Prepared Statement of the Federal Trade Commission
Presented by Robert Pitofsky[(1)], Chairman

Before
The Committee on Commerce, Science, and Transportation
United States Senate

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I. Introduction

Mr. Chairman and members of the Committee, I am pleased to appear before you today to present the testimony of the Federal Trade Commission concerning the important topic of mergers in the telecommunications industry. This is an industry experiencing rapid technological and regulatory change leading to new products and services not only in telecommunications, but also in industries that use telecommunications products as inputs, such as computers, data retrieval and transmission, and the defense industry. Anyone whose business depends on faster and more reliable data movement is benefitting from these kinds of changes in the telecommunications industry.

At the same time, we have seen a growing number of significant structural reorganizations, both in telecommunications and in other industries. Such reorganizations may be a legitimate response to economic needs, but may in other instances threaten competition and the rights of consumers. A vigilant merger policy is particularly important so that the forces pushing consolidation do not result in unilateral or collusive anticompetitive effects, which would result in a lost opportunity to strengthen competition in this vital industry and would defeat the purpose of your recent legislative efforts at deregulation.

II. The Merger Wave

Our country is clearly in the midst of an unprecedented merger wave. In fiscal year 1999, we received almost 4700 Hart-Scott-Rodino[(2)] filings. That number is approximately at the level of the record number of filings from the previous fiscal year, and is almost three times the number we received only four years ago. The total dollar value of mergers announced in 1998 was over $1.6 trillion, an increase by a factor of 10 since 1992.[(3)]

The telecommunications industry has been swept up in the merger wave. The telephone, cable, entertainment, data transmission, and other industry or market segments have recently experienced both fast growth and significant consolidation. Some flavor of the increase in telecommunications transactions can be gleaned from the number of HSR filings. The number of transactions filed under the Standard Industrial Code classification for communications has increased by almost 50 percent since 1995, while the total dollar value

has increased eightfold to more than $266 billion.

The antitrust agencies have been actively monitoring these areas. Since 1995, the FTC has investigated or brought cases in video programming and cable distribution,[(4)] several cable overbuild matters, and the acquisition of a movie studio by a cable company.[(5)] The Department of Justice has been similarly active, challenging acquisitions in satellite communications and broadcasting,[(6)] cellular and PCS telephone service,[(7)] and Internet backbone service.[(8)] Although the Commission has been active in cable and entertainment industries, most of the mergers involving telephones and commercial satellite services have been analyzed by the DOJ pursuant to the two agencies' clearance agreement, which divides matters on the basis of recent expertise. Moreover, the Commission is barred by Section 11 of the Clayton Act and Section 5 of the FTC Act from exercising jurisdiction over common carriers.

Despite little growth in resources since 1992, the Commission has established a strong track record of promptly identifying and remedying problematic mergers. In 1999, the Bureau of Competition issued 43 requests for additional information from potentially merging parties and brought 17 enforcement actions. In another 12 cases, the parties abandoned their proposed transactions based on concerns raised by Bureau staff. In 1998, the Commission litigated three merger cases: *FTC v. Cardinal Health, Inc.,*[(9)] *FTC v. McKesson Corp.,*[(10)] and *Tenet Healthcare Corp.*[(11)]

Why do merger waves occur, and what are the forces behind the current one? This is not the first time the United States has experienced a period of rapid consolidation. In the 1980s many larger acquisitions were fueled largely by junk bond financing, corporate raiders, and management-led leveraged buy-outs. Many companies were acquired for their financial break-up value.[(12)] Current consolidations are more likely to be motivated by strategic goals and to involve competitors, suppliers, purchasers, or manufacturers of complementary goods. They are therefore more likely to raise competitive issues and to require more resource-intensive scrutiny. Among the current factors behind the current merger wave are:

Increasing Global Competition

In 1995, the Commission held hearings on Competition Policy in the New High-Tech, Global Marketplace. During those hearings, many witnesses commented on the substantial increase in competition from foreign corporations.[(13)] In many of the most important product markets for consumers, international competitors have captured substantial market share. Automobiles, commercial aircraft, and financial services are now sold in world markets. The Commission's international workload component has grown accordingly. Approximately 25 percent of all mergers reported to the FTC and DOJ involve parties from two or more countries, and 50 percent of the FTC's full merger investigations involve a foreign party, or assets or information located abroad.

This increased international competitiveness is reflected in the telecommunications industry as well. With the erosion of trade restrictions and other regulatory barriers, the amount of telecommunications services flowing across borders, such as telephony, data transmission,

and entertainment, has grown, as have the number of mergers and joint ventures among firms headquartered in different countries.

Deregulation

A significant part of the merger wave is taking place in industries that are either undergoing or anticipating deregulation. In the past few years, deregulation has occurred in the natural gas industry and the airline industry, leading to a number of mergers in each.[(14)] Deregulation is now occurring in other industries, including electricity, financial services, and telecommunications, and we are beginning to see merger activity increasing in these industries also.

Deregulation of an industry often results in structural change and increased competition. Firms can take advantage of economies of scale and scope that were previously denied them. Mergers are often a way for these firms to acquire quickly the assets and other capabilities needed to expand into new product or geographic markets. They can also facilitate market entry across traditional industry lines. Firms in deregulated industries frequently seek to provide a bundle of products and services. We see all of these factors at work in telecommunications, particularly in the technological convergence of the cable and telephone industries.

Not all mergers that occur in response to deregulation are necessarily procompetitive, however. The lessons from the airline industry teach us that merger scrutiny in industries undergoing deregulation is necessary to prevent consolidations that are harmful to consumers. In the airline industry, the Transportation Department, which, at that time, had final merger authority, approved a number of mergers over the objection of the DOJ. Some antitrust experts believe that the result was higher fares, less service, and the domination of a number of major airports by a single carrier. Moreover, firms may react to deregulation by attempting to combine with other firms that threaten to enter historically protected product and geographic markets.

Technological Change

Technology is often an important factor in analyzing a merger. Rapid technological development may help a market self-correct any competitive problems. Now, technology also has become increasingly important as a catalyst for merger activity. We are increasingly certain that technological progress is vital to long-term economic growth. Increased merger activity in telecommunications is clearly a response to new technologies. For example, the extension of broadband access into consumers' homes is a key factor behind many telecommunications mergers. Once again, however, incumbent firms threatened by technological change may attempt to acquire new competitors instead of developing their own technologies, which may deprive consumers of the technological horse races that we see in many high-tech industries today.

Strategic Mergers

More recent mergers have involved strategic considerations. Firms have become more interested in pursuing leadership or dominance in their industries or market segments. There are several reasons for this trend. Concern about the large size of foreign competitors that dominate their home markets may lead to the conclusion that bigger is better. Anxiety about technological change may lead companies to hedge their bets through acquisitions or equity investments in a variety of firms. Firms may believe that efficiency continues to increase with size, or that profits will inevitably accrue from the acquisition of large market shares. These kinds of mergers may have serious competitive consequences by increasing a firm's unilateral ability to increase prices or reduce output.

Financial Market Conditions

Mergers need financing, and current financial conditions are ideal for an expansive supply of capital - low inflation, low interest rates, and a booming stock market. These conditions have led to an increasing number of deals financed through exchanges of stock. To the extent that mergers are strategic, and that is reflected in stock prices, the mergers will more likely be financed through exchanges of equity.

III. Competitive Concerns in Deregulating Industries

The elimination or substantial reduction of regulation is a laudable goal. As a believer in the efficiency of markets and of market-based incentives, the Commission applauds movement in these deregulating industries to more competitive marketplaces. During such a transition, effective antitrust oversight is critical to prevent private accumulation of control over important sectors of the national economy and to forestall abuses of market power. As the telecommunications industry is deregulated, we must be aware of a few general principles applicable to deregulating industries.

First, participants in an industry undergoing deregulation, accustomed to coordinated action among themselves or to the protection of regulators who guarantee a monopoly franchise, often seek to maintain or extend their market power after deregulation occurs. This effectively substitutes private regulation for public regulation, depriving consumers of efficiency without public accountability or supervision. Cartel behavior in place of government price restrictions is a classic example. This has not been a problem with respect to broadcast networks, cable distribution and cable programming. But there can be strong incentives for incumbents to keep new entrants out of what used to be a market protected by regulatory barriers. We can see aspects of this problem as the long distance telephone companies attempt to enter local markets through local exchange networks that are supposed to be, but may not effectively be, non-discriminatory. This can be a serious anticompetitive problem.

Second, transition out of a regulatory regime is almost never complete and immediate. Rather, a patchwork of state, federal and international rules continues to apply even as parts of a market are opened to competition. In the telecommunications area, Congress is still wrestling with the issue of direct broadcast satellites and the transmission of local stations. Serious regulatory problems may arise where some players in an industry are regulated and

others are not. It is difficult and often unfair to try to maintain a system where direct competitors are subject to substantially different regulatory rules. For example, many believe that a principal reason truck transportation was regulated for a time in the United States was to level the competitive playing field between trucking and the heavily regulated railroad industry. But if deregulation is to succeed, the more consistent strategy is to aim to equalize treatment by reducing regulatory burdens for all rather than by increasing them for new unregulated competitors.

Third, some policy goals that can be handled comfortably in a regulatory regime are difficult to achieve through antitrust enforcement. During a transition, some regulation may continue to be necessary -- for example, caps on cable rates or mandated access to local markets - to assist during the period before full competition emerges. While antitrust agencies can employ such remedies, we have been more successful with structural remedies than with behavioral relief. For example, we almost never use rate regulation remedies, and mandatory access remedies are seldom used.

Fourth, as a result of the factors discussed above, application of the antitrust laws to newly deregulated industries often raises difficult and unconventional issues from the point of view of traditional antitrust policy. The very fact that an industrial sector was regulated suggests the possibility of some past actual or perceived market failure, or at least some competitive peculiarities, and therefore calls for a special sensitivity in applying conventional antitrust rules.

IV. Competitive Concerns in Telecommunications Industries

A number of competitive concerns may be raised by the kinds of telecommunications mergers that we are seeing. A horizontal combination of competitors through merger, joint venture or other agreement can result in a direct loss of competition. An acquisition of a potential competitor might have significant current or future competitive effects. And a vertical merger of complementary but non-competing businesses might have foreclosure or bottleneck effects. Some mergers might have several of these effects.

Several of these potential anticompetitive effects are illustrated by the Commission's enforcement action in the Time Warner/Turner Broadcasting/TCI merger.[(15)] This transaction involved the proposal by Time Warner to acquire Turner Broadcasting to create the world's largest media company. These were two of the leading firms selling video programming to multichannel distributors, which in turn sell that programming to subscribers. Time Warner held a majority interest in HBO and Cinemax, two premium cable networks, and Turner Broadcasting owned several "marquee" or "crown jewel" cable networks such as CNN, Turner Network Television ("TNT"), and TBS SuperStation, as well as several other cable networks. Together, the two companies accounted for about 40 percent of all cable programming in the United States.

In addition, both firms were already linked with large cable operations, and the merger would have increased the level of vertical integration, and potentially foreclosed competitors in both the programming production and multichannel distribution levels. Time Warner was

already the second largest distributor of cable television in the United States, with about 17 percent of all cable households. Turner Broadcasting already had strong ties to TCI, the largest operator of cable television systems in the United States, with about 27 percent of all cable television households.

As a result of the proposed transaction, over 40 percent of programming would have been integrated by full or partial ownership with two cable companies that collectively controlled over 40 percent of cable distribution in the United States. In addition, as another part of the deal, TCI would have entered into a mandatory carriage agreement with Time Warner, which would have required TCI to carry four of Turner's top cable channels for 20 years, but at preferential prices. In effect, this was a form of partial integration by contract, and it would have further affected TCI's incentives to carry non-affiliated programming.

Both horizontal and vertical competitive issues were present in this case. The key horizontal issue was defining the relevant market when the merger combined different kinds of programming. In this case, Time Warner owned HBO and Turner owned CNN. For most customers, they might not be direct substitutes. However, from the point of view of the direct buyers of video programming - the multichannel distributors - a program like CNN can constrain anticompetitive pricing of other channels. Before the merger, a cable system operator could go without HBO as long as another marquee program such as CNN was available for packaging with other programs into a network that consumers would be willing to buy. That gave cable operators some leverage to resist anticompetitive pricing on HBO. However, if HBO and CNN were available to cable operators only as a bundle, cable operators would lose that leverage.

The key vertical issue in this case was access. By that, we mean not only access in absolute terms, but also the relative cost of access among competing firms. This transaction raised those concerns at two levels.

The first was upstream access to video programming by firms that distribute multichannel video programming to households and other subscribers. Upstream access was a concern because a merged Time Warner and TCI could block entry into their distribution markets or raise their rivals' costs through their control of a large portion of video programming. Potential entrants into local cable markets could be impeded from entering if they could not gain access to those "must have" channels at non-discriminatory prices. Other firms, such as a direct broadcast satellite service, could have their input costs raised to noncompetitive levels. In sum, increased vertical integration could create an incentive for the merged entity to use market power over programming to eliminate competition or potential competition at the distribution level.

The second concern was downstream access to multichannel distribution by producers of video programming. At the downstream distribution level, the acquisition was likely to make it more difficult for other producers of video programming to gain access to the distribution market. Time Warner's cable systems, and TCI through its financial interest in Time Warner, were likely to favor Time Warner and Turner programming over a competitor's. And since Time Warner and TCI together controlled such a large percentage of

the distribution market, a competing video programmer would have found it difficult to achieve sufficient distribution to realize economies of scale.

Development of alternative programming also would have been discouraged by TCI's long-term carriage arrangement with Time Warner. That carriage agreement would have lessened TCI's incentives to sign up better or less expensive alternatives to the existing Time Warner programming that is already committed under contract. The mandatory carriage commitment also would have reduced TCI's ability to carry alternative services, because current cable distribution is capacity-constrained to a large extent.

We dealt with both the horizontal and vertical concerns in this case by imposing a number of conditions on the transaction that were designed to control the specific mechanism by which competitive harm could occur. The FTC consent order included both structural relief and other provisions designed to prevent the exercise of market power resulting from the merger.

First, the order required TCI and Liberty Media to divest all of their ownership interests in Time Warner. Alternatively, the order would cap TCI's ownership of Time Warner stock and deny TCI and its controlling shareholders the right to vote the Time Warner stock. This divestiture provision addressed the concern that TCI's financial interest in Time Warner would make it difficult for competing producers of video programming to gain sufficient distribution to be competitively viable.

Second, the order required the parties to cancel the 20-year programming service agreement between Time Warner and TCI. The order permitted renegotiation of a carriage agreement after a six-month "cooling off" period, to ensure that negotiations are conducted at arm's length and are not influenced by considerations related to the merger. Any new carriage agreement is limited to five years.

Third, the order prohibited Time Warner from bundling HBO with any Turner networks, and it prohibited the bundling of Turner's CNN, TNT, and WTBS with any Time Warner networks. This provision addressed the concern that the acquisition could have enabled Time Warner to exercise market power through leveraging tactics by bundling "marquee" channels, either together or with less attractive channels.

Fourth, the order prohibited Time Warner from discriminating against rival service providers at the distribution level in the provision of Turner programming. This ensures that new entrants at the distribution level would not be unfairly disadvantaged in the pricing of Turner programming. It thus preserved reasonable access to programming for new services such as direct broadcast satellite services, wireless systems, and telephone company entrants.

Fifth, the order prohibited Time Warner from discriminating against rival video programmers that seek carriage on Time Warner distribution systems.

Sixth, the order required Time Warner to carry a 24-hour all news channel that would

compete with Turner's CNN. This provision was included because the all-news segment is the one with the fewest close substitutes, and the one for which access to Time Warner distribution is most critical.

Time Warner was a large and complex transaction. Many of the concerns we had in that case may also be present in other telecommunications mergers.[(16)] We see several common characteristics in many recent mergers, all of which have implications in the telecommunications industry.

First, many transactions involve a consolidation between firms at different functional levels. Economic theory teaches that most vertical mergers are more likely to have procompetitive aspects and less likely to have anticompetitive effects, but that this is not necessarily true in any given case. Moreover, both effects can be present in the same merger. Our task is to sort out those effects and correct the problems, while allowing companies to achieve efficiencies that will benefit consumers.

Second, some transactions threaten to create or tighten a potential bottleneck somewhere in the chain of production or distribution. A bottleneck transaction can have adverse effects at two levels. First, the acquisition can exacerbate competitive conditions at the downstream level by raising the costs of current rivals or by blocking potential entry. That is, the transaction can create or increase market power of the merged firm through control over upstream inputs that are essential or important to competitors or potential competitors. Second, a bottleneck acquisition can disadvantage competitors or potential competitors at the upstream level by impeding their access to customers. Therefore, the transaction can enable the parties at both levels to increase their market power and protect their turf against new competitors.

Third, many transactions occur in rapidly changing marketplaces. We frequently hear the argument that rapid technological change will prevent a firm from exercising market power, because a new competitor with a new technology will soon take its place. But that is not necessarily the case. In some situations, a merger can create a roadblock to technological change and prevent a new technology from reaching the market. Of course, a necessary condition for adverse effects to occur is that the bottleneck really must be a constraint, i.e., it cannot be easily expanded or circumvented. For example, we would not be concerned about foreclosure of new entry if an entrant could enter easily at both the upstream and downstream levels. But sometimes that may not be so easy.

In sum, acquisitions that raise bottleneck concerns are difficult to analyze, present difficult problems of proof, and raise difficult issues of relief. But it is important that we take a hard look at such acquisitions because a bottleneck can be an effective barrier to entry, and it can be used strategically to disadvantage rivals. Further, it can raise competitive concerns at both the upstream and downstream levels of the merging firms' operations. The key policy objective is to ensure that access to inputs and markets will not be eliminated by mergers and acquisitions.

V. Conclusion

Mergers and acquisitions in the telecommunications industry are occurring at a record pace, caused by technological change, deregulation, and other market forces. Many of these transactions have been good for the economy and consumers, bringing the ferment of innovation and new efficiencies to vital industries. Some transactions, however, may be an attempt to stifle new forms of competition. Sensible antitrust enforcement remains necessary so that the consumers may begin to enjoy the promise of deregulation - whether it be lower prices, greater choices, or new and innovative products and services.

Endnotes:

1. This written statement represents the views of the Federal Trade Commission. My oral presentation and response to questions are my own, and do not necessarily represent the views of the Commission or any other Commissioner.

2. *See* Pub. L. No. 94-435, 90 Stat. 1383 (1976) (codified as amended in scattered sections of 15 U.S.C.).

3. *See* Economic Report of the President 39 (1999), .

4. *Time Warner, Inc.,* 123 F.T.C. 171 (1997) (consent order).

5. *Tele-communications, Inc. and Liberty Media Corp.,* FTC File No. 941 0008, 58 Fed. Reg. 63167, 5 Trade Reg. Rep. (CCH) ¶ 23,497 (Nov. 15, 1993) (consent order accepted for public comment). The transaction was subsequently abandoned and the consent agreement was withdrawn.

6. *United States v. Primestar, Inc.,* Civ. No. 1:98CV01193 (JLG) (D.D.C. May 12, 1998) (complaint). The transaction was abandoned.

7. *United States v. Bell Atlantic Corp.,* Civ. No. 1:99CV01119 (D.D.C. May 7, 1999) (consent decree).

8. *United States v. Concert PLC,* Civ. Ac. No. 94-1317 (TFH) (D.D.C. June 14, 1994) (consent decree).

9. 12 F. Supp. 2d 34 (D.D.C. 1998).

10. *Id. Cardinal Health* and *McKesson* were joint actions by the FTC to enjoin two related, but separate, mergers of prescription drug wholesalers.

11. 17 F. Supp. 2d 937 (E.D. Mo. 1997), *rev'd,* No. 98-2123, 1999 WL 512108 (8th Cir. July 21, 1999).

12. *See* "Merger Wave Gathers Force as Strategies Demand Buying or Being Bought," Wall St. J., Feb. 26, 1997, at A1.

13. *See* FTC, Anticipating the 21st Century: Competition Policy in the New High-Tech, Global Marketplace (May 1996).

14. *See CMS Energy Corp.,* Dkt. No. C-3877 (June 10, 1999) (consent order); *Arkla, Inc.*, 112 F.T.C. 509 (1989) (consent order).

15. *Time Warner, supra* n. 4.

16. For instance, cable overbuild mergers are usually defended by pointing to the efficiencies of consolidating two competing systems, as well as the necessity of preparing for impending competition from the telephone companies. However, the consolidation that creates these efficiencies simultaneously eliminates competition that may benefit consumers through lower prices, a higher number of channels, and better service. As for telephone company entry into cable, most of that so far has been by purchase, rather than de novo entry. *See* "Amid All the Bets, One Stands Out: AT&T Ventures Into Cable," Wall St. J., Nov. 5, 1999, at A1. The Commission investigated a cable overbuild merger in Anne Arundel County, Maryland that raised all of these concerns. In addition, the merger raised potential competition problems since one of the systems had plans for expansion into parts of the county currently occupied only by the other system. The parties abandoned the transaction in the face of opposition from FTC staff and antitrust officials from the State of Maryland.