
NARROWING THE BROADBAND

The harmful effects of the
proposed AT&T-Comcast merger

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Executive summary

The telecommunications and cable TV industries are undergoing profound changes. Both the telephone and the cable industries have experienced tremendous growth in the markets for high-speed Internet access as the number of users has expanded from almost none to nearly 10 million within the past five years. New technologies that are being created and rapidly introduced to the public, such as provision of telephone services over cable networks, are changing the nature of competition in these industries. Bankruptcies and mergers are sweeping through the sector.

Some of the changes have been driven by changes in industry regulations and in policies that are being made by the Federal Communications Commission (FCC). The review and approval of mergers are critical aspects of these policies. The FCC and the Antitrust Division of the U.S. Justice Department (DOJ) are now considering Comcast's proposed purchase of AT&T's cable TV and broadband capacity. Broadband includes both high-speed Internet and other new communication services.

The merger would substantially reduce competition in both the cable TV market and the broadband market, creating a dominant firm in both. Additional mergers that would most likely follow would aggravate this loss of competition. There are a number of reasons why the FCC and the DOJ should not support the merger.

- If allowed to merge, AT&T-Comcast would control 30% of cable TV and broadband revenues, and even more if partial ownership of AOL Time Warner stock is considered. In combination with other concerns, such as high entry barriers and the trend toward concentration, the merger is harmful enough to competition for the Department of Justice to block it.
- The increase in control over broadband would be particularly important. Broadband has increasing importance to long-distance telephone service and to the hard tasks of entering local service against the Baby Bells' resistance. AT&T-Comcast would control between 47% to 65% of the market for broadband bundled with cable TV services. Economic research has demonstrated that competition is no longer effective when markets are this concentrated.
- This growing dominance of broadband would increasingly protect the cable TV market from growing competition by satellite TV technology. Cable TV users increasingly regard broadband access as a key feature, and AT&T-Comcast seems likely to keep tying broadband service to cable TV service. In any event, satellite TV has increasingly uncertain broadband prospects, partly because its service is inferior in reliability for users in most of the country.
- The merger would create vertical market power, raising AT&T-Comcast's ability to exert control and pressures on the providers of the video-programming content that cable systems carry. This upstream effect could significantly reduce the choice and variety of video program content. And if the AT&T-Comcast firm is able to drive down the prices of programming, then that could further reduce the ability of program creators to finance a full range and variety of content.

Comcast and AT&T claim that the relevant markets are extremely broad, including all forms of TV transmission and broadband: cable, satellite, and others. This could be true in some future years, but it currently is not. The markets for cable TV and broadband are distinct from those for satellite TV with broadband. As the sector continues to evolve, these diverse video and broadband services might increasingly overlap. But they may also actually diverge.

Comcast and AT&T say that cable TV markets are strictly local, each of them a pure monopoly. Therefore, in theory, the merger would not actually reduce competition in any of them. But such a claim is superficial. The main players in the cable TV industry (including AT&T and Comcast) range across large regions or the entire United States; their competitive strategies and actions are regional and/or national in scope. That reality makes the national market itself the relevant geographic market. The AT&T-Comcast merger embodies the reality of national and regional scope.

Both Comcast and AT&T can make large and legitimate gains by shifting their emphasis from long distance to broadband. But the merger goes too far toward creating cable and broadband dominance. That rise in monopoly power is inconsistent with the economics of competition and with protecting the public's welfare. Comcast and AT&T can both make the shift to broadband successfully by continuing to expand from their large and successful cable system bases. They should not be permitted to overreach and inflict the economic harms of the merger.

Introduction

Comcast's proposal to acquire AT&T broadband is a bold attempt to create market dominance in the U.S. cable services and broadband markets.¹ The resulting AT&T-Comcast corporation would become the leading cable and broadband company in the United States, with a dominant position in important markets. But the dominance would be achieved through merger, rather than through superior growth performance that meets market tests.

Part of AT&T-Comcast's market power would extend over cable services, whose prices could be raised further in line with past price increases. AT&T-Comcast would gain dominance over the nation's cable TV broadband capacity, which provides access to high-speed Internet and other new communication services. And as is widely recognized, broadband is more important for the future. Also, AT&T-Comcast could exert more vertical control over video-programming providers.

In these several ways, the merger would increase market power and, in turn, would probably cause higher prices, reduced incentives for innovation, and a narrower range of consumer choices.

Comcast and AT&T's economic defense of the merger offers a number of theoretical claims with inconclusive evidence.² Comcast and AT&T claim that the markets are broad, that monopoly will not be raised, and that competition will be increased in many directions. They also say that the merger will bring only large net benefits, including efficiencies, growth, and new services.

In fact, the markets are narrower, and the supposed net benefits are not assured. New technologies are still evolving rapidly, and they can be shaped by Comcast and AT&T, especially after the merger rather than shaping the industry's structure themselves. Moreover, many gains of the merger would not be "net" benefits. If Comcast and AT&T remain separate, many of the said gains could happen through their internal growth, long-term contracts, and direct innovation. Indeed, the progress might be larger and faster if the merger does not occur, because the incentives for many of the gains would be stronger.

In the background is the basic fact that a majority of large mergers have actually harmed the acquiring company and its shareholders, rather than yielded gains.³ Comcast's and AT&T's claims appear to display the same optimism that infuses many mergers that turn out instead to be harmful.⁴ Moreover, AT&T's own CEO, C. Michael Armstrong, is himself widely regarded as having bungled several earlier mergers, causing large financial losses for AT&T. One was the merger with Tele-Communications Inc., which was bought at too high a price. "TCI, for one thing, owned one of the most decrepit cable networks in the industry, which saddled AT&T with unexpected billions in costs to upgrade the system to handle two-way data, a prerequisite for Internet service. The company also is thought to have heavily overpaid for MediaOne, a four-million-subscriber cable operator acquired in 2000. In total, AT&T paid about \$100 billion for the two companies, which industry analysts valued at roughly half that sum."⁵

The merger is under review by the Federal Communications Commission (FCC) and the Antitrust Division. Both agencies need to consider skeptically how powerful the new forces of technology really are. They also need to consider the likelihood that approving the merger would trigger a series of follow-on merger proposals, which the business press has been actively discussing.

Monopoly and its impacts are the background feature of this industry. For over two decades, the U.S. cable TV industry has been keeping its local monopolies strong and imposing on consumers the standard impacts of monopoly: rising prices, restricted choice, problems of inferior service quality, and others. Only when regulation was briefly restored during 1993-96 was the rise in cable TV prices slowed down.

Relying on the supposedly new forces of competition would be premature. Satellite transmission is not yet a sufficient substitute for cable service in large parts of the country. Moreover, the merger's effect on the broadband market would be a special harm. Rather than be neutralized by the onset of new technology, the merger could provide AT&T-Comcast with a significant degree of control over the emerging technology, with both the incentive and the ability to control its progress into new areas, such as providing local telephone services. The merger's economic harms would focus on the customers of cable TV and broadband. The prices of those services would probably climb further, and the economy's progress from the spread of broadband would be slowed.

As I will explain, these dangers and impacts emerge from the economic research literature on monopoly power, from broad business experience, and from facts developed in the FCC's ongoing studies of the sector.⁶ Apart from approving the merger, the FCC could choose among three main alternatives: denial, revision, or postponement.

Denial. First, a simple denial is appropriate, because the merger would violate economic and legal standards, while probably providing scant benefits. If they were kept apart, Comcast and AT&T would continue to evolve as strong, innovative rivals within the competitive settings that involve other players as well. Competition would spread, rather than be quelled or chilled. Comcast and AT&T would separately promote the dramatic changes in these markets, rather than have incentives to slow them down.

Revision. Second, the FCC could revise the merger, requiring divestitures or other changes or constraints on the merger to preserve competition. Such revisions have become common in dealing with anticompetitive mergers.

One constraint would be to require equal-and-open access to both cable modems and DSL service. The equal-access paradigm of the AT&T divestiture in 1984 has led to a sharp reduction in AT&T's market power in the long-distance market. It is true that the price reductions in long-distance service after 1984 were mostly caused by regulated reductions in access charges. Yet there was a combined impact of regulatory oversight and the reduction of AT&T's market power. Absent close regulation and more competition, access reductions would instead have been turned into increased margins and profits rather than price reductions.

An equal-access basis for cable modems and DSL service will maintain competition among Internet Service Providers (ISP) for the right to serve the end user. This could mitigate part of the problem of the merger's impact on broadband service. Although it still would not prevent the merged firm from controlling the flow of innovation related to the underlying technologies, it could keep prices lower and would allow for innovation in service offerings that the ISPs could control.

Postponement. Third, the FCC could postpone the merger until the favorable changes in the markets' boundaries and technology have actually matured and occurred. That choice would be conservative and prudent. The postponement might require Comcast and AT&T to wait three to five years, although any earlier favorable developments could trigger an immediate reconsideration. If AT&T's claims have merit, the merger would be sound enough to stand the delay. If instead Comcast and AT&T are trying to rush the merger through, it may be because it does not have the lasting economic substance that AT&T asserts.