

Prime Communications v. AT&T – An Economic Analysis

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1.0 Introduction

In May 2001, Prime Communications filed suit against the AT&T Corp., AT&T Broadband, LLC, and AT&T Media Services¹, claiming a number of violations of Section 2 of the Sherman Act.² I have been asked by counsel for Prime to provide analysis and commentary on the economic and media-related issues presented in this case.

This report explains, in summary form, why AT&T's behavior in this case is anticompetitive and constitutes an abuse of its monopoly power. The report begins with a definition of the relevant product and geographic markets, then discusses both markets in the context AT&T's substantial monopoly power. The report goes on to explain why AT&T's refusal to sell cable television advertising directly to Prime and its bundling of automotive Internet-based services with cable advertising constitute unlawful monopoly maintenance, and how AT&T's conduct in this area is harming competition both in the primary market for cable advertising and in other downstream media markets. The report also examines AT&T's actions and lack of any justification for its refusal to deal with Prime in the sale of cable advertising, and explains how both consumers and Prime are being harmed by AT&T's unlawful conduct. The report concludes with analysis and computation of Prime's damages incurred as a consequence of AT&T's conduct.

1.1 Qualifications

I am the President and Senior Scholar of The Information Policy Institute (hereinafter the "IPI"), a bi-partisan non-profit research center focusing on the regulation

¹ We understand from our conversations with counsel for Prime that AT&T Media Services is no longer a party to this suit because it has been determined that AT&T Media Services is a division of AT&T Broadband, LLC.

of information in the U.S. and globally. I have been involved in media and communications policy for the past 13 years, and worked at various times with the North American Telecommunications Association (“NATA”), the Columbia Institute on Tele-Information (“CITI”) at Columbia University’s Graduate School of Business, and most recently as the Executive Director of the Information Services Executive Council (“ISEC”) and the Senior Director of the Strategic Information Unit of The Direct Marketing Association (“The DMA”). In addition, my doctoral thesis examined the history of U.S. telecommunications regulatory policy, including AT&T’s corporate practices under various regulatory regimes spanning the 19th and 20th centuries.

My primary areas of expertise are in the telecommunications and information technology industries and the economics of government regulation of these industries. I have also authored or co-authored dozens of articles, studies and books examining public policy issues both in the United States and Europe (see the attached Exhibit C for a complete list of my publications over the past ten years). Also, I have been invited to speak at numerous industry and academic conferences and have been quoted widely in both domestic and international media. I also serve on several advisory boards, including the Privacy Advisory Board for Preference Solutions, and I am an active member of the International Telecommunications Society (“ITS”), the American Political Science Association (“APSA”) and the European Union Studies Association (“EUSA”).

² Prime Communications, Inc./ v. /AT&T Corp. and AT&T Broadband, LLC, (D. Mars) Civil Action No. 01-10805MLW.

While a Graduate Fellow at CITI, I worked under its director, Professor Eli Noam, a renowned scholar of media concentration and convergence. Professor Noam also sat on my dissertation committee. My senior advisor for my dissertation was Professor Richard Nelson, George Blumenthal Professor of International and Public Affairs at Columbia University³, who with Sidney Winter, authored *An Evolutionary Theory of Economic Change*, which is widely hailed as a foundational work in the sub-discipline of Evolutionary Economics. Additional information concerning my qualifications can be derived from my curriculum vitae (attached as Exhibit A).

1.2 Compensation

My hourly rate for consultation, analysis and preparation of this report is \$150. My compensation is not contingent on my findings or the outcome of this litigation. In preparing this report, at various times members of my staff assisted me in gathering and analyzing certain data and materials. At all times, those staff members were acting under my direct supervision and control.

1.3 Documents Considered in Drafting This Report

See the attached Exhibit B.

1.4 List of Publications for the Past Ten Years

See the attached Exhibit C.

1.5 Summary of Opinions

The answers to the following economic questions are key to understanding and assessing *Prime v. AT&T*:

³ This chair is endowed jointly through Columbia's departments of Economics, Law, and the School of Public Affairs (SIPA).

1. Do pricing data and other factors indicate that cable advertising and other forms of media (*i.e.*, radio, newspapers, broadcast television, direct mail, magazine, billboards, et al.) are not reasonable substitutes for one another such that they should not be included in the same market?
- ~~1~~.2. Does AT&T possess monopoly power in the market for the provision of local cable television advertising services in each of AT&T's cable systems in Eastern Massachusetts and Southern New Hampshire?
- ~~2~~.3. Did AT&T engage in an unlawful refusal to deal and other anticompetitive conduct in an attempt to maintain and extend its monopoly in cable television advertising services?
4. Did AT&T use its monopoly power in the cable advertising market to distort competition in the market for web-based services and in other media markets so as to protect and expand its cable advertising revenue stream?
5. What was the harm to competition resulting from AT&T's anticompetitive conduct?
6. What was the monetary damage to Prime resulting from AT&T's anticompetitive conduct?

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The answers to these central questions are that:

1. Cable's unique function and uses, its insensitivity to the prices of other media, and substantial price differences on a cost per thousand basis indicate that the market for local cable advertising is separate and distinct from the markets for other media.

2. AT&T has monopoly power in the market for local cable television advertising in each of AT&T's cable systems in Eastern Massachusetts and Southern New Hampshire.

- a) AT&T has a 100% market share in 162 municipalities in Eastern Massachusetts, and a 100% market share in 61 municipalities in the Southern New Hampshire region. In the 12 cable systems in which AT&T faces competition, AT&T's average market share is 79%.
- b) The market for local cable television advertising, unlike the market for cable television programming, is unregulated by any public authority. Market share, therefore, is an appropriate indicator of AT&T's market power.
- c) AT&T's monopoly status is maintained by substantial barriers to entry in the cable advertising market. These entry barriers include:
 - i) Substantial scale and scope economies, such as the high cost of laying coaxial cable,
 - ii) Agreements between incumbent cable providers and programming networks which make it difficult for new entrants to obtain programming,
 - iii) The trend toward consolidation and concentration in the cable system market.

3. AT&T is acting to preserve its monopoly cable television advertising revenue stream by engaging in the following anti-competitive acts, including:

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- a) Exerting its monopoly power to coerce Prime, a downstream reseller of advertising media, including cable television advertising, to change the profile of its media purchases by purchasing more cable television advertising, thereby attempting to eliminate Prime as an independent advertising voice in the Eastern Massachusetts and Southern New Hampshire region.
- b) Damaging Prime's ability to function as a full service advertising agency by:
 - i) Refusing to deal directly with Prime in the sale of cable television advertising where there is no viable substitute vendor,
 - ii) Targeting Prime's customer directly through the use of proprietary data,
 - iii) Offering cable advertising discounts to Prime's clients that Prime could not and cannot match.
- 4. By maintaining and expanding its monopoly cable television advertising revenue stream, AT&T is also distorting and disrupting competition in markets for other advertising media by:
 - a) Bundling its online products and services (including, but not limited to, web site production, web hosting, online advertising, customer lead tracking and management) with the purchase of long term cable advertising contracts.
 - b) Offering these Vehix products for "free" and funding them through a substantial cross-subsidy from cable advertising that other online

automobile advertising providers are unable to match – on the condition that automobile dealers purchase and continue to purchase cable advertising in amounts specified by AT&T (whether the auto dealer wishes to purchase such amounts of cable advertising or not).

- c) Attempting to coerce Prime into selling or eliminating Prime IQ and Cablecars.com, each of which competes with AT&T's Vehix services, but more importantly, neither of which, unlike Vehix, is a promotional tool for selling cable advertising.
 - d) Failing to disclose adequately the terms and conditions by which dealers will be able to retain AT&T's Vehix services, namely by purchasing and continuing to purchase cable advertising in amounts specified by AT&T.
 - e) Utilizing (a) through (d) above to artificially increase demand for cable television advertising.
5. Competition has been and is being harmed by AT&T's unlawful monopoly maintenance activities in the following ways:
- a) Prime has been damaged severely as an independent, full service advertising agency in the eastern Massachusetts and southern New Hampshire region to the detriment of Prime's automobile dealer customers.
 - b) With the harm inflicted on Prime by AT&T and with AT&T's bundling of its "free" Vehix services, demand for cable television

advertising is artificially increased and cable advertising rates are raised.

- c) The increased cost of advertising, due to AT&T's anticompetitive activities, are and will be passed along to auto buying consumers, and auto buyers are and will be deprived of cost savings which would have been passed along to them but for AT&T's anticompetitive activities.
- 6. Prime to date has suffered damage of approximately \$530,000 as a result of AT&T's anticompetitive activities.

2.0 The Relevant Market: Local Cable Television Advertising

Assessments of monopoly power, its maintenance and abuse depend on the delineation of a "relevant" market in which that power is measured in terms of market share, or the share of total sales (revenue) in the market that is accounted for by one firm. It should be noted at the outset that the definition of the market is less a matter of precision for its own sake than a preliminary step in evaluating anti-competitive behavior. Thus a firm with a complete (100%) share of a market for a certain good may not have monopoly power if it were costless for a potential competitor to enter in the event the producer raised prices. The definition of the 'relevant market' and the firm's market share within is a preliminary step to identification of monopoly power.

The relevant market is delineated by goods that fulfill the same functions or uses, the area in which these goods are available and compete for a share of the market and plausible entry into the market for the good by existing or potential producers.

Determination of the relevant market requires consideration of the following:

- ◆ the availability of goods and services, within an area reasonably and practically accessible to consumers, that can constrain the behavior of the alleged monopolist by providing practical substitutes for consumers,
- ◆ suppliers which, though currently not supplying the good, could supply it to consumers with relative ease in the wake of a monopolist's attempt to garner supra-normal profits,
- ◆ barriers to entry, or the cost, including time and effort, to potential suppliers of duplicating the good in the wake of a monopolist's attempt to garner supra-normal profits.

In this case, the relevant product market is local cable television advertising. The relevant geographic market is each of AT&T's cable systems in eastern Massachusetts and southern New Hampshire. The sections that follow examine each market in turn.

2.1 The Product Market: Local Cable Television Advertising

Cable's unique functions and uses, its relative insensitivity of to the prices of other media, and substantial price differences all point to cable advertising as being a market separate and distinct from other media such as broadcast television, radio, newspapers, direct mail, magazines, infomercials, billboards and the Internet. In the sections that follow comparisons are made between the prices of television broadcast advertising and those of cable and between price changes in newspapers advertising rates and those quoted on AT&T rate cards.⁴ Those comparisons support a finding that cable is not readily substitutable with newspaper and broadcast television. For other media, the particular uses of each media and their different coverage rates are offered as evidence that local cable television advertising is separate and distinct from other media.

2.1.1 Television Advertising vs. Advertising in Other Media

Cable television advertising is primarily distinguished from non-televised advertising media (*i.e.*, radio, newspapers, billboards, magazines, direct mail and the Internet) by the unique impact that television has on viewers and its higher viewership and coverage rates. Because it offers a combination of sight, sound and motion, television is better suited to the task of selling many products and services than are either radio (sound alone) or magazines and newspapers (sight alone). For this reason, cable is

widely considered to be one of the more effective mediums for developing brand recognition.⁵ For example, industry data shows that viewers are far more likely to remember information about a seller's brand of good or service when it is presented to them via television as opposed to through another ad medium.⁶ Similarly, other AT&T promotional materials show that a majority (61%) of consumers "would recommend cable to an advertiser to make them aware of a new product or service."⁷ Cable homes also tend to be younger, with larger families and higher incomes, than are non-cable homes.⁸ For many cable television advertisers, therefore, alternative media like radio and print are distinctly inferior as channels of communication, and asking a cable advertiser to shift funds to radio or print might seriously undermine the advertiser's ability to sell its product or service.

Cable television is also distinguished from other media by its higher coverage rates. More than 99% of all American households have a color television.⁹ Although cable television coverage rates are, of course, lower than those for broadcast television, they remain larger than the rates for most other media. For example, the combined circulation of the 13 largest daily newspapers in the eastern Massachusetts and southern

⁴ In the absence of price and earnings data on advertising sales (notably from AT&T), a quantitative test of cross-price elasticities of differing advertising media and cable television advertising was not conducted.

⁵ "The Cable Television Advertising Advantage" Exhibit 6.

⁶ Ibid. AT&T promotional materials also show that 78% of consumers believe that television is the most "influential" media of the major media (compared to newspaper (7%), radio (4%), magazines (3%) and the Internet (8%)). AT&T Media Services "Image of Major Media". ATTB 3952.

⁷ Ibid.

⁸ AT&T Media Services "Competitive Binder". ATTB 3964.

⁹ The Economist, Pocket World in Figures (2002) (London: The Economist Newspaper, 2001) p. 225.

New Hampshire area was 1.28 million in 2001.¹⁰ Even putting aside likely overlap in coverage,¹¹ the coverage rate for newspapers in the region was only 56.9% of estimated households.¹² Cable television, meanwhile, had a household penetration rate of 82% for the same area.¹³ Coverage rates for cable television are also substantially higher than those for other media like magazines and the Internet.¹⁴ Moreover, industry data shows that consumers spend significantly more time watching television than they do listening to the radio, reading newspapers, or surfing the Web.¹⁵ Replacing cable with one of these other non-televised media channels would require that advertisers forego reaching a substantial and growing number of potential consumers,¹⁶ and thus suggests cable is not readily substitutable with other media.

2.1.2 Broadcast Television Advertising and Cable Television Advertising

Of course, many of the attributes of cable television discussed in the previous section apply as much to broadcast and other forms of video-based advertising as they do

¹⁰ Marketer's Guide to the Media, 2002. p. 191 and Essex County Newspapers, Advertising Rates 2001. The thirteen dailies are the Boston Globe, Boston Herald, Worcester Telegram & Gazette, Quincy Patriot-Leger, Manchester Union Leader, Metrowest News (Framingham), Lawrence Eagle-Tribune, Hyannis Cape Cod Times, Lowell Sun, Brockton Enterprise, Salem Evening News, Gloucester Daily, and the Daily News of Newburyport.

¹¹ Of course, accounting for any overlap would lower the coverage rate even further.

¹² Marketer's Guide to Media, 2002. p 191.

¹³ Ibid.

¹⁴ AT&T Competitive Binder "The Seven Benefits of Cable TV Advertising". ATTB 3966.

¹⁵ In terms of hours spent on a medium and thus in terms of the per person time available, television covers greater audience 'time' than radio or newspapers. Approximately 1580 hours were spent per person annually watching TV compared to 967 hours listening to the radio and 154 hours reading the newspaper. AT&T Media Services "Media Usage: Annual Time Spent". ATTB 3948. Internet usage rates are also much lower. For example, in any given week 71.3% of all persons watch cable television, while only 45.4% will access the Internet in a given *month*. Statistical Abstract of the United States, 2001. Table 911.

¹⁶ The fact that cable's penetration rate continues to grow in the greater Boston area makes cable a particularly important medium for advertisers in this area. For example, AT&T promotional materials show that cable television continues to grow and that cable's 83% penetration rate in the Boston market is the highest among the top ten television markets in the United States. AT&T Media Services "Delivering your Message to Television Audiences Community by Community." ATTB 3175-3176. and AT&T Media Services "Media Usage: Annual Time Spent." ATTB 3949.

to cable advertising. However, it is clear that for some advertisers cable television is superior to other forms of video advertising, such as broadcast or satellite television. This is particularly true for local advertisers who draw their customers from a narrow geographic area and cannot afford the relatively high cost of broadcast television.

From the perspective of the local advertiser, there are two distinct advantages to cable over broadcast -- demographic targetability and geographic targetability. Cable television's ability to narrowly target specific geographic areas is critically important for local businesses because of the nature of their markets. Broadcast generally is not a viable option for most local businesses because the coverage area for over-the-air programming is much larger than that for cable, and thus much of advertisement is "wasted" because the intended audience is outside of the geographically targeted market area. Because cable can be inserted locally, advertisers are better able to concentrate their advertising expenditures within the designated target market area. Advertising on broadcast, therefore, is a substantially less cost-effective and efficient way to target a local market than is cable.¹⁷

Cable's ability to offer a wider selection of programming also distinguishes it from broadcast insofar as it allows advertisers to better target viewers in terms of both demography and lifestyles. Cable, for example, has Nickelodeon for children, MTV for teenagers and young adults; ESPN for sports fans; and such highly specialized offerings as Food Network and the Travel Channel. Cable's wider selection of programming

¹⁷ Media channels like radio and satellite are also poor substitutes for cable insofar as they lack the local insertion capability necessary to limit waste and undue costs. For the same reason, RCN, the region's primary overbuilder and AT&T's only competitor in the region, should not be included in the relevant market insofar as it too lacks local insertion capabilities.

makes it easier for advertisers to specifically target audiences by income bracket, purchasing patterns and lifestyles. Indeed, AT&T's own promotional materials highlight cable's capacity to "zero in on people who tend to buy your products and services."¹⁸

Given cable's unique geographic and demographic targeting ability and the fact that advertising on broadcast is simply too expensive and wasteful for many advertisers, broadcast is not an adequate substitute for cable.

2.1.3 Consumers and Providers of Cable Television Treat Cable as a Separate Economic Entity/Market

The distinctiveness of cable television advertising is further made clear by the fact that suppliers, buyers, advertising associations and experts in the advertising industry often treat local cable television advertising as a separate market. Cable television advertisers themselves are organized in a distinct industry association, the Cable Television Advertising Bureau.¹⁹ References to cable television advertising (both national and local) as a separate product grouping are found in many ad industry publications. And the wider advertising industry recognizes local cable ad spots as distinct from network cable and regional cable spots in advertising and promotional material,²⁰ in industry self-descriptions for association members²¹ and industry reference

¹⁸ AT&T Broadband promotion material. "The Cable Television Advertising Advantage." August 2000.

¹⁹ www.cabletvadbureau.com

²⁰ AT&T own promotional literature clearly refers to local cable television advertising ('insertable cable' advertising) as a unique product. See Ex 90, JB, PAB 6-4-02. ATTB 3174: 3164-3189.

²¹ See www.cabletvadbureau.com for discussions of local cable television advertising.

material.²² These facts reinforce the observations above, namely, that there are distinct and unique uses for local cable television advertising.

2.2 Prices, Pricing and Price Sensitivity

Distinct prices and price sensitivity are taken to be the hallmark signs of whether two products are substitutable and thus belong in the same market.²³ Sensitivity to potential price/supply changes in the price and quantity of substitutes are manifest in the regular consideration by producers of both real and potential actions and reactions of producers, buyers and sellers of substitutes. This attentiveness by producers to the reaction of a supplier of a potential substitute good to changes in the price or output of their own product is a corollary of sensitivity to price changes insofar as substitutes shape behavior of a firm's pricing.²⁴ For example, prices may be stable because a firm that has a 100% market share in a good is dissuaded from raising prices because it is aware that to do so would lead to an exit of consumers to a substitute good. Crucially, it would look to production and pricing of the substitute to inform its own production and pricing decisions.

Examination of AT&T's guideline rates reveals that AT&T pays little if any attention to prices of other media when setting its own rates. In fact, in the few instances where AT&T has changed its guideline rates in recent years it has occurred primarily in

²² See for example *Marketer's Guide to the Media*, 2002. Vol. 25. (New York: VNU Business Publications USA, 2002).

²³ The price of one good may be responsive to that of another also if they are complements. Usually cross price elasticities are measured to determine whether goods are substitutes, complements or altogether unrelated. For two goods, when the change in the demand for one good is positive for a price increase in its putative substitute, the cross-price elasticity will be positive, *ceteris paribus*. They will be negative when the goods are complements, e.g., tape decks and audio tapes. And they will be effective zero when the two goods are unrelated. Cross-price elasticities were not calculated for lack of data on local cable television advertising spots sold by AT&T in the Western Massachusetts and Southern New Hampshire regions.

the context of consolidation or segmentation of its cable systems,²⁵ or the acquisition of part or all of a new system. For example, the only change to AT&T's guideline rates for the period May 2001 to May 2002 occurred in the aftermath of AT&T's acquisition of the Worcester system. Rates were raised in that system, however, not because of price increases in other media but because of a persistent shortfall in inventory at the then prevailing price. It is clear, therefore, that AT&T looks primarily to persistent shortages in inventory as the primary signal that its guideline rates should be changed, not the prices of other media.²⁶

2.2.1 Distinct Prices

Prices of cable television advertising tend to be distinct from arguably its closest substitute, broadcast television advertising.²⁷ To illustrate, the Boston system of AT&T Broadband contains 149,352 subscribers.²⁸ Prime time advertising on Tier 1 channels costs \$75 per 30 second spot.²⁹ The cost of advertising in per 1000 subscriber terms is approximately \$0.502. This price, however, does not permit any meaningful comparison with television broadcasting which is priced according to (expected) ratings points.

²⁴ This classic conception can be traced as far back as Edward S. Mason, "Price and Production Policies of Large-Scale Enterprises." *American Economic Review* Vol. 29, (1939).

²⁵ Because consolidation and segmentation alter the number of subscribers in the system, rates are lowered or raised based in order to maintain AT&T's per 1000 subscriber/viewer price. For example, segmentation of the Newburyport cable system led AT&T to lower its rates to reflect the smaller zone and smaller subscriber/viewer base in that area. Deposition of James Leidka, at 63.

²⁶ Insofar as AT&T may claim that pricing of other media is primarily taken into account by its sales staff in formulating and negotiating

²⁷ Cable television claims of a rising share of the audience must be offset against the growth in the number of cable channels available. Advertisers do not purchase advertising on cable qua all channels not available through broadcast. Rather they purchase advertising on one of many cable channels, which share this audience.

²⁸ Department of Telecommunications and Energy, Commonwealth of Massachusetts, Operator System List. July 10, 2002. p. 5.

Ratings points for cable vary show by show as in broadcast. Despite the rising share of the audience for cable in the aggregate, the average ratings per show are in fact very small, as they are averaged out over an increasing number of cable channels.

Conservative assumptions illustrate that cable television advertising prices are fundamentally distinct from and higher than prices for broadcast television. Channel 5 in the Boston area charges \$1,000 per spot for the 4 p.m. to 8 p.m. time slot.³⁰ The coverage area for Channel 5 is claimed to be 1,597,830 households. In 2000/2001, the primetime household rating of ad supported cable was 26.0, as compared to 27.6 for the 4 largest broadcast networks (ABC, CBS, NBC and Fox).³¹ Ad supported cable, however, is made up of more than 30 different channels -- AT&T notes 33 in its 3 tiers.³² Here we assume that the proportions that hold for primetime also hold for the 4 p.m. to 8 p.m. (i.e., cable's rating as only slightly smaller than that for the 4 major networks). Cable's share may be greater during this period but, for purposes here, we can compensate by allocating cable's ratings among the 11 tier 1 channels, thereby by distorting the relative size of their audience vis-a-vis broadcast television by a factor of 3.³³ The multiple (2.919) amounts to roughly the number of ads on cable seen by the same share of television viewers as one ad on broadcast. Furthermore, we weight the rate by the ratio of Channel 5's broadcast household coverage to the number of subscribers in a system. The Boston cable system

²⁹ NSA Rate Card. Exhibit 29, Deposition of James Liedtka. Information on electronically stored rates in AT&T's AdBlock system were not made available at the time of this report. Tier 1 comprises A&E, CNN, Discovery, ESPN, HGTV, Lifetime, Nick at Nite, Nickelodeon, TBS, TNT and USA networks.

³⁰ Affidavit of Donna Reid, para. 8.

³¹ Mitch Tebo, ed., *Marketer's Guide to the Media: 2002*. p. 51.

³² The programs in which AT&T can insert cable television advertising do not command the same audience shares as programs on broadcast television advertising. While cable's share of viewers has been growing, (i) much of it is captured by non-ad supported channels such as HBO and (ii) is shared among a growing number of channels.

³³ Using 33 instead of 11 channels generates a much larger multiple and thus higher prices.

with its 149,352 cable subscribers is weighed roughly 0.093 that of the channel 5 range.³⁴ The 4 p.m. to 8 p.m. rate is then multiplied by the ratings multiple and the broadcast household/cable subscriber ratio to generate comparable measures. The following table illustrates the differences.

SYSTEM	4P.M. TO 8P.M. RATE WEIGHTED BY RATINGS MULTIPLES AND BROADCAST RANGE/SUBSCRIBER RATIO (\$)³⁵
Boston	2,839.00
Braintree	4,348.68
Brockton	3,689.07
Cambridge	3,068.46
Lexington	1,621.05
Malden	2,720.14
Quincy	2,797.59
Scituate	3,607.68
Woburn	1,534.42

Although the above figures are imprecise, the relevant matter is the direction in which they err. They tend to greatly distort the price of cable advertising per viewer

³⁴ Subscribers as listed by Department of Telecommunications and Energy, Commonwealth of Massachusetts, Operator System List. July 10, 2002.

³⁵ Rates and subscriber base as quoted in Exhibit 29, Deposition of James Liedtka. Estimates using the number of subscribers cited in Department of Telecommunications and Energy, Commonwealth of Massachusetts, Operator System List yields higher prices. Prices may differ as a result of substantial quantity discounts. Even with a 30% bulk discounts, prices remain higher than for television advertising. They are, by this measure, approximately \$1,100 in Woburn and Lexington and in excess of \$1,900 elsewhere. However, recall that the weights are biased toward understating the differences in size of the viewing audience of cable channels with those of broadcast; in this light, the prices for advertising in these regions, including Woburn and Lexington, tend to be much higher.

downward toward the price of broadcast television advertising. The fact that the channels on tier 1 of AT&T's rate cards do not capture the entire cable viewing audience means that the ratings multiple to equalize cable television with broadcast in terms of viewing share is much higher, and therefore, the true cost is higher. In fact, cable's range of 1.53 to 4.35 times the cost of broadcast television for the cases listed above may be overly conservative.³⁶ The least expensive of these systems, Woburn, remains on estimate per viewer terms 53% more expensive than Channel 5.

One caveat to note when considering the estimated cost of viewership comparisons is that the effect of advertising in terms of frequency may not be linear. That is, the effect of two advertisements (in terms of brand recognition, leads generated) may be more than twice that of one advertisement. To the extent that the impact of frequency is non-linear, the value of the second ad to an advertiser may be greater than the value of the first ad, and the value of the third ad may be more valuable still, and so on. But there is no reliable evidence that AT&T's pricing actually follows this pattern.

The fact of the divisibility (of viewers) in the cable advertising slots as described above creates a separate market for 'smaller' units of advertising, a market monopolized by AT&T Media Services. For many local advertisers, therefore, broadcast television advertising is effectively beyond their budget, especially to the extent that frequency is key in advertising, and this does not enter into calculations of substitution. There is no clear reason why per viewer cable costs would be so much greater if the markets were

³⁶ Donna Reid notes that "On a cost per thousand basis, based on actual viewership, cable advertising can be much more expensive than broadcast." But she goes on to note "However, the ability to run ads that are specifically targeted (in terms of geographic area, channel, program audience, purchasing preferences, etc.) with greater frequency than would be possible for the same advertising dollars on broadcast television

indeed competitive and if the goods were substitutable. Rather, cable's higher prices, which persist for a non-negligible period of time, reflect AT&T's monopoly power in the market.

2.2.2 Sensitivity to Price Changes in Putative Substitutes

Comparison of the prices of cable television advertising rates over time with those of other media reveals the former to be insensitive to even significant and lasting changes in one putative substitute, newspapers. The advertising rates of several local newspapers for the period 2000-2002 serve as a case in point.³⁷ As the following table shows, between 2000 and 2002, prices for advertising in Essex county papers increased by more than 9 percent, while rates for cable television advertising in surrounding systems remained unchanged. Similarly, classified advertising rates for The Lowell Sun changed by nearly 6% as cable advertising rates in Lowell remained flat.

Year	LOCAL NEWSPAPERS			AT&T CABLE SYSTEM ³⁸			
	Essex County Papers, Retail Rates ³⁹	Essex County Papers, Classified Ad Display	The Sun (Lowell) Classified Ad Display	Beverly	Haverhill	Newburyport	Lowell

enables cable providers to set prices without regard to the prices charged by broadcast television." Affidavit of Donna Reid, para. 14.

³⁷ Given the effective absence of changes in the rate card (guideline) price for cable television spots save for a small handful of systems and the increase in the prices of advertising in newspapers and in television, the cross price elasticity can be said to be 0 since δp (the change in the price of cable) = 0. This reading of course should be resisted as actual average prices for advertising spots on cable are unknown as are quantities sold.

³⁸ Fixed Rates. Source: AT&T rate cards, Exhibits 26, 28, 29, Deposition of James Liedtka. While Liedtka and Sullivan could not fully authenticate these rate cards as the actual guidelines, in his deposition, Liedtka did state that to his knowledge guideline rates had been changed only in Worcester and in instance of the mergers and segmentations of cable systems. These 4 have been noted as separate and have continuously existed as a cable system of AT&T Broadband since 2000. There is evidence in the testimony to believe that rates have not changed in the four systems.

³⁹ Open Rate, cost per column inch. Source: Essex County Newspapers, Advertising Rates, 2000, 2001, 2002.

	Rates ⁴⁰		Rates ⁴¹				
2000	\$35.50	\$27.60	\$21.75	\$26.00	\$36.00	\$22.00	\$42.00
2001	\$37.30	\$29.05	\$23.00	n/a	n/a	n/a	\$42.00
2002	\$38.85	\$30.25	\$23.00	\$26.00	\$36.00	\$22.00	\$42.00
% Change 2000-02	9.4%	9.6%	5.7%	0.0%	0.0%	0.0%	0.0%
(2001-02)	(4.2%)	(4.3%)	(0.0%)				(0.0%)

While AT&T might claim that the prices quoted on rate cards are only rough guidelines, they do serve as a benchmark from which AT&T's discounts are determined. Moreover, to the extent that the rate cards are unchanged, the real price of these and thus of discounted prices *fall* since they are not adjusted to compensate for inflation. Yet, the only actual system of prices available is insensitive to prices and price changes in putative substitutes.

2.3 The Geographic Market

The geographic dimension of the market is determined by the ability of consumers to reasonably find alternative sellers of a product or its substitute in the wake of a price increase above competitive levels by another seller.⁴² The geographic market in this case is each of AT&T's cable systems in eastern Massachusetts and southern New

⁴⁰ Source: Ibid.

⁴¹ Source: The Sun (Lowell), Classified Advertising Rate Card, #66-67, 2002 figures obtained at http://63.147.65.14/lowellsun/advertising_ad_online/print_rates.html

⁴² Department of Justice, Horizontal Mergers Guidelines. Section 1.22

Hampshire. The market for local cable advertising is restricted to the geographical scope of each cable system by the fact that consumers have only one place to turn to get their advertising, the cable system (or systems) that service their particular community. Accordingly, the geographic scope of the market is necessarily defined by each of AT&T's cable systems in eastern Massachusetts and southern New Hampshire.

2.4 Market Share and Market Power

AT&T's near total market share in most of the communities in which it operates and massive barriers to entry in the cable system market indicate that AT&T has substantial monopoly power in the each of the local cable advertising markets in which it operates. For the vast majority of consumers, therefore, cable television advertising is monopolized by a single cable provider in Eastern Massachusetts⁴³ and Southern New Hampshire.⁴⁴ In conjunction with the aforementioned analysis of barriers to entry, AT&T's high market share translates into market power in all those municipalities in which cable subscribers do not have access to an alternate cable provider.

In the market for local cable television advertising, a 100% share of households subscribing to cable television necessarily implies a 100% share of the market for local cable advertising. The relationship between cable television services and cable television

⁴³ Defined here as Barnstable, Bristol, Dukes, Essex, Middlesex, Nantucket, Norfolk, Plymouth, Suffolk and Worcester Counties. This counties comprise 249 shires; AT&T is the sole provider in 190. In 12 others, there has been some overbuild.

⁴⁴ The New Hampshire Area comprises the regions around Concord, Manchester, Salem, Naaashua and Seacost. See AT&T Media Services "Market Coverage for the New Hampshire Area."

advertising is straightforward. Purchasers of the former are the 'products' (*qua* audience) sold (to advertisers) in the latter.⁴⁵

Of the 242 towns and cities in which AT&T has a cable system in eastern Massachusetts and southern New Hampshire, AT&T is the sole provider of cable system services (and, therefore, cable advertising services) in 230 of them, and thus its market share in each of those towns and cities is 100%. AT&T has a 100% share in 162 municipalities in eastern and central Massachusetts and 100% of 61 municipalities in southern New Hampshire.⁴⁶ 19 shires in Massachusetts have been granted over build licenses -- Arlington (81%), Boston (91.2%), Braintree (65.7%), Brookline (85.9%), Burlington (74.5%), Dedham (71.7%), Framingham (66.6%), Lexington (62.3%), Marlborough, Milton, Natick (87%), Needham (82.8%), Quincy, Randolph, Saugus,

⁴⁵ Prices for the transmission of cable advertising are of course distinct from prices for cable subscription. Yet the two are not totally insulated from each other in competitive environments. A rise in the price of cable television advertising provides incentives to reduce the price of subscriptions to gather a larger audience (the product offered by cable providers to advertisers)

⁴⁶ AT&T's would have monopoly power and a very high market share even if the relevant geographic market were broadened to include all of eastern Massachusetts and southern New Hampshire. As of July 2002, AT&T Broadband services approximately 78% of all cable subscribers in Massachusetts. The remainder of the market is shared by 9 other multichannel system operators. Only 3 operators, in addition to AT&T, had market shares in excess of 2%: Adelphia Cable (7.12%), Charter Communications (11%) and RCN (2.88%). (The HHI score for the state is 6217.) In Eastern Massachusetts, the area serviced by Prime Communications, the concentration of the provision of cable television is higher (HHI = 6432) with AT&T Broadband accounting for 79.5% of the market.⁴⁶ Markets for cable television services, in sum, are highly concentrated in the Massachusetts and, crucially, in its eastern region and dominated by AT&T. With respect to the offer and sale of cable television of advertising, a 'turnkey' agreement between Charter Communications and AT&T Media Services has made the latter the exclusive seller of cable television advertising spots on the system of the former. (Combined, AT&T's share of the Massachusetts market grows to 88.7% (HHI=7928)).

Somerville (68%), Stoneham, Wakefield (70.6%) and Weymouth. As of July 2002, subscribers had yet to be acquired in 7 of these shires.⁴⁷

In short, AT&T's market share indicates that it controls virtually 100% of the local cable television advertising services in the communities in which it operates. Given high barriers to entry in the cable system market, there are in effect no alternate suppliers of cable advertising services other than RCN. But as noted previously, RCN is not yet a major player in the market and it lacks the local insertion capability that is critical to many local businesses. In practical terms, this means that the market for local cable television advertising is monopolized by AT&T as there is no other cable system to target video commercials to a local audience. While overbuilding continues, it seems unlikely that AT&T's dominance (local total monopoly) will be challenged anytime soon.

2.5 Barriers to Entry

Barriers to entry in the market for local cable television advertising are considerable. They include:

- 1) The physical cost of building the network,
- 2) The use of exclusive licenses between programmers and incumbent cable providers such as AT&T.
- 3) Limited access to customers.

The physical costs of building a network are extensive. They vary according to population density as the cost of laying coaxial cable increases as the distance between

⁴⁷ Source: Department of Telecommunications and Energy, Commonwealth of Massachusetts, *Operator System List*. July 10, 2002;

households increases. RCN, the principal overbuilder in Massachusetts, has pursued a strategy of targeting urban centers for overbuilding and thereby offer households an alternative to the incumbent cable provider. RCN estimates costs of the physical network of laying coaxial cable to be \$900 per homes passed.⁴⁸ The cost of providing cable services to households in eastern Massachusetts served by AT&T is considerable. Assuming that all cable households in the 12 shires in which a competitor to AT&T has been granted an overbuild license are served by more than one cable system operator, the cost of providing an alternative to AT&T in the Boston area would be in excess of \$1.13 billion.⁴⁹ The cost would most likely be higher as the cost per house passed increased outside of urban centers.

In addition, large, incumbent MSO's also often have exclusive agreements with programming networks that inhibit entry into the cable system market. BellSouth and EchoStar have both argued that the clustering of cable systems affords incumbent cable MSOs with bargaining power vis-à-vis cable programming networks which renders the latter less willing to sell programming to competitors.⁵⁰ EchoStar argues that the significant bargaining power of large MSOs in obtaining programming presents a barrier to entry.⁵¹ One consequence of these agreements and this distribution of bargaining power is to make the services offered by competitors less attractive with no means for

www.state.ma.us/dpu/catv/2ndlicense.htm. Newton, Medford, Watertown and Woburn are also served by another cable provider, but it is not overbuild.

⁴⁸ See John Higgins, "RCN's high-wire act." *Broadcasting and Cable*. May 8, 2000. p. 23.

⁴⁹ Household figures based on Department of Telecommunications and Energy, Commonwealth of Massachusetts, Operator System List. July 10, 2002.

⁵⁰ FCC, "Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming: Seventh Annual Report." §90. www.fcc.gov.

⁵¹ FCC, "Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming: Seventh Annual Report." §163. www.fcc.gov.

competitors to reasonably acquire programming and thereby disadvantaging them in the market.

Finally, RCN has cited the tactics of incumbent MSO's as a major barrier to entry. Specifically, RCN notes delays in gaining access to local rights-of-way, delays in pole attachment and charging of excessive rates. It has also complained of the inability to acquire access to the inside wiring of MDU (multiple dwelling units).⁵² These three classes of obstacles have made the duplication of facilities difficult for even large telecommunications companies with substantial assets.

Given AT&T's high market share and the aforementioned entry barriers, AT&T clearly has monopoly power.

⁵² FCC, "Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming: Seventh Annual Report." §130. www.fcc.gov.

3.0 The Business Logic of Vehix

3.1 Summary of Opinion

AT&T's actions with respect to Prime are rational only in the context of a broader strategy by AT&T to stymie the emergence of competition in the online automobile advertising market in order to maintain its existing monopoly revenue stream from cable television advertising. Currently, online automobile advertising possesses all of the features – video, audio, text, and the ability to target geographically and demographically – the combination of which previously was unique to cable television advertising.⁵³ Online advertising possesses additional capabilities, most notably the instantaneous provision of vast amounts of product information, that may give online a distinct comparative advantage over cable as an advertising medium for auto dealers.

Automotive is the single largest product category advertised on both local and national cable television.⁵⁴ Given the potential for online advertising to quickly digest a large share of AT&T's most significant advertising category, AT&T has invested heavily in its online automobile advertising affiliate – Vehix – in an effort to prevent just that outcome. AT&T has entered online automobile advertising in a manner that will likely

⁵³ Online advertisers are able to target geographically and demographically using commercial e-mail. Information aggregators that specialize in interconnected households, such as Naviant Corporation, maintain files of e-mail addresses that are appended with third-party data, including self-reported data, public record data such as U.S. census data, marketing data, and other commercially available marketing data. Companies wishing to target a particular geographic region or demographic segment are able to purchase lists of e-mail addresses of individuals with specific common attributes. For a full discussion on the use of third-party data for online and offline target marketing, see Michael A. Turner, "The Impact of Data Restrictions on Consumer Distance Shopping." A joint Privacy Leadership Initiative/ Information Services Executive Council Study, March 2000.

⁵⁴ <http://www.cabletvadbureau.com>

A breakdown of spending by category can be found under the research, advertising expenditures subtab. Automotive in this chart is comprised by two subcategories, "AUTOMOTIVE DEALERS & SERVICES," and "AUTOMOTIVE, AUTOMOTIVE ACCESS & EQUIP."

distort competition in that market. Specifically, AT&T has bundled together an ensemble of separate online advertising products and services for automobile dealers, all of which are presently available competitively on the open market. AT&T offers these bundled products and services as part of a “leveraging” package at prices well below their true cost. In addition, AT&T has tied access to the bundled Vehix suite of online advertising products and services to the purchase of large amounts of cable television advertising over the course of a single year.⁵⁵ Finally, AT&T subsidizes its online automobile advertising affiliate with a multi-million dollar free advertising campaign over its own network that even the largest competitor in this market cannot match.

By disrupting competition in the Internet automobile advertising market, primarily through the massive advertising subsidy AT&T provides its Vehix affiliate without charge, AT&T continually increases the value of the Vehix “promotion” to auto dealers. However, by increasing the value of its Vehix promotion to auto dealers AT&T simultaneously increases the costs of “exiting” from the local cable advertising market. In this fashion, auto dealers will continually be compelled to purchase more local cable advertising than would otherwise be the case were competitive conditions to obtain in the Internet automobile advertising market.

⁵⁵ AT&T employees James Sullivan and Derek Casper refer to the AT&T Vehix suite of services as being “tied” to the purchase of local cable television advertising. This term has different “meanings” in law and economics. In the field of economics, it is frequently used synonymously with the term “bundled” to connote the conditional relationship between two separate goods or services. Specifically, “tied” refers to the condition in which access to one good is linked to access to another good. In antitrust law, the term “tied” refers to a specific practice whereby a monopoly conditions access to a good or service over which it has monopoly control upon the purchase of a good over which it does not access monopoly control or market power. In this sense, then, what AT&T has done with Vehix is a reverse tie. Unless specifically noted, the use of the term “tied” in this report is consistent with the economic definition.

The end result of the Vehix “Cable TV/Internet leveraging package” must be the disruption of competition in the online automobile advertising market to the benefit of AT&T and other cable television monopolies. AT&T’s conduct is fundamentally anticompetitive as it leverages its monopoly power in one market – the ability to cross-subsidize its Vehix affiliate with massive amounts of free cable television advertising over the networks it owns and operates – to protect and enhance the primary revenue stream in its monopoly market. AT&T’s refusal to deal with Prime Communications also must be understood in this context.

Specifically, the existence of CableCars.com as a regional online automobile advertising portal presented a direct threat to AT&T’s Vehix “Cable /Internet leveraging” rollout in the greater Boston market. When Prime rejected AT&T’s offer to become the exclusive regional agent for its Vehix “promotion,” an offer which necessitated that Prime discontinue its own online automobile advertising activities, AT&T acted anticompetitively in an attempt to harm Prime. In short, because Prime chose to compete with AT&T in the online automobile advertising market – a market AT&T entered specifically to maintain, protect and enhance its local cable television advertising monopoly revenue stream – AT&T exercised its monopoly power in the local cable television advertising market to harm Prime’s core business – that of serving as an independent, full-service advertising agency.

AT&T’s behavior harms competition in the online automobile market, forces auto dealers to buy more cable television than would be the case if competition obtained in all advertising markets, raises cable advertising rates by reducing inventory (through the cross-subsidy to AT&T affiliate Vehix) and artificially increases demand for cable

television advertising through tying two separate advertising media together and selling them for the price of one.

In essence, AT&T is dumping Internet automobile advertising services on the market and is willing to absorb enormous costs in the near-term in order to recoup these costs and more through the sale of cable television advertising.

3.2 Vehix: Rapid Entry Into Online Automobile Market

When AT&T acquired TCI Communications in 1999, it inherited TCI's 49 percent stake in Salt Lake City-based AutoMallUSA.com, an online advertising service provider centered upon an automobile portal developed by the Ken Garff Automotive Group.⁵⁶ Shortly thereafter, AutoMallUSA.com was renamed Vehix.com and was offered for free to automobile dealers located in select AT&T cable markets we agreed to a one-year cable television advertising contract with AT&T. In addition, AT&T committed to promoting the Vehix.com venture with between \$50 million and \$70 million worth of annual advertising on its own cable television networks.⁵⁷

By bundling the entire suite of Vehix services together – Web design, Web hosting, Web maintenance, inventory listing, lead generation, lead tracking and management – and tying access to these bundled services to the purchase of cable television advertising, AT&T was breaking with an established tradition of offering each of these services separately and for a fee. The AT&T “for-free” model enjoyed

⁵⁶ Deposition of Derek George Casper, by telephone, Vol.1, June 27, 2002. In the Matter of: Prime Communications, Inc. v. AT&T Corporation and AT&T Broadband, Inc.

⁵⁷ Prime Communications, Inc. v. AT&T. Exhibit 101. Various screen shots lifted from the Vehix.com Web site quote a figure for advertising support during the year 2000 as totaling \$52 million, and state that the level of advertising support will increase to approximately \$70 million during the year 2001.

instantaneous success in the market against more well-known automobile portals such as Autotrader.com and Autobytel.com that employed the traditional “for-fee” business model.

After less than 2 years, Vehix.com had enlisted more than 650 automotive dealers representing 1,200 dealer franchises in 25 of AT&T’s cable markets.⁵⁸ AT&T had targeted 7 new cable markets in which to roll out the bundled and tied Vehix suite of services in 2001. Among those cable markets targeted for introduction of Vehix was the greater Boston market.⁵⁹

3.3 AT&T’s Presentation of Vehix as a “Toaster”

Various AT&T employees have described AT&T’s business rationale for giving the Vehix suite of services away for free to auto dealers that make annual cable television commitments to AT&T as akin to a bank giving away a toaster to entice new depositors.⁶⁰ Categorizing Vehix as a “promotion” is misleading for at least two reasons. First, a customer at a bank is free to terminate at will her business relationship with that bank with no consequences. Thus, if she chooses to do so, an account holder could close her account the same day without fear that the bank would repossess her new promotional toaster. Auto dealers, on the other hand, are locked into an annual contract with AT&T and cannot sever that relationship without losing the entire Vehix suite of services. Second, unlike new bank customers who only must open an account to receive the

⁵⁸ ATTB 260 “Vehix.com: Roadmap to the Automotive World” slide show. In 2000, these markets include Chicago, San Francisco, Dallas, Pittsburgh, Seattle, Denver, Portland, Salt Lake City, and Nashville.

⁵⁹ Op. Cit.

⁶⁰ See depositions of James Sullivan, Robin Robertson, David Kotfilla, and Jim Liedtke.

promotion, auto dealers must reconfirm their commitment to AT&T each year or risk losing the entire value of the Vehix suite of services.

Clearly, the use of Vehix as a promotion insufficiently explains its function. More accurately, and consistent with AT&T's own characterization, is that Vehix is bundled with annual local cable television advertising purchase contracts to both increase the overall sale of AT&T's local cable television advertising slots, and to increase the retention rate of auto dealers that advertise locally on cable television. AT&T Director of Sales for Vehix.com stated clearly that the business rationale for AT&T's "for-free" model was increased incremental revenue and higher retention.⁶¹ AT&T defines incremental revenue as additional cable advertising revenues from extant advertisers and new revenues from organizations with no prior advertising history.⁶² The retention rate is simply the percentage of extant advertisers that renew their advertising commitment with AT&T each year.⁶³

To understand how AT&T's "leveraging" package constitutes anticompetitive behavior, it is necessary to fully comprehend the relationship between the costs associated with the Vehix "promotion" incurred by AT&T and the benefits AT&T anticipates its "for free" business model will yield. On average, Vehix bills AT&T Media Services \$400 per month per auto dealer hosted on the Vehix.com Web site. These recurring monthly costs totaled approximately \$260,000 per month or \$3.1 million during the year 2000 alone. AT&T's cost calculus does not include the salaries of the staff dedicated to the sale and marketing of Vehix.com (full-time in the case of Derek Casper,

⁶¹ Deposition of Derek Casper. Pgs. 49-50.

⁶² Op. Cit.

and part-time for additional staff including David Kotfilla) nor the value of the advertising campaign promoting Vehix.com – some \$52 million worth entirely subsidized by AT&T during the year 2000. Also excluded from the ledger sheet is the total cost of purchasing 49 percent of Vehix, an amount which will presumably be recouped by AT&T in order to justify its initial investment and ongoing subsidization. By keeping these real costs off the books, AT&T grossly understates the true costs of its Vehix promotion.

Using the broader accounting standard, it could be conservatively estimated that AT&T committed nearly \$60 million worth of resources to a “promotional” effort during the calendar year 2000 alone. The level of support committed by AT&T could only be expected to have increased during 2001, as AT&T pledged to increase its Vehix.com advertising efforts by nearly \$20 million dollars (approximately \$3 million in each of the 7 new cable markets in which it rolled out Vehix.com and the Vehix suite of services) and in 2002 as it increased the number of full-time staff dedicated to this ongoing promotional effort.⁶⁴

Given this considerable and increasing commitment of resources, to break even, AT&T will need to increase cable advertising sales through increased rates of retention, increased purchase orders, and new contracts by an equal amount to break even.⁶⁵ And given the size of annual auto dealer advertising expenditures on local cable television – nearly \$750 million in 2000/2001 – AT&T would need to capture an additional 10

⁶³ Op. Cit.

⁶⁴ Op. Cit.

⁶⁵ Op. Cit. Pg. 34

percent of this submarket just to cover its costs.⁶⁶ Nevertheless, as will be discussed below, there are forceful reasons to believe that this is AT&T's objective. AT&T's "promotion" is to combine two separate mediums and market them for the price of one.⁶⁷

3.4 The Vehix Model: Vehix Priced Below Cost

Auto dealers are enticed by a "promotion" valued at as much as \$50,000 per year, not including the auto sales from leads generated by AT&T's "leveraging" package.⁶⁸ These costs are calculated based upon the traditional "for-fee" model employed by the vast majority of automobile portals on the Web, including Prime's Cablecars.com and Prime IQ products.⁶⁹

Prime offers a complete package – Web design, hosting, maintenance, design changes, domain name registration and registration with search engines, data base management, lead tracking and lead management – for an average of \$1,250 per month.⁷⁰ Despite the competitiveness of Prime's package, the likelihood of future growth or even survival given the introduction of AT&T's "for-free" combined "leveraging" package has been reduced. In short, the established competitive market for online automobile advertising services has been substantially disrupted and distorted by the introduction of

⁶⁶ Depositions of Derek Casper and Jim Liedtka

⁶⁷ Op. Cit. Pg. 71.

⁶⁸ Derek Casper explained that an "average dealership can spend anywhere from \$20,000 to \$50,000 per year ... to have an Internet presence." This included Web design, Web hosting, Web maintenance, data base tracking capabilities associated with lead generation and lead tracking, and other ancillary expenses. Op. Cit. Pgs. 70 – 72.

⁶⁹ Op. Cit. Pg. 72. For example, according to Derek Casper developing a Web page typically costs an auto dealer between \$5,000 and \$10,000 while hosting the Web site averages between \$200 and \$300 per month. Maintenance is an additional \$200 to \$300 each month while design changes, updates and upgrades, and registering a Web site with search engines can cost an auto dealer thousands of additional dollars. Data base management, both for inventory listings and lead tracking and lead management, are perhaps the greatest monthly expense. For instance, AutoBytel charges \$2,800 per month (or \$34,000 per annum) just to generate leads for an auto dealer, while AutoWeb charges \$25 per lead

an entrant offering a comparable product as a free promotion. While the stated objective of AT&T's rollout of the Vehix "leveraging" package is to increase the sale of cable television advertising, the effect will be to harm competition in the online automobile advertising market.

Given the existence of a competitive market for online advertising services for auto dealers – one that has placed a positive valuation on the ensemble of goods and services that collectively comprise this market – AT&T's decision to provide these services for free is not consistent with the expected behavior of a profit-maximizing firm in a competitive industry. Why, then, would AT&T absorb tens of millions of dollars in costs without earning a penny in the market for online automobile advertising?

The answer is that AT&T is seeking to strategically manipulate competition in the market for online advertising services for auto dealers in an effort to stymie the growth of a competitive threat thereby protecting and expanding its monopoly revenue stream in cable television advertising.

3.5 The Relationship Between Cable TV and Internet Automotive Advertising

People are spending more time online. In Europe, the amount of person hours spent online per month increased by 225% between 2000 and 2001.⁷¹ In the U.S., during 2001 narrowband users (*e.g.* dial-up modem) spent 1.1 billion person hours online per month (a decrease of 3% over the previous year) while broadband users (*e.g.* cable modem and DSL) averaged 1.2 billion person hours online per month – a 67% increase year over

⁷⁰ Interview with Kevin Lash, Vice President, Prime Communications, Inc. 9 July 2002.

⁷¹ http://uk.jupitermmx.com/xp/uk/press/releases/pr_032801a.xml "European's Time Spent Online Increases by 225%," JupiterMMXI, March 28, 2001.

last.⁷² This pattern is evident with respect to online automotive retailing as well. In addition, the IT consultancy IDC estimates that broadband subscribers will increase from 11 million in 2001 to nearly 45 million in 2005.⁷³

A recent study released by Gartner highlights the fact that the ratio of online vehicle shoppers turning into buyers has grown considerably in the past two years.⁷⁴ And while the absolute number of online car buyers remains relatively low (4.7% of all new vehicle purchases are made via the Internet, and 3.4% of all used vehicles are bought online), the conversion rate of online shoppers to online buyers is expected to continue to grow as consumers gain more experience with the Internet.⁷⁵ For instance, from March 2000 to May 2001, the conversion rate for online new car buyers grew to 9% -- a 30% increase in just one year. Similarly the conversion rate for online used vehicle buyers quadrupled during the same time frame, reaching 12%, up from only 3%.⁷⁶

⁷² SBC citing an AC Nielsen/NetRatings report.

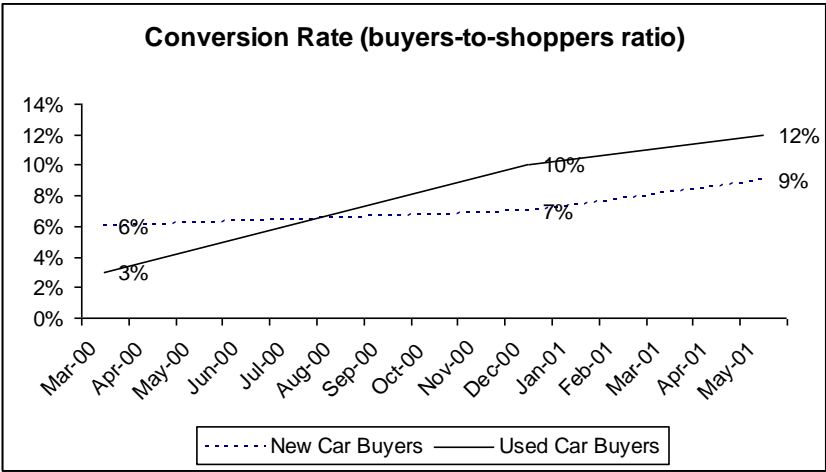
http://www.sbc.com/images/press_room/press_kit/DSL_Internet_Update_May_2002.pdf

⁷³ Op. Cit. SBC citing IDC.

⁷⁴ Koslowski, Thilo and Laura Behrens. "Online Automotive Retailing in the U.S.: Time for a Tune-Up." Stamford, CT. Gartner, Inc. February 2002.

⁷⁵ Op. Cit. Pg. 3. Online vehicle buyers are defined as consumers who decided to buy the vehicle they found on the Internet, or initiated the process of buying the car via the Internet.

⁷⁶ Op. Cit. Pg. 4. Conversion rate is defined as the percentage of online vehicle shoppers who became online buyers. That is, they decided to buy the vehicle they found on the Internet or to initiate the buying process for it online.



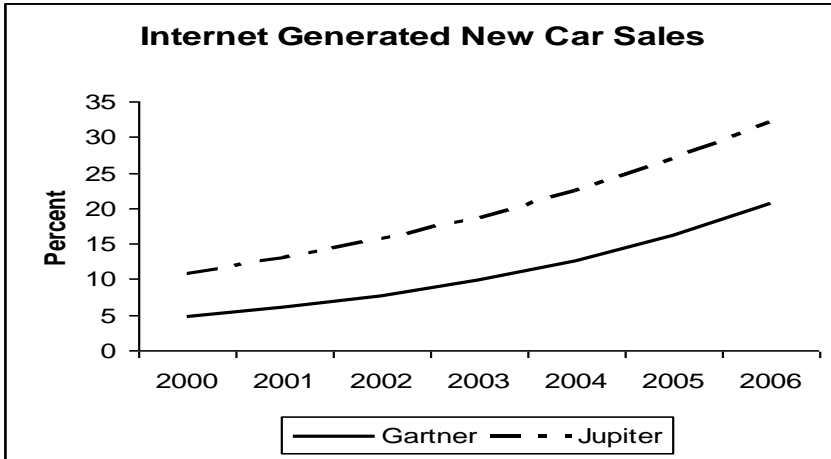
Source: GartnerG2, January 2002

Current online car buyers averaged 5 or more years Internet experience. Furthermore, half of all new car buyers use the Internet to help with their purchase decision. By 2003, the average Internet user will have 5 or more years experience with the Internet. These factors taken together Gartner believes could result in tremendous growth in online auto sales.⁷⁷ Other independent media analysis draws the same conclusion. A report issued by Jupiter Media Metrix indicated that 'Internet-generated' new car sales will jump from 13 percent of total new car sales this year to 32 percent in 2006.⁷⁸ The survey found only 4 percent of used car sales in 2001 are Internet-generated and Jupiter projects this will rise to 12 percent five years from now.⁷⁹

⁷⁷ Op. Cit. Pg. 1

⁷⁸ www.technews.com "A Third of New Cars Bought Online In Five Years," 11 December 2001. Based on a Jupiter survey of nearly 2,200 adults in the U.S. who had purchased or were likely to purchase an auto. 'Internet-generated' sales include consumers who find a dealership with the automobile they want online and make the purchase offline, as well as Web-based referrals to dealers, Jupiter Media Metrix said.

⁷⁹ Op. Cit.



Source: GartnerG2 and Jupiter Media Metrix⁸⁰

While there exists some disagreement about the total number of new car sales in the U.S. that can be directly attributable to Web-based auto retailing portals, both sources agree that online automobile retailing will become more important over time. Even if the absolute volume of cars sold as a result of the Internet is half of the most conservative estimate predicted in the graph above, it still means that 10% of all new cars sold in the U.S. during 2006 will be Internet-generated sales.

For auto dealers trying to reach potential customers, this represents a significant segment of prospective buyers. To reach this group of car buyers, auto dealers are likely

to invest more resources over time. If, however, dealers are receiving the full boat of online auto advertising services for free – as is the case with the Vehix suite of services – then the absolute value of the Internet advertising component in their media mix increases. As a result, auto dealers that have contractual obligations with AT&T would be less likely to exit from that relationship. Indeed, such dealers under contract would be both more likely to renew such contracts, even at levels above their initial commitment. The incentive to renew cable advertising contracts would be even greater if Vehix were the only significant online automotive portal in 2006, as will be discussed in detail below.

3.6 Comparing Online Auto Portals and Local Cable TV Advertising

Auto portals are growing in popularity and utility. According to a study from J.D. Powers & Associates, during 2001 62% of all new car buyers in the U.S. researched their purchase online, up from 54% the year before.⁸¹ A more recent study released by Vividence indicates growth in the use of automobile portals for both shopping and buying.⁸² The Vividence study reveals that 72 percent of car buyers use automaker sites to research vehicle specifications, performance, features, and options. Around 69 percent use the sites to view photos, videos and 360-degree views of vehicles, while 64 percent use them to customize vehicles.⁸³

⁸⁰ Figures for new cars sales attributable to the Internet for Gartner extrapolated from “Online Automotive Retailing in the U.S.: Time for a Tune-Up,” GartnerG2. February 2002. Calculation assumes 28 percent compound annual growth rate experienced between 2000 and 2001 will continue through 2006. Data for Jupiter Media Metrix taken from 11 December 2001 article in Technews.com “A Third of New Cars Bought Online in Five Years.” Author assumes a constant compound annual growth rate of 20 percent given bounds of 13% new car sales Internet-generated in 2002 and projected 32% new car sales in the U.S. attributable to the Internet by 2006.

⁸¹ Survey conducted by J.D. Power & Associates. Results released November, 2001. For more details, see article titled “Most Car Buyers Research Purchase Online.”

⁸² “Positive Experience Increases Online Car Sales,” Vividence, 10 April 2002.

⁸³ Op. Cit.

The Gartner study explained that the Internet's past popularity among car buyers was largely attributable to the desire to make an educated purchase decision and to be better prepared for negotiations with the dealer. Like buying a house or selecting a college, buying a car represents a "high-involvement" purchase (e.g. people get as much information as possible before making a decision), while buying laundry detergent or any other consumer packaged good is typically a "low-involvement" purchase. The ability of an online automobile portal to provide consumers with virtually endless data about every new and used car on the market, as well as provide images, video, and audio pre-sales features, makes online automobile advertising a potentially powerful resource for a "high-involvement" transaction.

In addition to the rich information sources available to online auto shoppers – consumer reports, price points, inventory, comparative analysis with other cars, streaming video with interior and exterior views – automobile portals also offer consumers services to ease the sales process, including assistance securing financing and insurance. Future growth of this advertising and sales medium will be contingent upon the ability of these portals to offer post-sale services, including the scheduling of maintenance visits and the pre-ordering of parts for convenience and expediency. Given the abundance of information and services currently available to vehicle shoppers visiting auto portals, their widespread appeal and growing use among consumers is not difficult to understand.

It is also not difficult to understand that AT&T would see the emergence of product specific portals – particularly those sectors that account for large shares of their advertising revenue – as potential competitive threats to their cable advertising revenue stream. If the Gartner and Jupiter figures are to be believed, and they seem somewhat

conservative given Autobyte's claim that they alone accounted for 4 percent of all new car sales in the U.S. during 2001, then online advertising plausibly spurred as much as \$21 billion worth of new car sales during 2001. Given that consumers are spending more time online, that the average Internet user will have at least 5 years of online experience by the end of 2003, the rapid growth in conversion rates from online auto shopper to online auto buyer, the continued growth in the overall number of Internet users, it is not inconceivable that online advertising could be directly responsible for 10% to 11% of all new car sales in the U.S. by 2005.⁸⁴

⁸⁴ Gartner. Calculation of growth in online vehicle buyers based upon extrapolation from data presented in GartnerG2 report (February 2002) and Jupiter Media Metrix study (December 2001). To err on the side of caution, this report takes the average of the two projections for that year (21.5%) and halves it (10.75%).

Table : Comparative Advantages of the Auto Portals v. Cable TV

(✓✓ indicates a comparative advantage)

Feature	Auto Portals	Cable TV
Reach	70% - 80% US	70% - 80% US
Ability to Target	Moderate (Pull Technology) High (in tandem with offline)	High (Push Technology)
Access Fee	\$9 - \$25 per month ✓✓	\$25 - \$100 per month
Data Capacity	High ✓✓	Limited
Video Capacity	High ✓✓	Limited
Interactivity	High ✓✓	None
Pre-Sale Features	Price, Research, Consumer Reports, Comparative Analysis, Inventory, Dealer Locator, Interior/Exterior images, Web video, Digital Brochures, Virtual Test Drive, etc. ✓✓	Basic Information
Sale Features	Auto Locator, Inventory, Dealer Locator, Order initiation service, auto insurance assistance, auto loan assistance, vehicle history, etc. ✓✓	None
Post-Sale Features	Advanced CRM, tune-up scheduling, pre-order parts, trouble-shooting ✓✓	None
Marginal Cost	Near zero ✓✓	Varied/Moderate
Measurability	High ✓✓	Moderate

Source: The Information Policy Institute, 2002.

When one considers the comparative advantages of the auto portals over cable television advertising, together with the dynamics associated with online automobile retailing discussed above, there is good reason for AT&T and any cable television advertiser to feel threatened by the Internet. This is perhaps why so many cable MSOs have rapidly embraced the Vehix “leveraging” package. The two advertising media that in the past have been characterized for their high degree of complementarity (cable television advertisements drive traffic to a Web site, while the Web builds brand and enhances image) are increasingly substitutable for one another across a range of functions.⁸⁵

Recent examples from the automobile industry highlight the increasing success of online as a marketing and sales tool. In 2000, Toyota launched a 3 month advertising campaign that promoted its new sports utility vehicle – the Tundra – by encouraging consumers to play a free online road race game. The virtual contest, located on MSN’s Gaming Zone, seated consumers in a Tundra and had them compete against one another for the chance to win a free Tundra. Brand awareness and the intent to purchase a Toyota Tundra among the target audience increased significantly. The 2.5 million visitors to the Gaming Zone, and the media coverage of the contest, resulted in record sales for Toyota. In fact, the Tundra recorded the fastest sales start of any new product in Toyota history.⁸⁶ Volvo enjoyed similar results with its online campaign, as its Web traffic increased as did

⁸⁵ For a discussion of the complimentary nature of online advertising and cable television advertising, see “Online Publishers Association Media Mix Study.” Conducted by the Online Publishing Association and Millward Brown IntelliQuest. March 2002. The relationship between cable television and the Internet will exhibit increasing tensions as people continue to spend more of their time online. Already, U.S. households that subscribe to cable are 16% more likely to use the Internet more than once a day than the U.S. household average. MRI Doublebase 1999, as it appears in the “2000 Cable TV Facts.”

⁸⁶ Taken from Microsoft’s MSN homepage.
http://advantage.msn.com/docs/case%20studies/toyota_page1.html.

requests for additional information. Volvo was even able to create an electronic mailing (e-mail) list from its digital brochure campaign, allowing it to follow up with interested consumers and “close the loop in the marketing process.”⁸⁷

3.7 Online Auto Advertising and Network Externalities: Tipping the Market

A network externality exists, in its simplest form, when the value of the network increases with each additional participant. The textbook example of such a network industry is the public switched telephone network (PSTN), whereby the value of the network to any given subscriber increases (however marginally) with each new subscriber to the PSTN.⁸⁸ Network industries often times confer significant “first mover advantages” upon the original producer or supplier, and which typically possess properties of path-dependency and “lock-in”.⁸⁹

The online automobile retailing market possesses properties characteristic of a network industry. Specifically, the value of an auto portal to a consumer increases in tandem with increases in the number of area auto dealers (and inventory) listed on a given portal. Further, from the perspective of an auto dealer, the value of an auto portal increases with growth in the number of shoppers and buyers visiting a particular portal.

⁸⁷ Taken from Microsoft’s homepage.

http://advantage.msn.com/docs/case%20studies/volvo/volvo_page1.html.

⁸⁸ For an excellent discussion of network externalities and network industries, see: David, Paul A. *Technical Choice, Innovation, and Economic Growth: Essays on American and British Experience in the Nineteenth Century*. London, Cambridge University Press, 1975. David, Paul A. "Clio and the Economics of QWERTY," *American Economic Review*, Vol. 75 (1985), Pgs. 332-337. David, Paul A. "Heroes, Herds and Hysteresis in Technological History: Thomas Edison and 'The Battle of the Systems' Reconsidered," *Industrial and Corporate Change*, Oxford University Press. Vol. 1, No. 1, 1992. Pg. 138. Arthur, W. Brian. "Competing Technologies, Increasing Returns, and Lock-In by Historical Events," *The Economic Journal*, 99 (March 1989), Pgs. 116-131.

There is also evidence to support the notion that early movers in this market enjoyed “first mover advantages,” as online auto retailing pioneers such as Autobytel and Autotrader are substantially larger than subsequent entrants in terms of dealer relationships and earnings. For instance, during its first 5 years Autobytel established 8,900 dealer relationships through its various auto portals (including Autobytel.com, AutoWeb.com, and CarSmart.com among others) while Autotrader has developed the largest dealer dealer directory (1.5 million used vehicles) on the Internet during the same period.⁹⁰ In the wake of the dotcom implosion, this market has experienced pronounced consolidation (*e.g.* DriveOff.com was acquired by CarPoint.com), as many firms were either absorbed or were forced out of the market (*e.g.* BestOffer.com). For instance, Autobytel acquired 15 separate auto portals during 2001, including AutoWeb and CarSmart.

Despite the impressive growth in this nascent market, it can only be characterized as fragile. For instance, while Autobytel’s revenues increased from \$15 million in 1997 to \$71 million in 2001, their operating expenses last year were 170% of its total revenue.⁹¹ Despite impressive revenue growth in earnings and dealer relationships, all significant players in the online automobile retailing market are operating at a loss.

⁸⁹ See Paul David, *Technical Choice, Innovation, and Economic Growth: Essays on American and British Experience in the Nineteenth Century*. London, Cambridge University Press, 1975; and Alan Stone. *Public Service Liberalism: Telecommunications and Transition in Public Policy*. Princeton, Princeton University Press, 1991.

⁹⁰ www.autotrader.com Autotrader’s Web site claims relationships with 40,000 dealer franchises. This seems somewhat exaggerated, as the U.S. Census Bureau places the total number of used car dealers in the U.S. at approximately 25,000. Used car dealers, NAICS 441120, 1997 data.

⁹¹ Autobytel. Annual Report 2001. Autobytel’s 10k is available at www.autobytel.com

To compensate for the shortcoming in revenues, most online auto retailers have implemented draconian cost-cutting measures. One of the expenditures most affected by cost-cutting is advertising. For example, the largest such retailer, Autobytel, did not spend any resources on advertising during 2001, but rather relied on co-branding through its network of affiliates and alliances.⁹² These dealers spent enormous amounts of capital on advertising initially to build inventory on their portals and build brand recognition. For instance, Autobytel spent over \$14 million during 1999 and over \$20 million in 2000 on advertising. The advertising faucet may have been turned off with the understanding that the portal's brand was secure. This strategy is consistent with one that is sensitive to first mover advantages.

The online automotive retailing industry also exhibits characteristics that indicate that once a portal has gained a first mover advantage, its position is locked-in. New research from Forrester and comScore indicates that visitors to car sites behave differently from visitors to other eCommerce sites.⁹³ According to these studies, even serious car buyers, for example, tend not to visit car sites repeatedly. Sixty-four percent of all buyers complete their online research in five sessions or fewer. A quarter buy a car within three months of visiting a car site. Further, according to a recent study from Gartner, nearly 75% of online new vehicle buyers concentrate their spending on a few Web sites they trust and with which they have become comfortable.⁹⁴ Only 10% of the respondents to the Gartner survey indicated that they would buy from a variety of sites.⁹⁵

⁹² Op. Cit.

⁹³ Newsfactor Network. "Car buyers use Web differently." 22 February 2002.

⁹⁴ GartnerG2. "Online Automotive Retailing in the U.S.: Time for a Tune-Up." February 2002.

⁹⁵ Op. Cit.

Consider all of these dynamics together:

1. Three quarters of all new car purchasers were influenced by auto portals;
2. 6% of all new car purchases and 4% of all used car purchases in the U.S. were Internet generated during 2001;
3. Online car shoppers are being converted to buyers at a double digit rate;
4. As much as one-third of all new car purchases may be Internet generated by 2006;
5. Online auto portals are a network industry – more dealer inventory increases the value to consumers, while more consumer traffic increases the value to auto dealers;
6. The market, while growing, is fragile as most major players in this space are operating at a loss;
7. Because of the potential first mover advantages and lock in phenomenon, the remaining auto portals have dispensed with advertising expenditures to cut costs.

This is the market into which AT&T has forcefully moved. In this currently competitive market, no existing auto portal can match AT&T, let alone a merged AT&T/Comcast, in terms of advertising. As mentioned earlier, AT&T subsidized its jointly-owned affiliate Vehix to the tune of \$70 million in cable television advertising last year. At a minimum, AT&T's massive advertising cross-subsidy plus its "for-free" pricing model will distort competition in the online automobile retailing market. There is good reason to believe that the Vehix "cable/Internet leveraging package" will "tip" the market, thereby allowing AT&T to dominate the fragile online auto retailing industry.

3.8 The Real Business Rationale for the Vehix Leveraging Package

The bundling of distinct Internet advertising services, and the provision of this ensemble of services "for free" to those auto dealers that purchase a specified minimum

amount of cable television advertising is expressly anti-competitive. AT&T has stated that it intends to limit Vehix-related costs to approximately 10% of the incremental gains it attributes to ad sales generated by the Vehix “promotion.”⁹⁶ Using its true costs, for AT&T to maintain this cost/benefit ratio, it would have to generate nearly \$800 million in incremental gains in local cable ad sales to auto dealers. Even if one uses a more generous accounting standard – AT&T only includes the \$400 monthly fee it must pay Vehix for each auto dealer listed on the portal – it is still necessary to generate at least \$40 million in incremental gains in local cable ad sales to auto dealers. Given the overall estimated size of the local cable TV auto advertising market – approximately \$1.07 billion in 2001 – this would be a tall order even for a combined AT&T/Comcast.⁹⁷

Because AT&T is unlikely to recoup the costs it has incurred associated with its Vehix – AT&T would have to capture between 4% and 80% of the national total for local cable advertising expenditures for auto dealers depending on which accounting standard obtains – their decision to offer the Vehix suite of services below cost is economically irrational as a “promotion” alone. If, however, AT&T’s intent is to recoup all Vehix-

⁹⁶ Derek Casper stated that AT&T’s policy was to keep costs associated with the Vehix promotion at approximately 10% of the incremental gains derived from the Vehix package. AT&T attributes all increases in cable advertising from existing auto dealers, and all new advertising after the introduction of Vehix, to the Vehix promotion. On the cost side of the ledger, AT&T only includes the monthly Web hosting fee it is assessed by its affiliate company Vehix. In this fashion, it excludes staff salaries, benefits, overhead, administrative costs, and the enormous multi-million dollar advertising subsidy.

⁹⁷ The estimate for the size of the local cable television advertising market was derived as follows: The U.S. Census Bureau lists approximately 26,000 new car dealers and 25,000 used car dealers as of 1997 in the United States. Using these figures, it is assumed that each new car dealer spends \$30,000 per month on advertising on all media. It is further assumed that spending on advertising among used car dealers is considerably more varied. To capture the range of spending patterns by used car dealers, 50% are assumed to spend an average of \$2,000 per month on advertising, 35% are assumed to spend \$6,000 per month on advertising, while the remaining 15% are assumed to spend \$10,000 per month on advertising. Finally, it is assumed that local cable television advertising accounts for 10% of all advertising expenditures by both new and used car dealers. This yields a total of \$138,000,000 annual local cable advertising spending by used car dealers and \$936,000,000 annual local cable television advertising spending by new car dealers, for a total of approximately \$1.07 per annum local cable advertising spending by new and used car dealers.

related costs by distorting competition in a related advertising market, and then forcing auto dealers interested in advertising in that medium to buy substantial amounts of local cable television advertising avails, then its decision to invest in Vehix and subsidize it with a free multi-million dollar advertising campaign becomes more rational.

Further, as the importance of online advertising to auto dealers increases, and this is likely to be the case if studies from industry-watchers such as Gartner, Forrester, and Jupiter are at all credible, then AT&T's incentive and ability to recoup its Vehix costs by either increasing the required amount of cable advertising purchases necessary to qualify for the Vehix "leveraging" package, or by spinning Vehix off and charging a substantial fee (particularly if its efforts to tip the fledgling online auto retailing market are successful) substantially increase as well.

In this scenario, there would also be very little recourse for auto dealers that want access to Vehix but simultaneously wish to buy cable below the requisite minimum established by AT&T. Even those auto dealers that initially qualified for Vehix by purchasing the required amount of cable television avails, but that subsequently wish to reduce or eliminate cable advertising purchases will be denied the ability to advertise on Vehix and will be forced to absorb related switching costs. Similarly, auto dealers that wish to be listed on Vehix – largely due to the barrage of Vehix ads continually running on the cable system in their dealership's geographic market – and that would be willing to pay a fee for it separately but do not want to purchase cable television avails are also left with a suboptimal choice set – namely, advertise on cable or list your inventory on a portal with no local advertising support. The impact of Vehix on auto dealer incentives with respect to allocating advertising dollars is depicted below.

**IMPACT OF AT&T'S VEHIX "PROMOTION" ON AUTO DEALER'S
INCENTIVE MATRIX**

	Purchase	Renew	Terminate
Above AT&T's specified minimum	Vehix	Vehix	← No Vehix
Below AT&T's specified minimum	No Vehix ↑	No Vehix ↑	↖ No Vehix

Auto dealers, if they are economically rational, profit-maximizing actors will respond to this incentive structure in the following fashion. Those dealers already advertising at or above AT&T's required minimum level making them eligible for the Vehix promotion have taken advantage of it. After all, it is a valuable service to an individual auto dealer (worth as much as \$50,000 in services alone) and it is supported by a multi-million dollar advertising campaign. Such dealers, to the extent that they continue to value the combined Cable/Internet "leveraging package" at least as much as they previously valued cable advertising alone are unlikely to alter their commitment to cable.

Auto dealers that spent less than the required minimum, but that value the Vehix "promotion" at a level greater than the difference between their current cable television advertising expenditures and AT&T's required minimum will increase their cable television expenditures to an amount that at least equals if not exceeds the threshold for Vehix eligibility. Assuming such a dealer values online advertising services at \$30,000 a year, but is currently purchasing only \$8,000 worth of cable advertising from AT&T each month. In this case, the auto dealer would be willing to increase its cable advertising

expenditures to a level above the \$10,000 per month required by AT&T to qualify for the Vehix Cable/Internet “leveraging package.”⁹⁸ Finally, many auto dealers spending above and below the specified minimum that were considering terminating cable altogether are likely to be deterred from doing so if the value they place on the Vehix suite of services – valued by AT&T at between \$30,000 and \$50,000 per annum – is greater than the reduction in the value that they’ve placed on renewing cable television alone.⁹⁹

In short, AT&T has radically altered the incentive matrix for auto dealers considering whether to allocate advertising dollars to cable television and how much to allocate. By bundling together an ensemble of distinct online advertising services that had been sold separately in a competitive market, and pricing them well below cost (free is less than the \$400 AT&T pays Vehix each month to list a dealer, and is considerably less than the AT&T estimated value of \$30,000 to \$50,000 per annum) and supporting the “promotion” with \$70 million in annual local cable television advertising. Not only will this have the effect of distorting competition in the highly competitive yet fragile online automobile retailing market, it also produces inefficiencies in cable television advertising as auto dealers invariably purchase more cable than they otherwise would have had the Vehix “promotion” not been tied to the purchase of local cable avails.

⁹⁸ In this hypothetical situation, the auto dealer values the bundled online advertising services that together comprise the Vehix promotion at \$30,000 per year, or at \$2,500 per month. Given this, it would be rational for the auto dealer to increase the amount of cable television it purchases each month to a level above \$10,000 and below \$10,500, assuming no transactions costs such as the cost of switching from an existing online advertiser to Vehix.

⁹⁹ In this hypothetical case, an auto advertiser that had been spending \$120,000 per annum on cable advertising with AT&T (the target required minimum) reduced the value placed on cable expenditures by 20 percent due to shortfalls in projected customer inquiries, showroom traffic and car sales. This dealer, however, values Vehix at \$30,000 per annum, which exceeds the decrease in value it places on cable advertising (\$24,000). An economically rational auto dealer would renew the contract at the same level, or even slightly higher, to capture the consumer surplus – the difference between what it costs to get the combined Cable/Internet leveraging package and the value the dealer assigns to the combined package, which in this case is \$6,000.

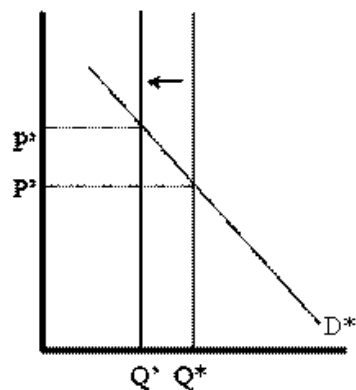
The structure of AT&T's Vehix "promotion" is anticompetitive to the extent that it artificially inflates local cable television advertising rates for both auto dealers and all advertisers. Through the Vehix "promotion," AT&T reduces the supply of local cable television advertising avails by 18,000 a year, or 1,500 per month.¹⁰⁰ This represents 2% of the total 30 second avails, or 4% of the total 60 second avails on an average cable system.¹⁰¹ The price impact of the reduction in supply of total local cable avails is compounded by the artificial increase in demand for local avails by auto dealers stimulated by the tying of the Vehix suite of services to the annual purchase of cable local television avails discussed above. These two separate dynamics are illustrated graphically below.

At equilibrium, the prevailing price for the fixed stock of local avails is set at P^* . AT&T's Vehix promotion (a minimum of 1,500 commercials in each of its cable systems per month) reduces the stock of 30 and 60 second local avails by 3%, which is represented by the leftward shift in the supply curve. This supply reduction will have the effect of raising the market price from P^* to P^1 .

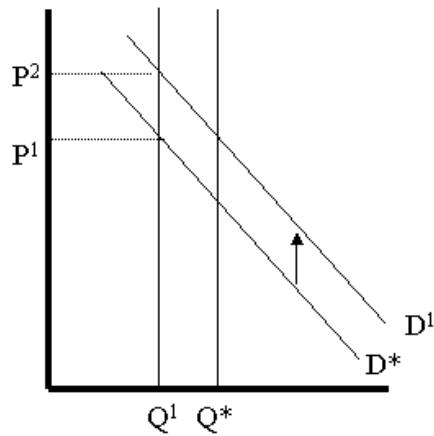
¹⁰⁰ <http://toolbox.vehix.com/>

¹⁰¹ There are 2 minutes of total advertising time per hour dedicated to local advertising for most Tier 2 and Tier 3 stations in the greater Boston market. Some Tier 2 stations, and all 11 Tier 1 stations have only 1 minute per hour of local advertising time. If we assume all 35 advertising supported cable networks included in basic cable in the relevant geographic market run 24 hours per day, 7 days per week (a generous assumption as some of these channels run national infomercials), and we assume there are 15 stations that offer only 1 minute of local cable per hour and 20 stations offer 2 minutes per hour, this translates to 21,600 30 second slots per month among the 15 Tier 1 and Tier 2 stations offering 1 minute per hour and 57,600 30 second local advertising avails per month among the 20 Tier 2 and Tier 3 advertising supported stations in the same market. As such, AT&T's commitment to Vehix to run at least 1,500 commercials per month in each of its cable systems amounts to a 2% reduction in the supply of 30 second cable avails or a 4% reduction in the total 60 second cable avails offered to all local advertisers. Assuming an equal distribution among the 30 and 60 second avails, this represents a 3% reduction in the supply of local cable advertising avails on the market for any advertiser.

In this situation, the cable company behaves as though the total supply of advertising slots on its channels is fixed. (This is not classic monopolist behavior, but the deviation may be accounted for by the fact that the cable company is a regulated monopolist.) The diversion of some portion of the advertising slots to the auto portal affiliate reduces the supply available for other purchasers from Q^* to Q^1 . The demand



curve is initially unchanged because the auto portal affiliate – Vehix - did not previously buy \$70 million worth of cable advertising. The reduction in supply to the existing cable advertisers initially increases the equilibrium price from P^* to P^1 . Although the cable company has not apparently changed its rate card in the recent past, this price increase could be brought about by reducing the average rate card discounts received by cable advertisers.



The Vehix promotion – promoted by AT&T as “100% value added for free” – alters the equation for auto dealers considering whether to purchase cable and at what level, as well as for auto dealers deliberating on whether to renew or terminate their existing contract and at what level. Instead of making a decision based purely on the assessment of the value of cable television advertising alone, auto dealers now must weigh how much they value the bundled ensemble of Internet advertising products and services that comprise the Vehix “cable/Internet leveraging package.” Given the high value of this package -- \$30,000 to \$50,000 by AT&T’s own calculation – many auto dealers will purchase more local cable avails than they otherwise would have absent the bundling and tying activities of their local cable monopolist. This artificial increase in demand, stimulated exclusively by the bundling and tying activities of AT&T, is depicted by the upward and rightward shift in the demand curve from d^* to d^1 . This change in demand has the subsequent effect of further increasing the market price for local cable advertising slots from P^1 to P^2 .

The key point here is not that AT&T is raising rates for all local cable advertisers. As this is an unregulated activity, AT&T is free to raise advertising rates as it see fit – directly or indirectly. Rather, it is that all local cable advertisers -- particularly smaller advertisers that don't typically enjoy the volume discounts, bonus spots and other perks associated with larger contracts (and pay rents in the absence of competition at the sizes of advertising they buy) – are cross-subsidizing AT&T's Vehix "promotion" in the form of higher advertising rates. Whether or not these "incremental" gains from the Vehix "promotion" offset AT&T's investment in Vehix is immaterial to the cable monopoly.

AT&T will not recoup their investment in Vehix through marginally higher ad rates in the short run. To truly recover the true costs of their investment, AT&T must either exact monopoly rents from auto dealers for the Vehix suite of services once the online automobile industry has been "tipped," or must continue with the same "promotion" that will have transformed from a reverse tie (mandating the purchase of a monopoly good for access to a competitively offered good) to an actual tie (mandating the purchase of one monopoly good – in this case cable television avails – for access to another monopoly good – in this case Vehix, the dominant player in a "tipped" online automobile retailing market). AT&T, reacting to a potential competitive threat to its monopoly advertising revenue stream, would be willing to absorb enormous short run costs in order to stymie this threat. This is precisely what they will accomplish by bundling distinct online advertising products and services with the purchase of local cable television avails, and subsidizing their "Cable/Internet leveraging package" with massive amounts of free cable television advertising.

3.9 Impact of Vehix “Cable TV/Internet Leveraging Package”: Harm to Competition, Harm to Advertisers, Harm to Consumers

As was detailed above, AT&T’s actions will at a minimum disrupt and distort the currently competitive yet fragile online automobile retailing market. AT&T’s incentive for entering this market is to stymie the growth of an advertising medium that not only possesses – in some form – all of the properties of cable television advertising (video, text, audio, geographic and demographic targeting) but also possesses numerous additional attributes making online advertising a potential substitute for local cable television advertising for automobile retailing. AT&T has acted in a way so as to link these two separate advertising media into a single package, thereby protecting and preserving its cable television monopoly revenue stream.

By bundling together distinct online advertising products and services – upon all of which the market has bestowed a positive valuation in the form of a price advertisers are willing to pay – and offering it at a price well below actual cost to all auto dealers that purchase a pre-specified level of local cable television advertising, AT&T has put its online advertising affiliate Vehix in a position to rapidly dominate the maturing online automobile retailing market. The online automotive retailing industry, characterized by properties of a network industry, is ripe for “tipping” as all significant players in that space are operating at a loss and are incapable of matching AT&T in terms of price (free) and in terms of advertising (AT&T subsidizes Vehix with \$70 million worth of free local cable television advertising per annum). Firms offering online automobile advertising services on competitive terms, including Prime, are at a distinct disadvantage because they do not own, nor can they build their own cable television system that would enable

them to compete with AT&T in terms of advertising or in terms of offer two advertising media for the price of one.

In addition to harming competition in the online automobile retailing industry, AT&T's bundled and tied Vehix "Cable TV/Internet leveraging package" will necessarily harm both automobile dealers and all firms that advertise on local cable television in AT&T's cable system. Auto dealers are harmed in two ways. First, some are compelled to buy more local cable advertising than they would in the absence of the Vehix promotion. Given relatively fixed advertising budgets, auto dealers may not invest in the appropriate media mix due to the sizeable commitment they must make to cable television in order to qualify for the Vehix "promotion." This allocative inefficiency may result in less showroom traffic and lower overall car sales. Second, should AT&T succeed in tipping the market in Vehix's favor, they will lose the ability to select from among a group of competitive Internet advertising service providers to customize an optimal advertising package that best meets their own criteria for functionality, price and quality of service. Finally, the use of AT&T advertising inventory for Vehix commercials artificially inflates cost of cable TV avails to all advertisers on AT&T (and a merged AT&T/Comcast) as supply is diminished.

Most importantly, AT&T's anticompetitive conduct with respect to the fledgling online automobile retailing market will harm consumers. Specifically, the growing number of consumers who are both shopping for cars online, and buying cars online, will be denied the efficiencies and cost savings yielded by a currently competitive market. Recently, the National Bureau of Economic Research (NBER) investigated the effect of

Internet car referral services on dealer pricing of automobiles in California.¹⁰² The NBER study found that customers of an online service pay on average 2% less for their car (\$450 for the average car). 25% of the savings come from purchasing at low-price dealerships affiliated with the online service. The remaining 75% stem from information provision by the online service, bargaining by the service on behalf of consumers, and cost efficiencies.¹⁰³ A consumer receiving the mean online price does better than 65% of offline consumers, conditional on the car being purchased.¹⁰⁴

This is the promise held out by Web-based advertising. Because online automobile advertising has all the formerly unique attributes of cable television advertising – video, audio, the ability to target demographically and geographically – and because it can be conducted so inexpensively, over time, auto dealers should be able to rely more heavily on the less expensive Internet advertising medium. Savings from reduced advertising budgets, in turn, could be passed on to consumers. AT&T, however, by tying Vehix to the purchase of significant annual amounts of local cable television advertisers, maintains its monopoly revenue stream and eliminates any potential for passing reduced ad expenditure savings along to auto buyers.

¹⁰² Fiona Scott Morton, Florian Zettelmeyer and Jorge Silva-Risso “Internet Car Retailing,” National Bureau of Economic Research, NBER Working Paper No. w7961, Vol. 49 (4), October 2000. Pgs. 501-519.

¹⁰³ Op. Cit.

¹⁰⁴ Op. Cit.

4.0 Strategic Behavior

The behavior exhibited by AT&T toward Prime can be divided into two strategic phases: (i) a set of strategic incentives to compel Prime to modify its cable television ad buying strategy; and (ii) the decision to terminate Prime's status as a reseller of cable ad avails to its clients. Both reflect AT&T's frustration with Prime's failure to modify its ad buying strategy to match AT&T's imperatives, sentiments documented at length in the depositions of Jim Sullivan and Robin Robertson.

Quantitatively, AT&T sought to substantially increase Prime's sales of cable advertising relative to other advertising media. Qualitatively, AT&T sought a fundamental change in the counsel Prime provides to its clients regarding cable, from a buying strategy emphasizing primetime fixed assets to one emphasizing frequency and distribution of ad placements to so-called second and third-tier networks. By contrast, Prime viewed itself as an honest broker of advertising,¹⁰⁵ and only saw fit to recommend to their clients allocations of advertising dollars that would produce the greatest return on investment for their clients.

Unable to compel Prime via numerous financial incentives to adopt AT&T's preferred ad purchasing methodology, AT&T took advantage of their privileged place in the marketplace. This phase of behavior was inaugurated by a refusal to sell cable advertising to Prime, coupled with the targeting of Prime's clients through the use of privileged data. While AT&T's behavior appears manifestly predatory on its face, AT&T's stated contention is that the deployment of Prime IQ, a web-based lead tracking

and regeneration tool, alters the fundamental nature of Prime's business.¹⁰⁶ AT&T contends that this substantive change in Prime's business nature renders Prime a competitor, therefore legitimating AT&T's denial of access to an "essential facility" to Prime.

The evidence suggests this reasoning is pretextual. Prime IQ only enhances Prime's ability to engage in a core value-added service that, by definition, a multimedia advertising agency provides to its clients: allocating advertising dollars as effectively as possible among a variety of media. By contrast, AT&T's core business depends on the sale of cable television advertising slots.

4.1 Coercion

It is a basic tenet of price theory (and common sense) that businessmen generally seek to maximize returns. As such, one can surmise that Prime's allocations of advertiser dollars among different media are premised on a desire to retain and acquire advertisers as customers. Likewise, advertisers, who are presumed to behave rationally as well, generally seek to contract with an advertising agency which offers them the most efficient return on their advertising dollars, measured by Prime's clients in showroom traffic and car sales.

It is in this light that one must evaluate Prime's behavior. During a December 1999 meeting between AT&T Media Services and Prime, AT&T Media Services via Jim Sullivan expressed dismay with both the quantitative and qualitative character of Prime's

¹⁰⁵ Letter from Neal Bocian James Sullivan in response to the confirmation of intent to compete letter from James Sullivan to Neal Bocian dated April 13, 2001.

cable ad buying practices. At this meeting, Sullivan offered to Prime a number of incentives aimed at modifying both the frequency and placement of Prime's cable placements, asserting that Prime's preference for what AT&T characterized as a "short flights, limited audience" strategy was not in the best interest of Prime's clients.¹⁰⁷ In fact, their rationale was less altruistic. As testimony by James Sullivan makes plain, the meeting was intended to compel Prime to increase their level of spending of cable advertising, and by extension, AT&T's Cable advertising revenues.¹⁰⁸

The incentives offered to Prime at the December 1999 meeting included a 30% bulk discount on cable television ad purchases, double the "usual and customary" industry agency discount of 15%. Prime was also offered the 15% agency discount on the net on top of the bulk discount. Moreover, Prime would be entitled to a quarterly 20% discount net of the agency discount (which was to be paid in 15-second spots and purchases of ads in New England Auto Dealers monthly, a publication of Prime Communications).¹⁰⁹ AT&T also contended that Prime's media profile was partly a function of their lack of "stewardship" software, which permits the automated purchase of cable avails from AT&T. In response, Sullivan offered Prime "Ad Blocks", AT&T's

¹⁰⁶ Letter from James Sullivan to Neal Bocian re: Confirmation of intent to compete dated April 13, 2001. See also Deposition transcript of James Sullivan, vol. 2.

¹⁰⁷ Deposition of James Sullivan, vol. 2, p. 140.

¹⁰⁸ Deposition of James Sullivan, vol. 1, p.115 – 116.

Q: What do you recall about that [December 1999 meeting with Prime]?

A: We expressed our disappointment that Prime wasn't recommending our products and services to their advertisers. I think we had just finished up a year at about \$190,000 of total media spending by Prime accounts, which was probably an all-time low.

Q: Was there more discussion about the cable TV advertising levels?

A: There was. There was significant discussion about that. That was why we were there.

(While the deposition quotes a figure of \$19,000 for Prime's spending on Cable during the aforementioned period, the figure quoted in deposition transcript is clearly a typographical error.)

¹⁰⁹ Deposition of James Sullivan, vol. 2, p. 126

proprietary stewardship software, for free, an offer that was unprecedented. Finally, Prime was granted free access to the Scarborough media database.¹¹⁰

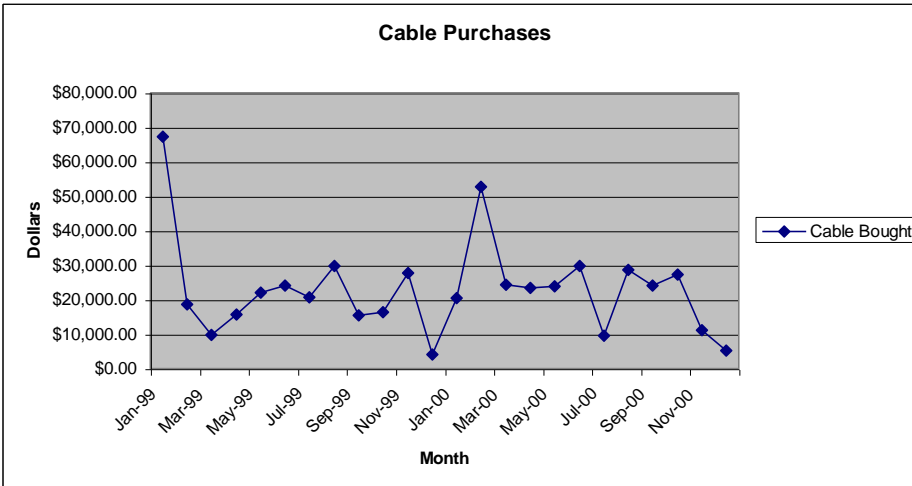
These incentives were coupled with a set of rough “conditions”, although these conditions were never contractually stipulated to. Most important, Prime was to increase its spending levels on cable television advertising to a minimum of \$350,000 dollars per year. Second, Prime was to spread 50% of its advertising dollars to so-called second and third-tier networks.¹¹¹ (Typically second and third tier networks are characterized by lower viewership and thus advertiser demand, however, the designations are ultimately left to AT&T’s discretion). Finally, they were required to extend the duration of their buys to a minimum of 8 weeks per 13 week quarter.¹¹²

Over the course of 2000, Prime’s purchases of cable ad avails remained roughly the same, at least insofar as the profile failed to reflect the prerogatives attached to the incentives offered by AT&T. The chart below describes Prime’s purchases of cable television during 1999 and 2000.

¹¹⁰ Ibid., p. 25.

¹¹¹ Ibid., p. 129.

¹¹² Ibid., p. 25.



As the chart makes plain, Prime’s purchases of cable ad avails did not change between 1999 and 2000 in a manner that suggests AT&T’s incentives had an influence on Prime’s cable purchases. The peaks observed at the beginning of 1999 and 2000, and the dip at the end of each year, are typical of the market's cycle.

The charge that Prime was not placing ads as effectively as they could be on behalf of its clients and that they were misrepresenting the medium to their clients seems at odds with Prime’s demonstrated behavior. After all, given the litany of discounts offered to them by AT&T, it would seem rational for Prime to sell cable television ads more aggressively and in a manner consistent with AT&T’s stated view of the medium. Given the 30% bulk discount, and the subsequent discounts described above, the margins on cable television ad sales would increase. The continuation then of their historical purchase pattern after the December 1999 meeting would appear to reaffirm Prime’s contention that their purchases merely reflected what they in good faith believed was in the best interest of their clients.

According to Neal Bocian, during the period of incentives, Prime's margins on cable were higher than those for any other media.

"As a percentage, Prime's profit margin for cable advertising under the special discount program that began in January of 2000 was much higher than for the CableCars television show or the CableCars.com Internet site. It was as high or higher than the margin for any media used by Prime, even after Prime reduced dealer pricing to share a portion of the discount with dealers."¹¹³

Frustrated with what AT&T viewed as Prime's continued intransigence, AT&T resumed discussions as to how to change Prime's media buying profile. The first "substantive" conversation concerning this occurred roughly a month prior to the April 2001 meeting between Jim Sullivan and Neal Bocian. During the conversation, Jim Sullivan and Jim Liedtka appeared to come up with the idea of reclassifying Prime as a competitor and media company and thus not a suitable reseller of AT&T's cable ad avails.¹¹⁴ Sullivan and Liedtka also discussed the notion that Prime was thereby competing directly with AT&T.¹¹⁵ Furthermore, testimony in Jim Sullivan's deposition confirms this reclassification to be a matter of business strategy rather than one of fact:

¹¹³ Second Affidavit of Neal Bocian, p. 9.

¹¹⁴ Deposition of Jim Sullivan, vol 2., p. 23.

Q: Could you tell me what you said and what Mr. Liedtka said, to the best description that you can of the conversation.

A: Certainly. I was concerned about Prime's inability to fulfill the agreement that we had made the prior December, and I was trying to come up with some proposal that we could make to Prime to move the business forward. That's when Jim and I ended up discussing the nature of Prime's business, how they were transacting business, and the need for a definition of what an advertising agency is and how they act

¹¹⁵ Ibid., p. 24.

A: ...I remember asking Jim about Prime's performance and him indicating that they had failed to meet their obligations.

I asked if he was aware of any changes in Prime's business, and we discussed in general terms our concerns about Prime's activity as a media company in the marketplace in competition with us.

A: ...My job is to find solutions.

One of the options that occurred to me was that Prime was...really a media company not an ad agency.

That certainly occurred to me as I was on the way back to my office. I couldn't say I had an intention, but that was one of the scenarios that played in my head.¹¹⁶

The final incentive in AT&T's arsenal was a pitch to make Prime the agent for Vehix in the Northeast.¹¹⁷ (See Section 3.0.) The pitch was made by Jim Sullivan to Prime on April 13, 2001. This pitch was unsuccessful given that Prime had already developed a similar product that duplicated many of the functions of Vehix, notably its lead management and media regeneration capabilities.

It is also important to note that there is no evidence to suggest that the pricing structure of Vehix would be modified were Prime to accept AT&T's offer to be its agent for Vehix in the local market. After all, as we have detailed at length in earlier sections, Vehix was a bundled set of services, tied exclusively to the purchase of cable ad avails. Once again, AT&T, by proposing to make Prime a vendor of Vehix, was attempting to coerce Prime into making disproportionate placements of cable ad buys, which was at odds with what Prime viewed to be the best allocation methodology for its dealer clients.

Moreover, by becoming AT&T's agent for Vehix in the marketplace, Prime would essentially have to forfeit Cablecars.com and Prime IQ. There was some tentative and hasty discussion during the April 13 meeting to address this – an offer to purchase

¹¹⁶ Ibid., pp. 113 –114.

Prime IQ. Again, the structure of the proposal was aimed at maximizing AT&T's cable advertising revenue:

A: ...I think my proposal [to purchase Prime IQ] was, well, you would need to make a commitment of advertising allocations in the cable of probably in the magnitude of \$4 to \$6 million a year in order for us to be able to make sense out of it and in order for the incentives to be there so he could recover the cost that he put forward as his cost, which he said was between \$800,000 and a million.¹¹⁸

4.2 Refusal to Deal

AT&T claims that the April 13 meeting precipitated the change in attitude towards Prime. Prime was purportedly linking the sale of its media properties, specifically Cablecars and their direct mail offerings, to a product, Prime IQ, that competed directly with a product offered by AT&T – the Sales Matrix component of Vehix. By doing so they forfeited their status as an advertising agency in the eyes of AT&T because, according to Jim Sullivan, “by [] definition [an ad agency] is supposed to be independent of any financial influence when they select where media spending is placed.”¹¹⁹ Sullivan argued that Prime IQ was significant because “they were going to link the financial performance of Prime IQ to other media, thus significantly changing the profile of their media investments.”¹²⁰ This reasoning is reiterated in the April 23 letter from Jim Sullivan to Neal Bocian.

¹¹⁷ Deposition of James Sullivan, p. 82.

¹¹⁸ Deposition of James Sullivan, volume 2. p.97

¹¹⁹ Ibid., p. 87

¹²⁰ Ibid., p. 91

“As I explained in our meeting, AT&T Media Services plans to launch the Vehix service in this market, this product is tied directly to our television product through both on air promotion and client incentive. Prime Communication’s objective of marketing the Prime IQ product by tying it to the Cable Cars and direct mail product, is clearly intended to compete directly with AT&T media services.”¹²¹

The rationale for termination of the business relationship between Prime and AT&T offered by Jim Sullivan is dubious as a matter of “economic sense,” and wrong as a matter of fact (although we will avoid treatment of the latter issue, it is worthwhile to note, that in a subsequent reply by Neal Bocian to Jim Sullivan’s April 23rd letter, Bocian makes clear that Prime IQ “is not tied to the purchase of any media or to any service provided by Prime Communications, such as direct mail and Cable Cars”). Below is a summary of why the various grounds offered by AT&T for its “refusal to deal” with Prime are economically irrational.

Claim 1: Prime is a media company, not a full-service advertising agency.

Response: Only a small portion of Prime’s revenues are comprised by it’s own media offerings. The chart below illustrates that Prime’s own media offerings represent less than a tenth of Prime’s revenues. The timing of AT&T’s determination of “intent to compete” comes at the end of a 5 month period in which the share of Prime’s business associated with it’s own media properties had actually dropped by approximately 35%,

¹²¹ Letter from James Sullivan, Vice President/General Manager of AT&T Broadband to Neal Bocian,

		<i>Auto Guide (discontinued)</i>	<i>Cable Cars</i>	<i>Direct Mail</i>	<i>Prime IQ</i>	<i>TOTAL SALES</i>	<i>Prime offered direct media revenue as a % of total sales</i>	<i>Prime offered direct media revenue as a % of total sales (excl. Direct Mail)</i>
2001	<i>Dec</i>	600.00	44,500.00	98,854.74	250.00	1,483,090.93	9.72%	3.06%
2002	<i>Jan</i>	600.00	57,700.00	68,786.74	250.00	1,819,677.09	7.00%	3.22%
2002	<i>Feb</i>	600.00	49,300.00	101,244.81	-	2,031,528.67	7.44%	2.46%
2002	<i>March</i>	600.00	43,200.00	65,256.00	-	1,953,000.00	5.58%	2.24%
2002	<i>April</i>	600.00	41,300.00	75,203.40	-	1,875,732.75	6.24%	2.23%

Claim 2: Prime has a proprietary interest in various ad media that compromises its ability to give objective advice to its dealer clients.¹²²

Response: This is trivially true at best. Ad agencies have a “proprietary interest” in every medium they recommend insofar as they collect a fee for placing ads in that medium. Moreover, it is quite common for full service advertising agencies such as Prime to have their own direct mail offerings

More importantly, as we argued earlier, Prime IQ only improves Prime’s ability to engage in a core value-added service that, by definition, multimedia advertising agencies provide to their clients: allocating advertising dollars as effectively as possible among a variety of media.

Claim 3: Prime is “misrepresenting” the value of cable advertising to its clients.

Response: The margins on Cable TV advertising were as high or higher than the margin for any other media used by Prime, even after Prime reduced dealer pricing to share a portion of the discount with dealers. The set of incentives offered by AT&T increased the margins on Cable TV advertising sales. The

President of Prime re: Confirmation of intent to compete dated April 13, 2001

¹²² Letter from Jim Sullivan to Neal Bocian dated April 23, 2001.

persistence then of Prime's media profile after the December 1999 meeting would appear to reaffirm Prime's contention that their purchases merely reflected what they in good faith believed to be in the best interest of their clients

4.3 Targeting Prime's Clients

After the termination of the relationship between AT&T and Prime, AT&T initiated a concerted effort to acquire Prime's clients. AT&T benefited from the advantage of having access to a list of Prime's clients (at least those clients that had purchased cable) through the "Ad Blocks" system as well as invoices to Prime that included the names and contact information of Prime's dealer clients. Internal documents suggest that AT&T intended to pursue Prime's clients even prior to April 23. An email a week prior to the April 23 meeting between Jim Sullivan and Neal Bocian reads:

"...please send to me via e-mail by **noon on Friday** (emphasis original email) a list of all auto dealers who have Prime Communications acting as their agency."¹²³

The reply e-mail lists many of Prime's clients and provides contact information. Soon after August 31, 2001, AT&T began selling cable television advertising directly to Prime's former clients. Kevin Lash explained Prime's conundrum:

"...AT&T has sold cable television advertising at a combined gross price of \$110,799 directly to at least two of Prime's clients; [] in both cases, AT&T

¹²³ Email, Bowman to NE Advertising Sales Team. ATTB 116555.

offered the client a 40% discount off published rates; [] the 40% discount is substantially greater than any discount previously offered to Prime...”¹²⁴

A review of documents in connection with AT&T’s cable ad sales to two of Prime’s clients shows that Prime offered enormous discounts to those clients, rendering it impossible for Prime to compete because the effective retail price that AT&T offered to Prime’s clients was lower than the wholesale price that AT&T was offering to Prime. The chart below lists the cable advertising purchases directly from AT&T for two former Prime clients, Minuteman VW, and Santilli Autos.

<i>Dealer</i>	<i>Invoice Date</i>	<i>Advertising Gross Total</i>	<i>Discount</i>	<i>Agency Net</i>	<i>Bulk Discount</i>	<i>Agency Discount</i>
MinuteMan VW	12/3	\$12,308.00	\$6,154.00	\$5,230.90	50%	15.0%
		\$34,082.00	\$13,632.80	\$20,449.20	40%	0.0%
		\$7,056.00	\$0.00	\$7,056.00	0%	0.0%
		\$34,082.00	\$13,632.80	\$20,449.20	40%	0.0%
		\$87,528.50	\$33,419.60	\$53,185.80	38%	1.7%
Santilli Motors	3/20	\$6,530.00	\$2,285.00	\$4,244.50	35%	0.0%
		\$2,400.00	\$1,080.00	\$1,320.00	45%	0.0%
		\$214.00	\$0.00	\$214.00	0%	0.0%
		\$130,045.00	\$65,022.50	\$65,022.50	50%	0.0%

¹²⁴ Affidavit of Kevin Lash, p.1.

	\$1,538.00	\$0.00	\$1,538.00	0%	0.0%
	\$1,073.00	\$0.00	\$1,073.00	0%	0.0%
	\$150,876.00	\$75,438.00	\$75,438.00	50%	0.0%
	\$138,303.00	\$69,151.50	\$69,151.50	50%	0.0%
	\$430,979.00	\$212,977.50	\$218,001.50	49%	0.0%

With the exception of a few smaller purchases for which the dealer did not receive a discount, the discounts offered to these dealers were far in excess of the discounts offered to Prime at any time during its relationship with AT&T. The average bulk discount (discarding purchases that did not merit a discount) is 45%. Furthermore, once Prime was denied the ability to purchase cable advertising directly from AT&T, it could only purchase cable time via a third party, Independent Media Services. IMS charged a 7.5% fee for its services, thereby reducing the bulk discount by 25%, and IMS did not extend Prime AT&T's "usual and customary" 15% agency discount. This new arrangement made it extraordinarily difficult for Prime to compete with the massive discounts AT&T was offering directly to Prime's former clients.

5.0 Damages

As a result of AT&T's refusal to sell cable ad spots to Prime, Prime has incurred costs. The damages to Prime stem from two aspects of the disruption of Prime's normal course of business: (i) the increase in the price that Prime must pay to acquire cable television ad spots from a third party in order to provide cable ad services for its clients and (ii) from lost revenue as a result of the loss of clients in the sale of cable ad spots. In the case of the latter, two clients (as noted above) discontinued purchasing cable television advertising from Prime as a result of discounts offered by AT&T that could not be matched by Prime or by any advertising agency.

5.1 Estimation of Lost Business and Lost Margins

For both sets of losses to Prime Communication's business, actual sales numbers for the period of AT&T's refusal to deal were used as benchmarks. For local cable television avails sold, the lost margins are directly calculable as a percentage of gross sales. The latter were directly observable from clients and did not need to be estimated. Gross sales of local cable television ad avails directly to Prime's clients by AT&T media services were also observable and did not need to be estimated. Prime's operating profits are directly calculable as the bulk discount on gross sales and the agency discount net of the bulk discount.

5.2 Estimation of Discount Rate

In calculating the present value of lost business, the discount rate is assumed to be the interest rate on debt. The weighted average cost of capital measures the discount rate as equity capital as a share of total capital weighted by the cost of capital plus debt capital as a share of total capital weighted by the cost of debt adjusted for the marginal corporate tax rate.¹²⁵ It was not used in favor of the interest rate on debt for a number of reasons. Prime Communications has an "S" corporation status since December 1992 and has not been subject to federal corporate income tax. Income and losses are taxed on the individual shareholders return. More importantly, Prime is very unlikely to issue any equity in the future to raise capital. Shares in Prime are not publicly traded and are all held by its Sole Shareholder/President Neal Bocian. Prime has not issued any equity shares in the last 5 years.¹²⁶ It is far more likely that future expansions will be financed by debt, as in the case of expansions in 2000. (In 1999, Prime Communication's long-

¹²⁵ The Weighted Average Cost of Capital (WACC) for Prime for the years 1997-2000 was 29.2%. The WACC provides a means of calculating the discount rate by the expected returns on equity and debt financing. The result of a weighted sum of the expected rates of return offers a market assessment on the estimated risk and therefore appropriated discount rate. The change in the value equity for 1997-2000, weighted by its value in starting years, was 52.9% on an average starting amount of \$139,354. The average annual long term debt for the starting years 1997-99 was \$175,698. Various segments of this debt were/are valued at differing rates. 10.5% was the highest rate and was applied to the whole of the debt as a measure of the risk of the investment. The compound annual growth rate of cable television purchases is 6.54% for the period 1997-1999. (2000 was a high purchase year and its inclusion raises the compound annual growth rate to 19.7%.) Assuming that margins remain constant, because cable is purchased on behalf of the client for a percentage of sales based on agency and bulk discounts enjoyed by Prime until the refusal to deal, and thus also that cash flow can be expected to growth at the same rate as cable television purchases, the discount rate on the WACC would be 22.7%. Prime estimates an average tenure of 5 years for its clients. Using the expected growth in cash flow adjusted WACC and compounding discounted losses for 5 years, Prime's total losses would be \$448,670, including the losses in the margin of cable advertising sales as a result of Prime's relationship with IMS. (It is \$416,928 under the assumption that cash flow from these lines of business does not increase.) But as argued above, the proper discount rate is given by the interest rate on debt as equity financing plays no role in Prime's financing, save in its initial period and is unlikely to be used to raise capital. Source: Prime Communications, Inc. Financial Statements, 1996 and 1997, 1998 and 1999, 1999 and 2000.

¹²⁶ Bocian has also provided 0% interest loans with no maturity date to Prime Communications.

term debt was \$0.) The opportunity costs of investment and thus the level of risk is thus best captured by the interest rate charged on debt taken to finance Prime's business.

Prime estimates an average tenure for a continuing relationship with a client of five years. It estimates it to be longer with those such as Center for Autos and Minuteman Volkswagen for whom it offers a wide range of services. These dealers have not abandoned all relationships with Prime, but have instead ceased to purchase local cable television advertising spots through Prime as a result of AT&T offers of prices below what an advertising agency can offer. A relationship with North End Auto Centers was incipient with a local cable television advertising campaign as the initial set of Prime delivered services. AT&T's refusal to sell Prime local cable television advertising avails has damaged the overall relationship, including revenues from other lines of business, but here we restrict the calculation of lost revenue to local cable television advertising. We also assume tenure of 5 years.¹²⁷

In its dealings with its clients, Prime continues to offer cable television advertising to most. The costs of doing so have increased as a result of Prime's inability to purchase local cable television advertising avails directly from AT&T. In response to AT&T's refusal to sell cable television advertising spots on its cable systems, Prime Communications has turned to Independent Media Services to purchase cable ad spots for the advertising campaigns of its clients. Prime purchases ad spots from IMS to sell to its clients in exchange for 7.5% of the gross sale. IMS receives a 30% discount for the bulk purchase of cable television advertising. 75% of the share of the bulk discount, or 22.5% of the gross value of the retail sale to Prime's clients, is passed onto Prime by IMS. But for AT&T's refusal to sell cable television advertising to Prime, it would receive the 30%

discount it received prior to the break of commercial relations by AT&T. Additionally, IMS receives the standard 15% agency discount net of the 30% bulk discount, which it does not pass on to Prime. The costs imposed on Prime are in the form of a reduction in its margins or the mark up as a share of the price. These total thus far \$35,773.22.

Since the refusal to deal, Prime has lost the Cable television advertising business of three clients, Center for Autos, Minuteman Volkswagen and North End Motors. It has also lost the video production business of Minuteman Volkswagen and North End Motors, as well as revenue from a contract with Minuteman for web services. Gross revenue from the three clients in the lost lines of business is \$107,274.59, using the actual value of cable advertising contracts signed by these three auto dealers with AT&T. An additional \$12,000 was lost in an annual contract for Web services with Minuteman Volkswagen. Prime was in the process of designing a web site for Minuteman Volkswagen and maintaining it at a rate of \$1000/month. Minuteman Volkswagen opted to switch to the Vehix suite of services when it was offered as part of a tied package. The total value of business opportunities lost since AT&T's refusal to sell local cable television avails to Prime and since the tying of Vehix to the purchase of these avails is \$119,274.59, broken down in the table below.

<u>Client</u>	<u>Gross Rates</u>	<u>Lost Income (30% bulk discount)</u>	<u>Lost Income (15% (net of 30%))</u>	<u>Estimated Production Revenue Currently Providing</u>	<u>Lost web Revenue (annual contract)</u>	<u>Total Lost Income</u>
Center for Autos	\$150,876.00	\$45,262.80	\$15,841.98		\$0.00	\$61,104.78
Minuteman VW	\$34,082.00	\$10,224.60	\$3,578.61	\$5,000.00	\$12,000.00	\$30,803.21
North End Motors	\$61,399.00	\$18,419.70	\$6,446.90	\$2,500.00	\$0.00	\$27,366.60
TOTAL		\$73,907.10	\$25,867.49	\$7,500.00	\$12,000.00	\$119,274.59

127 Interview with Kevin Lash.

Assuming a discount rate of 10.5%, given by the highest interest on debts that have been held by Prime in the last 6 years, and an expected tenure period of 5 years, the discounted present value of lost business opportunities to Prime Communications is \$493,302. (That is, $\Sigma \$119,274/(1+i)^n$, where $n = 0, \dots, 4$.) It is unlikely that Prime will recover these clients if it were able to once again purchase local cable television avails from AT&T. AT&T has offered these clients discounts on advertising that cannot be matched by Prime even with the standard discounts offered to advertising agencies.

When combined with the losses from the purchase of local cable ad avails through IMS, the total losses to Prime equal \$529,076.01.

<i>Source</i>	<i>Damages</i>
Lost business opportunities = $\Sigma \$119,274/(1+i)^n$, where $n = 0, \dots, 4$.)	\$493,302.79
Increase in cost of providing service	\$35,773.22
TOTAL	\$529,076.01

5.3 Appendix: Losses resulting from purchases of cable television avails through a 3rd party:

		GROSS COST	7.5% OF ACTUAL		
ACCOUNT	DATES	BILLED DEALER	GROSS COST PAID	AGEICY DISCOUNT 15%	
NORTH SHORE BUICK PONTIAC	8/29-9/2/01	\$5,998.80	\$449.91	\$629.87	
	9/3-9/16/01	\$11,985.60	\$898.92	\$1,258.49	
	2/4-2/24/02	\$30,012.00	\$2,224.12	\$3,151.26	
CLAIR MERCEDES	9/12-9/17/01	\$3,646.38	\$248.63	\$382.87	
	10/12-10/18/	\$3,646.38	\$247.50	\$382.87	
	1/18-1/27/02	\$1,590.00	\$116.10	\$166.95	
	2/4-2/10/02	\$1,590.00	\$116.10	\$166.95	
MOTORQUEST WELLESLEY	1/21-1/31/02	\$5,544.00	\$374.76	\$582.12	
	2/12-2/18/02	\$5,544.00	\$412.60	\$582.12	
MOTORQUEST MELROSE	1/21-1/31/02	\$5,476.00	\$403.57	\$574.98	
	2/12-2/18/02	\$5,476.00	\$410.69	\$574.98	
WOBURN BP	2/12-2/16/02	\$5,001.00	\$348.81	\$525.11	
	2/26-3/2/02	\$5,001.00	\$375.08	\$525.11	
O'KEEFE	2/6-2/20/02	\$1,400.00	\$136.35	\$147.00	
	3/11-3/24/02	\$1,400.00	\$136.35	\$147.00	
DANVERS CHEVROLET	12/11-12/30/	\$17,000.00	\$1,265.06	\$1,785.00	
	1/7-1/27/02	\$14,934.00	\$1,102.71	\$1,568.07	
FERREZ GROUP	10/15-11/18/	\$69,920.00	\$5,129.06	\$7,341.60	
HONDA NORTH	4/24-4/28/02	\$5,000.00	\$359.56	\$525.00	
TOTAL		\$200,165.16	\$14,755.88	\$21,017.34	\$35,773.22