CENTER FOR BUSINESS & PUBLIC POLICY

GEORGETOWN UNIVERSITY McDonough SCHOOL of BUSINESS

Responses to Questions for the Record of

Larry Downes

Project Director, Georgetown Center for Business and Public Policy

The Evolution of Regulation and Innovation Project

U.S. Senate Committee on the Judiciary

Subcommittee on Antitrust, Competition Policy and Consumer Rights

"The AT&T/DIRECTV Merger: The Impact on Competition and Consumers in the Video Market and Beyond"

July 14, 2014

Senator Amy Klobuchar

1. **You have studied disruptive forces in the telecomm industry. In your testimony, you talk about how Google, Amazon, Apple and others have experimented with new technologies and new business models. That's exactly the kind of innovation we like to see. Absent this merger, do you think AT&T and DIRECTV would have the incentive to react to the changes and challenges in the market place with their own experimental business models and disruptive forces?**

There is no doubt that AT&T and DIRECTV, along with every other incumbent enterprise in the video market, already have powerful incentives to respond to the disruptive challenges presented by an explosion of largely unregulated new businesses offering competing and complementary products and services using the Internet.

The question, however, is whether they have the ability to respond with their own experiments and disruptions. Absent the proposed transaction, I do not believe that either company can be successful in the long-term as the video market continues its rapid reconfiguration.

The challenges are both regulatory and technological. As noted in my written testimony, both companies must innovate from within the constraints of a dense thicket of MVPD video regulations that have built up over the last few decades in response to earlier disruptive technologies, including once-experimental technologies for distributing video content over satellite, microwave, coaxial cable, copper, cellular and fiber-optic cable.

To protect important public interests including localism and the preservation of traditional advertising-supported over-the-air broadcast television, Congress, the FCC and the courts have cobbled together a series of compromises that, whatever their continuing value, severely limit the flexibility and adaptability of MVPDs in the face of substantial disruptive innovation in the over-the-top market.

The complex interactions of must-carry, retransmission consent, network nonduplication, the compulsory license and other limits, and their unintended impact on private negotiations between content providers and MVPDs, for example, several constrain the ability of incumbent video providers to innovate. They cannot easily offer more personalized packages of channels, or experiment with new kinds of payment options including ad-supported, on-demand, subscription, “freemium” and others.

Such regulatory constraints are almost entirely absent in the OTT market, on the other hand, which is why we see such remarkable experimentation going on, not only with traditional content but with new forms of user-created programming. As a result, a vast new world of video products and services has opened up, built on increasingly better and cheaper video production equipment, cloud computing, bootstrapped funding sites including Kickstarter, and new aggregators such as YouTube and Vimeo.

On YouTube alone, users upload 100 hours of original programming every minute, and not all of it about cats. Broadcaster and unaffiliated domain-specific sites, including VSauce (science), Machinima (gaming), and Funny or Die (comedy), are among the most visited sites on the Internet. Popular channels on these sites support tens of millions of subscribers, and maintain a level of interactivity unheard of in the stagnant world of traditional media. Producers ask the viewers what shows they want to see next, and promptly produce them. Fans share the programming they like on large-scale social networks including Twitter, Reddit, and Facebook.

Beyond these regulatory constraints, technical challenges weigh particularly hard on DIRECTV. Simply put, as I indicated at the hearing, the physics of satellite transmissions have made it extremely difficult for DIRECTV and other satellite-based MVPDs to offer native Internet access to their customers, or, indeed, any kind of two-way interaction between the MVPD and its customers.

While DIRECTV has tried with limited success to meet its customers’ increasing demands for bundled video, voice and Internet through partnerships with other companies, this is at best a stop-gap measure. To truly compete with OTT providers, incumbent video providers need the technical ability not just to offer Internet access to their customers but to integrate video with other information products and services, allowing the kind of interaction with the content and its producers that consumers are already taking for granted, particularly in the OTT market.

DIRECTV doesn’t simply require better integration of Internet access, in other words. It needs the ability to offer native Internet content and interactivity as its core product.

The merger, I believe, would help both companies close their regulatory and technology gaps, creating a more formidable competitor both to other MVPDs as well as to emerging OTT providers. With DIRECTV’s customer base, U-Verse would have considerably more bargaining leverage with increasingly powerful content providers such as Disney, CBS, and FOX. With U-Verse’s state-of-the-art Internet architecture, DIRECTV would be able to offer its customers not only better-integrated Internet access but native Internet-based interaction.

Without the merger, I don’t see how either company can effectively respond to these challenges.

As I explained in **The Washington Post**[1] following the hearing:

> For video consumers, as for the residents of Napoleonic Paris and London in Charles Dickens's classic novel, it is the best of times and the worst of times.
>
> Those who rely on traditional broadcast, cable and satellite television are living in a world where fewer content providers own and control the bulk of the programming, using their leverage to force operators to take ever-larger bundles of channels at higher prices that are passed on to consumers. As much as 60 percent of the average cable bill, for example, goes directly to mega-producers such as Disney, Fox and CBS. The average cable viewer pays nearly $6 just for ESPN, whether they watch it or not.
>
> Trapped by bloated channel packages and limited flexibility, consumers are voting with their feet. Pay TV networks have lost millions of viewers in the last few years, bringing into serious question how much longer its mature model of content aggregation and distribution can last.
>
> Where are consumers going? The Internet, of course. And why not? For those who have cut the cord (or, for a growing segment of younger consumers, never had a cord in the first place), the world is much brighter and the focus far sharper. Much of the network programming they want is available on demand from the programmers' own Web sites, or from virtual bundlers including Hulu, Amazon, Apple and Netflix, either for free or at a fraction of the cost of a standard cable subscription, offered through customizable a la carte, subscription, and ad-supported options.
>
> But beyond content traditionally available from cable, satellite or broadcast, a vast new world of video has opened up, built on increasingly better and cheaper video production equipment, cloud computing, bootstrapped funding sites including Kickstarter, and new aggregators such as YouTube and Vimeo. On YouTube alone, users upload 100 hours of original programming every minute, and not all of it about cats.
>
> Popular channels on these sites support tens of millions of subscribers, and maintain a level of interactivity unheard of in the stagnant world of traditional media. Producers ask the viewers what shows they want to see next, and promptly produce them. Fans share the programming they like on large-scale social networks including Twitter, Reddit, and Facebook.
>
> […]
>
> My testimony focused on disruption in the video marketplace. I noted that AT&T's U-Verse video service is a loss leader the company offers largely to supplement its broadband Internet business (the company has fewer than 150,000 customers who subscribe only to video), while DirecTV offers no native Internet service, and is unlikely to given the limits of satellite technology. AT&T needs DirecTV's customer base to improve its bargaining position with increasingly powerful

---

[1] Larry Downes, *A Tale of Two Video Markets: Welcome to the Post-Aereo World*, THE WASHINGTON POST, July 2, 2014, *available at* [*http://www.washingtonpost.com/blogs/innovations/wp/2014/07/02/a-tale-of-two-video-markets-welcome-to-the-post-aereo-world/*](http://www.washingtonpost.com/blogs/innovations/wp/2014/07/02/a-tale-of-two-video-markets-welcome-to-the-post-aereo-world/).

> content providers, and DirecTV needs U-Verse's broadband network to remain competitive with cable and other networks.
>
> Both companies need each other, more to the point, to offer customers the kind of flexibility available today from largely unregulated Internet video services. Cord-cutters are demanding the ability to watch whatever content they want wherever they are and whatever device they happen to have handy. Together, the two companies could do that. Separately, they cannot.

As I also noted in the **Post** article, in the long-term even this transaction will not overcome the unintended constraints on regulated MVPDs imposed by the existing legal regime. This Subcommittee, of course, has held numerous hearings on the problem and its members have taken the lead in proposing reforms large and small to address the imbalances between content providers and MVPDs and between MVPDs and fast-rising unregulated OTT competitors.

While I believe the proposed transaction will give a new lease on life to both U-Verse and DIRECTV, I want to underscore the continued need for regulatory reform to preserve competition from and among the traditional video industry.

2. **This merger is primarily about video service, but mobile phone service is relevant here as well because this merger involves one of the top two wireless carriers and we are beginning to see wireless, broadband and video markets start to converge. AT&T will gain significant relationships by acquiring its DIRECTV's 20 million subscribers. Do you think this will enhance competition in the wireless market? How would NFL Sunday ticket impact or disrupt the wireless market if AT&T is able to make a wireless deal with the NFL?**

I am unable to comment on the specific impact of NFL Sunday Ticket on the existing or future dynamics of the video market. Both existing licenses and pending negotiations are not public, and I have no access to the specifics of existing or rumored deals between the respective parties.

I do, however, see significant positive impacts on competition through synergies between AT&T's mobile and video services. As you note, convergence on native Internet products and services is not a Big Bang Disruption limited to the video market. More and more, voice, video and data services are converging on Internet standards, leading consumers to demand full integration and the ability to mix and match services old and new.

In the mobile market, the unprecedented adoption by consumers of smartphones and tablets since 2009 has been largely driven by an explosion in video-based services that consumers can't seem to get enough of. The vast bulk of mobile traffic is now video traffic, as consumers engage with old and new forms of programming on their mobile devices. And they fully expect all content to be available on all devices and, indeed, expect that content begun on one device and network can be continued on all the others, depending on where they are and what they are doing.

Competition in the mobile market today is driven by several factors, including price, device and operating system availability, proprietary and open app stores, network coverage, speed, and reliability.

Integration between mobile networks and other services, however, is fast emerging as a competitive imperative for network operators. Soon, emerging services including home automation, health monitoring and tele-health, home security, the smart grid and other utility integration, remote education and other new technologies will increase the pressure on mobile network operators, as well as wired providers, to offer fully-connected platforms.

Following the transaction, the combined AT&T/DIRECTV will need to expend considerable financial and technical resources to complete the integration of their video and Internet services. In the short term, therefore, I do not anticipate significant impact on competition in the mobile market from this transaction. Once that integration is completed, however, the combined company may well see competitive advantage in further integrating its video offerings to customers of AT&T's mobile network.

Given insatiable consumer demand for such services, it is reasonable to assume that if the company does proceed in this manner, competitive pressure will build on other mobile network operators to accelerate their own integration of voice, video, and data services on multiple technologies onto a single Internet-based platform that is transparent to consumers. In that regard, the transaction could significantly encourage competition in the mobile market.

As with the traditional MVPD market, as noted above, the combined consumer base of the two companies will likewise help to better balance negotiations between AT&T/DIRECTV and dominant content providers in negotiations for content access over mobile devices. That too could in turn encourage innovative competitive responses from other mobile network operators.