TWE of certain interests in the Partnership; (E) the indemnification of any partner or affiliate for liabilities in excess of $500,000; (F) the incurrence of debt for money borrowed above a defined ratio; (G) the admission of a new general partner; (H) the extension of the Corporate Services Term beyond that contemplated by the LPA; and (I) certain acquisitions above the greater of $750 million or ten percent of TWE's consolidated revenues for its most recent fiscal year. The five "Unanimous Matters" specified in Section 12.1(c)(ii) relate to even more extraordinary decisions: (A) cash distributions above the level provided for in the LPA; (B) the dissolution of TWE; (C) the voluntary bankruptcy of TWE; (D) any amendment or modification of the LPA; and (E) the transfer or sale of certain major interests in TWE or any sub-partnership thereof.

19. In overview, it is abundantly clear that none of these transactions relate to ordinary business transactions or the normal business operations of TWE. Such matters remain entirely in the hands of the Managing General Partners under Section 12.1(b) or the Voting Class B Representatives under Section 12.1(c). Indeed, this point is underscored by Section 12.1(c)(i)(I) which forbids acquisitions in excess of $750 million or ten percent of TWE's consolidated revenues "otherwise than in the ordinary course of business". In short, transactions in the ordinary course of business are not subjected to these special approval rights; rather, MediaOne possesses only a veto power over extraordinary changes in the business and affairs of TWE.

III. THE NORMAL STATUS AND POWERS OF LIMITED PARTNERS

20. The limited partnership is a unique legal entity, which evolved from origins in the Roman law and French civil law. First recognized in the United States by the State of New York in 1822, it was originally strictly regulated, and even minor deviations from the statutory requirements resulted in loss of limited liability, based on the then dominant maxim that statutes in derogation of the common law were to be strictly construed. *See* R. Kurt Wilke,

Limited Partnership Control: A Reexamination of Creditor Reliance, 60 Ind. L.J. 515, 517 (1984). In 1916, the National Conference of Commissioners on Uniform State Laws promulgated the Uniform Limited Partnership Act ("ULPA"), which was subsequently adopted in every state except Louisiana. Section 7 of the ULPA, entitled "Limited Partner Not Liable to Creditors," provided that a "limited partner shall not become liable as a general partner unless, n addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business".

21. Control and limited liability were then seen as almost mutually exclusive. Over the years, a number of judicial decisions have interpreted this control test as frustrated creditors have regularly sought to reach limited partners to satisfy their claims. In general, participation in ordinary business decision-making created a high risk of liability for the limited partner. *See,* e.g., Holzman v. De Escamilla, 86 Cal. App. 2d 858, 195 P.2d 833 (1948) (limited partner participated in decisions as to kinds of produce that would be farmed and hence was found liable); Filesi v. United States, 352 F.2d 339 (4th Cir. 1965). But where the limited partners retained only rights to approve major decisions or even select managers, their limited liability was not disturbed. *See,* e.g, Plasteel Products Corp. v. Helman, 271 F.2d 354 (1st Cir. 1959); Trans-Am Builders, Inc. v. Woods Mill, Ltd., 210 S.E.2d 866 (Ga. Ct. App. 1974) (limited partners could participate in refinancing negotiations and raise additional funds for financially troubled firm without sacrificing liability).

22. Extensive analysis of these decisions is not necessary because the ULPA has been repeatedly amended to liberalize the ability of limited partners to exercise approval rights. The Revised Uniform Limited Partnership Act ("RUPLA") was adopted in 1985 and has been substantially enacted by Delaware (the state in which TWE's certificate was filed).

23. Under Section 17- 303(a) ("Liability to third parties") of Delaware's Revised Uniform Limited Partnership Act, which became effective on January 1, 1983, and was amended in 1988, a limited partner is not liable for the obligation of a limited partnership:

> "unless .... in addition to the exercise of his rights and powers as a limited partner, he participates in the control of the business."

24. Section 17-303(b) then sets forth a lengthy safe harbor, listing a series of activities in which a limited partner may engage without such conduct being deemed to amount to participation "in control of the business." Put simply, all the activities that MediaOne (or its successor) may engage in after the closing of the acquisition are amply protected by Section 17-303(b). For example, Section 17-303(b)(8) expressly permits limited partners to approve, consent or disapprove the "sale, exchange, lease, mortgage, assignment, pledge or other transfer of ..... any asset or assets of the limited partnership" or the "incurrence ... of indebtedness, of the limited partnership."

25. Commentators on Delaware law have expressed similar conclusions that the Delaware Revised Uniform Limited Partnership Act intended to broadly protect the exercise of voting rights by limited partners. *See* Craig Smith, Limited Partnerships - Expanded Opportunities Under Delaware's 1988 Revised Uniform Limited Partnership Act, 15 Del. J. Corp. L. 43 (1990). Mr. Smith, a Delaware practitioner, notes that limited partners may vote under Section 17-303(b) (8) on any matters stated in the partnership agreement or in any other agreement or writing without risking liability. Id. at 59-60. He also observes that it has become common for partnership agreements to "restrict the actions of general partners in managing the partnership, frequently confining them to the defined business purposes of the limited partnership." Id. at 60.

26. In short, both Delaware and the Revised Uniform Limited Partnership Act recognize that it is prudent and desirable to permit limited partners to possess some negative veto over significant business transactions and that such approvals or disapprovals do not amount to a participation in control. Indeed, I can think of few legal conclusions that would be less controversial with the business community.

IV. CONCLUSION

27. Viewed either in terms of standard business practice or the legal definition of control under Delaware law or the law of the vast majority of states, AT&T and MediaOne simply do not have the power to control decisions, policies, or practices at TWE, and, indeed, have no involvement in day-to-day management of TWE's cable operations. All they have is the ability to enforce the fundamental terms of a limited partnership agreement that was negotiated well before their appearance on the scene. In my judgment, these rights are not significantly different from those that a lender or other financial institution would normally negotiate.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

John C Coffee Jr

John C. Coffee, Jr.

Executed on September 15, 1999

F

Before the

FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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

SUPPLEMENTAL DECLARATION OF PROFESSOR JOHN C. COFFEE, JR.

Introduction

1. I make this supplemental declaration to address a question that has been raised in connection with the proposed acquisition by AT&T Corp. ("AT&T") of MediaOne Group, ("MediaOne"): What is the realistic nature of the economic relationship between AT&T and Liberty Media Corporation ("Liberty"), a Delaware corporation and AT&T's wholly owned subsidiary? For purposes of this analysis, it is understood and conceded that AT&T owns 100% of the stock of Liberty; that such stock is subject to the claims of AT&T creditors; and that such ownership entails real tax consequences, such as the membership of Liberty in AT&T's consolidated federal income tax group. Nevertheless, the issue remains whether AT&T can exploit this legal ownership of Liberty so as to derive any material economic benefit from that relationship. If it can, then it might well be in the interest of AT&T to seek to exercise control over Liberty. But if it cannot (which is the conclusion that I reach below), then AT&T lacks any

rational incentive to seek to dominate or influence Liberty. As detailed below, I find that the structure of the relationship between AT&T and Liberty effectively denies AT&T any realistic prospect of economic benefit from, and any ability to exercise control over, Liberty.

2. Because this declaration supplements another declaration of even date herewith in which I examined the level of influence and control that AT&T would have over Time Warner Entertainment Company, L.P., a Delaware limited partnership ("TWE"), by virtue of MediaOne's status as a limited partner in TWE, I will not again set forth my background and experience, which are detailed in that declaration, other than to state that I am the Adolf A. Berle Professor of Law at Columbia University School, where I specialize in corporate and securities law. In making this declaration, I am assuming that all the agreements and contracts referenced herein were duly authorized, constitute valid and binding obligations of the parties, and are enforceable according to their terms.

II. AT&T's Relationship with the Liberty Media Group

3. The special status of Liberty Media Group predates AT&T's 1999 acquisition of Tele-Communications, Inc. ("TCI"). TCI in fact had three distinct "tracking stocks": the TCI Group Tracking Stock, the Liberty Media Group Tracking Stock, and the TCI Ventures Group Tracking Stock. In preparation for the merger with AT&T, TCI combined TCI Ventures Group with Liberty Media Group and simultaneously consolidated their two tracking stocks into one. Thus, the resulting entity, Liberty Media Group, has been an independent business entity with its own tracking stockholders for some time, first as an independent business segment within TCI and now as a similar entity within AT&T. Under the Agreement and Plan of Restructuring and Merger by and between AT&T and TCI, dated June 23, 1998 (the "Merger Agreement"), a

wholly owned subsidiary of AT&T was merged into TCI, with TCI becoming a wholly owned subsidiary of AT&T (the "Merger"). As a result of the Merger, the assets and business of the combined AT&T/TCI entity were divided into two groups: (1) the "Common Stock Group," which consists of the assets of AT&T and TCI, other than certain of the assets previously held by either the Liberty Media Group or the TCI Ventures Group, and (2) the Liberty Media Group, which consists of the majority of the assets formerly held by the Liberty Media Group and the TCI Ventures Group. The former holders of the Liberty Media Group Tracking Stock and the TCI Ventures Group Tracking Stock received the Liberty Group Tracking Stock of AT&T, whereas the former holders of the AT&T Common Stock and the TCI Group Tracking Stock received AT&T Common Stock.

4. At the time of the Merger, a variety of intercompany agreements were entered into, and other protections were implemented, in order to ensure the independence of the Liberty Media Group. Before analyzing these agreements, it makes sense to begin with a short explanation of what a "tracking stock" is and what purposes it serves.

5. The idea of a "tracking stock" was pioneered by General Motors Corporation in the 1980's and has since been adopted by a number of large corporations, including USX Corp. (the former U.S. Steel) and Ralston Purina Co., as well as smaller high-tech companies, such as Genzyme Corp. The goal underlying the use of tracking stocks is to provide investors with the economic equivalent of an equity stock in an independent business entity or group of businesses, even though that entity or group remains owned by a diversified parent corporation, which itself issues the tracking stock. The alternative to a tracking stock is a spin off by the parent of the subsidiary or subsidiaries holding the assets that are to be separated from the parent. However,

tax and/or operational reasons often complicate any such complete separation and make the use of a tracking stock preferable. Although the goal of keeping the two business segments separate and independent requires careful tailoring of the dividend, voting, and liquidation rights of these two groups of shareholders, the Securities and Exchange Commission ("SEC") has repeatedly processed and declared effective registration statements relating to such transaction and has developed certain standard procedures. For example, the SEC has coined the term "group" and requires that each entity or group of businesses be collectively referred to as a "group;" it also specifies the nature of the financial statements that are to be provided to holders of the tracking stock. See Hass, Directorial Fiduciary Duties in a Tracking Stock Equity Structure: The Need for a Duty of Fairness, 94 Mich. L. Rev. 2089, 2090-91, (1996).

6. Probably the most sensible way to analyze the various charter, by-law, and contractual provisions that are intended to protect the holders of the Liberty Media Group Tracking Stock is to focus on the various means by which a majority shareholder group could ordinarily seek to exploit, or expropriate value from, a separate class of shareholders in the same corporation. In overview, these techniques, while diverse, are likely to fall under one of the following general headings:

(1) Share Issuances: absent limitations, the dominant group could seek to issue additional shares of the minority class in order to either dilute the holders of the minority class or to shift voting control to the dominant group or some third party;

(2) Self-Dealing Transactions: through control of the AT&T board, a dominant group could conceivably seek to divert assets or funds away from the Liberty Media Group or enter into otherwise unfair or non-arm's length transactions that imposed

liabilities on the Liberty Media Group in order to benefit the Common Stock Group;

(3) Withholding Dividends: By refusing to pay out as dividends the profits earned by the Liberty Media Group, the dominant group might seek to force the Liberty Media Group shareholders into accepting some unfair alteration of their rights as the price of receiving any economic return; or

(4) Imposition of Disloyal Agents: If the dominant group could impose its own directors or officers on Liberty Media Corporation, it could then conceivably engage in low-visibility transactions that imposed either diverted assets or income from, or otherwise imposed unfair terms on, the Liberty Media Group shareholders, even if the contractual agreements or the charter documents mandated fairness.

Each of the possibilities will be considered in order below.

7. Share Issuances. All the outstanding shares in the Liberty Media Group were distributed to the former holders of the Liberty Media Group Tracking Stock of TCI on a one-for-one basis and TCI Ventures Group Tracking Stock on a 0.52-for-one basis. Moreover, AT&T cannot authorize additional Liberty Media Group Common Stock, or alter or change the powers, preferences, privileges, or special rights of such shares, without a special class vote of the holders of Liberty Media Group Common Stock. See Certificate of Amendment of the AT&T Certificate of Incorporation Under Section 805 of the Business Corporation Law, dated March 10, 1999, Article III, Part B, Section 1. (b) (i).

8. Although it remains possible (at least in theory) that AT&T could issue the authorized, but unissued, shares of the Liberty Media Group Tracking Stock in a manner that either diluted the existing holders of that class or conferred voting control over that class on persons whose real

interest was that of holders of the Common Stock Group, any such scenario runs into at least three major obstacles:

9. First, AT&T's Bylaws were specifically amended at the time of the Merger to provide for a Capital Stock Committee, which is to consist of Dr. John Malone, the former chief executive officer of TCI, and two independent directors, who may not be current or former officers or employees of AT&T or have certain other affiliations with AT&T. See By-laws of AT&T, as amended on March 1, 1999, Article VI. This committee is charged with the implementation of the policies set forth in the Policy Statement Regarding Liberty Media Group Tracking Stock Matters (the "Policy Statement"), which document was adopted by a resolution of a majority of the entire AT&T Board of Directors and imposes a standard of fair dealing on all transactions relating to the Liberty Media Group Tracking Stock. Not only would any scheme or artifice to violate this standard of fair dealing invite litigation, but, even more to the point, it is wholly unrealistic to imagine the Capital Stock Committee issuing additional shares of Liberty Media Group Tracking Stock -- except on terms that are scrupulously fair to the holders of that stock. Put simply, Dr. Malone has every incentive to resist any such unfair scheme and is ideally positioned to do so successfully.

10. Second, the proceeds of the issuance of any additional shares of Liberty Media Group Tracking Stock must be invested in Liberty. See Inter-Group Agreement between and among AT&T Corp. and Liberty Media Corporation and Liberty Media Group LLC, dated as of March 9, 1999, at Section 1.3(b). Thus, the proceeds of any such issuance cannot be distributed, directly or indirectly, to the holders of the Common Stock.

11. Finally, the ultimate weapon that precludes any such overreaching of the holders of the Liberty Media Group Tracking Stock is the Contribution Agreement by and among Liberty Media Corporation, Liberty Media Management LLC, Liberty Media Group, LLC, and Liberty Ventures Group LLC, dated as of March 9, 1999 (the "Contribution Agreement"). Under the terms of this agreement, if a "Triggering Event" occurs, then Liberty is required to convey and assign effectively all its assets to a separate entity, Liberty Media Group LLC, which is entirely separate from AT&T and cannot be controlled by it. Essentially, because the definition of "Triggering Event" includes any substitution of directors at Liberty that changes the control of its board, this in terrorem sanction effectively insulates the Liberty Board of Directors from any interference by AT&T or its shareholders. Indeed, even if it were possible for AT&T somehow to dilute the Liberty Media Group Tracking Stock, neither it nor its agents (nor frankly anyone else) could use that power to replace a majority of the incumbent directors of Liberty (or their chosen successors). Even the apprehension that such a control shift "is reasonably likely to occur" is deemed sufficient by the definition of "Triggering Event" in Section 1.1 of the Contribution Agreement to justify the contribution of Liberty's assets to Liberty Media Group, LLC, where they would be managed by a management group now headed by Dr. Malone.

12. Self-Dealing Transaction. It is even harder to imagine a realistic scenario under which the assets of Liberty could be expropriated by AT&T, or otherwise diverted to others, at unfairly low prices. Liberty will continue to be managed by its current management. Only the Liberty Board of Directors can change its management, and under Liberty's Certificate of Incorporation, a majority of its board of directors, who were directors or officers of TCI prior to the Merger, will remain in office for at least the first seven years. See Restated Certificate of Incorporation

of Liberty Media Corporation, Article V, Section B (providing for a staggered board of three classes with the term of the Class B directors expiring in 2006 and the term of the Class C directors expiring in 2009). Moreover, removal of Liberty's directors without cause is precluded by its Restated Certificate of Incorporation (See Article V, Section C). Although a removal for cause is necessarily permitted, the term "cause" is defined to "mean the conviction of a felony including moral turpitude." (See Article V, Section C). Even once it becomes possible to elect successor directors to replace these incumbent directors, the terms of the Contribution Agreement will still apply and authorize the "contribution" of Liberty's assets to Liberty Media Group LLC if the de facto control of the incumbent directors is ever overturned (or even reasonably threatened). As a practical matter, absent any judicial invalidation of the Contribution Agreement, AT&T is effectively forced in my judgment to elect directors to Liberty's board that are satisfactory to a majority of Liberty's current directors.

13. Beyond these negative sanctions that bar AT&T from interfering with Liberty's board structure, it is also necessary to remember that AT&T has bound itself in its Policy Statement to adopt and pursue a "fair dealing" policy in all inter-group dealings and has appointed a Capital Stock Committee (on which Dr. Malone sits) to implement that policy. See Policy Statement at Paragraphs 1(ii) and 2. Thus, whether one examines AT&T/Liberty relationship from the perspective of the AT&T side or from that of the Liberty side, the possibility for unfair self-dealing has been foreclosed from both sides, and more than ample safeguards have been erected.

14. Withholding Dividends. A standard technique for the exploitation or "oppression" of minority shareholders is to withhold dividends. Then, even if the minority has effective voting protections, they may agree to waive their rights in return for some economic return. But here,

AT&T possesses no such stranglehold over Liberty. The Liberty board of directors, which, as noted above, is beyond AT&T's control, can declare dividends from its earnings or capital, as it chooses. These dividends will, of course, go to Liberty Ventures Group LLC as its sole shareholder (which, in turn, is wholly owned by AT&T) but, at this point, AT&T is committed to pass through these dividends to the holders of the Liberty Media Group Tracking Stock. See Policy Statement at Paragraph 4.1. Under the terms of the judgment entered into by AT&T in the United States District Court for the District of Columbia in the TCI matter, "AT&T shall adhere to the Policy Statement Regarding Liberty Tracking Stock Matters contained in the Exhibit D to the AT&T/TCI Merger Agreement." Finally, any material modification to the policy statement would be publicly known and could invite litigation by the shareholders of Liberty Media Group Tracking Stock if they deemed the change to be materially adverse to their interests.

15. Appointment of Liberty Officers and Agents. If AT&T could appoint the officers or agents of Liberty, it might still be able to divert earnings or assets to the holders of its Common Stock Group. But AT&T is only a shareholder in Liberty (albeit the exclusive shareholder), and American corporate law does not empower a shareholder with the ability to appoint or remove corporate officers. Only Liberty's board of directors has this inherent power, and as already indicated the Liberty board is effectively independent -- both because of the three class staggered board that keeps a majority of pre-Merger Liberty directors in office until at least 2006 and, ultimately, because of the Contribution Agreement.

CONCLUSION

16. Based on the foregoing, I do not believe there is any realistic way that AT&T can dominate or control the Liberty board of directors, divert assets or earnings from Liberty to itself, or receive any material economic benefit from its ownership of Liberty. In turn, this implies that, having no economic incentive to control Liberty, AT&T should be rationally indifferent as to the management policies and practices that Liberty follows.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

John C Coffee Jr

John C. Coffee, Jr.

Executed on September 15, 1999

G

AN ECONOMIC ANALYSIS OF THE EFFECTS OF THE AT&T-MEDIAONE MERGER ON COMPETITION IN THE SUPPLY AND DISTRIBUTION OF VIDEO PROGRAM SERVICES: RESPONSE TO THE CRITICS

Stanley M. Besen
Serge X. Moresi
John R. Woodbury

Charles River Associates Incorporated

September 17, 1999

Table of Contents

Introduction **1**
Concentration in Program Services **3**
Accounting for Partial Ownership Interests 7
An Interest Resulting in Complete Control *7*
A Silent Financial Ownership Interest *7*
Ownership Interests That Convey Partial Control or Influence *8*
Evaluating the Competitive Significance of a Financial Interest When the Firms Are Horizontal Rivals 9
Measuring Market Concentration 10
The Modified Herfindahl-Hirschman Index 10
Calculating the MHHI 12
Summary 15
The Effect of Competition from DBS **15**
The Issue of Monopsony **18**
The Hausman-CFA Approach to Measuring AT&T's Subscriber Share Is Flawed 20
Summary 28
License Fee Discounts **29**
Program Service Prices 29
The Magnitude and Sources of Program Pricing Differences 30
Reported Rate Card Discounts *30*
Comparison of Top of the Rate Card Rates and Average Fees *32*
Why Quantity Discounts Are Efficient 35
Implications of Differences in Fees among Distributors 38
The Issue of Vertical Foreclosure **40**
Empirical Evidence on Vertical Foreclosure 42
Why Vertical Foreclosure Is Unlikely Here 45
Hausman and CFA Fail to Demonstrate That AT&T Has the Ability to Foreclose a Rival Service *45*
Hausman and CFA Fail to Demonstrate That AT&T Has an Incentive to Foreclose a Rival Service *47*
Counterstrategies to Prevent Foreclosure 50
Foreclosure vs. Efficiency 51
Summary and Conclusion **55**
Appendix A - The Technical Underpinnings of the MHHI Analysis **60**
Appendix B - Ownership and Control Shares in Program Services **68**
Appendix C - Ownership and Control Shares of MVPDs **82**
Appendix D - Empirical Evidence on Vertical Foreclosure **99**
Appendix E - Curricula Vitae of Authors

Introduction

In connection with the proposed AT&T-MediaOne merger, AT&T has asked CRA to respond to claims made by a number of economists retained by parties opposed to the transaction. These claims focus on the allegedly adverse effects the combination would have on competition in the supply and distribution of video program services. We first show why claims that the merger will dramatically increase concentration in the supply of program services are incorrect. Among the major flaws in the analysis of economists who make such claims is their treatment of the AT&T-MediaOne merger as if it were accompanied by a complete merger of the economic interests of AT&T, MediaOne, Cablevision and Time Warner. Once this and other conceptual flaws are corrected, the change in concentration resulting from the AT&T-MediaOne merger is a fraction of that claimed by opponents. For these and other reasons, we find that the merger is likely to have little effect on competition among program services.

We further explain why the claim that DBS places no significant competitive constraints on cable system pricing is incorrect. Indeed, it appears that DBS is a potent competitor to cable and that the current market share of DBS substantially understates the significance of this competitive threat. This threat not only increases the alternatives that are available to consumers but it also reduces whatever power large cable MSOs may have over cable program services.

We next take up the issues of monopsony power and vertical foreclosure. In analyzing the ability of an MSO to obtain anticompetitive concessions from program services or to foreclose rival services, the only relevant systems are those for which the MSO buys programming or controls or influences programming choices. Obviously, an MSO derives no power to force concessions from program services based on cable systems for which it plays no role in programming choices.

In analyzing the claim that the merged entity will be able to exert monopsony power in purchasing programming, we conclude that the effect of the merger on program service pricing is likely to be small. We also explain why the competitive threat of DBS, as well as competition from over-the-air broadcasters, reduces the ability of large MSOs such as AT&T to exercise monopsony power. In addition, we make clear why, even if AT&T possesses bargaining power in its dealings with program services, there is likely to be little or no effect on the quantity or quality of programming available to MVPD subscribers.

Next, we analyze the claim that large cable MSOs receive inefficiently large discounts when they purchase cable programming. We conclude both that the evidence for the claimed magnitude of these discounts is weak and that substantial discounts can be justified by the efficiencies involved in selling to large MSOs.

We then examine the claim that large vertically integrated MSOs in general, and the merged AT&T-MediaOne in particular, will attempt to foreclose rival program services. We begin by summarizing the empirical evidence on foreclosure by vertically integrated cable operators and conclude that this evidence is not consistent with a pattern of foreclosure, even by the largest vertically integrated MSOs. We then explain that there are many factors tending to offset any incentives that any large MSO might otherwise have to engage in foreclosure, and we describe how these factors support the conclusion that AT&T is unlikely to have either the incentive or ability to foreclose rival programmers. In addition, we explain why the growth of DBS serves to attenuate further the ability of AT&T to foreclose rival program services.

Besides greatly overstating the increase in concentration that would result from the AT&T-MediaOne merger, the opposing economists completely ignore the associated efficiency gains. As a result, they greatly overstate the risks and understate the benefits of the merger. In sharp contrast, throughout our analysis, we identify these efficiency gains and describe the corresponding benefits the merger will produce for MVPD subscribers.[1]

Concentration in Program Services

In its report to the Commission, the Consumer Federation of America (CFA) asserts that AT&T's acquisition of MediaOne will result in a substantial increase in concentration in the supply of program services.[2] CFA reaches this conclusion by assuming that the AT&T-MediaOne merger is effectively a complete merger of AT&T, MediaOne, Cablevision, and Time Warner (including Time Warner Entertainment). Based on this flawed assumption, CFA calculates that the increase in the Herfindahl-Hirschman Index (HHI) of concentration[3] in the supply of program services resulting from the AT&T acquisition of MediaOne is about 1200, raising the

---

[1] The efficiencies discussed in this paper are those that affect the supply and distribution of video program services. Merger-related efficiencies in the supply of telephone and broadband services are discussed in the accompanying Declaration of Janusz A. Ordover and Robert D. Willig.

[2] Consumers Union, Consumer Federation of America, and Media Access Project (CFA), *Breaking the Rules* (hereafter *Breaking the Rules*), pp. 52-55.

[3] The HHI, which is generally accepted by economists as a measure of concentration for the purpose of evaluating horizontal competition, is equal to the sum of the squared market shares (measured in percentage terms) of all the firms in an industry. The HHI ranges from near zero, when there are many firms with very small shares, to 10,000 under monopoly.

HHI to a level exceeding 2500, a level that the *Horizontal Merger Guidelines* (issued jointly by the Federal Trade Commission and the U.S. Department of Justice) would characterize as highly concentrated.[4] On this basis, CFA concludes that the merger, "given the level of concentration in the industry, should be challenged."[5]

CFA's implementation of the HHI grossly distorts the effect of the merger on concentration in the supply of programming to MVPDs. For example, in its calculations, CFA assumes that AT&T's one-third ownership interest in Cablevision is equivalent to *complete* ownership and control of Cablevision by AT&T. This assumption exaggerates the effect of the merger on concentration because it overstates the market share of AT&T.

CFA's approach effectively assumes both that AT&T would capture 100% of the benefits that accrue to Cablevision if AT&T program services were to compete less aggressively, and that AT&T could also compel the program services affiliated with Cablevision to compete less aggressively with AT&T's affiliated program services. In fact, AT&T's interest in Cablevision's program services is only 33%; thus, AT&T could capture only 33% of the benefits from its actions, not 100%. In addition, AT&T's financial interest conveys little if any control over the operations of

[4] CFA calculates an industry HHI that is slightly under 2500 based upon total subscribership to program services, but the HHI calculation does not include the shares of all service providers, Exhibit 11, p. 54.

[5] *Breaking the Rules*, p. 54.

Cablevision that could be used to compel the Cablevision program services to compete less aggressively.[6]

In a similar, but even more distorting, manner, CFA implicitly assumes that AT&T's acquisition of MediaOne completely merges the economic interests of Time Warner and AT&T. Although the acquisition does provide AT&T with a financial interest in Time Warner Entertainment (TWE) (approximately 25%), that interest is significantly less than the 100% interest effectively assumed by CFA.

In addition, according to a recent Form 8-K filed by TWE, as a result of the proposed acquisition, "MediaOne's governance and management rights have terminated immediately and irrevocably to the fullest extent permitted by... the TWE Partnership Agreement."[7] Our understanding is that, as a result, AT&T will have no relevant control over the actions of TWE management.[8]

Equally important, the acquisition does not increase AT&T's interest in the Time Warner program services that are held outside TWE, most importantly the Turner services (for example, CNN, TNT, and the Cartoon Network). By contrast, CFA's methodology implicitly assumes that, as a result of the merger, AT&T will acquire a 100% financial interest in, and complete control of, these services.

CFA's calculations also assume that AT&T has a 100% financial interest in, and complete control over, Liberty, which, in CFA's view, houses the various program service interests "owned" by AT&T. However, we understand that, under

[6] AT&T has a 33% ownership share in Cablevision, but only an 8.9% voting share. Moreover, as described in AT&T's and MediaOne's Public Interest Statement (p. 12), the Dolan family exercises virtually complete control over Cablevision's operations.
[7] Securities and Exchange Commission Form 8-K, Current Report, August 3, 1999, Time Warner Entertainment Company, L.P.
[8] *See* Declaration of Professor John C. Coffee, Jr.

the terms of the Liberty tracking stock, AT&T shareholders cannot receive any increase in profits experienced by Liberty, and that AT&T lacks effective control over Liberty's behavior.[9] If so, then Liberty behaves more like an independent firm than a subsidiary of AT&T.

Finally, even if it had correctly implemented the HHI, which it has not, CFA fails to consider other factors that reduce the competitive significance of a high HHI. In particular, entry into the program services market seems relatively easy; in the last two years alone, the number of new services offered totaled 98.[10] We are also unaware of any significant legal or regulatory barriers; in fact, the Commission has promulgated a number of rules designed to ensure that programmers have the ability to obtain distribution from unaffiliated MSOs. Finally, it is our understanding that many cable systems are upgrading their capacity and, as a consequence, will need to purchase additional programming.

In what follows, we provide a method for accounting for AT&T's partial ownership interests in other program services without assuming that a partial ownership interest, no matter how small, provides AT&T with 100% of the profits and complete control of the "acquired" firm. In this way, we develop a more appropriate and sensible framework for evaluating the effect of AT&T's proposed acquisition of MediaOne on concentration in the supply of program services to MVPDs and, using this framework, we show that this effect is small.

---

[9] *See* Supplemental Declaration of Professor John C. Coffee, Jr.

[10] Federal Communications Commission, *Fourth Annual Report In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, CS Docket No. 97-141, Released January 13, 1998, para. 158; and *Fifth Annual Report In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, CS Docket No. 98-102, Released December 23, 1998 (hereafter "Fifth Annual Report"), para. 159.

Accounting for Partial Ownership Interests

As the previous discussion suggests, it is important to distinguish the *financial interest* the investor has in a firm — roughly speaking, the share of the firm's profits that are due the investor — and the *control* over the behavior of the firm conveyed by the financial interest. Specifically, the implications of a financial interest for horizontal competitive concerns depend upon 1) whether the financial interest conveys control of the firm in which the investment has been made (the "acquired" firm), 2) the size of the financial interest, 3) the competitive significance of the investor, and 4) the competitive significance of the acquired firm.

An Interest Resulting in Complete Control

If a program service acquires a partial ownership interest in another service that effectively permits the former to control the latter, an argument might be made that the investing entity has the same ability to control the acquired firm as under a complete merger. However, even in this case, the incentives for the investor to take actions that may benefit the acquired firm will be less than under a complete merger because the investor obtains less than a 100% share of the profits of the acquired firm. Thus, even in this case, one should treat the acquisition of the ownership interest as being different from a complete merger.

A Silent Financial Ownership Interest

A silent financial ownership interest in a program service is one that does not afford the investor any control or influence over the management of the acquired program service. Thus, although the investor may alter its own behavior as a result