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Before the
Federal Communications Commission
Washington, D.C. 20554

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

EX PARTE REPLY DECLARATION OF ROBERT H. GERTNER

I. INTRODUCTION AND OVERVIEW

1. I, Robert H. Gertner, am Professor of Economics and Strategy at the Graduate School of Business of the University of Chicago. In addition to my academic experience, I am Principal and Vice-President of Lexecon Inc. On August 17, 1999, I submitted a declaration in this matter on behalf of GTE and Bell Atlantic that analyzed the potential impact of AT&T's proposed acquisition of MediaOne on competition in the provision of Internet services. In that statement, I concluded that the proposed merger raises the risk of harm to competition in the provision of broadband Internet content and also raises the risk of anticompetitive harm in the provision of broadband Internet access services based on alternative technologies, such as Digital Subscriber Line (DSL) services.

2. The Reply Comments filed on September 17, 1999 by AT&T and MediaOne include a Declaration by Professors Janusz A. Ordover and Robert D. Willig. Among other issues, Profs. Ordover and Willig discuss the potential impact of the proposed transaction on the provision of broadband Internet services and comment on portions of my analysis. This affidavit

presents a response to some of these claims.[1] I have not attempted to address other aspects of their declaration that are unrelated to my initial affidavit.

3. My comments focus on three issues:

- First, I respond to claims made by Profs. Ordover and Willig regarding market definition and market power, specifically whether the availability of narrowband Internet services limits the ability of AT&T to exercise market power in the manner discussed in my earlier declaration. I show in Section II below that Profs. Ordover and Willig incorrectly characterize market definition and market power issues in this case and thus make incorrect inferences about the ability of narrowband Internet services to constrain AT&T from pursuing potentially anticompetitive exclusionary strategies. I also show that Profs. Ordover and Willig mischaracterize the pricing of narrowband and broadband Internet services and thus err in concluding that these services are close substitutes today.
- Second, I respond to the claim made by Professors Ordover and Willig that imposition of "prophylactic" remedies, such as GTE's proposal to require that AT&T adopt an "open access" for its broadband Internet access services, would be inappropriate as a matter of policy. Section III discusses how the imposition of remedies in anticipation of anticompetitive harm is the rule, not the exception, in merger analysis. This approach can be economically appropriate when the cost of avoiding harm is lower than the cost of ex post remedies.
- Third, I point out that the Ordover/Willig analysis contradicts itself in claiming that government regulation of open access requirements of AT&T would be "dysfunctional" while also claiming that Digital Subscriber Line (DSL) services, which

1. This declaration focuses on areas of significant disagreement with the Ordover/Willig Declaration. This decision reflects an editorial judgement and should not be read to imply that I agree with other statements that are not directly addressed.

are subject to such regulation, provides "effective competition" for AT&T broadband Internet access services. Both statements cannot be correct.

II. PROFS. ORDOVER AND WILLIG INCORRECTLY CONCLUDE THAT NARROWBAND SERVICES CONSTRAIN AT&T'S ABILITY TO SUCCESSFULLY ENGAGE IN AN ANTICOMPETITIVE EXCLUSIONARY STRATEGY

3. In my Declaration (¶13), I concluded that "[b]ecause broadband services provide (at least the promise of) access to very different types of content, the availability of narrowband distribution would not prevent a monopolist of broadband access from exercising market power with respect to firms that supply broadband-specific content." Professors Ordover and Willig dispute this conclusion and instead claim that AT&T would not be able to exercise market power due to competition between broadband and narrowband Internet services. They state:

- "Opponents of the merger have not shown -- and cannot show -- that AT&T has monopoly power in any relevant market." (¶81)
- "[B]roadband and narrowband last-mile data transport are plainly competing products." (¶82)

4. To support this conclusion, Profs. Ordover and Willig note that "[b]roadband customers do not simply appear, they must be convinced to switch from the current narrowband providers." (¶84) They also cite a statement from an AT&T executive that AT&T now "price[s] the AT&T@Home service to compete with dial up service." They also cite the "small" difference in the cost of narrowband and broadband Internet services in support of their conclusion that these services are in the same market. (¶87)

5. This section shows that the "marketplace evidence" cited by Profs. Ordover and Willig does not provide an adequate basis for concluding that the availability of narrowband services constrains AT&T's ability to exercise market power as a provider of broadband services. I also show that in focusing on competition between narrowband and broadband services, Prof. Ordover and Willig address the wrong question for the purpose of antitrust analysis.

A. THE "MARKETPLACE EVIDENCE" CITED BY PROFS. ORDOVER AND WILLIG FAILS TO SUPPORT THEIR CONCLUSION THAT NARROWBAND AND BROADBAND SERVICES ARE IN THE SAME PRODUCT MARKET

1. The coexistence of broadband and narrowband Internet services does not mean they are in the same market.

6. The fact that broadband access customers are drawn from the pool of narrowband customers does not imply that these products are in the same market. Instead, customers of virtually all new products and services are drawn from the ranks of the customers of the services that are displaced. By this logic, airlines and passenger railroads would be in the same market because air travelers were drawn from the population of people who once traveled by rail.

7. Even if the pricing of a new technology is made to attract customers of an older technology, this does not necessarily suggest that customers would revert to the old technology if its price falls, as would be expected if the new and old products are in the same market. If customers are unlikely to switch back to the old technology in response to changes in relative prices, the coexistence of an old technology will not necessarily constrain pricing of the new technology, especially after the new technology has been gained acceptance in the marketplace. The customers that irreversibly switch from narrowband to broadband services could be adversely affected by a monopolist provider of broadband services.

2. Profs. Ordover and Willig mischaracterize the difference between narrowband and broadband Internet access prices.

8. In attempting to support their argument that narrowband and broadband Internet access services compete today, Profs. Ordover and Willig claim that the prices of these services are comparable. They state that "what is striking is how *small* a difference there is between the cost of narrowband Internet access and the cost broadband Internet access." (¶90) They state "[t]he only reason that Gertner ... found a significant price differences in that ... [he] ignored the cost of an additional telephone line."

9. Profs. Ordover and Willig mischaracterize the difference between narrowband and broadband Internet access prices. My August declaration compared the price of @Home and Road Runner ($40 to $50 per month) to the price of AOL (about $22 per month). The use of AOL in this comparison minimized the differences between narrowband and broadband Internet access pricing because AOL provides extensive proprietary content in addition to Internet access.[2]

10. In analyzing market definition, it is important to distinguish (to the extent possible) between the price of access and the price of content. Available data indicate that the price of access is considerably lower than the price of access/content provided by AOL. Many ISPs now offer service for as little as $10 per month. Table 1 identifies a number of national ISPs that offer low-priced service. In addition, many non-national services also provide low cost access services. Some services, such as AltaVista, Net Zero and CompNet USA offer narrowband Internet access at no charge.[3]

11. Moreover, current differentials in the price of narrowband and broadband Internet access services are not likely to be representative of the differentials that will prevail in the future. Merrill Lynch, for example, notes that:

> It appears that there are changes brewing in the typical pricing model for Internet access services. We believe these changes are significant enough that they potentially have an impact on the competitive landscape. . . . The end result of the innovation in access pricing, if they gain momentum, should be to make it easier and cheaper to get online.[4]

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2. @Home, of course, does not offer "access only" services, choosing instead to bundle access with its own content. Thus, customers that prefer "access only" services pay the same amount as those that desire ancillary @Home services.
3. http://micrav.com
4. Merrill Lynch Capital Markets, "Internet/Electronic Commerce: Changes in Access Pricing," Report No. 2880382, June 18, 1999. For a similar perspective see: Peter Henig, "Are ISPs dead?" Red Herring: The Business of Technology, June 26, 1999. [http://www.redherring...nsider/1999/0626/inv-deadisps.html]

Table 1

Examples of Low Priced National Dial-Up Internet Service Providers

ISP Name	Number of Area Codes Serviced	Price for 28.8 Kbps	Price of 56 Kbps
AccessMaster.com	92	$8.25	$9.95
AltaVista	N/A	$0.00	$0.00
Bewell Net	76	$9.95	$9.95
BizNet Communications	41	$9.95	$9.95
Cable & Wireless	158	$9.95	$9.95
CariNet	78	$7.00	$7.00
CompNet USA (Freewwweb)	176	$0.00	$0.00
Internet Central	176	$10.00	$10.00
Internet services, Inc.	102	$9.95	$9.95
MegaHertz Communications	85	$4.95	$4.95
MegsINet Inc	80	$9.95	$9.95
MegsINet-CLEC, Inc.	75	$9.95	$9.95
NetZero	39	$0.00	$0.00
Visual Perspectives Internet, VPINET	222	$6.95	$6.95

Source: Boardwatch Magazine's Directory of Internet Service Providers, 11th Edition, 1999; Altavista.com

Note: National Dial-Up ISPs are defined as companies with services in twenty-five or more area codes. AltaVista offered free dial-up service starting 8/12/99 and recorded 550,000 users as of 10/7/99.

12. Profs. Ordover and Willig also incorrectly suggest that the price of narrowband Internet access should include the full cost of a second telephone line. Even for homes that purchase a second telephone line for narrowband access, and many do not, the second line provides services other than Internet access. Profs. Ordover and Willig themselves note that customers "can use that second line for regular voice communication, as well as for a fax." (¶83) Evaluation of the extent to which second telephone lines contribute to the cost of narrowband Internet access requires consideration of the extent to which consumers value these other services. For example, for individuals that would have two lines without Internet access services, the implicit prices of narrowband Internet access might be ISP charges alone.

13. Finally, the suggestion by Profs. Ordover and Willig that differences in narrowband and broadband prices are "small" is inconsistent with the "staggering investment" that AT&T is making in upgrading its cable television facilities to provide ancillary services. (¶108) As emphasized in my prior report, the magnitude of AT&T's investment suggests that it expects the value of broadband services to be provided over these facilities to be significantly greater than that of narrowband services. If not, then AT&T instead could simply continue to offer services through its narrowband ISP facilities. This again suggests that the presence of narrowband services would not be likely to prevent AT&T from successfully engaging in an anticompetitive exclusionary strategy.

B. PROFS. ORDOVER AND WILLIG FAIL TO ADDRESS THE APPROPRIATE QUESTION FOR ANTITRUST ANALYSIS

14. Profs. Ordover and Willig's focus on the extent of competition between broadband and narrowband services today addresses the wrong question for analyzing the competitive effect of the proposed transaction.

15. As discussed in my initial declaration, the proposed transaction creates the opportunity for AT&T/MediaOne to exercise market power by excluding, or imposing costs upon, unaffiliated providers of broadband content services. The market definition/market power analysis presented by Profs. Ordover and Willig does not address this question.

16. Profs. Ordover and Willig present no cogent explanation of how the widespread availability of narrowband access services would prevent AT&T from successfully engaging in this strategy. As discussed in my initial declaration, broadband-specific content services are being deployed and will become more widespread as broadband access becomes more widespread.[5] The existence of narrowband customers would not prevent AT&T from

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5. Examples include streaming video and audio services; teleconferencing services for home offices and telecommuters; home shopping and video catalog services; interactive games; high-speed software downloads and other services.

successfully engaging in a strategy that harms a distinct group of consumers that prefer broadband-specific services.

17. Similarly, AT&T's current pricing practices provide no guidance as to whether an anticompetitive exclusionary strategy would be successful. Even if, contrary to available evidence, narrowband and broadband services compete today, this would not be relevant in analyzing whether narrowband service would constrain AT&T once broadband-specific services become more widely deployed.

18. Instead of addressing the narrow question of the extent to which narrowband and broadband services compete today, antitrust analysis in this case needs to focus on the competitive effects of the proposed transaction. As in the evaluation of unilateral effects in mergers, not all antitrust issues can be evaluated through a conventional market definition analysis. Profs. Ordover and Willig's market definition analysis does not address the likely competitive effect of the proposed transaction.

III. PROFS. ORDOVER AND WILLIG INCORRECTLY CLAIM THERE IS NO RATIONALE FOR REGULATION TODAY

19. According to Profs. Ordover and Willig, the potential harm to competition resulting from the proposed merger "would not justify prophylactic regulation now. Opponents of the merger have not offered any evidence or argument as to why it would be hard to regulate at that time -- when the preconditions for access regulation are hypothetically satisfied -- then it would be now." (¶108)

20. The imposition of "prophylactic" conditions may be efficient if, as is typically the case, the cost of avoiding harm to competition before it takes place is lower than the cost associated with imposing remedies after the fact. For example, harm to competition is more efficiently avoided by preventing anticompetitive mergers from taking place instead of through litigation and unwinding integrated operations after a merger has been completed. Harm to competition also may be avoided at low cost prior to a merger through regulatory conditions

and/or partial divestitures. This, of course, is the logic of merger review by the U. S. Department of Justice and Federal Trade Commission, as well as the FCC.

21. With respect to broadband Internet access, I understand that the cost of deploying an open access structure is lower when initially upgrading a cable system to provide Internet access compared to the cost of retrofitting existing cable broadband systems to provide open access. (See accompanying Ex Parte Reply Declaration of Albert Parisian.) Thus, if the FCC and or Department of Justice determine that risks of harm to competition from the proposed transaction are substantial, the "prophylactic" approach is likely to be more efficient than ex post remedies.

IV. PROFS. ORDOVER AND WILLIG'S ANALYSIS SUGGESTS THAT AT&T'S RIVALS ARE AT A SIGNIFICANT COMPETITIVE DISADVANTAGE

22. Profs. Ordover and Willig claim that AT&T will not be able to engage in an anticompetitive exclusionary strategy due in part to competition faced from suppliers of DSL services. For example, they claim that "AT&T's services face effective competition from other broadband services." (p. 44) They further state that "claims that DSL and satellites are fundamentally flawed as broadband alternative appear to us to amount to little more than histrionics." (¶99)

23. While claiming that DSL is a viable competitive alternative to AT&T's broadband Internet access services, Ordover and Willig at the same time stress the impediment that an open access requirement would impose on AT&T. They state that "[o]pen access is an intensely regulatory process. . . . For services as complex and multidimensional as online services, this is a huge undertaking." (¶71) They further claim that "[i]n this dynamic environment, any centralized scheme of forced access and price regulation is likely to be dysfunctional from the outset, and increasingly dysfunctional as time passes. The overwhelming harm of unnecessary forced access is total paralysis of one of the most dynamic markets the world has ever seen."

(¶76) AT&T's Reply Brief makes this point even more forcefully, stating that "[b]urdensome regulation could delay or even halt the deployment of such facilities ."[6]

24. Very simply, Profs. Ordover and Willig cannot have it both ways. DSL either is paralyzed by regulation or its competitive viability is not undermined by an open access requirement, but not both.

- If regulation precluded DSL services from being effective competition to AT&T's broadband Internet access services, then it is likely that AT&T could exercise market power as a result of its role as a provider of broadband service to 80 percent of current customers and undertake an anticompetitive exclusionary strategy.[7]
- Alternatively, the statement by Profs. Ordover and Willig regarding the "dysfunctional" nature of access regulation can be dismissed as "histrionics." If so, and DSL has the potential to become an effective competitor to AT&T broadband services, then it would seem unlikely that imposing open access conditions on the AT&T/MediaOne merger would adversely affect the deployment broadband Internet access services. Under these circumstances, imposition of an open access requirement on AT&T would reduce the risk that AT&T could engage in an anticompetitive strategy at relatively low cost.

CONCLUSION

25. Prof. Ordover and Willig incorrectly characterize market definition and market power issues in this case and thus draw incorrect inferences about the ability of narrowband Internet services to constrain AT&T from pursuing the potentially anticompetitive exclusionary targeted strategy outlined in my August Declaration. The "marketplace evidence" they cite -- the fact that broadband customers are drawn from the ranks of narrowband customers and the

6. Reply Comments of AT&T Corp. and MediaOne Group, Inc., p. 107.
7. See ¶8 of my August Declaration.

factors considered by AT&T in setting broadband prices -- do not support a conclusion that narrowband and broadband Internet access services are close substitutes. Profs. Ordover and Willig provide no cogent explanation of how the existence of such narrowband customers would prevent AT&T from successfully engaging in a strategy that harms a distinct group of consumers that prefer broadband-specific services. Moreover, Profs. Ordover and Willig's claim that the prices of narrowband and broadband Internet access services are similar also is incorrect. Properly evaluated, narrowband access prices are substantially lower than broadband prices and appear to be falling. Thus, available pricing evidence also suggests that narrowband and broadband services are not close substitutes.

26. In stressing the "dysfunctional" role of open access regulation, Profs. Ordover and Willig's analysis also provides support for the view that DSL will not constrain AT&T from successfully pursuing an anticompetitive exclusionary strategy.

27. In sum, Profs. Ordover and Willig have presented no evidence that allays concerns that the proposed transaction raises the risk that AT&T can successfully engage in an anticompetitive exclusionary strategy.

I declare under penalty of perjury that the foregoing is true and correct.

Signed this 29 day of October, 1999.

Robert H. Gertner