

October 6, 2006

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
Room TW-325
445 12th Street, S.W.
Washington D.C. 20554

EX PARTE

Re: In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer Of Control, WC Docket No. 06-74

Dear Ms. Dortch:

Time Warner Telecom, Inc. (“TWTC”) by its attorneys, hereby files this ex parte notice of a telephone conversation held on October 5, 2006, between Thomas Jones and Jonathan Lechter of Willkie Farr & Gallagher LLP, counsel to TWTC, and Scott Bergmann, Legal Adviser to Commissioner Jonathan Adelstein. The conversation took place before the FCC announced the inclusion of the above-referenced proceeding on the agenda for the FCC open meeting to be held on October 12, 2006.¹

During the discussion, we described in detail the reasons why the Applicants’ claim that the merger will accelerate the deployment of IPTV and enhance MVPD competition in the BellSouth region is based on incorrect factual and theoretical predicates.² We made the following points:

- There is no basis for the Applicants’ assertion that, absent the merger, BellSouth would not roll out IPTV due to “the cost disadvantage it would face as a distributor that has a small, geographically limited subscriber base and [because] it would be unable to achieve economies of scale.”³
- In its prior BOC merger orders, the FCC rejected the notion that the achievement of scale and scope economies for the purpose of making entry less

¹ See “FCC To Hold Commission Meeting Thursday, October 12, 2006,” Commission Meeting Agenda Notice, Item No. 4, October 5, 2006.

² See Application of AT&T Inc. and BellSouth Corp., Public Interest Statement, WC Docket No. 06-74, at 20-28 (filed Mar. 31, 2006) (“*Public Interest Statement*”).

³ Declaration of William L. Smith, ¶ 14, attached to *Public Interest Statement* (“*Smith Decl.*”).

costly are a cognizable benefit if the merging parties are able to enter a market in the absence of the merger.

- In the *SBC/Ameritech Merger Order*, SBC and Ameritech argued that, standing alone, neither company could effectively compete out-of-region through its “national-local strategy” because each lacked sufficient scale and geographic scope.⁴
- The FCC rejected SBC’s and Ameritech’s argument, holding that the parties were financially able to enter out-of-region markets on their own. In so doing, the FCC specifically relied on the fact that smaller carriers than either SBC or Ameritech had effectively entered territories in which the smaller carriers were not affiliated with the ILEC. *See id.* ¶¶ 276, 278.
- Many carriers, including many ILECs that are much smaller than BellSouth, have deployed or have committed to deploying their own IPTV service. Cincinnati Bell, CenturyTel, Citizens Telephone Company, SureWest, the Rural Telephone Service Company, Hawaiian Telecom, and Cavalier Telephone are all much smaller than BellSouth and have all either begun to offer IPTV or committed to doing so.⁵ Infrastructure and programming costs have not prevented these companies from deploying their own IPTV services more rapidly than either BellSouth or AT&T.
- There is no basis for the Applicants’ assertion that the merger would produce substantial savings in the infrastructure necessary to deploy IPTV service in BellSouth’s region. In fact, the merger would have no material effect on many of the costs BellSouth must incur to provide video service.
- BellSouth has already committed the resources necessary to upgrade its physical plant for carrying video. BellSouth committed to spending \$2.2 billion over five years to upgrade its core network for the primary purpose of carrying IPTV signals. *See Public Interest Statement* at 23. This upgrade is by far the single largest expense involved in deploying IPTV service. BellSouth asserts that 75 percent of its homes will be passed by this upgraded network by 2009. *See*

⁴ *See Applications of Ameritech Corp., Transferor, and SBC Communications, Inc., Transferee, Memorandum Opinion and Order*, 14 FCC Rcd 14712, ¶ 263-265 (1999) (“*SBC/Ameritech Merger Order*”).

⁵ As we explained to Mr. Bergmann, many of these companies’ plans and accomplishments are outlined in the FCC’s most recent report on video competition. *See Annual Assessment of the Status of Video Competition in the Market for the Delivery of Video Programming*, Twelfth Annual Report, 21 FCC Rcd 362, ¶¶ 125, 204 (2006).

Public Interest Statement at n.68. Independent analysts in mid-2005 believed that BellSouth's commitment to upgrade its core network placed it in a "very good position [for IPTV]. . . .The fact that they've been deploying fiber for several years--and their choice of technology, could make them winners."⁶ This investment would have occurred in the absence of the merger. Indeed, the Applicants do not argue that the merger would speed along this expensive core network upgrade.

- The Applicants claim that, beyond this substantial investment to which BellSouth has already committed, BellSouth would have to make a "substantial additional investment . . . to offer a commercial IPTV service." *Public Interest Statement* at 23. Yet, the Applicants' own public interest statement indicates that the additional infrastructure investment would only amount to \$100 million, approximately half of which the Applicants claim would not be incurred if the merger took place. See *Smith Decl.* ¶ 14. As the FCC recognized in its *SBC/Ameritech Merger Order*, any merger savings must be weighed against the premium paid by the shareholders. In that case, the FCC rejected the argument that the alleged savings from the Applicants' "national-local" strategy would outweigh the \$13 billion premium paid by SBC to Ameritech. See *SBC/Ameritech Merger Order* ¶ 295. Here, \$50 million in purported merger-specific efficiencies from a combined AT&T/BellSouth IPTV deployment pale in comparison with a \$10 billion premium to be paid by AT&T in the present merger.⁷

- The Applicants are also wrong that the Commission should treat as a merger-specific benefit the claims that BellSouth can speed its IPTV services to market because it can rely upon the infrastructure that AT&T has already built (such as headends) and programming contracts which AT&T has already negotiated. These claims rely upon the incorrect assumption that speedier BellSouth entry into the IPTV market is, by itself, a cognizable merger-specific benefit. While a more rapid delivery of service to consumers may increase consumer welfare, all other things being equal, there is no basis for concluding that all other things are in fact equal in this situation. It is entirely possible that a stand-alone BellSouth, pursuing its more deliberative approach, would have ultimately delivered an IPTV service that offered greater consumer benefits than would be the case if BellSouth provides the service sooner as part of a merged firm with AT&T. The Commission simply lacks the information to determine which approach would benefit consumers more.

⁶ Marguerite Reardon, *BellSouth's IPTV Strategy May Pay Off*, CNET.COM, June 10, 2005, available at http://news.com.com/BellSouths+IPTV+strategy+may+pay+off/2100-1034_3-5739844.html.

⁷ Press Release, AT&T, AT&T Delivers Strong First Quarter Earnings Growth with Progress in Wireless, Broadband and Business Services (Apr. 25, 2006) (on file with author).

- The FCC should reject the argument that, because programmers have refused to negotiate with BellSouth until it commits to its IPTV initiative, the FCC should credit a merger-specific benefit to the merged companies' IPTV deployment plans. *See Smith Decl.* ¶ 7. Indeed, BellSouth has recently been able to secure programming contracts for its limited IPTV trial to a number of communities.⁸ *See Supp. Smith Decl.* ¶ 4. In any case, as Access Point *et al.*, argues, the Applicants “virtually admit” that the merger of the two companies will likely involve a renegotiation of programming contracts and therefore no benefits will accrue to BellSouth because of AT&T’s “head start.”⁹ Whether or not renegotiation will be necessary is a function of the language of AT&T’s programming contracts, and neither Applicant has proffered that these contracts explicitly permit the addition of customers in geographic areas outside AT&T’s original footprint.
- In any case, there is little doubt that BellSouth would offer IPTV absent the merger. The fact that BellSouth has committed to spending \$2.2 billion to upgrade its network for which a primary purpose is the deployment of IPTV services is a strong indication that BellSouth intended to deploy its own IPTV service.¹⁰ The Applicants have not presented a compelling reason, other than IPTV deployment, for BellSouth to have invested such substantial sums in its network. It strains credulity to assert that BellSouth would forego the full benefits of this enormous investment simply because it did not want to spend an additional \$100 million to complete its infrastructure upgrade.
- Indeed, since the filing of its public interest statement, BellSouth has recently made the decision to pursue video business opportunities in a small number of newly constructed, multi-family communities. *Supp Smith Decl.* ¶ 1. BellSouth’s IPTV deployment will involve “an offering of 225 channels, 45 music channels and 500 hours of VOD.”¹¹ The Applicants’ own economists admit that “in the absence of the merger BellSouth would have started to deploy

⁸ Supplemental Declaration of William L Smith, WC Docket No. 06-74, ¶ 4 (filed May 31, 2006) (“*Supp. Smith Decl.*”).

⁹ *See* Comments of Access Point, *et al.*, at 49 (filed June 5, 2006).

¹⁰ *See Public Interest Statement* at 23 (“BellSouth is investing \$2.2 billion over a five year period to upgrade substantially its broadband access network and core network infrastructure, which will have the bandwidth necessary to support an IPTV service.”).

¹¹ *Telco Video: BellSouth Commits to Deploying Some IPTV Next Year*, 17 CABLEFAX DAILY No. 107 (2006).

IPTV services either 12 or 24 months later than the start date that would be realized following approval of the merger.”¹²

- The Applicants’ argument that the merger will permit the merged firm to achieve lower programming costs (*see e.g., Public Interest Statement* ¶ 24) essentially ignores the fact that programmers charge MVPDs based on their *actual* (not potential) number of subscribers.
 - The merger will not effect on BellSouth’s or AT&T’s programming costs in the short term. Immediately after the merger, AT&T and BellSouth will together have only a handful of video subscribers, providing no reduction in programming costs below what AT&T and BellSouth would be forced to pay individually.
 - In the long term, BellSouth has the potential to become one of the largest MVPD’s in the country with, in turn, relatively low programming costs. BellSouth assumes that 12.7 million households in its region currently subscribe to video services (*see Carlton and Sider Reply Decl.* ¶ 179), and it is nearing completion of a \$2.2 billion network upgrade that would prepare half of the homes in its region to receive IPTV service by 2007 and 75 percent of its homes to receive IPTV service by 2009.¹³ Verizon’s FiOS rollout provides a general indication of BellSouth’s potential video success. By 2010, Verizon expects to pass approximately 18 million homes, with video penetration at 20-25%, or about 3-4 million customers.¹⁴ Assuming that 9.525 million of BellSouth’s homes demanding MVPD service would be “passed” by its IPTV infrastructure by 2009, and, like Verizon, 25 percent of its passed homes were to purchase its IPTV service, BellSouth, absent the merger, could serve over 2.3 million MVPD customers. According to recent NCTA statistics, this would make BellSouth the 7th or 8th largest cable provider in the country, just behind Cablevision and comparable to Bright House Networks.¹⁵ It can hardly be argued that a

¹² See Reply Declaration of Dennis Carlton and Hal Sider, ¶ 75, attached to Joint Opposition of AT&T Inc. and BellSouth Corporation To Petitions to Deny and Reply to Comments, WC Docket 06-74 (filed June 20, 2006) (“*Carlton and Sider Reply Decl.*”)

¹³ John Buckingham, *The Market Sees the Light in Optics*, FORBES.COM, Mar. 3, 2006, available at http://www.forbes.com/investmentnewsletters/2006/03/06/verizon-bellsouth-fiber-in_jb_0306soapbox_inl.html.

¹⁴ See Timothy Horan *et al.*, *Verizon Communications: FiOS Services Gaining Momentum; Guidance Mostly In Line With Expectations*, CIBC WORLD MARKETS, at 2-3, Sept 28, 2006.

¹⁵ See NCTA, Top 25 MSOs, <http://www.ncta.com/ContentView.aspx?contentId=73> (last visited Oct. 4, 2006).

company of such a size would be unable to obtain programming at competitive prices.

- AT&T CFO Rick Linder has recently admitted that, although AT&T's programming costs are *currently* higher than many cable companies with more subscribers, this fact does not mean that AT&T's suite of video services is less profitable than other companies'. Because AT&T is selling, on average, higher margin digital packages than the typical cable company, Mr. Linder has explained that "the gross margin, in dollars, if you will, per customer will be pretty consistent with what I think you see in a typical cable franchise."¹⁶ BellSouth would likely receive similarly high margins if it chose to roll-out its service, eliminating any barrier to deployment that might arise from slightly higher initial programming costs.
- There is also little basis for the Applicants' arguments that the merger will permit Verizon to attract more national advertisers to its service and that MVPD advertising is an important source of revenue for MVPDs and programmers.
- Most commercials (and the revenue they generate) on a particular show are dedicated to the programming network airing the show. The programming network, not the MVPD, receives the revenue from these commercials. According to Comcast, of the 12-14 minutes of advertising per show, cable "operators generally negotiate for two minutes of spot advertising time per hour."¹⁷ Even for the most successful cable companies with the largest revenue per ad, these "spot" advertisements "generate considerably less than 1% of the companies' revenues." *Comcast Comments* at n. 68. Moreover, contrary to the Applicants' claims, the revenue from spot advertising goes entirely to the MVPD operator, not the programmer. *See id.* at 21.

Please let us know if you have any questions with respect to this submission.

Respectfully submitted,

/s/

Thomas Jones
Jonathan Lechter

WILLKIE FARR & GALLAGHER LLP
ATTORNEYS FOR TIME WARNER TELECOM INC.

cc: Scott Bergmann

¹⁶ AT&T, Q1 2006 Earnings Conference Call (Apr. 25, 2006) (transcript available at <http://seekingalpha.com/article/9502>).

¹⁷ Comments of Comcast Corp., MB Docket No. 04-207, at 20 (filed Jul. 15, 2005) ("*Comcast Comments*").