeguards against the risk that the incumbent local carriers will extend their market power into next-generation technologies and services.

16. There is every reason to expect that the projected public interest benefits will occur. Both the merging parties' self interest and well-established principles of industrial organization suggest that the efficiencies the merging parties have identified are likely to be achieved. Of course, we can make no more claim to clairvoyance on these matters than can opponents of the merger. But there are a number of reasons why the Commission can and should credit the judgments of the managements of AT&T and MediaOne that the merged firm is likely to wrest customers – and, more importantly, competitive responses – from today's dominant providers at a faster pace than would have occurred absent the merger.

17. *First*, as the Commission properly recognized earlier this year in approving AT&T's merger with TCI, having committed their corporate assets to the merger (and, in AT&T's case, having committed tens of billions of dollars of funds), AT&T and MediaOne have every incentive to make the merger succeed.

18. *Second*, the synergies that the managements of AT&T and MediaOne expect to attain from combining their complementary assets are consistent with well-established economic theory, and with the Commission's analyses of similar complementarities in the AT&T/TCI merger case. The efforts of AT&T and other competitors to enter local telephone markets through non-facilities-based entry since enactment of the Telecommunications Act of 1996 ("the Act") provide ample confirmation that relying on competitors' facilities is an inferior alternative to ownership of direct physical access to customers' premises. Likewise, the modest success of MediaOne and other cable companies in winning telephone customers from the incumbent carriers underscores the critical importance of an established telephone service reputation and brand, along with first-hand experience in providing and marketing telephone services.

19. Economic theory likewise teaches the importance of the scale and clustering efficiencies identified by AT&T and MediaOne – and that entrenched incumbents that currently serve virtually all customers in concentrated and vast geographic areas may have insurmountable advantages unless potential competitors can aspire to similar scale and other efficiencies. And having spent decades monitoring – and, where appropriate, regulating – the incumbent local exchange carriers ("LECs") to prevent them from leveraging the advantages of their incumbencies into dominance over

new services, the Commission needs no reminding that this threat is all too real. Here too, economics teaches that the best medicine is to encourage – or at least not to interfere with – efforts by firms like AT&T and MediaOne to assemble and deploy the assets that will allow them to compete effectively *before* the incumbents have an opportunity to extend their dominance to new services.

20. *Third*, and most fundamentally, this is the rare case in which regulators evaluating merger benefit claims need not trust to their best predictions whether the benefits are likely to occur. The competitive benefits projected by AT&T and MediaOne and by economic theory and experience have *already* begun to receive empirical confirmation. The mere announcement of the proposed merger and AT&T's aggressive cable-based entry strategies has triggered a stampede of DSL, broadband and other competitive service offerings by the dominant service providers. We understand that it would have been technologically feasible for the dominant providers to deploy these offerings years ago. Not until AT&T and TCI and then AT&T and MediaOne announced their plans to merge, however, did the incumbent providers make any serious efforts to deploy and promote these services. Likewise, it took telephony offerings from the combined AT&T/TCI finally to provoke competitive responses to those offerings. The incumbent carriers' belated competitive offerings speak far more loudly than their briefs and testimony in this case about the true competitive significance of the merger.

21. Finally, the dominant providers' claim that AT&T or MediaOne could achieve the same competitive synergies through joint venture arrangements short of a merger – a claim for which they offer no supporting economic testimony – conflicts with both economic theory and

experience. Analysis of the behavior of firms in a variety of markets teaches that a joint venture contract will generally prove an inferior substitute for a full equity merger when the proposed enterprise requires a large initial sunk investment by one or more of the parties (as well as the sharing of facilities by the venture and one of the parties to the venture), and when the ultimate risks and rewards of the enterprise are highly uncertain. Providing new services over cable requires large sunk investments on both sides, in a commercial environment as dynamic and unsettled as any we have yet witnessed. Hence, there is every reason to credit the testimony of Terry Wingfield, the leader of AT&T's efforts to negotiate telephony joint ventures with existing cable companies, and Doug Holmes, MediaOne's strategic planning head, that such contractual arrangements are difficult to achieve, and unlikely to provide the full consumer benefits of integration.

A. The Increased Bypass Of The Local Telephone Loop By Cable-Delivered Services From AT&T and MediaOne Would Offer Enormous Public Interest Benefits.

22. The public unquestionably would derive enormous benefit from any arrangement that offered large-scale facilities-based bypass of the local telephone loop. Competitive entry of this kind would not only bring real choice and competition for the first time to millions of captive consumers of local telephone service, but would also reduce the likelihood that dominant providers could extend their bottleneck control to other services. Thus, unless the proposed merger threatens significant competitive harms – and, in our view, none has been demonstrated – the mere *potential* of the merger for significant facilities-based bypass of the local loop alone should be ample support for a determination that the transaction is in the public interest.

23. More than three years after passage of the Act, incumbent LECs still face no significant competition in local exchange and access services. Although niche competition for the largest business customers has begun to develop in some urban areas, competition for mass-market residential and small business customers is virtually nil. In the United States as a whole, incumbent LECs still capture about 95 percent of all revenue from local residential service, and about 90 percent of all revenue from local business service. *See, e.g.*, FCC Common Carrier Bureau, *Local Competition* (Aug. 1999) at 1 and Table 2.1 (incumbent LECs' share of total service market by revenue approximately 96.5 percent).

24. The enormous injury inflicted on consumers in MediaOne's service areas by local telephone monopolies takes several forms. Most directly, the unavailability of competition for local telephone service forces consumers to pay higher prices for telephone service of lower quality (including fewer features and options) than a competitive market would offer. Local telephone carriers extract billions of dollars annually from consumers by collecting access charges from long distance carriers that far exceed the cost of access. *See* Letter from Joel E. Lubin, AT&T, to Magalie Roman Salas, FCC, CC Docket No. 96-262 (Feb. 25, 1999); *Access Charge Reform*, CC Docket No. 96-262, Comments of AT&T Corp. (filed Jan. 29, 1997), p. 13.

25. As the Commission has recognized, the incumbent LECs' control of the local bottleneck is also a chronic threat to competition in adjacent markets. The ability of local carriers to leverage the local bottleneck into long distance is the reason why the RBOCs have been excluded from interexchange service since the break-up of the Bell System in 1982. It is also why the Commission

required incumbent LECs to open their facilities to unaffiliated enhanced service providers on nondiscriminatory terms. *See, e.g.*, Notice of Proposed Rulemaking, *In the Matter of Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services*, 10 F.C.C.Recd. 8360 (1995). So long as these incumbents continue to dominate the provision of local telephone service, the Commission must take great care to ensure that they cannot leverage their dominance over local exchange and exchange access services into Internet, video, and other next-generation services.

26. These risks cannot be overemphasized. The incumbent LECs have enormous competitive advantages over any potential competitors, including the scale and clustering economies permitted by the incumbent firms' enormous customer bases and large self-contained service territories, the sunk nature of much of their existing investment (which enables them to strand new entrants' investment by reducing the incumbents' prices to short run incremental cost), the barrier to entry created by the sheer scale of the infrastructure that facilities-based competitors must replicate, and the complexity and rapid evolution of their technology and operations, which enables vertical leveraging, exclusionary behavior and other misconduct to evade scrutiny.

27. Both Congress and the Commission have recognized that the local telephone monopoly is a major public interest problem, and that breaking the monopoly warrants extraordinary efforts. *See* First Report and Order, *In re Implementation of the Local Competition Provisions in the Telecomms. Act of 1996*, 11 FCC Rcd. 15499, ¶¶ 1-13 (1996) ("*Local Competition Order*").

28. The mechanisms for competitive entry enacted by Congress in 1996, however, offer little prospect of broad scale relief for the currently foreseeable future. Entry into local telephone markets through resale of services purchased at wholesale from the incumbent carriers has proven uneconomic. The wholesale discounts set by state public utility commissions have been too small to allow new entrants to cover their own costs and earn a competitive return on investment, and because entrants' costs remain tethered to incumbents' prices, this form of competition can only drive down prices by the margins of retailing costs.

29. The alternative of purchasing unbundled network elements ("UNEs") has also been largely ineffective. The incumbent LECs have resisted efforts to open up their networks at every step of the way – from the definition of elements to be unbundled, to the pricing of those elements, to the myriad operational details needed to make access a reality. Any doubt on this score is removed by the Common Carrier Bureau's recent local competition survey which reports that the number of incumbent LEC unbundled local loops leased to competitive LECs amounts to only 0.2 percent of total incumbent LEC lines. *See* FCC Common Carrier Bureau, *Local Competition*, *supra*, at 23 & Table 3.3.

30. For these reasons, cable telephony offers an important prospect of large-scale competitive entry into local telephony, even in the short run. As the Commission has recognized, and as analysts, investors and industry leaders seem to agree, cable-based competitive telephony offerings are among the most promising vehicles for widespread competitive bypass of the incumbent LEC-owned local loops and other bottleneck facilities that stand between residential consumers and the

national telecommunications network. *See* Memorandum Op. and Order, *In re Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from Tele-Communications, Inc., Transferor to AT&T Corp., Transferee*, 14 FCC Rcd. 3160, ¶ 47 (1999) ("*AT&T-TCI*").

31. Cable-based telephony is by no means the only plausible threat to incumbent local monopolies. As always in markets newly opened to competition, entry strategies may take as many different forms as there are new entrants willing and able to enter the game. But in fields as dynamic as communications, efforts at handicapping are almost certain to be futile. Rather, economics and experience teach that the best safeguard against perpetuation and extension of market power is to encourage – or at least not stand in the way of – efforts by new entrants to combine the assets that *they* believe are needed for a plausible challenge to the entrenched power of the incumbents. If AT&T's and MediaOne's cable-based strategy has a real prospect of greater success than other approaches – and, as we explain below, there is every reason to believe the near consensus that it does – then AT&T and MediaOne's claims that their merger will serve the public interest cannot seriously be questioned.

B. Economic Theory And Industry Experience Support The Judgments Of AT&T And MediaOne That Merging Will Greatly Enhance The Ability Of The Combined Firm To Compete Effectively With Incumbent Service Providers.

32. AT&T and MediaOne have determined that competing effectively with the incumbent LECs (and with other service providers such as AOL) requires, among other things: (1) facilities capable of providing competing services on a mass market level and across a broad geographic area that will allow the spreading of the substantial initial fixed costs; (2) a strong

telephony and mass market brand; (3) recognized experience and expertise in providing the services in question and in marketing such services in competitive markets; and (4) experience in dealing with the dominant providers with whom interconnection is needed. Together, the two firms will possess those assets; separately, neither does.

33. In an industry as fast-moving and unsettled as the telecommunications industry today, neither we nor anyone else can predict with certainty whether the merged entity will enjoy commercial success over the long run. The judgments of AT&T and MediaOne's management, however, have a great deal of credibility. As a general proposition, the participants in an industry are in the best position to foresee the requirements of commercial success. Furthermore, the $60 billion that AT&T has paid to buy MediaOne creates a powerful incentive to make the merger work. The purchase premium paid by AT&T reflects the earnings that AT&T hopes to gain through the synergies of offering telephony, Internet access and cable over the MediaOne and AT&T systems combined, and can be recovered only if the combination as a whole is successful. Hence, AT&T can recover its enormous investment in MediaOne only by moving aggressively to deploy, market and support local telephony, high-speed Internet and other new services as planned.

34. By contrast, the claims of the merger opponents merit great skepticism. To begin with the obvious, the most aggressive opponents of the merger are AT&T's potential *competitors* – *i.e.*, the very entities whose commercial self-interest would be most threatened if the merger succeeds. In this regard, it is telling that the economists' affidavits sponsored by the opponents of the merger *do not even discuss* the public interest benefits asserted by AT&T and MediaOne.

35. Moreover, we can confirm that the types of assets and synergies that AT&T and MediaOne have identified are ones that economics and experience teach are likely to generate efficiencies that serve the public interest. The complementary assets that AT&T and MediaOne bring to the merger table include MediaOne's and AT&T's facilities, AT&T's brand name, and the specialized expertise and experience of each firm. The merger also offers clustering and scale economies unattainable by either firm alone. As the Commission recognized in the AT&T/TCI merger case, these merger-related synergies should allow the merged entity to deploy cable telephony and advanced services far more quickly, broadly and competitively than either party could do separately.

36. The claimed synergies begin with physical assets. MediaOne's cable access to millions of households is a means of bypassing the bottleneck facilities of the incumbent LECs that currently serve virtually all of the local telephone customers in MediaOne's service areas. AT&T could not duplicate MediaOne's facilities-based access without prohibitive expense. *See* Declaration of Nancy McGee, Vice President-Digital Telephone Service Marketing, MediaOne Corporation ("McGee Decl."). The costly, protracted, and thus-far largely unsuccessful efforts of AT&T and other CLECs to enter into local telephony over the past three years through the purchase of unbundled network elements from the incumbent carriers has demonstrated that relying on competitors' facilities is a second-best solution at best.

37. In this regard, we are puzzled by the claims of certain merger opponents that AT&T's acquisition of TCI's cable facilities obviates any benefit from acquiring MediaOne's facilities. We understand that there is essentially no overlap between the households served by the

MediaOne and TCI cable networks. AT&T's physical access to TCI's customers does no good to consumers in MediaOne's service areas who are currently captive to their existing telephone service providers.

38. Conversely, the merger will give MediaOne access to the existing network infrastructure that AT&T obtained through its acquisition of TCG. Through its acquisition of TCG, AT&T owns a limited number of wire centers and transport facilities used to provide service to large business customers in some of MediaOne's cable markets. AT&T uses these facilities to connect some of its customers directly to its long distance network and thereby bypass incumbent LECs' exchange access facilities and non-cost based access charges. AT&T can also use the facilities to interconnect to incumbent networks at end offices rather than tandem switches, thereby avoiding the incumbent LECs' charges for tandem switching and shared transport. In contrast, MediaOne has few transport assets. It normally must interconnect to incumbent networks through tandem switches for both local exchange and exchange access calls. By combining MediaOne's cable facilities with AT&T's existing (albeit limited) large business local telephone infrastructure, the merger should allow some cost reductions in the provision of local and long distance service to some MediaOne customers. *See* McGee Decl.[1]

[1] Bell Atlantic's claim that the Commission should be concerned about the loss of potential mass market local telephone competition in MediaOne's service areas between MediaOne and AT&T is plainly misguided. AT&T's ownership of limited switching and transport facilities that it uses to provide competing service to large business customers does nothing to overcome the mass market local *loop* bottleneck that prevents AT&T – in the absence of the MediaOne facilities that can be used to bypass that bottleneck – from effectively competing with the incumbent LECs.

39. Another key asset that AT&T brings to the table is its brand name. It is common knowledge that the AT&T brand has a very high reputation among consumers of telecommunications service; by contrast, cable companies suffer from a popular perception as unresponsive customer-unfriendly monopolists. *See, e.g.*, *AT&T-TCI* ¶ 47. As the Commission has recognized, brand and reputation are extremely important in attracting customers away from a dominant provider to a new and relatively untested means of providing service. *AT&T-TCI* ¶ 148. A reputation for average or less than average service and quality is extremely difficult to correct.

40. MediaOne's existing efforts to market cable telephony underscore the competitive handicap of a firm lacking a well-established telephony brand name like AT&T's. MediaOne has invested billions of dollars to upgrade its system to provide cable telephony, yet has attracted only a few tens of thousands of telephone customers. *See* McGee Decl. We understand that absent the AT&T merger, MediaOne projected that it would not achieve significant customer penetration levels for at least a decade. *See id.* MediaOne believes (and has apparently heard from customers themselves) that this slow rate of penetration stems, in large part, from the unwillingness of consumers to buy a service as basic and essential as local telephone service from a firm without an established reputation for reliable, high quality service. *See id.* By reputation, MediaOne is a good cable company. But the business models in the cable business are very different from those in the telephone business. Because consumers regard telephone service as a lifeline in medical and other emergencies, the quality of service and customer care are much more important for telephony than for

cable. As the Commission has recognized, *AT&T-TCI* ¶¶ 47-48, the AT&T brand has an extremely high reputation for reliability among consumers.

41. AT&T and MediaOne have also identified synergies in their relevant experience and expertise. AT&T has much more experience in competitive markets than does MediaOne. It has honed its marketing and competitive response skills against MCI, Sprint and hundreds of other aggressive rivals in the long distance business for nearly two decades. More recently, it has gained costly but invaluable experience negotiating the hurdles of obtaining interconnection and unbundled network elements from incumbent LECs. It has significant experience in mass market Internet business through its WorldNet offerings, and its recent purchase of IBM's IGN network earlier this year. We understand that AT&T also has extensive experience in the development of packet switching IP telephony, which is more efficient and flexible than the circuit switching architecture of MediaOne's existing cable telephone network. *See* Holmes Decl. These kinds of marketing, regulatory and engineering experience are enormously valuable strategic assets.

42. MediaOne has the edge in other areas of expertise. MediaOne has a head start in deploying cable telephony with a circuit switching architecture. Acquiring this know-how will enable AT&T to jump-start its deployment of cable telephony on the TCI system until IP-based cable telephony can be deployed. *See* McGee Decl. And MediaOne has developed technological and practical experience and expertise in installing and maintaining the necessary customer premises equipment. It is likely that AT&T can also benefit from these investments after consummation of the merger. *See id.*

43. The final merger efficiencies identified by AT&T and MediaOne involve scale and clustering. It is well established that the deployment of new telephony and internet services over cable requires an enormous fixed investment in research and development; development of engineering protocols and operating standards and practices; construction and furnishing of central offices, transport facilities and databases; hiring and training of installation and maintenance crews; and establishment and staffing of customer care centers. We understand that the costs of marketing new cable service to mass market residential consumers are also large, and, in part, fixed. *See, e.g.*, McGee Decl.; Holmes Decl.

44. As the Commission has recognized, the ability to spread fixed costs among a large customer base gives the dominant incumbent providers an enormous cost advantage, and hence an enormous competitive edge. *See Local Competition Order* ¶11. These advantages are particularly stark on the telephony side – incumbent LECs today serve virtually all the customers available in contiguous territories of vast geographic scope – but AOL has similar advantage in the provision of online services. If new entrants are to compete with incumbent LECs and leading Internet and online service providers, they also must have the opportunity to serve a large customer base.

45. Incumbent LECs enjoy a further advantage from their ability to position key assets to serve clusters of contiguous customers or service territories. Clustering can increase localized management, allow more efficient architecture, reduce per-customer marketing, maintenance and operating costs, foster regional programming, such as news and sports, and enhance compatibility of customer premises equipment. *See, e.g.*, Holmes Decl. In these circumstances, there is every reason

to credit AT&T's and MediaOne's prediction that this merger, by allowing them to aspire to become a facilities-based competitor with a scale and scope currently enjoyed only by dominant service providers, promises increased competition and choice across the whole range of services that will be provided to mass market consumers over alternative networks as technologies and services converge.

46. In this regard, it is important to recognize a fundamental difference between incumbent LECs and cable providers. We understand that completion of the MediaOne merger will give AT&T control of cable facilities that pass roughly the same number of households that would be passed by the facilities of Ameritech-SBC-PacBell or Bell Atlantic-NYNEX-GTE. For AT&T and MediaOne, however, these households translate to far fewer *customers*. *First,* cable and telephone services have dramatically different penetration rates: on average, 94 percent for telephone and 65 percent for cable. Thus, even when a cable company passes as many homes as a telephone company, it has almost 30 percent fewer customer relationships.[2] *Second,* as new entrants into the telephony market, cable companies start with *no* telephone customers. *Third,* as noted above, cable companies must expend enormous sums of money to research, develop, and implement broad-scale cable telephony networks, while incumbent LECs already have ubiquitous networks in place. Thus, to achieve the same economies of scale and compete on an equal footing with incumbent LECs, cable

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[2] *Compare Seventh Report & Order and Thirteenth Order on Reconsideration, In the Matter of Federal-State Board,* CC Docket No. 96-45, ¶ 38 (May 28, 1999) (94.2 percent telephone subscribership rate as of November 1998); Fifth Annual Report, *In re status of Competition in Markets for the Delivery of Video Programming,* CS Docket No. 98-102, ¶ 17 (Dec. 23, 1998) (cable penetration of 68.8 percent at the end of June 1998).

companies must be permitted to achieve footprints as least as large, or larger, than the footprints of large incumbents.

47. In short, the complementary assets and expected synergies that AT&T and MediaOne have identified are of the types that economics and experience teach are most likely to produce benefits to the public, particularly where, as here, they promise to create a more effective competitor to existing monopoly providers.

48. The merger opponents attack a straw man. They claim that both AT&T and MediaOne would invest in telephony even without the merger. We have no reason to question that prediction, and are not aware that the Applicants have ever claimed otherwise. But the relevant question is not whether either or both firms would go it alone if the merger were disapproved, but whether combining the two firms' complementary assets would permit facilities-based competitive entry that is faster, broader, and more cost-effective than going it alone. The experiences to date of MediaOne, AT&T and competitive LECs – and the unprecedented competitive responses, discussed below, already spawned by the mere announcement of the AT&T/MediaOne strategy – suggest to us that AT&T and MediaOne are right in claiming that neither one would have been as successful alone in trying to bring choice and competition to captive local telephone customers in MediaOne's service areas. *See* McGee Decl.

49. Finally, a brief response is warranted to Bell Atlantic's claim that the increased competition resulting from the merger should be counted as a public interest benefit only if AT&T

promises to offer plain old telephone service ("POTS") over MediaOne's cable network, unbundled from services such as cable television or high-speed Internet access. The merger benefits consumers by offering them competition and more options for many services. The notion that no competitive benefit can occur unless the new entrant replicates *every* service provided by the incumbent is inconsistent with antitrust and regulatory economics. In any event, we understand that AT&T does offer unbundled POTS.

C. The Competitive Benefits Of The Merger Have Already Begun To Materialize.

50. As is often the case, the actual behavior of firms in the marketplace is much more informative than their statements in adversary proceedings. The best evidence that the merger, and not business as usual, creates the best prospect for widespread near-term competition is the incredible pace and breadth of the *anticipatory* competitive responses following the mere announcements of AT&T's plans to invest tens of billions in cable-based alternatives to dominant providers' services.

51. AT&T's announcements that it will begin to provide competing local telephony and Internet services over facilities purchased from TCI and MediaOne has triggered nothing less than a competitive avalanche. As AT&T and MediaOne detail in the public interest section of their reply comments, all of the major incumbent LECs (as well as AOL, the leading internet service provider) have abandoned their long-standing reluctance to market DSL and broadband services since AT&T announced the TCI and MediaOne mergers. And where AT&T-delivered cable telephony services have been rolled out, incumbent LECs have responded swiftly with their own price cuts. These belated

competitive offerings have given rise to a consensus among securities analysts and the press that AT&T's strategy is the one that the dominant providers fear most – and hence that proponents of the public interest should encourage.

52. The stampede of anticipatory competitive offerings in the wake of the merger *proposal* refutes any possible claim that the competitive benefits of the proposed merger will be nonexistent or trivial. The competitive benefits of the merger are no longer a matter of speculation. They have already begun to occur.

D. Joint Ventures And Other Contractual Arrangements Are Unlikely To Achieve The Same Public Interest Benefits As The Merger.

53. Certain opponents of the merger assert that its competitive benefits could be attained as readily through joint ventures or similar contractual arrangements.[3] It is true that contractual arrangements short of full integration can, in certain circumstances, yield significant synergies. But opponents of the merger do not even attempt to show that such circumstances are present here, and for good reason. Great uncertainty about technology and service advances and the impact of such advances on consumer demand and competitors' offerings is a powerful deterrent to any long-term contractual arrangement that requires contract-specific investments and commitments by one of the contracting parties to share its facilities capable of providing multiple services. And it is difficult to imagine an industry characterized by greater uncertainty in this regard. In these

[3] *See* SBC at 49-50; Bell Atlantic at 56; GTE at 69-72; Consumers Union at 25-26.

circumstances, the testimony of the leader of AT&T's cable telephony joint venture efforts and the head of MediaOne's strategy group that joint venture arrangements, to the extent they can be consummated at all, are unlikely to provide the full consumer benefits of integration are consistent with the predictions of economic theory and should be credited. *See* Wingfield Decl; Holmes Decl.

54. The attractiveness of a joint venture or other contract as a substitute for vertical integration by merger depends largely on two factors: (1) the amount of contract-specific investment that each party must make in the contract, and (2) the ability of the parties to negotiate a "complete" contract – *i.e.*, one that anticipates and specifies the parties' rights and duties under all circumstances.

55. By contract-specific investment, we refer to expenditures (1) which a company must make to perform its obligations under a contract, or to receive the benefits of the other party's performance, but (2) which cannot be recovered should the company terminate the contract before full performance by the other side. Examples of such investment include the expenses of promoting or marketing a trade name controlled by the other party, training personnel in the use of a product or process that is proprietary to the other party, or acquiring equipment or supplies that are useable only with the other party's goods or services.

56. Where contract-specific investments are insignificant, businesses typically do not need to merge with their suppliers or customers. Most businesses obtain their stationery and office supplies from third-party vendors rather than from a wholly-owned subsidiary. As computer monitors have become fungible commodities, companies like Dell and Compaq typically buy them from third-

party vendors rather than build their own. If the contractual arrangement becomes unsatisfactory, the buyer can readily switch to an alternative supplier with little or no loss of sunk investment in the original contract.

57. A contract that requires a party to make significant contract-specific investments, however, renders that party vulnerable to appropriation of some or all of its investment by the other party if the costs or benefits of performing the contract unexpectedly change after the contract is signed. At the extreme, the party satisfied with the existing contract could hold up the other party for an additional payment as large as the latter party's contract-specific investment before the latter party would find it economically advantageous to walk away from the contract. *See generally* Oliver Hart, *Firms, Contracts and Financial Structure* 29-55 (1995); Jean Tirole, *The Theory of Industrial Organization* 21-23 (1990).

58. Assume, for example, that Fisher Body had remained an independent company rather than becoming a wholly-owned subsidiary of GM. In the event of an unexpected rise or fall in the demand for GM cars, GM's ability to negotiate a contract amendment changing the quantity of bodies supplied by Fisher Body would be impaired by GM's investment in assembly line equipment compatible only with Fisher Body products. Likewise, in the event of an unexpected rise in Fisher Body's labor costs, Fisher Body's ability to negotiate a contract amendment increasing the price of the bodies would be impaired by Fisher Body's investment in tools and dies compatible only with GM designs. *See* Benjamin Klein *et al.*, "Vertical Integration, Appropriable Rents, and the Competitive

Contracting Process," 21 *J.L. & Econ.* 297, 308-10 (1978) (explaining General Motors's decision to manufacture its own auto bodies).

59. To a certain extent, the risk of appropriation of contract-specific investment can be minimized by drafting contracts that specify in advance an appropriate set of changes in price or other contract terms for each potential change in economic circumstances. Cost-plus arrangements, price escalation clauses, sliding scale discounts for quantity purchases, and liquidated damage clauses are examples of these provisions. The effectiveness of these contingency clauses, however, is limited by the powers of human foresight. The more unpredictable and uncertain the economic environment, the more incomplete the contractual safeguards are likely to be. When a vertical supply relationship requires substantial contract-specific investment in an uncertain economic environment, vertical integration by merger is likely to be the preferred alternative to contracting. Economists have shown that requiring market participants in these circumstances to obtain critical inputs through contracts rather than merger is likely to result in underinvestment and insufficient new entry.[4]

60. The rollout of telephony and Internet services over cable networks involves both large contract-specific investments and enormous uncertainty. The contract-specific investments include the costs of research and development, licenses and permitting, acquisition of real estate and capital assets, installation of cable and customer premises equipment, marketing and advertising, and

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[4] *See generally*, Ronald H. Coase, "The Nature of the Firm," reprinted in *The Firm, the Market, and The Law* 46 (1998); O. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* 82-105 (1975); J. Tirole, *supra*, at 25; Alan J. Meese, "Price Theory and Vertical Restraints: A Misunderstood Relation," 45 *U.C.L.A. L. Rev.* 143, 168 (1997) (footnotes omitted).

staffing of customer care centers. Many of these investments, once made, are contract-specific (in the sense that they could not be redeployed elsewhere by a party that withdrew from the project) and sunk (in the sense that they could not be recovered even upon termination of the project).

61. The development of cable broadband telephony also entails enormous technological and commercial risks. Because cable broad-band telephony is in its infancy, the costs of marketing the service, the speed and extent of market penetration, the price levels and structure permitted by competition, the break-even volume, and the ultimate profitability of the service are all large unknowns.

62. Even more fundamentally, technologies and services are rapidly evolving and converging; hence, no one can reliably predict what business models, service offerings or technologies are likely to emerge as successful even over the next few years. As Mr. Wingfield and Mr. Holmes explain, this uncertainty makes it extremely difficult for a cable company that owns facilities potentially capable of providing multiple existing and future services, and a telephone company that wants to use those facilities to compete with the offerings of incumbent LECs whose facilities likewise have multiple potential uses, to agree in advance on limits on the services that the telephone company will offer and the amount of cable bandwidth it may use. The cable company will, of course, insist on some limits; an arrangement free of limits that encouraged a venture only partly owned by the cable company to compete directly with the cable company's 100%-owned core business would surely incur the wrath of shareholders. *See* Holmes Decl.; Wingfield Decl. And, it is far too early to reliably

predict which services – telephone, video, interactive online or other – will achieve the greatest commercial success, and thus how much of the cable bandwidth should be allocated to each service.

63. At the same time, AT&T is properly concerned that contractual limitations that might be imposed on the basis of imperfect information today could have the unintended effect of hampering the ability and flexibility of the joint venture to respond to offerings of the incumbent LECs that may flow from technology or other advances. *See* Wingfield Decl. How, for example, could a joint venture limited to plain old telephone service hope to compete with a successful incumbent LEC videophone offering?

64. Our conclusions about the likely difficulties with joint venture contractual arrangements are, unsurprisingly, confirmed by AT&T's own experiences in trying to negotiate such contracts. As explained in detail in the accompanying Declaration of Mr. Wingfield, although AT&T has been negotiating with a number of unaffiliated cable companies for more than a year, it has yet to reach agreement for a telephony joint venture with any such company. *See id.*

65. We do not mean to say, of course, that joint ventures are impossible or that they will not bring public interest benefits. We mean only to say that they are a less effective solution in this area. Because the parties to such a contract must necessarily divide the risks and gains *ex ante* on the basis of very imperfect information, absent extreme good fortune or prescience on the part of the contracting parties, the constraints the contract places on the venture's flexibility in responding to competitive offerings is likely to deny consumers many of the benefits that a full merger would bring.