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August 9, 2002

Ex Parte

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Re: *AT&T/Comcast License Transfer Application*, MB Docket No. 02-70

Dear Ms. Dortch:

This letter responds to the July 18, 2002 *ex parte* letter submitted on behalf of SBC Communications, Inc. ("SBC") in the above-referenced docket. SBC alleges that the proposed merger of AT&T Broadband and Comcast "would permit AT&T to extend its anticompetitive restrictions on the distribution of Headend In the Sky," SBC *ex parte* at 1, AT&T Broadband's "HITS" digital programming aggregation and transmission service. SBC also speculates that AT&T Comcast will use "buyer power" to obtain "unfair" prices from suppliers of video programming who will then be forced to raise prices to other multi-video programming distributors ("MVPDs"). *Id.* at 4-7. As explained below (and also in Applicants' May 21, 2002 reply comments and supporting declarations), both arguments are logically and factually infirm.

HITS. HITS obtains rights from programming networks to compress, multiplex and uplink their content to leased satellite transponders for transmission to the headends of MVPDs, which separately contract with the owners of video programming for the right to distribute that content to subscribers. *See* May 17, 2002 Declaration of Gregory Braden (attached to Applicants' Reply Comments) at ¶ 14. *Id*. The programming transmitted by HITS is also available to MVPDs directly from the owners of that programming *Id*. ¶¶ 18, 21. "[T]he technology and equipment used by HITS is commercially available and is not proprietary." *Id*. ¶ 16. Accordingly, other cable MSOs can – and have – developed HITS-like capabilities for their own use. Unlike these other MSOs, and although it had no obligation to do so, AT&T Broadband elected to sell its digital programming aggregation and transmission service to unaffiliated MVPDs. SBC would have the Commission make this a punishable offense on the grounds that, notwithstanding the many alternatives to HITS service, HITS is an "essential facility."

In its earlier comments in this proceeding, SBC complained that WSNet, a reseller of HITS service, had refused to transmit the HITS service to an SBC headend in an AT&T Broadband service area. SBC Comments at 24-25. Applicants pointed out that those allegations would be irrelevant here even if true, because AT&T Broadband's incentives and ability to sell or refuse to sell its HITS service to third parties in AT&T Broadband service areas are entirely unaffected by the proposed merger. *See* Applicants' Reply Comments at 59. Applicants also demonstrated that any cable overbuilder in any AT&T Broadband service area *can* obtain the HITS service under the model agreement available to any member of the National Cable Television Cooperative ("NCTC") and that overbuilders in AT&T Broadband service areas do, in fact, purchase the HITS service. *See* Braden Declaration at ¶ 24; Applicants' July 2, 2002 Response to June 11, 2002 Document and Information Request at 4.

Lacking any possible claim of merger specificity with respect to its original allegations, SBC abandons them. SBC now claims that the problem is access to the HITS service by overbuilders in Comcast service areas. SBC does not claim ever to have requested the HITS service in a Comcast service area and does not dispute that WSNet can and does sell the HITS service to overbuilders in Comcast service areas. *See* Braden Declaration ¶ 23. Rather, SBC speculates that the WSNet contract might, in the future, be amended to eliminate WSNet's ability to resell the HITS service in Comcast service areas. SBC *ex parte* at 2. But neither AT&T Broadband nor its successor has any unilateral right to amend the contract, and WSNet obviously has strong economic incentives to retain its existing rights to resell HITS as broadly as possible. SBC also complains that the primary term of the HITS/WSNet contract expires in "only" four years. SBC asserts, without explanation or support, that four years is not enough time "to provide the stability of content needed to justify starting a new service." SBC *ex parte* at 2. The marketplace realities are quite different; in fact, almost *no* HITS contract – including the NCTC agreement, which is likewise available to overbuilders in Comcast service areas – has a primary term that exceeds five years.

SBC then changes theories again and suggests that even if traditional cable overbuilders will continue to be able to purchase the HITS service in Comcast areas, SBC and other SMATV operators will not. That too is false, as SBC well knows. WSNet's primary business is reselling HITS service to SMATV operators – including, apparently, SBC, *see* www.wsnet.tv/about_us/aboutwsnet.asp (listing SBC as a customer of WSNet) – and the contract between HITS and WSNet expressly allows WSNet to resell the HITS service to SMATV operators wherever they are located (including Comcast and even AT&T Broadband service areas). *See* July 2, 2002 Letter from David L. Lawson to Ms. Marlene H. Dortch (submitting the WSNet contract pursuant to the terms of the protective order in this proceeding). Nor, as SBC claims, does the ownership of SMATV systems disqualify a cable operator from NCTC membership – indeed, the model agreement NCTC negotiated with HITS expressly provides for the provision of the HITS service to NCTC members' SMATV systems. *See* July 2, 2002 Letter from David L. Lawson to Ms. Marlene H. Dortch (submitting the NCTC contract pursuant to the terms of the protective order in this proceeding).

Contrary to SBC's claim, SMATV operators (and other "small" MVPDs) also have non-HITS alternatives. DirecTV, for example, provides digital feeds to SMATV operators.[1] In addition, both existing commercial digital programming aggregation and transmission services and other large MSOs already have operational facilities and equipment that are comparable to those used by AT&T Broadband to provide the HITS service. SBC contends that both current providers of digital programming aggregation and transmission (such as TVN and OlympuSAT) and other MSOs that could provide such services should be ignored, because they do not *currently* aggregate and transmit to third parties the full range of programming aggregated and transmitted by HITS. The relevant point, however, is that all of these other entities *could*, with existing facilities, provide the full range of digital programming to meet any unmet demand for such services.

But even if these alternatives did not exist, any MVPD can, using commercially available equipment, obtain digital programming through direct feeds from the owners of that video programming. HITS uses commercially available, non-proprietary equipment. SBC does not dispute that many MVPDs already do obtain digital feeds, including multiplexed digital feeds, directly from their suppliers of video programming. *See* Braden Declaration ¶¶ 18-21. In these instances, the transmission of the content to the MVPD by the programmer is generally done free of charge to the MVPD, unlike HITS which charges the MVPD for the delivering the content to the MVPD via the HITS feeds. In this respect then, the HITS service is actually less economically advantageous to the MVPD than direct feed of the content from the programmers.

SBC contends that a direct feed would not be economic for its own Mission Bay development, but that allegation, like SBC's original allegations, fails for lack of merger specificity, because the Mission Bay development is apparently in an AT&T Broadband service area. *See* www.sbc.com/data/Mission_Bay_Release_FINAL. SBC's Mission Bay allegations plainly cannot support any broader inferences about the economic feasibility of direct feeds. As an initial matter, SBC continues to refuse to provide even the barest support for its figures (which have somehow doubled from its initial comments to its *ex parte* filing). And SBC does not deny that the relative cost of "self-supply" through direct feeds as opposed to the purchase of a HITS-like aggregation service depends upon the particular MVPD's programming selections. "An MVPD that chooses popular digital programming from large, established providers like Disney, AOL/Time Warner, and Viacom, or from independent transmission cooperatives like the A&E group that have existing compressed multiplexed packages, may not incur substantially high fixed costs compared to a HITS subscription. On the other hand, an MVPD that chooses a wider range of programming may need to invest in additional satellite receivers and grooming equipment." Braden Declaration ¶ 28. Moreover, an MVPD that uses direct feeds avoids the recurring HITS fees. *See id*. ¶ 21 ("For some HITS customers, the fee can be as high as

[1] *See, e.g.*, Report, *Report to Congressional Committees Pursuant to the Rural Local Broadcast Signal Act*, 16 FCC Rcd. 578, ¶ 29 (2001).

$800,000/year/headend"). The relevant comparison is thus total costs – *i.e.*, "up-front" costs plus recurring costs – and on this score, SBC offers no evidence at all.

It is precisely because of these existing and potential alternatives to HITS that not a single SMATV operator or other "small MVPD" agrees with SBC. To the contrary, small MVPDs agree with Applicants that "HITS has generally been a good actor, dealing fairly with small cable companies and their buying cooperatives" and that SBC's demands in this proceeding are "untenable and threaten[] substantial harm to the public interest in smaller markets." American Cable Association Reply Comments at 5.

Monopsony Power. SBC's "buyer power" claims are equally infirm. According to SBC, AT&T Comcast will exercise monopsony power and pay much less to suppliers of video programming. SBC *ex parte* at 4. This, in turn, according to SBC, will "force" video programming suppliers to increase rates to smaller MVPDs making them less effective competitors. *Id.*

As Applicants have previously explained, SBC's theory fails at the outset, because suppliers of video programming already have incentives to charge smaller MVPDs (and larger ones as well) as much as they are willing to pay, and presumably are doing just that. Thus, if AT&T Comcast did (for whatever reason) pay less to suppliers of video programming, that would not affect either the incentives or ability of video programming suppliers to increase the prices they charge to other MVPDs. *See* May 17, 2002 Declaration of Janusz Ordover ¶ 39 (attached to Applicants' Reply Comments) ("if, as hypothesized by [SBC], a programmer has the ability to force overbuilders to accept higher prices, then it would be charging those higher prices *before* AT&T Comcast exercise their purported power to gain a lower price").[2]

Thus, SBC's theory can only be that AT&T Comcast would squeeze so hard that it would substantially degrade the quality of video programming. But that would reduce the quality of AT&T Comcast's *own* offerings, and it would plainly have no incentive to do that. *Id.* ¶¶ 25-30. To the contrary, "as a cable MSO gets bigger, its incentives to buy the quantity and quality of programming that is likely to attract the greatest number of viewers relative to the cost of securing the such programming are not affected." *Id.* ¶ 30.

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[2] SBC's theory also suffers from a second basic economic flaw. A video programming supplier will sink costs only if it expects to recover them. Ordover Declaration ¶ 40. Under SBC's theory, AT&T Comcast would pay so little that the programmer would have to raise prices to overbuilders who, the theory goes, would then be unable to compete. But in such a situation, the video programming supplier would be left holding the bag. Recognizing this, it would demand that AT&T Comcast pay at least its proportionate share of the costs before agreeing to sink them. *Id.*

Indeed, economic theory predicts that as a cable MSO becomes larger, it becomes *more* concerned with the consequences of its bargaining on quality of programming, *id.* ¶¶ 31-41 – as even the economists cited by SBC and other opponents of the merger have recognized. In a June 7, 2002 *ex parte* filed on behalf of Qwest, for example, Messrs. Haring, Rohlfs and Shooshan rely heavily upon David Waterman & Andrew Weiss, VERTICAL INTEGRATION IN CABLE TELEVISION (1998). Professors Waterman and Weiss make exactly the point that SBC and Qwest dismiss as unrealistic: "the greater the national market share of an individual MSO, the *less* its incentive to free ride." *Id*. at 83 (emphasis added).[3]

SBC next claims that because DBS competition does not fully constrain *retail* cable rates, Applicants have overstated the impact of DBS competition on cable operators' incentives to obtain the quality video programming that consumers demand. Even ignoring that SBC's premise is false,[4] the argument is a *non sequitur*. Regardless of the impact of DBS competition

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[3] Waterman and Weiss do predict, based upon their own simplistic model, that a large cable MSO may have a greater *ability* to dictate the price of programming (although, as noted, they agree that the larger a cable MSO grows the greater its incentive to ensure that it does not squeeze so hard as to affect the supply or quality of programming that is produced). *Id.* at 83. But as SBC itself has recently acknowledged, a "study can be useful only if the model used . . . reflects the real world situation and the behavior of the experimental participants can reasonably be expected to mirror that of real marketplace participants." SBC Supplemental Comments, CS Docket Nos. 98-82 *et al.*, at 2. And the model used by Waterman and Weiss does not remotely reflect the real world purchase and sale of video programming rights. For example, Waterman and Weiss assume that cable systems "provide the only practical outlet for large numbers of television producers." David Waterman, *Local Monopsony and Free Riders*, 8 Information Economics and Policy 337, 339 (1996). Whatever validity that assumption may have had in 1996, it is clearly inapplicable now with the explosive growth and ubiquitous availability of DBS. *See id.* (the "appropriate criteria for assessing monopsony power is the relative bargaining power of the MSO and the various program suppliers, which in turn depends on the extent of upstream economies of scale and alternative means of distribution which the program supplier may have"). Waterman and Weiss also assume that all programming is of equal quality, *id*. at 342, and thus fail to account for the real-world fact that suppliers of video programming often control rights to "must have" content that gives them substantial bargaining leverage in marketing all of their networks to any cable operator, regardless of size.

[4] SBC notes that cable rates have increased faster than inflation, but ignores that cable costs (most importantly, video programming costs) have increased even faster. *See* Ordover Declaration at ¶ 118 (summarizing evidence showing that programming costs have increased faster than cable rates).

on retail rates, it is undeniable that consumers can and do switch to DBS if they are unhappy with a cable operator's programming choices. *See* Ordover Declaration ¶¶ 79-81, 117-29.[5]

In short, although the precise level at which buyer market power concerns might arise in this industry continues to be debated in ongoing rulemaking proceedings, it is quite obvious that no such concerns arise here (and that AT&T Comcast will, of course, comply with any ownership concentration limits that are promulgated in the rulemaking proceedings).

In the end, SBC's *ex parte*, like its previous submissions, reveals that its only real interest in this proceeding is as another forum for its ever-present "regulatory parity" arguments for deregulation of its own broadband services. SBC *ex parte* at 7-11. AT&T has detailed the obvious fallacies in SBC's arguments in a number of ongoing rulemaking proceedings (*e.g.*, CC Docket Nos. 02-33 and 01-338 and GN Docket No. 00-185). Applicants will not repeat that showing here, because SBC's arguments have nothing whatever to do with the proposed merger of AT&T Broadband and Comcast.

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[5] SBC's claim that Applicants' DBS arguments are inconsistent with AT&T's arguments in other proceedings that SBC remains dominant in the provision of local wireline services fundamentally misapprehends the nature of DBS competition. It is the ubiquitous "*availability*" of DBS alternatives to cable – with the ability to serve at a moment's notice virtually every existing cable customer – that prevents the exercise of market power by cable companies. *Id.* ¶¶ 73, 81. Thus, SBC's market share comparison is simply irrelevant – most of SBC's residential local telephone customers have *no* alternative supplier. In any event, as AT&T explained at length in its reply comments in CC Docket No. 01-338, even where local telephone competition exists, SBC grossly overstates the market share that it has lost to competitive carriers.

Sincerely,

/s/David L. Lawson

David L. Lawson

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