



Facts about Market Power and Profits in the Internet Space

The Federal Communications Commission is now engaged in a broad review of the nation's broadband performance and policy, including the possibility of new government regulations to achieve broadband goals. Indeed, the Commission is charged by Congress with the responsibility for formulating and submitting by February next year a National Broadband Strategy or Plan. Chairman Julius Genachowski and his team have made a concerted effort to emphasize the importance of facts, verifiable facts, in contrast (presumably) to the conjectures and rhetoric they perceive in the record thus far. We applaud the Commission's interest in fact-based analysis. There can be no reliable analysis, or policy, without facts.

This is the first in a series of ConsumerGrams that attempt to provide a factual basis related to some of the key issues the Commission will address.

Financial Indicia Related to Market Power for Selected Companies

	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8
	Profit Margin* (%)	Return on Invested Capital (%)*	Return on Assets*	Sales Growth** (%)	Price To Cash Flow	P/E Ratio	Annual Sales (\$B)	Market Cap (\$B)
S&P 500	11.4	10.5	17.5	13.2	7.7X	11.2X	NA	NA
Google	22.9	19.7	18.1	71.6	25.8X	34.6X	22.3	157.0
Yahoo!	11.9	7.6	6.5	34.7	41.1X	NM	6.8	25.3
eBay	17.1	10.5	8.6	31.6	13.3X	20X	8.3	30.5
Amazon	3.7	21.8	9.7	29.5	39.1X	60.2X	20.5	40.3
Apple	12.2	21.6	14.0	39.2	28.6X	32.4X	34.6	166.0
Comcast	7.0	1.8	1.7	13.3	5.3X	17.5X	35.1	48.4
T-Warner	(5.7)	NM	NM	17.4	NM	NM	17.6	15.8
AT&T	10.7	5.0	4.3	25.1	5.0X	13.5X	111.4	159.0
Verizon	7.1	4.7	3.3	7.6	3.6X	14.2X	102.9	86.0
Merck	22.5	17.4	11.6	1.2	8.9X	11.8X	23.3	67.0
Abbott	13.8	13.5	9.9	11.3	10.7X	14.7X	29.7	76.5
Exxon	9.7	23.2	17.5	14.1	7.7X	11.2X	360.9	329.7

Source: <http://moneycentral.msn.com/investor> (Accessed September 30, 2009)

* Trailing Five-Year Annual Average; **Trailing Five Years

Perhaps the most important reason for regulation is the existence of market power. There are several potential indicators of market power drawn from measures of market structure (monopoly for

example), market conduct (predatory pricing for example), and, most importantly, abnormal returns on investment or high profit rates. Advocates for additional regulation rely on assorted rationales, but a common and popular theme is that network providers have substantial power over price and use that power to earn anticompetitive profits and returns on investment. The facts suggest otherwise.

The accompanying table reports calculations based on data taken from audited financial statements. It looks at indicia of size and profitability for a selection of firms: some from the IT space and others from the energy or pharmaceutical sector. All are compared to the Standard and Poor (S&P) average. The data were recently accessed from MSN and can be verified at <http://moneycentral.msn.com/investor>.

The first three columns contain for each of the companies in the sample three different measures of profit – the profit margin (net income divided by sales); the return on invested capital (equity and debt); and the return on assets used in production. Column 4 shows revenue growth in the past five years. Columns 5 and 6 report ratios of stock price to cash flow or earnings. The last two columns indicate the relative size of the firms in the sample as measured by annual sales and the total market value placed by investors in outstanding stock (“Market Capitalization” equals share price times the number of outstanding shares).

Readers will be interested in different comparisons, but the data make clear that, according to each of these measures, operators of broadband networks (Comcast, Time Warner, AT&T and Verizon) earn relatively modest returns compared to other major companies both inside and outside the Internet sector. Indeed, in each case, returns are below the average for firms in the S&P 500 index and substantially below those posted by other firms in the Internet Value Cluster. For example, Google’s profit margin is 2-3 times greater than earned by network providers and twice the average rate for S&P 500 firms. The comparisons are even more striking in the case of returns to investors or on assets. Return on investment for network providers are a fraction of those enjoyed by the average of all S&P 500 firms and, depending on the measure and company, are between 10% and 25% of those earned by Google. These earnings are the average for the past five years and are thus insulated somewhat from cyclical effects associated with the current recession.

Conclusion

Firms included in the table provide a variety of different services, each of which very likely earns a different return. Providers of broadband access – mainly cable television and traditional telephone service providers – are no exception. A variety of conclusions might be adduced from the table, but one that clearly stands out is that earnings and returns of network access providers do not reflect market power and do not provide the basis for concluding market failure that should be addressed by new regulations. Proponents of regulation should look elsewhere.

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