October 24, 2002

Marlene H. Dortch
Secretary
Federal Communications Commission
TW-A325
445 Twelfth St., SW
Washington, DC 20554

Re: *Notice of Ex parte* presentation in: MB Docket No. 02-70

Dear Ms. Dortch:

On October 23, 2002, Andrew Jay Schwartzman, President, and Harold Feld, Associate Director, Media Access Project (for CFA, *et al.*); Earl Comstock, Sher & Blackwell (for Earthlink) met with Commissioner Martin and his media advisor Catherine Bohigan.

Mr. Schwartzman recounted the oral argument in *UCC v. FCC* that he attended Friday. He described the Court of Appeals taking the Commission to task in very strong terms for failing to make a public interest finding on the record. Mr. Schwartzman suggested that this should be a "heads up" to the FCC that it cannot ignore its duties under the Communications Act and must therefore act on CFA's motion to require production of the High Speed Internet Access Agreement.

Mr. Schwartzman stated that he understood that Media Bureau staff would take no action on the Motion and urged OGC to talk to the Commissioners. Mr. Schwartzman emphasized the need to have a written order ***before*** the issuance of a final decision, even if the written order denies the motion. When asked why, Mr. Schwartzman said CFA, et al. were "studying their options" and that if interlocutory review were sought, a written order would be in everyone's best interests. It would give CFA a final order, and would give the Commission reasoned basis for its decision if it needed to defend it.

Mr. Comstock stated that the Commission has five open proceedings on broadband. It is therefore impossible to say this agreement lies outside the Commission's scope of review. In addition, Mr. Comstock expressed frustration at what the he termed the staff's "deliberate blindness" to broadband arrangements having a profound impact on the industry. In addition to the refusal to ask for the agreement, Mr. Comstock observed that staff never asked for any details on any AOL Time Warner broadband access agreements (the pending example of the Texas.net complaint – denied by the staff and on appeal to the Commission– was cited by Mr. Feld). Mr. Comstock concluded that the Commission's willful blindness is likely to eliminate all competition in the broadband industry.

Mr. Feld made a presentation essentially similar to that recorded in the October 17, 2002 *Notice of Oral Ex Parte* agreement. To summarize, Mr. Feld observed 1) The case law requires the Commission to make a decision on all "relevant facts;" 2) The Commission may determine after looking at the agreement that no action is required, but it cannot avoid looking at the agreement; 3) The Commission's previous merger orders, as well as previous merger orders by the 2 expert antitrust agencies, have made it clear that the Commission must consider effects in the broadband access and broadband content aggregation market; 4) In addition, the agreement reaches areas in the Commission's core video services market and voice market, since it gives ATT Comcast veto power over the provision of potentially rival services such as streaming video or IP telephony. Mr. Feld drew parallels to the practices cited in the 1992 Act as evidence of cable market power, notably the finding in the legislative history that CNBC had signed as a condition of carriage an agreement that

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it would not compete directly with CNN; 5) It is merger specific because it is the combined market power of ATT Comcast that makes it possible for them to extort this deal – as evidenced by the "staging" of access, *i.e.* AOL gets access to 10 million subscribers, then, if they behave, access to another 10 million, then if they continue to behave, another ten million. Furthermore, CFA, et al. used their economic model to predict precisely this outcome in their Petition to Deny. Accordingly, the agreement is proof that Petitioners predictive model is correct. In this regard, Mr. Feld observed that the Commission had issues an OPP paper discrediting the Ordover paper relied on by Applicants.

Mr. Comstock also made the point that the TWE divestiture agreement and the HSIA are intertwined. The HSIA may contain clauses that essentially undo the staff review of the TWE divestiture and the safeguards the Commission may impose. Mr. Scwartzman observed that one of the issues in the Commission's recent decision of *LUJ* (cited in CFA's motion) was to address this problem of cross referenced documents or documents whose titles hide significant relevant information. Accordingly, *LUJ* required broad disclosure to ensure that all relevant information was disclosed.

Commissioner Martin asked whether the Commission could request the HSIA or whether the Commission should simply examine the material the parties submit and then make a straight yes/no decision based on that information (with the answer being "no" if the parties chose to submit insufficient information). Mr. Schwartzman answered that the Commission should, indeed, refuse to grant the merger if the parties do not provide sufficient information, and again cited UCC v. FCC. Mr. Comstock argued that the parties have already chosen to submit additional evidence beyond the initial application and that the Commission, not the parties, must set the scope of the inquiry. Here, the parties chose to submit some information and not more. Mr. Comstock observed that it is a frequent tactic for parties to submit reams of irrelevant information to "bury" staff and avoid revealing important information. Both Mr. Schwartzman and Mr. Comstock pressed the point that the reluctance to submit this document into the record is itself highly suspicious.

Commissioner Martin asked to what degree the FCC could rely on the DoJ failure to act under the ATT-MediaOne consent decree. In this regard, Ms. Bohigan stated that she believed that the FCC staff may have consulted with the DoJ and may or may not have seen the document. Mr. Schwartzman stated that any consultations would need to be submitted into the record and that if the Commission staff had seen the document, it would need to go into the record. Ms. Bohigan said she was not clear what level of consultation had occurred and she may have mispoken.

Commissioner Martin asked for the following: a copy of those sections of Petitioners' *Petition to Deny* most predictive of this result, a transcript of the *UCC v. FCC*, oral argument, and an excerpt of the AOL/Time Warner *Merger Order* supporting Petitioners' position that the FCC has defined the broadband access and aggregation markets as relevant to merger review. Mr. Feld promised to provide this information.

Commissioner Martin asked how long Petitioners would need to review the agreement. Mr. Comstock and Mr. Schwartzman both agreed that 10 days would be appropriate.

In the discussions, frequent reference was made to the attached article from the September 16 issue of Electronic Media magazine.

In accordance with Section 1.1206(b), 47 C.F.R. § 1.1206, this letter is being filed electronically with your office today.

Respectfully submitted

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cc: Catherine Bohigan
Commissioner Martin

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Deals

Comcast makes out; AOL TW works it out
Diane Mermigas

In their recently announced Time Warner Entertainment settlement, what both AOL Time Warner and AT&T-Comcast left on the negotiating table-and the restrictions on what each "won"-are more telling than anything else revealed so far.

With billions of dollars at risk and the opportunity to set a business precedent, the protracted negotiations between AOL Time Warner and the new AT&T-Comcast gave both companies what they needed, but also, in some cases, left them wanting.

AOL Time Warner got its first critical Internet Service Provider agreement with a nonaffiliated cable operator and the right to boast about unraveling its long-suffering TWE partnership.

For its part, AT&T-Comcast, which will complete its $50 billion-plus merger by early November, got much-needed cash out of the deal. It initially can walk away with as much as $4 billion in cash and can eventually sell a 21 percent stake in a newly formed Time Warner Cable company, worth about $6 billion even in today's weak cable values. Despite circumstances and timing working in its favor, Comcast also won high marks for demonstrating it is a strong, savvy negotiator.

But well-placed industry sources said both companies made notable compromises that could have future implications.

Originally, Comcast wanted all cash for AT&T's 27 percent stake in TWE, then valued at between $8 billion and $10 billion, well-informed sources said. AOL Time Warner flatly refused.

Instead, when the TWE deal closes, what AT&T-Comcast gets is $2.1 billion in cash upfront and $1.5 billion in AOL Time Warner stock it can sell.

Debt a concern

The cash is critical for the new AT&T-Comcast, which will be strapped with about $30 billion in post-merger debt that quickly will be reduced to $26 billion to protect the merged company's investment grade rating. Even with an estimated $2 billion in post-merger costs to upgrade AT&T

systems, the combined company has about $2 billion in noncore cable, AT&T stock and Sprint PCS assets it can sell to reduce debt even if it decides to hold on to its AOL Time Warner stock until it appreciates in an improved stock market.

Comcast officials said they got what they needed out of the TWE deal to create a new merged company balance sheet leveraged at a low 3.5 times $7.5 billion cash flow to debt. Comcast officials who led the negotiations protected the merged company's downside risks in a nonexclusive three-year ISP arrangement with AOL that required AOL Time Warner to make some major compromises.

In what was supposed to be a sparkling template for ISP pacts with other cable operators, and a pillar of its evolving broadband service, AOL Time Warner began negotiations asking for lucrative carriage renewals for its Turner cable network and HBO programming units. Comcast official flatly refused, sources said.

The AOL Time Warner brain trust also was adamant about controlling the subscribers it signed for its AOL broadband and other services, such as subscription music, subscription video and home networking, sources said.

But that didn't happen, either.

AT&T-Comcast not only retains control of the billing and customer service, but sources said that the new pact also prohibits AOL from offering any service that would directly compete with AT&T-Comcast's digital cable content, such as streaming video. That is a very big deal, considering that the ability to layer on new music, video, home networking and other subscription services is what eventually will make and keep AOL broadband profitable.

AOL Time Warner anchored its now-rocky merger on the premise that it can generate boundless profits "mining" its collective 155 million cross-media subscribers (which include AOL, magazines and cable) with new services, content and marketing. Without freedom to do so in cable's broadband arena, AOL is just another ISP.

AOL Time Warner also did not gain access to as much of AT&T-Comcast's new "footprint" as it originally sought.

To survive the transition from narrowband to broadband, AOL needs access to more than Time Warner Cable's 13 million cable subscribers, only about 20 percent of which it has captured with its broadband service, sources said.

But the new AT&T-Comcast initially will limit AOL's ISP access to only one-third of its combined 22 million-subscriber footprint. At best, AOL will only have access to 10 million homes, which could eventually be expanded to 19 million of AT&T-Comcast's combined 38 million-home platform. "This leaves a sizeable gap in AOL's potential coverage across the nation's largest cable operator," observes Merrill Lynch analyst Jessica Reif Cohen.

That said, AOL's most formidable challenge may be proving itself in the broadband arena by being able to drive its applications into the

mass market. Access to Time Warner's 16 percent of U.S. cable homes passed and ATT-Comcast's slice of 10 percent homes passed still trails compared with AOL's 40 percent market share of the stagnating narrowband market.

AOL currently is working overtime to create unique and more compelling broadband product and services in an effort to reinvent the online service in the same way that Time Warner's subscriber-based HBO has been successfully transformed, insiders said.

But because AOL Time Warner failed to raise the bar on terms for third-party ISP agreements, it will have to work even harder for its new pact with AT&T-Comcast to generate the funds to subsidize that process.

That won't be easy given formidable competition from the new broadband services from Microsoft Corp., which has a 5 percent stake and "favored nation" status in AT&T-Comcast. Other ISP competition includes United Online, Earthlink and AT&T-Comcast's new proprietary ISP services.

AOL Time Warner also is under pressure to take its cable entity public within 90 days after the TWE deal closes, after which time Comcast is free to sell all or part of its stake to outside investors, sources said.

Enter John Malone

One tax-free scenario being considered would have John Malone's Liberty Media Group swap its 42 percent stake in QVC, valued at about $6 billion, for Comcast's 21 percent stake in Time Warner Cable. Liberty already owns 4 percent of AOL Time Warner.

The notion that AOL broadband is a potential "profitability savior" is a "flawed" one unless AOL can drive substantially higher revenues per household through premium services, Ms. Reif Cohen concedes.

The economics of the broadband deal are "inferior" for AOL compared with its narrowband deals, while AT&T-Comcast's profit per subscriber is higher than that from its own ISP services.

Sources said, AT&T-Comcast will get as much as $38 ($27 of which is guaranteed) of the $54.95 paid by subscribers for the ISP broadband service, leaving AOL Time Warner with $17 per sub to cover its $7 per subscriber service costs. That leaves an estimated profit of $10 per subscriber before overhead, marketing, research and development costs.

As a result of Comcast's expert negotiating, Time Warner Cable now is renegotiating its ISP pact with AOL, which generates only about $27 per subscriber for the cable operator, sources said.

For now, it would the new AT&T-Comcast emerged from the deal with a decisive edge.

"Comcast was able to leverage their customer access into over $2 billion of cash, $1.5 billion of stock, and a clear exit strategy. In addition, it was able to negotiate a favorable broadband carriage agreement," Ms. Reif Cohen said. "That's pretty impressive."

---- INDEX REFERENCES ----

COMPANY (TICKER): America Online Inc.; At&T Corp. (AOL T)