

Testimony of
Mr. Scott Cleland

February 11, 2004

Testimony of Scott Cleland, CEO of the Precursor Group®

Hearing on:

Cable Competition - Increasing Price; Increasing Value?

Before the U.S. Senate Judiciary Antitrust Subcommittee, February 11th, 2004

Mr. Chairman, thank you for the honor of testifying before your Subcommittee and for the Subcommittee's interest in an independent analyst perspective on the state of cable competition.

I am Scott Cleland, a cable and telecom investment analyst.

? I am also founder and CEO of Precursor®, an independent research broker-dealer, which provides investment research to institutional investors covering the technology, telecom, and media sectors.

o Precursor's business interests are aligned with investors' interests - actual and perceived.

o We do no investment banking for companies; do not manage money or trade for proprietary gain; and our researchers may not trade individual stocks.

? In addition, I am Chairman of the Investorside Research Association, an association of over 60 independent research providers, which work for investors and do not have investment banking conflicts of interest.

Testimony Overview:

I believe the whole communications industry, including the cable sector, is going through a profound competitive change. The pay-TV market of today will not be the pay-TV market of tomorrow. Today's market is an "artificial" market with three dominant players (cable and the two Direct Broadcast Satellite (DBS) providers - News Corps/DirecTV and Echostar's DISH), who compete on many aspects, but rarely on price. However, digital convergence, and more specifically, the advent of deployment ready Voice over Internet Protocol (VoIP) service are changing the competitive game of the industry. VoIP, which allows cable to add voice to its current products of video and high-speed data, will quickly shift the market from traditional pay-TV vs. pay-TV competition to service-bundle vs. service-bundle competition. The much anticipated bundle wars among cable, telecom, and satellite are finally happening. All you have to do is look at the marketing alliances that rapidly formed in 2003 between the Baby Bells and DBS providers. Market success, especially for the most profitable, high-end customers, will depend on a provider's ability to offer a broader package of services in a cost-efficient, technologically-sophisticated manner. In this market dynamic, I believe cable, with its superior two-way broadband network, holds a big technological and business model advantage over the telecom and satellite partnerships.

My testimony has three main parts:

A. An Overview of the Current Market Dynamics: The Cable and Direct Broadcast Satellite (DBS) Oligopoly

B. How the Communications Market Is Changing: A Shift to Greater Bundle Competition

C. Why Cable Is Best Positioned to Compete in a Converged and Bundled Environment

A. An Overview of the Current Market Dynamics: The Cable and Direct Broadcast Satellite (DBS) Oligopoly

In order to understand current pay-TV competition, it is critical to realize that this is an "artificial" market. Pay-TV competition exists only because of government action. Cable's main competitor, DBS, is a government-created and licensed market that needed the landmark program access protections from predatory cable practices in order to become a viable industry. In fact, the government initially licensed spectrum for four DBS providers, but the market has only funded and supported two strong providers, DirecTV and Echostar. (A third provider, Cablevision's VOOM DBS service, is still a nascent offering and faces a high hurdle for success.)

As the two dominant players, cable and DBS have enjoyed oligopoly power. Cable and DBS have chosen to compete on almost everything (marketing, features, and content), but rarely on price. So, consumers have enjoyed many new services and improvements in customer service, but have rarely received significant price reductions. This is natural and economically rational in an oligopoly environment, especially in a market with such a large amount of fixed and capital costs.

I believe wide-scale entrance of a third facilities-based competitor, who could break this pay-TV oligopoly, is very unlikely given the high fixed costs of launching service, and the reality that cable and DBS are already very capable competitors.

? Cable overbuilders could be successful under certain market conditions, primarily in areas with high customer density or in "new build" communities. But, even with the presence of overbuilders, pay-TV prices are only slightly lower (~15%) than in other markets. Overbuilders are profit driven. They only want to offer a discount that will entice a customer to switch providers while covering their fixed costs. Overbuilders are not altruists. Large entry costs limit an overbuilder's ability to cut prices. Overbuilders are also at a scale disadvantage to incumbent cable and DBS providers since they have smaller networks and dramatically fewer customers.

? The Baby Bells (Verizon, SBC, BellSouth, and Qwest), who are the most capable of deploying video on a large scale, have all but given up (at least for now) on providing video services over their own networks as Fiber-to-the-Home (FTTH) is currently too risky and expensive. The FCC's Triennial Review decision fell way short of expected deregulation. Moreover, Section 653 of the 1996 Telecom Act (Open Video Systems) requires that the Bells share two-thirds of their network bandwidth with competitors. These events lower the Bells' confidence in being able to achieve a good return on investment for FTTH.

B. How the Communications Market Is Changing: A Shift to Greater Bundle Competition

The current "artificial" pay-TV market is going through significant change. Digital convergence (and more specifically the advent of deployment ready Voice over the Internet Protocol (VoIP)

service) is a "game changer" that is irreversibly altering the competitive balance of power in the entire communications sector in favor of cable. VoIP allows cable providers to leverage their broadband integrated networks and offer a more robust bundle of services that include video, data, and voice. This is causing a competitive shift in the market. Competition is now moving from simple pay-TV vs. pay-TV service (cable vs. DBS) to a battle over more comprehensive service bundles (video, data, and voice) offered by telecom providers, DBS, and cable. This is a pro-competitive development as prices will come down, but it will also sort out which network, bundle, and business model is better. My view is that it's cable, hands down.

The pay-TV market will change as convergence and VoIP are...

? Realigning the market structure: VoIP has forced alliances between DBS and the Baby Bells in an attempt to better compete with cable's superior integrated bundle of video, data, and voice. The Bells need DBS because they lack a video offering of their own. DBS needs the Bells because it can't compete by itself in voice and broadband due to the inherent transmission latency issues of satellite technology.

? Accelerating competition for bundled services: DBS and Bell alliances along with cable's ability to offer voice will increase the importance of the service bundle. Consumers are also getting more accustomed to receiving a bundle for their communication services. Local and long distance voice has almost become a single product as over 40% of consumer households subscribe to a voice bundle. It is just a matter of time before more consumers will demand bigger bundles that include video services. In this environment, success in the market will depend on the ability to offer multiple services - not just voice, not just data, and not just video.

C. Why Cable Is Best Positioned to Compete in a Converged and Bundled Environment

In this growing bundle war, cable holds an advantage over telecom providers and DBS for several reasons:

? Cable Has the Best Network: Cable has already spent the capital to upgrade its network to a superior two-way broadband service. Cable enjoys tremendously more two-way bandwidth (~750+ MHz of capacity to the Bells' 1 MHz of capacity) to offer more and better services. DBS broadband capacity is primarily limited to one-way.

? VoIP Adds Incremental Value: For cable, VoIP provides new revenue with only incremental new costs since voice is a low bandwidth application that rides over the high-speed data network, leveraging cable's existing infrastructure investments. In contrast, for the Bells, VoIP is a cheaper and better substitute for their existing voice service. Furthermore, as more VoIP equipment gets deployed, the Bells' traditional circuit switch network will have less use and value, but will still require large operating expenses.

? Cable Has a Favorable Regulatory Environment: Cable is not weighed down by regulation to unbundle its network to competitors, unlike the Bells. Cable is also trying to mitigate fears about limited access, recently taking the initiative to open its network to other VoIP providers.

In conclusion, the market's shift towards broader based competition for multiple services may provide some benefits to consumers. Consumer will likely see more competition for their complete communication needs. Digital convergence and bundling mean that consumers will be able to get more services from more providers. Consumers may also get individual products at a lower average price as part of a bundle since a key aspect of bundling is to provide a discount over the same services offered a la carte.

This market has been a huge competitive success for Congress, following the 1992 program access and local programming rule. Over twenty million customers have exercised their choice to leave cable. In fact, I have been one of them. However, because I could not get DSL high-speed Internet from Verizon, I had to get a cable modem. So, I'm greatly interested in the new competitive choice that I will have to save money with an overall bundle of services from one provider.

Thank you again Mr. Chairman for the honor and opportunity to testify before your Subcommittee on this important matter. I am available for questions, and you have my consent to include any of my comments in the official record.