Consumer Federation of America

ISSUE BRIEF

THE TIGHT OLIGOPOLY ON STEROIDS IN THE DIGITAL COMMUNICATIONS SECTOR OPPOSING THE ATT-TIME WARNER MERGER OR FIXING THE MARKET STRUCTURE? WE NEED TO DO BOTH

MARK COOPER,
DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA

OCTOBER 2016

INTRODUCTION

For the third time in less than a decade a merger proposed by ATT has triggered the usual "just say no/just say yes reactions. The volume of debate has been amplified by the fact that, after more than a decade in which dozens of mergers were approved with, weak condition, at best, the Obama administration moved merger policy in the opposite direction (see Exhibit 1). The DOJ and the FCC blocked two mergers (ATT/T-Mobile, Comcast/Time Warner) and jawboned another out of existence (Sprint/T-Mobile). They imposed extensive conditions on others (Comcast-NBC, ATT-DirecTV, Charter-Time Warner-Bright House, the Verizon-cable joint venture (Cellco).

However, whether or not ATT-TW rises to the level of an outright rejection or strong conditions, there is a more profound problem that is highlighted by the merger. The merger is certainly a problem, but the market structure is a much bigger problem. A tight oligopoly on steroids has emerged in the sector that rejecting or conditioning mergers cannot address.

THE RECENT SHIFT IN MERGER POLICY

The shift in direction in competition policy began with then Comcast-NBC merger. The FCC and DOJ demanded the Comcast accept an extensive set of conditions before the merger could be accepted, even though Comcast and NBC do not compete head-to-head. The FCC/DOJ concluded that combining Comcast's control of access to consumers (broadband and cable), would give it the incentive and ability to withhold or manipulate access to NBC's must have (marquee) content to undermine actual and potential competition from online video distribution (OVD), which is emerging as the only effective competition to cable TV.

EXHIBIT 1:
MERGERS CREATED A TIGHT OLIGOPOLY ON STEROIDS IN THE DIGITAL COMMUNICATION SECTOR
THE OBAMA ADMINISTRATION SET A NEW DIRECTION FOR MERGER POLICY

<u>**Landline and Wireless**</u>

~~ATT-T-Mobile~~

1995 2000 2005 2010 2015

ATT (SBC)

PacBell SNET Ameritech Bell South ATT **DirecTV**

McCaw Linn SNET Bell South Cingular Dobson Centennial Alltell Leap

Cingular

Verizon
(Bell Atlantic) NYNEX GTE MCI XO

Vodafone GTE Price CalNor Rural Alltel Vodafone

Airtouch CellularOne Cellco

<u>**Video and Broadband**</u>

~~Time Warner~~

1995 2000 2005 2010 2015

Comcast

Scripps Philadelphia Lenfest Susq, Adelphia Patriot NBCU

Prime Jones

Storer

Media one TCI ATT

Charter

Avalon, Falcon Cablevison ATT Time Warner

Helicon, Interlink Bresnan Bright House

Renaissance

Time Warner KBL, Summit Century Adelphia Insight Duke

Cablevision

Legend: Cable in **bold.** *Wireless in Italics.* ~~Merger Blocked~~ *Extensive Conditions*

Sources: Older mergers from: Eli Noam, *Media Ownership and Concentration in America,* 2009, pp. 77, 236, 237, 240, 246; Federal Communications Commission, *Competition Reports, Cable and Wireless,* various years; Wall Street Journal, "A Tangled Family Tree,"," Pew Research.org, Chart of the Week, based on Rani Molla, *Wall Street Journal.* U.S. Department of Justice, *Complaint, Competitive Impact Statement, United States v. Comcast Corp*., 808 F. Supp. 2d 145 (D.D.C. 2011) (No. 1:11-cv-00106); *Complaint, Competitive Impact Statement, United States v. AT&T Inc. and Deutsche Telecom, AG,* (No. 1:11-cv-01560), August 31; Competitive Impact Statement, *U.S, and the State of New York, v. Verizon Communications Inc., CEllCO Partnership d/b/a Verizon Wireless, Comcast Corp., Time Warner Cable Inc., Cos Communications, Inc., and Bright House Network, LCL,* No. 1:12-CV-01354, August 16, 2013; Competitive Impact Statement *Charter Communications, Inc., Time Warner Cable Inc., Advance/New House Partnership, and Bright House Networks, LLS. Civil Action No. 1:16-cv-00759 (RCL), May 10, 2016;* Jon Sallet, Federal Communications Commission General Counsel, Remarks to the "Telecommunications Policy Research Conference: "The Federal Communications Commission and Lesson of Recent Merger & Acquisition Review, September 25, 2015., explains the FCC approach in several of the mergers

The rejection of the Comcast-Time Warner merger reflected similar concerns. Although Comcast and Time Warner did not compete head-to head, combined they would have a huge share of the broadband market. Refusing to allow OVD providers to reach broadband customers on their networks would be a severe blow to competition. Similar reasoning was applied to the Charter Time Warner merger, but here the market share was much smaller (about half the size of Comcast Time Warner) so strong conditions were deemed to be sufficient.

The rejection of the ATT/T-Mobile merger was an antitrust "no brainer." ATT and T-Mobile were clearly in head-to-head competition. The merger involved two of the top four firms that totally dominate the industry.

Although AT&T and DirectTV do compete head-to-head in video distribution, the FCC and the DOJ found that they were both weak competitor in emerging market for broadband/video bundles. They required that ATT not only expand its broadband capabilities, but also banned certain anticompetitive practices and make the terms and conditions for interconnecting with Internet traffic transparent.

The ATT-Time Warner (TW) merger falls squarely in the middle of these outcomes, which guarantees a long and intensive review. The concern about the incentive and ability to manipulate access to marque content (like HBO and CNN) that has motivated the opposition to prior mergers clearly applies here. ATT's market share in video distribution exceeds that of Comcast and Charter and its market share of wireless rivals that of Verizon. Its commitment to expand fiber broadband under the ATT-DirecTV order, will increase its importance in the true broadband Internet access market.

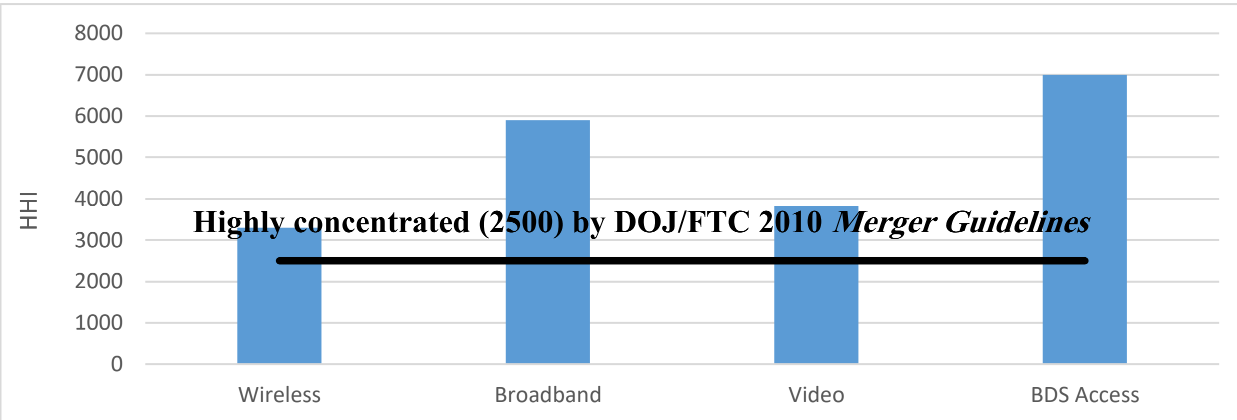
The FCC worked closely with DOJ in the merger reviews, but also exercised its independent authority under the Communications Act that goes beyond the antitrust scope. The FCC added conditions, like promoting universal service under section 254 of the Act and promulgated orders that affect the digital space including the Open Internet Order, the definition of "adequate service" under the Communications Act and the Section 706 finding that broadband deployment is inadequate.

THE TIGHT OLIGOPOLY ON STEROIDS

While the response to mergers and the FCC rules of general applicability do not fully respond to the underlying market structure problem that developed over a decade and a half of lax antitrust policy and premature deregulation of dominant communications incumbents. The fact that four firms (ATT, Verizon, Comcast and Charter) totally dominate the digital communications landscape is a deeply troubling public policy problem (see Exhibit 2).

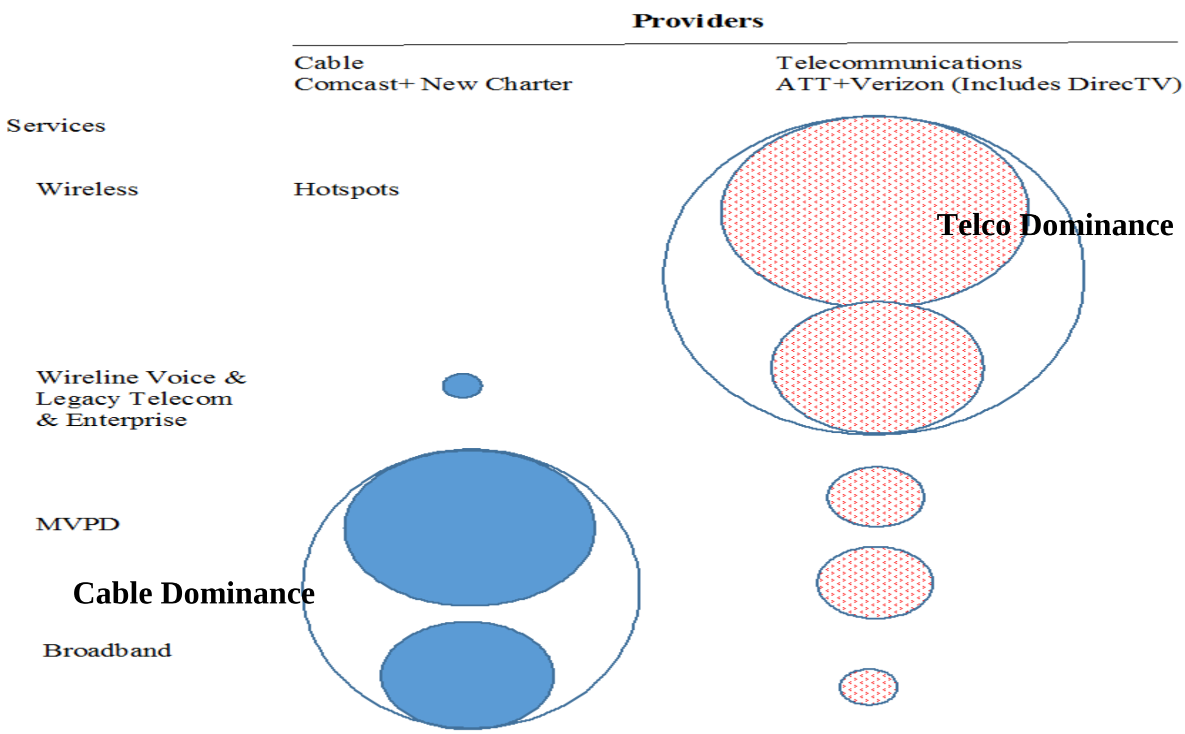
EXHIBIT 2
FOUR FIRMS CONSTITUTE A TIGHT OLIGOPOLY ON STEROIDS
(ATT, VERIZON, COMCAST AND CHARTER)

Local Concentration of Digital Communications Markets: HHI



Four Firm Share	**70**	**79**	**74**	**80**

Geographic separation, technological specialization and product segmentation



Sources: Thresholds, U.S. Department of Justice and the Federal Trade Commission, 2010, *Horizontal Merger Guidelines*, Wireless: Federal Communications Commission, *19th Annual Report and Analysis of Competitive Market Conditions with Respect to Mobile Wireless, Including Commercial Mobile Services*, for national market shares. Local market shares adjusted based on *Complaint, Competitive Impact Statement, United States v. AT&T Inc. and Deutsche Telecom, AG*, (No. 1:11-cv-01560), August 31. Cable/Broadband: Paul e Sa, Paul, Ian Chun, and Julia Zheng, 2015, "U.S. Telecom: Pay TV—A New Way to Look at Cable/Telco Competition and Market Shares," AB Bernstein Analysis, December 9. Craig Moffett, *U.S. Cable & Satellite: A Funny Thing Happened on the Way to the Graveyard*, MoffettNathanson, January 13, 2016, for cable and telephone company broadband subscribers Business Data Services, *In the Matter of Special Access Rates for Price Cap Local Exchange Carriers, AT&T Corporation Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, WC Docket No. 05-25, RM-10593.

These four firms constitute what is known as a tight oligopoly. The markets are highly concentrated and the top four firms have more than a 60% share combined. The fact that it is the same four firms that constitute the tight oligopoly across all four markets (video, broadband, wireless and business data services) makes the oligopoly even tighter.

In fact, their market power is reinforced by other market structural characteristics. They all started with local franchise monopolies (when the 1996 Telecommunications Act was passed) and refused to enter new markets to compete head-to-head with their sister companies. Cable companies never overbuilt other cable companies; cable never entered the wireless market, telephone companies never overbuilt other telephone companies and were slow to enter the video market. Teach chose to extend their geographic reach by buying out their sister companies, rather than compete.

Today we have a tight oligopoly on steroids, with four firms enjoying geographic separation, technological specialization and product segmentation that makes it easy to avoid competition. Instead, they cooperate (e.g. TV Everywhere subscriber authentication), collaborate (e.g. the Verizon-cable joint venture) or engage in reciprocal reinforcing conduct (e.g. purchase of out-of-region special access and political action) rather than compete.

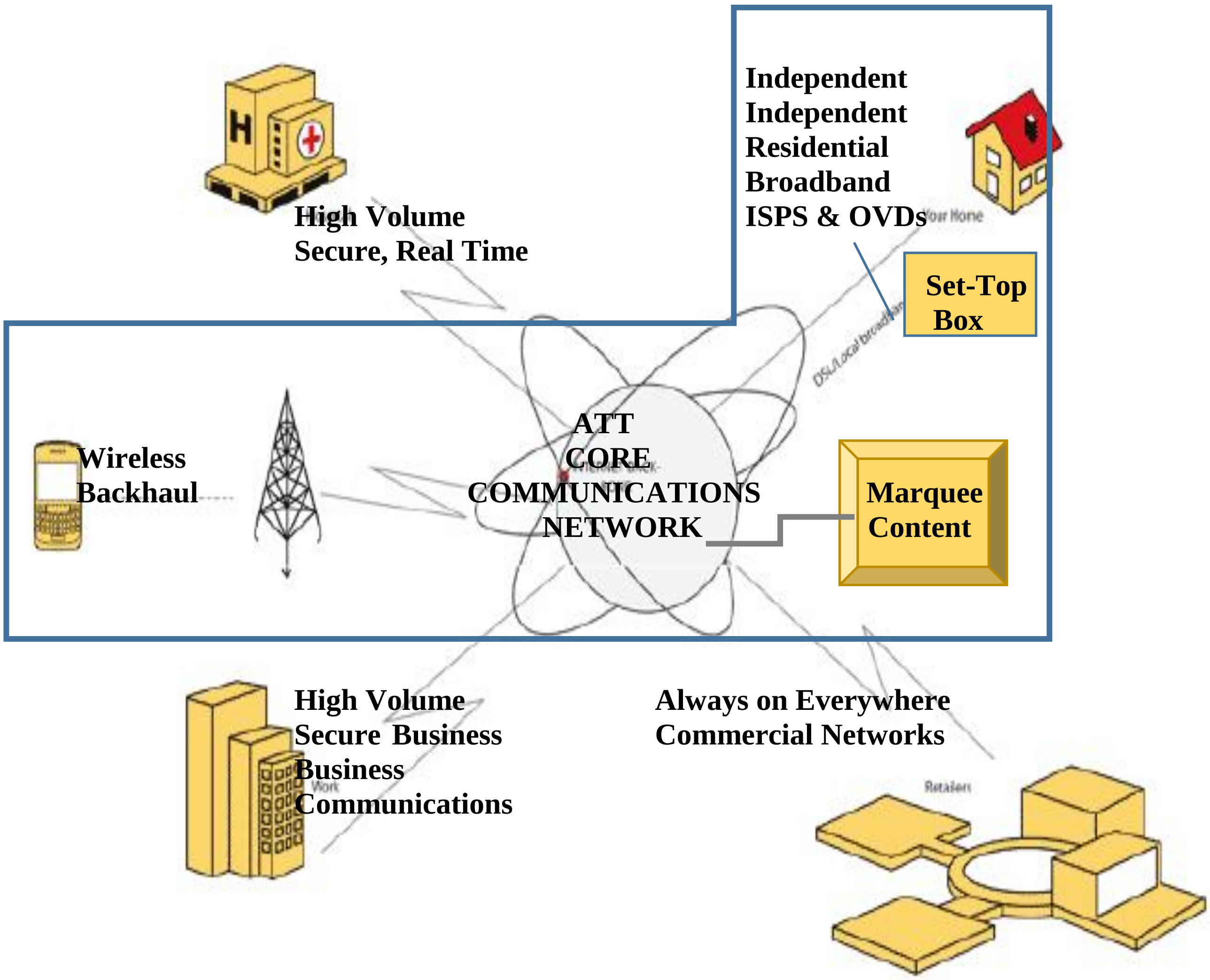
BUSINESS DATA SERVICES THE KEY CHOKE POINT IN THE DIGITAL COMMUNICATIONS NETWORK

For a wide range of businesses and public agencies, plain old telephone service does not meet the service and quality needs of an increasing array of users and uses. There are hundreds of millions of end-users spread all over the map that must rely on Business Data Services (BDS). With the expansion of the Internet of Things there will be billions. All of these services involve a connection to a business. In addition to the sale of communication services to residential end users, there are numerous other business that rely on these big pipe services (see Exhibit 3).

- broadband Internet Access Service, including online video distribution,
- mobile broadband and phone service,
- OVD service providers that need to stream large quantities of data,
- small, medium, and large businesses that need much more capacity than a single telephone line,
- branch networks (like ATM’s or gasoline stations) that have many nodes that need to be online all the time, and
- businesses like health care providers, who need to move large quantities of data between their offices, frequently in real time

Because the local phone companies inherited the ubiquitous network from the monopoly era and these services were deregulated long before competition could grow, the incumbents have been able to ruthlessly exploit their market power to undermine competition (with anticompetitive practices), cross subsidize their more competitive businesses, like mobile (by shifting costs onto local telephone ratepayers) and overcharge their business customers. These overcharges are passed through to consumers in the prices they pay for all goods and services that use the high capacity digital network.

EXHIBIT 3
BUSINESS DATA SERVICES ARE CENTRAL TO THE DIGITAL COMMUNICATIONS NETWORK



ATT straddles the core of the digital communications network and it has been the loudest in resisting efforts to eliminate the anticompetitive practices in the BDS market. Adding Time Warner will give it another tool and reason to abuse its market power.

REGULATORY POLICY TO CONSTRAIN THE ABUSE OF MARKET POWER

Preventing any further consolidation of distribution is a no brainer, but that does not address the underlying problem. Promoting competition between the distribution networks is one answer, but as we have learned since the 1996 Act, public policy cannot force firms to compete and the prospects of a new distribution networks entering the market are slim and none.

Breaking up the dominant firms may be seen as an attractive approach, but it is a daunting undertaking. It took three quarters of a century from the time the market power of the old ATT was first addressed by antitrust officials to the breakup of the national monopoly. The case took three decades.

A different type of answer is to ensure that competition for content and applications can flow over these dominant networks and that that network operators cannot user their power over distribution to frustrate competition. The FCC, which has joined hands with the DOJ in laying down the legal and analytic framework to oppose mergers, has four active proceedings in which it has set out to accomplish exactly that.

The logic of these policies is simple. Network operators have immense market power and can use control over access to the network or the information necessary to operate it to undermine competition and increase their profits. Regulation can ring fence this market power.

Set Top Boxes: The set top box is the device that controls the connection to the video network. Although the 1996 Act required the market to be open to competition, the FCC never set conditions that would make competition possible. As are result, cable companies charge consumers almost $10 billion more per year than the cost of the boxes and prevent others from connecting devices that would enable them to provide enhanced services and combine Internet access with video access.

Zero rating: The network operator could give its affiliate a pricing advantage, by not counting the minutes of use against the usage cap it imposes. Since the usage of other, competing services would be counted, those service would effectively cost more.

Privacy: Network operators have a unique advantage with respect to customer network information because they can see everywhere the consumer goes on the network. This information can be combined with other information to create uniquely powerful profiles of individual customers, which can then be transferred to the content/applications affiliates for exploitation. This gives the affiliate a substantial advantage over independent content providers.

Business data services: All high volume, high speed transmission needs to move large quantities of data to consumers. The ubiquitous telephone network is still the only way to reach the overwhelming majority of customers and the network operators totally dominate this big pipe service (have an 80% market share). They can charge competing services more for the "special" access to the network than they charge their own services. Overcharges in this market have been estimated at $40 billion per year. They impose contract conditions on BDS customers that lock out competitors.

P:\Documents\CFA\Statements Testimonies\Cooper ATT-TW Issue Brief 10-26-16.docx