Insight

Charter/TWC Relevant Market Analysis

WILL RINEHART | JUNE 17, 2015

At the end of May, Charter Communications announced it would acquire Time Warner Cable (TWC) for $55 billion.[1] New Charter, as it is to be called, will be a broadband Internet, TV, and phone company serving 23.9 million customers across the US, including three of the largest markets: New York, Dallas and Los Angeles. Even though the merger was just proposed, it is not too early to review the pay TV and broadband Internet markets, as well as a review of the risk of the Federal Communications Commission (FCC) regulating the broadband market.

Pay TV

The first market of importance for antitrust review is the pay TV market, which includes transactions in both local consumer choice and video programming. An initial analysis of the official FCC coverage maps suggests that there are few markets where Charter and Time Warner Cable compete with each other for consumers.[2] This shouldn't be particularly surprising as the Cable Communications Policy Act of 1984 and countless local provisions make entry into this market exceedingly difficult.[3] As a result, this merger should not spark any concerns that it will lessen the number of competitors for a specific market because Charter and TWC barely compete with each other currently. The lack of overlap is evident in the map below showing TWC's market in orange and Charter in blue.

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Because the absolute players in any given market is unlikely to change, there won't be many changes from the current competitive environment that would trigger further investigation. For one, the newer company would sit below the 30 percent market threshold that had long been a cap by the FCC, but was struck down by the courts in 2009.[4] Moreover, in every market that both Charter and TWC exist, there are two other satellite pay TV providers competing for consumers.[5] On top of this, over 30 percent of Americans have a fourth provider of pay TV service, which is typically the traditional phone provider.[6]

While consumers have lamented the rising cost of television, the vast majority of that cost is due to rising cost of programming.[7] Of course, the quality of content has gotten precipitously better in recent years, so there is logic to the increases. Spurred on by The Sopranos, high quality serial content has changed the economics of the TV business. From 2006 to 2013, the total cable channels available to consumers increased from 565 to approximately 800 in 2013, an increase of about 42%.[8] On average, a single Game of Thrones episode will cost $6 million to make, two to three times higher than a typical network or cable show cost.[9] Meanwhile, sports have become big business with programming costs nearly doubling since 2008.[10] In 2013, ESPN got nearly $6 billion in fees from cable providers by producing 35,000 hours of television, which amounts to half of all athletic televised events.[11]

For their own part, pay TV providers, also known as Multi Video Program Distributors (MVPD), have tried to put the brakes on these rising costs. In 2013, TWC was on the losing end of a high profile programming dispute with CBS that resulted in a blackout.[12] During a normal contract renegotiation, CBS asked for an increase in the fees from TWC. When the cable company balked, CBS pulled its content from TWC's TV and Internet networks. The result was a record loss of nearly 306,000 subscribers in the following quarter, tallying up to nearly 3 percent loss of their entire base.[13] Consumers ultimately held TWC liable for the breakdowns in dealings.

This incident and others like it evince the reality of TV programming disputes. Game of Thrones, House of Cards, and the NFL are each unique programs with one provider and specific audiences. In turn, these providers sell this content to one pay TV provider. In other words, these bargains are struck between one buyer and one seller, making the relative strength of each party paramount in the final deal.[14] For an MVPD, a larger company amounts to a better bargaining position that could help to keep costs down.

The Broadband Market

The market for consumer broadband Internet will be the other sector of scrutiny in this deal, but it will present regulators with a more difficult task. Both the FCC and the Department of Justice (DOJ) will have to determine if the deal will be in the best interest of consumers using a snapshot of an industry, even though the market is exceptionally dynamic. In an earlier age, products could be compared with relative ease, since they weren't likely to change much over the course of a large deal. Now, from the beginning of a deal to its conclusion, both the market structure and the underlying product will likely have changed dramatically.

Research across countless disciplines has found that individuals are especially bad at estimating quality improvement, and thus regulators will need to resist current negative sentiment.[15] Even as broadband Internet speeds increased by 48 percent from May 2014- May 2015, ISPs still ranked towards the bottom of consumer satisfaction surveys.[16] This dissatisfaction exist even though US companies generally exceed their advertised speeds.[17] Consumers also lament broadband prices, but when quality is actually considered, consumers have seen continual 5-7 percent declines in real price per year for their speed tier.[18] Few other goods or services can match this decline.[19]

Recent FCC Decision with TWC and Comcast

If the deal between Comcast and Time Warner Cable is any indication, the relationship between the merged company and upstream content providers will also be squarely in the FCC's spotlight. Yet, the agency set up a logically confusing precedent that provides little guidance into how they might treat this new deal. As the Commission noted, that previous deal was shot down because of concerns in the nascent online video market.

Meanwhile, the FCC just enacted sweeping regulations to ensure fairness in the online video space via the network neutrality rules. In that new regulation, the agency adopted rules banning specific practices by Internet service providers (ISPs) that it claimed were harmful. Moreover, the rules established "a strong standard of conduct designed to prevent the deployment of new practices that would harm Internet openness." Advocates have long said that a more aggressive FCC is needed to even the playing field in the online video market, even though the agency has resolved the four cases of harmful behavior without the new rules. The new standard of conduct goes far beyond the rules that even the most ardent advocates pushed, giving the FCC vast discretionary power over the broadband industry without the proper safeguards.

Taken together, the network neutrality rules and the reasons for the nixed deal don't jive. By stopping the deal, the FCC and the DOJ suggest that there are market forces in online video that are potentially anticompetitive and nothing in the network neutrality rules stop this. But the FCC has broad power to enforce their new standard of conduct. So either the FCC cannot properly enforce the broad rules they just implemented, which means that they have overplayed their hand, or the Comcast deal was stopped for baseless reasons, which means that these agencies are trying to pick and choose winners in the broadband space. Neither of those reasons paints either agency in an effective light.

For their own part, Charter has made verbal commitments to not "block, throttle or engage in paid prioritization of Internet traffic" which might harm online content providers like Netflix. As a long term strategy, this makes sense. As more content flows over your network as an operator, the value of access goes up. Analysts continually mischaracterize the relationship between content providers and Internet access providers as a rivalry, when it is in fact a complementary relationship. Just as the iPhone becomes more valuable with more Apps, Internet access becomes more valuable when there is more readily available content.

Regulators also need to resist unrealistic 'what ifs.' Former FCC Commissioner Michael Copps isn't alone when he told the New York Times that "We should be in a Golden Age of television with all of the new over-the-top services and online services. We should be about enabling that, rather than enabling gatekeepers to squelch that."[20] We are in a Golden Age of television, but we are also in the middle of a vast transformation towards Internet based video. Nobody's quite sure how this change will shake out. Perhaps it will be a completely mobile enterprise. Consumers may opt for desktop based viewing or choose to attach a player like the Apple or Chromecast to their TV. Regardless, vast experimentation and countless failures prove that content players are trying to discover the most consumer friendly method, of which mergers are a natural part.

Regulatory Risk

The real unknown is how the FCC will approach the evaluation of this merger.[21] Unlike the DOJ and the Federal Trade Commission (FTC) which focus on consumer welfare, the FCC has developed under a more amorphous public interest mandate, giving it characteristics that are often ill suited to regulating the new 21st century economy.[22]

Over the last 50 years, the DOJ and the FTC have utilized economic analysis into their reviews, thus grounding their policy decisions in empirical studies. The FCC has not incorporated economic analysis into their review, this can be attributed to their public interest mandate. The impact of this mandate has been hugely important. While both the FTC and DOJ have dedicated economics departments, the FCC doesn't, tilting the agency towards attorneys. In the most recent study of its kind, the FCC was staffed by over 60 percent attorneys, the highest of all countries surveyed, including many in Europe.[23] In fact, France, Germany, the Netherlands, and Sweden were staffed by far more economists than the FCC. The lack of this vital skill set has yielded poor policies. In one of the most important pieces of regulation in the last two decades, the agency failed to conduct a basic economic analysis of the rules, while simultaneously making countless and egregious errors.[24] The FCC has become very adept at using the letter of the law to expand their power, but well-researched policy has been harder to come by.

The dynamic nature of broadband Internet makes traditional analysis more difficult, especially since regulatory decisions for a short term outcome might impair long term dynamic efficiency.[25] While the DOJ and the FTC have grappled with this problem, the FCC has been reticent to move towards dynamic analysis. The FCC should adopt AAF's framework for competition policy, "identifying damages only as they occur and imposing appropriate remedies."[26] While the facts of the deal are still being discovered, regulators at the FCC need to set a new course that incorporates dynamism, sound empiricism, and humility into their analysis.

[1] Charter Communications, *Charter Communications to Merge with Time Warner Cable and Acquire Bright House Networks*, http://phx.corporate-ir.net/phoenix.zhtml?c=112298&p=irol-irhome