

**EXHIBIT A**

**Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, DC 20554**

In the Matter of:	)	
	)	
General Motors Corporation, Hughes	)	
Electronics Corporation, and the	)	
News Corporation Limited	)	MB Docket No. 03-124
Application To Transfer Control Of FCC	)	
Authorizations And Licenses Held By	)	
Hughes Electronics Corporation	)	
To The News Corporation Limited	)	

**AN ECONOMIC ANALYSIS OF THE COMPETITIVE EFFECTS  
OF THE TAKEOVER OF DIRECTV BY NEWS CORP.**

My name is William P. Rogerson. I am a professor of economics at Northwestern University. In 1998-99 I served as Chief Economist at the Federal Communications Commission ("Commission"). I have published numerous academic articles on industrial organization, regulation, the economics of contracts, and telecommunications. I have served as chairman of the Department of Economics at Northwestern and am currently Co-Director of the Center for the Study of Industrial Organization and Director of the Program for Mathematical Methods in the Social Sciences at Northwestern. I served as the outside economic expert for the Federal Trade Commission when it reviewed the AOL-Time Warner merger, and also served as the economic expert for the National Association of Attorneys General to support its analysis of the DirecTV EchoStar merger. A copy of my curriculum vitae is attached at Exhibit 1.

## INTRODUCTION

The proposed takeover of DirecTV by News Corp. can be classified as a vertical merger because News Corp. operates in “upstream” industries that provide programming<sup>1</sup> to the “downstream” multichannel video programming (“MVPD”) industry, in which DirecTV provides direct broadcast satellite (“DBS”) service. News Corp. owns thirty-five local broadcast television stations across the country. As such, News Corp. supplies the “retransmission consent” rights that authorize MVPDs to retransmit local over-the-air broadcast signals to their subscribers. News Corp. is also the producer of some of the most popular and heavily watched subscription video programming in the country, including Fox News Channel, FX, Fox Movie Channel, Speed Channel, Fox Sports Networks, and the Fox Regional Sports Networks (“RSNs”). DirecTV is one of the three largest MVPD in the country, competing with cable operators for the delivery of video programming in every local market nationwide.

A large body of scholarship using the methodologies of modern industrial organization theory has shown that, in oligopolistic market structures, circumstances exist where vertical mergers can exacerbate horizontal market power and create competitive harms.<sup>2</sup> I believe that the facts of this case fit these circumstances. In particular, I believe that there are two distinct

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<sup>1</sup> I consider both local broadcast television retransmission consent and the subscription video programming channels as “programming” inputs below.

<sup>2</sup> See, e.g., Michael H. Riordan & Steven C. Salop, *Evaluating Vertical mergers: A Post-Chicago Approach*, 63 Antitrust L.J. 513 (1995); Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 Yale L.J. 209 (1986); Janusz A. Ordover, Garth Saloner, and Steven C. Salop, *Equilibrium Vertical Foreclosure*, 80 American Economic Review (1990); Oliver Hart and Jean Tirole, *Vertical Integration and Market Foreclosure*, *Brookings Papers on Economic Activity: Microeconomics 1990* (1990); Ilya R. Segal and Michael C. Whinston, *Exclusive Contracts and Protection of Investments*, 31 Rand Journal of Economics (2000).

but related economic reasons to expect that the merged entity will raise the prices that it charges for programming to MVPDs that are rivals of DirecTV.

First, I believe that News Corp. will have an increased *incentive* to raise prices because raising the prices it charges to rival MVPDs will increase the profits of DirecTV. This explanation of why a vertically integrated supplier will raise prices to rival downstream firms is typically referred to as the incentive to “raise rivals’ costs” in the economics and antitrust literature and is generally viewed as the most standard explanation for why vertical mergers can cause price increases. It is an issue that the Commission has considered and addressed many times before and provides the underlying rationale for “program access” rules that prohibit programmers who are vertically integrated with cable MSOs from discriminating against rival MVPDs.<sup>3</sup>

Second, I believe that News Corp. will have an increased *ability* to raise prices to rival MVPDs because its bargaining power will be increased. News Corp.’s “bargaining power” is based on its ability, when negotiating with an MVPD, to credibly threaten to withhold programming from the MVPD. This threat will be less costly to News Corp. (and, therefore, more credible) after the merger because the cost of lost subscription and advertising revenues from withholding programming will be to some extent offset by the increased profits that DirecTV will earn when a rival MVPD is denied this programming. The merger will give News

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<sup>3</sup> I understand that News Corp. also controls the leading electronic program guide (“EPG”) technology. EPGs essentially act as the operating system for digital set-top boxes in a cable system. I understand that the Department of Justice believes EPGs are a relevant antitrust product market and there are numerous barriers to entry into that market. Although I will not discuss this market in further detail in this paper, I believe that News Corp. may also have a similar sort of incentive to raise rivals’ costs in this market.

Corp. the ability to obtain higher prices in its negotiations with program purchasers to the extent that it can more credibly threaten to withhold programming from DirecTV's rivals.

The exclusionary dangers of a "raising rivals' costs" strategy are an important concern in this merger. Indeed, they are significant enough in and of themselves to warrant the Commission's attention. The danger of enhancing News Corp.'s bargaining power is a more novel issue that I do not believe the Commission has ever explicitly addressed before in its evaluation of the competitive harms of vertical integration. I believe this second danger is also significant enough to merit close scrutiny by the Commission.

It is also important to note that both of these effects will be particularly serious in less dense regions of the country served by small to medium sized cable systems. This is because raising the price of programming or withdrawing programming from these firms is more likely to drive them entirely out of the market. This will increase both News Corp.'s incentive to raise prices and withdraw programming and the bargaining power it can wield by threatening to withdraw programming. Therefore the merger is most likely to cause significant price rises in less dense regions of the country served by small to medium sized cable systems.

As I explain in more detail below, News Corp.'s increased incentive and ability to raise prices will cause two important harms to consumers. In the short run, price increases to MVPDs will harm consumers because they will be passed through in the form of higher subscription prices. In the long run, price increases to MVPDs will harm competition at the MVPD level -- especially in less dense regions of the country where the business case for multiple MVPDs is more tenuous -- as DirecTV's rivals will be driven out of business or fundamentally weakened. In those markets, DirecTV will eventually be able to increase prices even more.

I understand that News Corp. has, as part of its application for merger approval, offered to abide by the same non-discrimination rules that would apply to a cable network programmer that is vertically integrated with a cable system. I have a number of serious reservations regarding the adequacy of this proposed condition to address the foregoing harms. First, News Corp.'s offer to abide by nondiscrimination conditions applies only to the prices it charges for cable network programming and does not apply to the prices it charges for retransmission consent for local broadcast signals. Therefore, it leaves a major aspect of the problem completely unaddressed. Second, since the proposed condition expressly allows quantity discounts, it places very little constraint on the prices that News Corp. could charge smaller cable systems. Finally, even if these problems could be solved, the proposed condition only requires that News Corp. charge the *same* prices to all MVPDs. News Corp. could comply fully with the condition and still charge high prices to its rivals simply by charging equally high prices to DirecTV.

My analysis is organized as follows. Section I explains how local television station signals are both unique and desirable and how there are no adequate substitutes for them as a result of government regulations relating to retransmission consent, such that News Corp. would have the ability to significantly harm rival MVPDs by either withholding this programming or by raising its price. Section II explains how it is similarly difficult for MVPDs to find substitutes for the regional sports programming offered by News Corp., such that News Corp. would have the same ability to significantly harm rival MVPDs by withholding this programming or by raising its price.

Section III explains why News Corp. will have an increased ability to increase prices for these programming inputs following the merger. Section IV explains why News Corp. will have an increased incentive to raise prices following the merger. Section V makes a few brief comments comparing the two theories. Section VI describes the harms to consumers that will result. Section VII explains why the non-discrimination condition proposed by News Corp. is inadequate to address the potential harms I have identified. Section VIII presents a brief and preliminary discussion of conditions to remedy these harms. Finally, Section IX draws a brief conclusion.

**I. RIVAL MVPDs WOULD BE HARMED IF THEY WERE DENIED RETRANSMISSION CONSENT OF NEWS CORP.'S LOCAL BROADCAST STATIONS**

A vertically integrated programmer will only be able to raise prices to rival MVPDs if it controls “must have” programming that is highly desired by consumers and for which no good substitutes exist. In this section I will argue that the signals of News Corp.’s local broadcast stations meet these criteria. Furthermore, there is no substitute for such programming primarily because government regulation protects these stations from competition. The next-best substitute for the signal of a local broadcast station that is affiliated with a particular network is the signal of an out-of-region affiliate of the same network. Government regulations allow the local network affiliate to prohibit MVPDs from retransmitting this next-best substitute. For these reasons, I believe that News Corp. could harm rival MVPDs by denying them retransmission consent for News Corp.’s local broadcast stations.

## A. Background

Cable operators and other MVPDs retransmit the signals of local broadcast stations as part of their multichannel video programming package. The 1992 Cable Act allows local broadcasters to elect either “must carry” or “retransmission consent” status with each MVPD in their broadcast area. If a broadcaster elects “must carry” status with respect to a particular MVPD, then the MVPD must carry the signal of the local broadcaster at no charge to the broadcaster. If a broadcaster elects “retransmission consent” status with respect to a particular MVPD, the local broadcaster has the right to deny the local MVPD the right to retransmit its signal and is allowed to seek to negotiate consideration for the right to retransmit the signal.

Most commercial stations elect retransmission consent status and negotiate some consideration for the right to retransmit their signal. At the moment, I understand that most stations negotiate a “payment in kind” rather than a cash payment. Many stations are owned by parent companies that also own cable programming interests. In these cases, the parent company typically negotiates agreements for the MVPD to carry (and pay for) affiliated cable programming.<sup>4</sup>

However, it is reportedly becoming more common for local broadcasters to attempt to negotiate cash payments (on a per subscriber per month basis) for retransmission consent.

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<sup>4</sup> The American Cable Association has filed a petition for inquiry with the Commission asking it to investigate retransmission consent practices, which describes retransmission consent negotiations in more detail. See American Cable Association, *Petition for Inquiry into Retransmission Consent Practices* (“Retransmission Consent Petition”), October 1, 2002, and American Cable Association, *Petition for Inquiry into Retransmission Consent Practices First Supplement* (“Retransmission Consent Petition First Supplement”), December, 2002. See also American Cable Association, *Reply Comments In the Matter of 2002 Biennial Regulatory Review and Review of the Commission’s Broadcast Ownership Rules and Other Rules Adopted Pursuant to Section 202 of the Telecommunications Act of 1996* (“ACA Reply Comments”), MB Docket No. 02-277, February 1, 2003.

ABC/Disney, for example, has reportedly offered a number of MVPDs the option of paying \$.70 per subscriber per month as an alternative to carrying certain Disney cable channels. News Corp. has asked for a payment of \$.65 per subscriber per month to carry Fox and \$.30 per subscriber per month to carry UPN as an alternative to carrying certain News. Corp. Channels. Gannett Broadcasting Group has apparently begun to ask for cash payments of between \$.18 and \$1.00 per subscriber per month with no other alternative being offered.<sup>5</sup> These represent very significant dollar payments and are comparable in size to the prices that programmers charge for marquee -- and even some premium -- channels.<sup>6</sup>

In a recent news interview Lachlan Murdoch reported that he plans to begin asking for payments for retransmission consent. He is quoted as saying:

We're going to have to work with MSOs (multiple system operators) on a payment for the retransmission of the broadcast signal, which, frankly, is what's fair because of the ratings broadcast television drives. Broadcasters need a healthy revenue stream to offset rising costs.<sup>7</sup>

Therefore, although we may not normally think of local broadcast signals as a type of programming that is sold to MVPDs for a positive price, this is in reality the case. Furthermore,

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<sup>5</sup> See *ACA Reply Comments*, Exhibit D, "Examples of Retransmission Consent Abuse Reported by ACA Members, November 1, 2002-January 31, 2003."

<sup>6</sup> For example, ESPN currently charges \$1.30 per subscriber per month, USA Network charges \$.40 per subscriber month, and Comedy Central charges between \$.09 and \$.16 per subscriber per month. Even Starz!, one of the fastest growing premium networks, charges only \$2.35 per subscriber per month. See R. Thomas Umstead, *Sure it's a Spring Rite, But Ops Say: Not Right*, Multichannel News, April 21, 2003, at 1 (providing numbers for ESPN); Kagan Cable Program Investor, February 20, 2003, at 5 (providing numbers for USA); Linda Moss & Mike Farrell, *Viacom Buys Custody; Comedy Central Joins MTVN Stable*, Multichannel News, April 28, 2003 at 1 (providing numbers for Comedy Central); Kagan Cable Program Investor, April 16, 2003, at 11 (providing numbers for Starz!).

<sup>7</sup> See *Lachlan Murdoch's Lead: Enhancing TV Stations and Family Biz*, Merimigas on Media, March 18, 2003

the fact that local broadcasters derive a majority of their revenue from advertising sales does not stop them from taking advantage of their control over retransmission rights to also negotiate positive prices for retransmission consent.

**B. News Corp's Local Station Signals Are "Must Have" Programming**

MVPDs view the local broadcast signals of the affiliates of the four major over-the-air broadcast networks, including the Fox Network owned by News Corp., as "must have" programming that they must carry in order to compete effectively for customers. In its *Retransmission Consent Petition* the American Cable Association summed up the situation as follows:

No one can seriously question who holds the power when a small cable operator must deal with . . . Fox/News Corp. . . . The network owners know that local network signals are essential services for small cable operators.<sup>8</sup>

To some extent, therefore, the power of News Corp.'s stations is the power of their programming. Fox network programming includes such popular items as the World Series and other Major League Baseball post-season games, the 16 National Football Conference games in the National Football League, and shows like "The Simpsons," "24" and "American Idol."

The power of a local broadcast station that is an affiliate of one of the major networks would be dramatically reduced if MVPDs were able to negotiate with out-of-region affiliates of the same network for the right to retransmit their signals. This, however, is prevented by government regulations such as the "Network Non-Duplication Rule" and the "Syndicated Exclusivity" rule. Therefore, to some extent, the power of local broadcast stations is enhanced by government regulation.

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<sup>8</sup> See *Retransmission Consent Petition* at 11.

Moreover, News Corp. exercises this power in local markets nationwide. News Corp. owns 35 broadcast stations,<sup>9</sup> and its owned and operated (“O&O”) broadcast station group has the second largest reach, in terms of households, out of all station owners in the U.S.<sup>10</sup> This means that News Corp.’s power over local broadcast signals currently reaches into more local markets than almost anyone else. And, the Commission’s recent relaxation of the national broadcast ownership cap from 35 percent to 45 percent will permit News Corp. to even further expand its ownership of local stations. I understand that News Corp. has already purchased more local stations than the rules allowed under the old cap.<sup>11</sup> Now that the cap has been relaxed further, it is very likely that News Corp. will expand its holdings to the extent allowed by the new cap.<sup>12</sup>

**C. Customer Response to Temporary Withdrawals of Retransmission Consent from MVPDs Confirms That Fox Stations Are “Must Have” Programming**

I believe it is instructive to look at the marketplace today to determine whether the foregoing conclusions can be verified. There have been a number of well-publicized incidents in the last few years where News Corp. or some other local broadcast station has withdrawn retransmission consent from an MVPD during negotiations. The evidence suggests that significant numbers of customers leave the MVPD that can no longer offer the local station and,

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<sup>9</sup> See *Top 25 Television Groups*, Broadcasting & Cable, April 8, 2002, at 48.

<sup>10</sup> See *Less is More as Viacom Retakes Top Spot*, Broadcasting & Cable, April 8, 2002, at 46.

<sup>11</sup> See Frank Ahrens, *FCC Rule Fight Continues in Congress*, Newsbytes, June 4, 2003 (noting that Fox already owns stations in excess of the FCC’s former ownership cap, reaching 37% of households); David Folkenflik, *FCC Opens Door to Survival For Biggest Media*, Baltimore Sun June 4, 2003.

<sup>12</sup> See *Some See Opportunity For Deals in FCC Rules, Others See Legal Action*, Communications Daily, June 4, 2003, at 5 (quoting Legg Mason analyst Blair Levin).

instead, switch to another MVPD that can. Furthermore, MVPDs that are still able to offer the local station typically heavily advertise this fact in an attempt to steal customers away from the affected MVPD.

In a recent case from the Washington, D.C. area, News Corp. withheld the signal of Fox station WTTG-TV during a retransmission consent negotiation.<sup>13</sup> The dispute arose near the beginning of the NFL playoffs and subjected Cox Communications to significant negative customer relations in several markets.<sup>14</sup> During the course of negotiations, satellite providers “profit[ed]” from the disruption of service, aggressively marketing themselves to consumers as an alternative to Cox.<sup>15</sup> Eventually, Cox Communications agreed to News Corp.’s demands and the signal was restored. In other cases of which I am aware, there have been similar results. The lack of available substitutes makes News Corp.’s local stations “must have” programming for MVPDs.

**D. Customer Response to Local-to-Local Offerings of DBS Providers Confirms That Fox Stations Are “Must Have” Programming**

DirecTV and EchoStar claim that their ability to attract customers away from cable increased significantly when they were able to begin offering local broadcast signals,<sup>16</sup> and this provides more evidence that local signals are “must have” programming. In filings with the

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<sup>13</sup> See *Comments of Cox Enterprises, Inc.*, MB Docket No. 02-277, at 45 (January 2, 2003) (“*Comments of Cox*”).

<sup>14</sup> See Linda Moss, *Some Subs Who Lost Fox Get Refunds From Cox*, Multichannel News, January 17, 2002, at p. 3.

<sup>15</sup> Kristina Stefanova, *Satellite Soaring: Fox-Cox Flap Also Sells Antennas*, The Washington Times, January 4, 2000 at p.B8.

<sup>16</sup> See Satellite Home Viewer Improvement Act, Pub. L. No. 106-113, 113 Stat. 1501 (1999) (“SHVIA”) (*codified at* 47 U.S.C. § 338, “Carriage of Local Television Signals by Satellite Carrier”).

Commission, EchoStar reports that the addition of local channels has made DBS more competitive with incumbent cable providers and has led to an increase in DBS subscribership and a restraint on cable prices,<sup>17</sup> and DirecTV reports that its overall subscriber levels have increased by 20 percent due to the provisioning of local broadcast channel service.<sup>18</sup> Such evidence confirms that local broadcast signals generally are “must have” programming.

The Commission itself has recognized that the offering of local channels, which it calls “valuable programming,” has allowed DBS providers to make significant gains in the MVPD market:

DBS providers have made significant progress as competitors to cable, capturing 18 percent of MVPD subscribers, due in part to authority granted by SHVIA to DBS operators to distribute local broadcast television stations in their local markets. Indeed, we believe that the marked growth of DBS since the enactment of SHVIA provides an informative example of the impact on competition in the distribution of video programming when marketplace participants gain access to valuable programming to which they were previously denied.<sup>19</sup>

## **II. RIVAL MVPDs WOULD BE HARMED IF THEY WERE DENIED NEWS CORP. REGIONAL SPORTS PROGRAMMING**

News Corp.’s regional sports networks are also “must have” programming that are highly desired by consumers and for which no good substitutes exist. This means that News Corp.

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<sup>17</sup> *Annual Assessment of the Status of Competition in the Market For the Delivery of Video Programming, Ninth Annual Report*, MB Docket No. 02-145, at ¶ 61 (2002).

<sup>18</sup> *Annual Assessment of the Status of Competition in the Market For the Delivery of Video Programming, Eighth Annual Report*, 17 FCC Rcd 1244, 1273-1274 ¶ 59 (2001) (“*Eighth Annual Video Competition Report*”).

<sup>19</sup> *In the Matter of (i) Implementation of the Cable Television Consumer Protection And Competition Act of 1992 (ii) Development of Competition and Diversity in Video Programming Distribution: Section 628(c)(5) of the Communications Act and (iii), Sunset of Exclusive Contract Provision, Report and Order*, 17 FCC Rcd 12124, 12144 ¶ 46 (2002) (“*Sunset Extension Order*”).

could also harm its rivals by pursuing exclusionary or cost-raising strategies with respect to this programming.

**A. Regional Sports Programming is “Must Have” Programming**

The Commission has generally concluded that a significant amount of cable programming is of the “must have” variety and has specifically given RSNs as an example of such “must have” programming. For example, in its order extending the Sunset of Program Access Rules (*Sunset Extension Order*) the Commission found that:

given the unique nature of cable programming, there frequently are no good substitutes available for . . . [regional sports services, which] are considered ‘must have’ programming by competitive MVPDs and the subscribers they serve . . . .<sup>20</sup>

To explain its conclusion regarding regional sports programming the Commission noted that this programming is by its very nature unique, since networks typically purchase exclusive rights to show sporting events:

Competitive MVPDs argue that regional or local sports programming presents a special problem because it is unique programming. Commenters argue that local sports cannot be duplicated by competing MVPDs or acquired from alternative sources, even if the cost of doing so were not an issue. RCN asserts that for the fan who wishes to see a Washington Redskins game, the alternative of a local NBA or NHL game, or even a distant NFL contest, is not an acceptable substitute. . . . These commenters contend that because local sports programming is so highly desired by subscribers, its unavailability imposes an unusually significant competitive harm [footnotes omitted].<sup>21</sup>

To support its conclusion that regional sports programming is “must have” programming the Commission cites data provided by DirecTV and EchoStar showing that they have significantly lower subscribership in Philadelphia as compared to other large cities and noting DirecTV’s and EchoStar’s claim that “this is directly attributable to their inability to access Comcast

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<sup>20</sup> *Id.* at 12139 ¶ 34.

<sup>21</sup> *Id.* at 12137 ¶ 29.

SportsNet.”<sup>22</sup> In its most recent working paper the Commission’s Office of Plans and Policy concludes that:

Regional sports programming in particular has been, and continues to be, an important segment of programming for all video program providers. According to a 2000 survey, between 40 and 58 percent of cable subscribers would be less likely to subscribe to cable service if it lacked local sports. Cable overbuilders have frequently noted that access to sport programming is so essential to the success of a cable system that many operators will pay exorbitant prices and agree to entertain other less attractive business arrangements just to obtain it.<sup>23</sup>

Simply put, sports fans feel there is no good substitute for watching their local and/or favorite team play an important game.

#### **B. News Corp. Holds a Powerful Position in Local Sports Programming**

It is widely recognized, to quote the Commission’s own Office of Plans and Policy, that “regional sports distribution is dominated by Fox Sports Net,”<sup>24</sup> which is of course owned by News Corp. Today, News Corp. owns interests in 19 regional sports networks (“RSNs”) reaching three-quarters of all television households.<sup>25</sup> The Fox RSNs carry 67 of the 80 professional MLB, NBA, and NHL teams.<sup>26</sup> The RSNs produce over 4,500 professional live events annually.<sup>27</sup> News Corp. also controls the national broadcast rights to NFC professional

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<sup>22</sup> *Id* at 12139 ¶ 33 n.107.

<sup>23</sup> Jonathon Levy, Marcelino Ford-Livine, and Anne Levine, *Broadcast Television: Survivor in a Sea of Competition*, Office of Plans and Policy Working Paper 37, September 2002, at 124 (“*Broadcast Television OPP Working Paper*”).

<sup>24</sup> *See Broadcast Television OPP Working Paper* at 125.

<sup>25</sup> *See Application* at Attachment F. However, News Corp. claims 21 RSNs on its website. *See* [www.newscorp.com/management/fsn.html](http://www.newscorp.com/management/fsn.html).

<sup>26</sup> *See* [www.newscorp.com/management/fsn.html](http://www.newscorp.com/management/fsn.html).

<sup>27</sup> *See* [www.newscorp.com/management/fsn.html](http://www.newscorp.com/management/fsn.html).

football and major league baseball games as well as NASCAR races.<sup>28</sup> And, News Corp. controls several major packages of college basketball and football games.<sup>29</sup> Therefore it is clear that a very large fraction of the most desirable local sports programming is controlled by RSNs owned in whole or in part by News Corp.

### **C. Customer Response to Temporary Withdrawals of Local Sports Programming from MVPDs**

There have been a number of well-publicized incidents in the last few years where News Corp. or some other program supplier has withdrawn regional sports programming from an MVPD during negotiations over prices. These incidents provide us with a sort of “natural experiment” that we can use to measure the extent to which News Corp. could damage rival MVPDs by withdrawing regional sports programming from them. The evidence suggests that significant numbers of customers leave the MVPD that can no longer offer local sports and, instead, switch to another MVPD that can. Furthermore, the MVPD that is still able to offer the local sports programming is apparently well aware that this creates an enormous strategic advantage for it and its typical response is to heavily advertise the fact that it still offers the local sports programming in an attempt to steal customers away from the affected MVPD.

For example, in Minnesota, Fox Sports Net North was cut from more than 150,000 Time Warner Cable homes when the two could not come to terms. EchoStar distributors reported their business “tripled as soon as [FSN] was taken off cable.”<sup>30</sup> DirecTV officials likewise reported

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<sup>28</sup> See [www.newscorp.com/management/fsn.html](http://www.newscorp.com/management/fsn.html).

<sup>29</sup> See [www.newscorp.com/management/fsn.html](http://www.newscorp.com/management/fsn.html).

<sup>30</sup> Judd Zulgadd, *Cable Squabble Leaves Sports Fans Pondering Options*, Star Tribune, Jan. 27, 2003, at 1A.

increases in sales.<sup>31</sup> And, when YES network failed to reach a carriage deal with Cablevision, DirecTV immediately began to advertise heavily in Cablevision markets to pick off subscribers.<sup>32</sup> During the dispute, DirecTV's rate of signing up new customers increased 100 percent.<sup>33</sup> Cablevision lost at least 30,000 customers to DirecTV as a result.<sup>34</sup>

### **III. THE MERGER INCREASES THE ABILITY OF NEWSCORP TO RAISE THE PRICES IT CHARGES FOR PROGRAMMING**

In this section, I will explain how the merger increases the ability of News Corp. to raise the prices it charges for its "must have" programming. Essentially, the merger will enhance News Corp.'s ability to walk away from the bargaining table with an unaffiliated MVPD because it will be able to more credibly threaten to withdraw programming from the MVPD. After the merger, the cost of such a strategy will go down because the loss of programming revenues from the rival MVPD will to some extent be offset by the increased profits of DirecTV. Moreover, News Corp. will be able to engage in temporary withdrawals of programming from MVPDs that refuse to go along with higher prices. As I show below, the costs of such a "temporary withdrawal" strategy to News Corp. will be even smaller, but the damage to MVPDs will be

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<sup>31</sup> *Id.* Such examples are not uncommon. In 2001, when Time Warner Cable refused to accept Fox Sports West terms for Dodgers games, DirecTV stepped right in and advertised free equipment and installation to Time Warner subscribers. Linda Haugsted, *Subtracting Sports: Licensing Hassles Lead to Cable Drops*, Multichannel News, July 2, 2001, at 1.

<sup>32</sup> In an undated open letter to New York Yankees fans during the Cablevision dispute, YES network president Leo Hindery highlighted his partnership with DirecTV. The letter ran in numerous New York metropolitan area newspapers on March 7, 2002 and encouraged Cablevision subscribers to call 1-800-DirecTV to subscribe. See Richard Sandomir, *Pressure Increases on Cablevision to Carry YES*, N.Y. Times, March 8, 2002, at D1 (discussing open letter).

<sup>33</sup> Richard Sandomir, *YES-Cablevision War Has a Winner: DirecTV*, The New York Times, April 25, 2002 at D2.

<sup>34</sup> Staci D. Kramer, *It's Spring, and Hope Again Springs Eternal*, Cable World, March 17, 2003, at 11.

substantial. Because MVPDs will know these alternatives are available, News Corp. will dramatically increase its ability to raise prices for its programming in negotiations with them.

**A. The Merger Will Increase News Corp.'s Bargaining Power with Rival MVPDs**

News Corp will be able to charge higher prices because the merger will increase its bargaining power with MVPDs. News Corp.'s essential threat when bargaining for higher prices with an MPVD is the threat of withholding programming from the MVPD. This threat will be less costly to News Corp. (and, therefore, more credible) after the merger, because the cost of lost subscription and advertising revenues from withholding programming will be to some extent offset by the increased profits that DirecTV will earn when the rival MVPD is denied this programming. Standard bargaining models in economics all predict that a firm should be able to negotiate higher prices if the option of not selling becomes more attractive to the firm.<sup>35</sup> There are a number of papers in the economics literature that examine the effects of vertical relationships by focusing on how vertical relationships change firms' threat points in bargaining over price.<sup>36</sup>

Of course News Corp.'s threat to withdraw programming will be most credible against small and medium sized cable systems in less dense regions of the country where the withdrawal of programming is more likely to induce its rivals to exit. There are many regions of the country served by small cable systems that have not yet invested in digitalizing their networks. Many

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<sup>35</sup> See, e.g., John C. Harsanyi, *Bargaining in The New Palgrave Game Theory*, W.W. Norton (1989); Alvin Roth, *Axiomatic Models of Bargaining*, Springer-Verlag (1979).

<sup>36</sup> See, e.g., Janusz A. Ordover, Garth Saloner, and Steven C. Salop, *Equilibrium Vertical Foreclosure*, 80 *American Economic Review* (1990); Oliver Hart and Jean Tirole, *Vertical Integration and Market Foreclosure*, *Brookings Papers on Economic Activity: Microeconomics 1990* (1990); and Ilya R. Segal and Michael C. Whinston, *Exclusive Contracts and Protection of Investments*, 31 *Rand Journal of Economics* (2000).

analysts have speculated that there is already a danger that many of these firms will simply decide to exit the industry instead of investing more money<sup>37</sup> and the probability of this occurring will only increase to the extent that News Corp. raises their programming prices. If a rival will exit the industry in response to News Corp.'s withdrawal of programming, News Corp. might expect to lose very little programming revenue so long as News Corp. continued to sell its programming to both of the DBS providers because customers of the failed cable system switched to one of them. Therefore even relatively small increases in the profits of DirecTV would be enough to offset these negligible losses or programming revenue. However, this effect would still exist in reduced magnitude even in regions of the country where News Corp could not necessarily expect somewhat to drive a rival MVPD out of business by withholding programming.<sup>38</sup> Furthermore, as will now be explained, the threat to temporarily withdraw programming may provide an even more credible threat in many cases.

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<sup>37</sup> See generally Monica Hogan, *Pagon: Pity Cable's Rural Ranks*, *Multichannel News*, June 4, 2001, at 36.

<sup>38</sup> As the owner of 34% of DirecTV, News Corp. is of course automatically entitled to 34% of any increase in profits that DirecTV receives and I believe that in many cases this will be sufficient to significantly increase the credibility of News Corp.'s threat to withhold programming. In particular, so long as News Corp. expects to drive its rival out of business so that the loss of programming revenues will negligible, even a 34% share of the profits will almost surely be significant compared to the negligible revenue loss.

Furthermore, it seems likely to me that News Corp. may well receive more than 34% of the incremental profits it creates for DirecTV by withholding programming from DirecTV's rivals. DirecTV will have its own private incentives to encourage News Corp. to withhold programming from rival MVPDs and is likely to offer News Corp. extra incentives to encourage it to bargain harder and increase the chance that programming will be withheld. (Or, depending upon one's view of the extent to which News Corp. will control DirecTV, it may be that News Corp. will simply demand extra compensation.) For example, DirecTV might agree to accept slightly higher programming prices to the extent that programming is withheld from its rivals. Although an explicit agreement would likely be illegal, informal coordination to achieve this effect should be possible under the umbrella of News Corp.'s joint ownership of both companies. Therefore News Corp. may well receive more than 34% of incremental profits it creates by withholding

**B. Temporary Withdrawal of Programming During Price Disputes Will Be a Particularly Attractive and Credible Threat for News Corp.**

It is important to note that the power of News Corp.'s threat to withdraw programming is magnified immensely by the fact that News Corp. is able to withdraw programming temporarily during disputes over prices. These temporary withdrawals have a minuscule effect on News Corp.'s revenues because the loss of subscription and advertising revenues is only temporary, but they can have a potentially enormous and lasting effect on the MVPD because customers switch to rivals and it is unlikely that they will switch back the instant the programming is restored. As I described in the previous section of this paper, News Corp. can and does routinely withdraw programming as a negotiating tactic when an MVPD will not agree to the terms it asks for.<sup>39</sup> After the merger this imbalance of bargaining power will become even more severe because the lasting losses to the rival MVPD resulting from the fact that customers shift to DirecTV will become lasting gains for News Corp. as the owner of DirecTV.

In fact, it seems likely to me that, once it owns DirecTV, News Corp. may well determine that it is a profitable strategy to begin to more routinely engage in temporary withdrawals of programming from rivals.

As will be seen below in section III(C), most industry participants and industry analysts seem fairly certain that the merger will increase News Corp.'s bargaining power with respect to rival MVPDs.

Finally, the Commission should take into account the extent that News Corp. will be able to increase its ownership share after the merger is approved with no scrutiny or reduced scrutiny. If, for example, News Corp. would be able to increase its ownership level to 100% with very little further scrutiny from the Commission, then it would be appropriate for the Commission to evaluate the harms of the merger at the 100% ownership level now at the last time that the merger will be subject to detailed scrutiny.

<sup>39</sup> I understand that certain rules may make it more difficult for News Corp. to overtly engage in such a strategy for the express purpose of harming an MVPD, but there could be any number of justifications given by News Corp. to comply with the rules while engaging in this gamesmanship.

programming when negotiating agreements with rival MVPDs, even ignoring its effect on News Corp.'s ability to negotiate higher prices. After all, the effect of a short term withdrawal of programming on News Corp.'s programming revenues would be minuscule but, as the owner of DirecTV, there would be a lasting and potentially significant increase in its profits to the extent that customers switch from the rival MVPD to DirecTV. Therefore, it may well be that, after the merger, News Corp. will be "looking for a fight," in the sense that it will actually be able to increase its profits by manufacturing a dispute that would create the pretext for a temporary withdrawal of service. This of course will simply create additional harms for the customers who are affected by these disruptions as well as further magnifying News Corp.'s bargaining power.

**C. There is Widespread Agreement Among Industry Participants and Analysts That The Merger Will Increase News Corp.'s Bargaining Power**

Finally, I find it significant that it is a widely shared belief among industry participants and analysts that the merger will increase News Corp.'s bargaining power. Almost every news story or analyst's report covering this merger mentions this as a significant effect of the merger. Immediately after the merger was announced, the New York Times reported in an article entitled *Murdoch Gets Upper Hand on Cable With Hughes Deal* that:

with the agreement yesterday to acquire the satellite broadcaster DirecTV, Mr. Murdoch, chairman of the News Corporation, can transmit his own channels into homes across the country, redoubling the company's bargaining power with cable operators, television networks, and Hollywood studios.<sup>40</sup>

The same article quoted Robert Kaimowitz, chief executive of the investment fund Bull Path Capital Management as stating that:

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<sup>40</sup> David D. Kilpatrick, *Murdoch Gets Upper Hand on Cable With Hughes Deal*, New York Times, April 10, 2003, at C1.

My sense is that the major purpose for News Corporation controlling DirecTV is to use it as a tactical weapon against the cable companies to get them to pay up for its proprietary programming.<sup>41</sup>

The communications newsletter *Mermigas on Media* further reported that the merger gives News Corp. “unprecedented negotiating leverage with cable operators”<sup>42</sup> and quoted Tom Wolzien, a Sanford Bernstein analyst as stating that News Corp. will obtain through the merger:

four-way leverage against cable operators, competing with satellite and using the requirement that cable get retransmission consent to carry Fox-owned TV stations, while potentially leveraging price for Fox-owned regional sports networks and its national cable and broadcast networks. The threat to cable is that News Corp. might legally withhold programming in a rate dispute in favor of telecasting it exclusively on satellite. At best, this will result in higher program costs to cable operators and shift viewers to satellite.<sup>43</sup>

Kagan sports analyst John Mansell is quoted in another industry publication as stating:

There certainly would be some incremental leverage News Corp. would have over cable operators in terms of regional sports-network rights fees. There’s greater chance of YES-type situations – only it’ll be Fox [networks], and they’ll be even more inclined to go out and promote DirecTV in regions where the cable operator doesn’t pay up.<sup>44</sup>

The impressions of these marketplace observers helps to confirm my view that the transaction would increase News Corp.’s ability to raise programming prices.

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<sup>41</sup> David D. Kilpatrick, *Murdoch Gets Upper Hand on Cable With Hughes Deal*,” New York Times, April 10, 2003, at C1.

<sup>42</sup> *Mermigas on Media*, April 16, 2003.

<sup>43</sup> *Id.*

<sup>44</sup> *No Death Star: Cable Takes News-DirecTV Deal in Stride*, Multichannel News, April 14, 2003, at 1 (quoting cable programming executive saying that Murdoch will “use every ounce of his leverage to beat up cable operators who don’t carry his content”).

#### **IV. THE MERGER WILL INCREASE NEWS CORP.'S INCENTIVE TO RAISE PROGRAMMING PRICES TO RIVAL MVPDS IN ORDER TO DISADVANTAGE THEM**

There is a large body of economics and anti-trust literature that explains why a vertically integrated supplier will generally have an incentive to “raise rivals’ costs” either by raising the price of the inputs it sells rivals or withdrawing them altogether.<sup>45</sup> The idea is that a vertically integrated firm cares about maximizing the joint profits of its upstream and downstream division and that it can generally increase the profits of its downstream division by raising input prices to its rivals. Therefore, there is an extra benefit to raising price and a vertically integrated firm would rationally respond to this extra benefit by raising price higher than it otherwise would. To put this another way, the price that News Corp would charge rival MVPDs to maximize the joint profits of News Corp and DirecTV is larger than the price that News Corp. would charge to maximize the profits of News Corp. alone.<sup>46</sup> It follows that, after the merger, News Corp. will

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<sup>45</sup> See, e.g., Michael H. Riordan & Steven C. Salop, *Evaluating Vertical mergers: A Post-Chicago Approach*, 63 Antitrust L.J. 513 (1995) (overview of vertical mergers); Jonathan B. Baker, *Vertical Restraints Among Hospitals, Physicians and Health Insurers That Raise Rivals’ Costs*, 14 Am. J. L. and Med. 147 (1988) (discussing history of raising rivals’ costs theory); Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals’ Costs to Achieve Power Over Price*, 96 Yale L.J. 209 (1986) (discussing vertical harm in terms of raising rivals’ costs); Steven C. Salop & David T. Scheffman, *Raising Rivals’ Costs*, 73 Am. Econ. Rev. 267, 268 (1983) (discussing exclusionary practices having the effect of raising rivals’ costs).

<sup>46</sup> The profit maximizing price is not infinite because MVPDs pass through price increases to consumers and consumers reduce their demand in response. Therefore one negative consequence to News Corp. of raising the price that it charges to an MPVD is that the MPVD will pass through some if not all of these costs to its customers in the form of higher prices. To the extent that customers of the MPVD discontinue their service because of the price increases, News Corp. will lose both subscription revenue (since the MPVD pays News Corp. on a per subscriber basis) and advertising revenue (since News Corp. will be unable to sell its advertising as much if the subscribership to its programming falls). After the merger this cost of raising prices will be offset by a new benefit. Namely, it is likely that some of the consumers that leave

want to charge a higher price to rival MVPDs for its programming.<sup>47</sup> The incentive to raise rivals' costs will of course be particularly high for the case of small to medium sized cable MSOs in less dense regions of the country since, in these cases, News Corp. might actually be able to completely drive its rival out of business by following such a strategy.

In its recent order extending the exclusive contract prohibition of the program access rules, the Commission reaffirmed its long-standing conclusion that programmers that are vertically integrated with cable systems have the incentive to withhold programming from rival MVPDs in order to increase their own downstream profits.<sup>48</sup> It also noted that the incentive to raise rivals' costs would be particularly great in circumstances where such actions might drive a rival out of business.<sup>49</sup> The same reasoning applies to the case of a programmer that is vertically integrated with a DBS provider. News Corp.'s power over "must have" programming (both

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the MPVD when it passes through price increases will switch to DirecTV and, as an owner of DirecTV, News Corp. will now earn positive profits on each of these consumers.

<sup>47</sup> The fact that News Corp. is acquiring a 34 percent ownership interest in DirecTV instead of a 100 percent ownership should not significantly affect the extent to which News Corp. has the incentive to raise rivals' costs. The overlapping ownership between News Corp. and DirecTV should be more than sufficient to enable them to reach agreements to undertake any actions which maximize their joint profits, so we should expect News Corp. to have the incentive to raise rivals costs to the extent that this will increase the firms' joint profits, just as if it owned 100 percent of DirecTV. The ownership share might affect how the firms split the gains from maximizing their joint profits but it would not affect their incentive to maximize their joint profits. Note that the 34 percent ownership issue has a slightly different effect on the "increasing bargaining power" theory than the "raising rivals' costs" theory. See note 39 for a discussion of the effects of this issue on the "increasing bargaining power" theory.

<sup>48</sup> *Sunset Extension Order*, 17 FCC Rcd at 12147 ¶ 53.

<sup>49</sup> "Moreover, if the long-term result is to limit or eliminate competition, the exclusive arrangement will result in increased profit through the subscribers that migrate from failing or defunct competitors to the programmer's cable affiliate, and through the ability to raise rates without fear of losing subscribers to competitive MVPDs." *Id.*

retransmitted broadcast stations and sports channels) imparts an incentive for it to exert anticompetitive control over these services

## V. COMPARING THE THEORIES

The theories presented in sections III and IV provide two related but distinct reasons why the merger is likely to result in higher prices. One can think of the bargaining power theory as explaining why News Corp. will have the *ability* to raise prices after the merger and the raising rivals costs theory as explaining why News Corp. will have an increased *incentive* to raise prices after the merger.<sup>50</sup>

The “raising rivals’ costs” theory is generally viewed as the standard explanation for why vertical mergers can cause price increases and is an issue that the Commission has considered and addressed many times before. For example, this was the main issue that motivated Congress to require the Commission to adopt Program Access rules that prohibit programmers who are

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<sup>50</sup> From a slightly more formal economic modeling perspective, the raising rivals’ costs literature typically abstracts away from the bargaining problem completely by simply assuming that the upstream division has all the bargaining power and is able to make a take-it-or-leave-it offer to the rival downstream firm. This literature calculates the profit maximizing take-it-or-leave it price for the upstream division to offer. The formal result is that the price that maximizes the joint profits of the two divisions is larger than the price that maximizes the upstream division’s profits alone. In bargaining models another price becomes important besides this price. This is the minimum price that the upstream firm would be willing to accept. (This is also the price that the rival downstream firm would offer the upstream division if it had all the bargaining power and could make a take-it-or-leave-it offer to the upstream firm.) Models of bargaining predict that the price the upstream firm is able to negotiate will also generally be affected by the minimum price it would be willing to accept. In terms of this model, the argument in Section III is that the minimum price that the upstream firm is willing to accept goes up once the upstream firm is vertically integrated with the downstream firm. This is because the downstream division’s profits go down when the upstream division makes the input available to the rival downstream firm and the minimum price that the vertically integrated firm will accept must include compensation for the lost profits of the downstream division.

vertically integrated with cable MSOs from discriminating against rivals MVPDs.<sup>51</sup> While this issue is an important concern in this merger and is significant enough in and of itself to warrant the Commission's attention, it is important to note that this merger raises an entirely new and different potential cause for concern, which I do not believe the Commission has ever explicitly addressed before. This is the first reason described above, *viz.*, that the merger will increase News Corp.'s bargaining power and hence its ability to raise prices. Therefore the Commission should be aware that there is potentially an extra cause for concern with this vertical relationship than with many other vertical relationships it has considered before.

#### **VI. CONSUMERS WILL BE HARMED BY THE MERGER**

When News Corp. raises the prices it charges rival MPVDs for programming, consumers will be harmed in the short run because most, if not all, of these programming price increases will be passed through to consumers in the form of increased cable subscription prices. Cable programming networks charge cable systems for their programming on a per subscriber per month basis.<sup>52</sup> Therefore, the cable system views the per month per subscriber fee as a marginal cost of providing service to a customer. It is of course standard economic theory that a firm facing a downward sloping demand curve (as cable systems surely do) will respond to an increase in its marginal costs by increasing price.<sup>53</sup>

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<sup>51</sup> See *Sunset Extension Order* for a recent articulation of this rationale by the Commission.

<sup>52</sup> See *Reply Comments of MediaCom Communications Corporation* for a general discussion of pricing practices for cable network programming.

<sup>53</sup> The FTC concluded that increases in programming prices would result in increases in prices charged to subscribers in its analysis of the TimeWarner Turner Merger. See Federal Trade Commission, *Analysis of Proposed Consent Order to Aid Public Comment*, Federal Register, Vol. 61, No. 187, September 25, 1996, at 50309: "The complaint alleges . . . that substantial increases in wholesale programming costs for both cable systems and alternative service providers – including direct broadcast satellite service and other forms of non-cable distribution

In the long run, the potential harm to consumers will be even greater to the extent that rival MVPDs are either driven out of business or at least weakened to the point where competition is reduced. A reduction in competition would of course cause further price rises for all consumers. The danger of this occurring is especially high in less dense regions of the country where the business case for multiple MVPDs is weakest. In particular, there are many regions of the country served by small cable systems that have not yet invested in digitalizing their networks. Many analysts have speculated that there is already a danger that many of these firms will simply decide to exit the industry instead of investing more money<sup>54</sup> and the probability of this occurring will only increase to the extent that News Corp. raises their programming prices.

#### **VII. THE CONDITION SUGGESTED BY NEWS CORP IS INADEQUATE TO ADDRESS THE FOREGOING HARMS**

As part of its application for merger approval, News Corp. has offered to abide by the same non-discrimination rules that apply to cable network programmers that are vertically integrated with cable systems. I have a number of serious reservations regarding the adequacy of this proposed condition to address the harms I identify.

##### **A. The Proposed Condition Does Not Apply to Prices for Retransmission Consent**

News Corp.'s offer to abide by nondiscrimination conditions applies only to the prices it charges for cable network programming and not to the prices it charges for retransmission consent for local broadcast signals. Therefore it leaves a major aspect of the problem

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– would lead to higher service prices and fewer entertainment and information sources for consumers.”

<sup>54</sup> See generally Monica Hogan, *Pagon: Pity Cable's Rural Ranks*, Multichannel News, June 4, 2001, at 36.

completely unaddressed. Given that the underlying economic factors are almost exactly the same for the cases of cable network programming and local broadcast signals, there is no reason to treat these two types of programming differently.

**B. The Proposed Condition Allows Quantity Discounts**

Since the proposed condition allows quantity discounts, it places very little constraint on the prices that News Corp. could charge smaller cable systems. DirecTV is certainly much larger than even medium sized cable systems. Therefore News Corp. could always argue that higher prices to these cable systems were justified because it was simply giving a “quantity discount” to DirecTV. As argued above, small and medium sized cable systems are precisely the set of MVPDs for which News Corp. will have the greatest incentive and ability to increase programming prices. Therefore the condition will be most ineffective precisely in the cases where it is needed most.

**C. The Condition Will Be of Limited Effectiveness Because (i) News Corp. Can Raise Prices to All MVPDs Including DirecTV and (ii) There Will be No Out-Of-Region MVPDs Whose Prices Can be Used as a Benchmark**

Finally, even if the above two problems could be solved, the proposed condition only requires that News Corp. charge the *same* prices to all MVPDs. In particular News Corp. could comply fully with the condition and still charge high prices to its rivals simply by charging equally high prices to *all* MVPDs including DirecTV.

Of course, because News Corp. will only own 34 percent of DirecTV after the proposed merger, the public shareholders of DirecTV would be harmed if News Corp. raised prices to DirecTV and one might therefore expect public shareholders or those charged to represent their interests (such as the Audit Committee of the Board of Directors) to stand in the way of such

price increases. For two different reasons, I believe that this factor will not provide any significant restraint on News Corp.

First, when the audit committee examines the program prices that News Corp. charges DirecTV to see if they are “fair,” the only simple objective test it will be able to employ is to examine whether or not DirecTV is being charged more than other MVPDs for the same programs. Since News Corp. only needs to charge DirecTV prices that are as high as those it charges other firms to meet the nondiscrimination condition, it will of course pass this “test” with flying colors. The issue of whether News Corp.’s prices appear to be “too high” relative to other programmers’ prices is an inherently subjective and qualitative issue that an audit committee would find very difficult to make any objectively verifiable determinations about.

Second, even if the Board of Directors of DirecTV had perfect information about all the business decisions of DirecTV and was able to perfectly and fairly represent the interests of the public shareholders, it would still be optimal for them to allow News Corp. to charge high prices to DirecTV so long as News Corp. could find a way to return some of the gains to DirecTV in some other form. This is because DirecTV and News Corp. can maximize their joint profits by doing this (so News Corp. is able to charge high prices to rivals without violating the nondiscrimination condition). News Corp. will be engaging in a broad range of cooperative and joint activities with DirecTV which involve large exchanges of benefits and payments in both directions. In fact, News Corp. touts many of these activities as “efficiencies” related to its ownership of DirecTV. News Corp. could essentially refund some of the high price that it charges DirecTV simply by being slightly more generous in some other exchange.

There is some evidence to suggest that News Corp. has followed precisely this “raise prices to everyone” strategy in the United Kingdom in order to raise prices to rival MVPDs without violating nondiscrimination rules. In the U.K., News Corp. owns a 35 percent interest in British Sky Broadcasting (“BSkyB”) and competes with two cable systems, Telwest and NTL. In addition to its delivery platform, BSkyB has a dominant position in programming in the U.K. The two main providers of cable television in the U.K., Telewest (1.7 million subscribers) and NTL (1.2 million subscribers), have each lost dramatic amounts of money and market share competing with BSkyB,<sup>55</sup> and rising programming costs have been identified as a key culprit.<sup>56</sup> In a recent article in *Fortune* on the proposed News Corp. merger, *Fortune* reported the following conversation with an unnamed cable operator:

‘Look at the U. K. experience,’ says one U.S. cable operator, who’s not ready to speak publicly yet. ‘BskyB, which was controlled by News Corp., had very tight control over movies and sports, and the cost of programming to cable operators was higher than anywhere else in the world.’ Told that Murdoch promises to sell his content to cable and satellite on the same terms, the cable guy replies, ‘It’s easy to overprice programming when you’re paying yourself.’<sup>57</sup>

In addition to the foregoing, it is interesting to note that the failure of the proposed condition to prevent the “charge high prices to everyone” strategy is caused to some extent by the fact that DirecTV has a national footprint. If News Corp. were to merge with an MVPD with

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<sup>55</sup> See *Tony Ball*, *Financial Times*, October 29, 2002, at 10 (“during the past year, the shortcomings of ITV Digital, the digital terrestrial platform that collapsed into bankruptcy this year, and the crippling debt burdens of cable groups Telewest and NTL have served only to exaggerate BSkyB’s strength”).

<sup>56</sup> See *Price*, *Telewest Attacks BSkyB Price Rise*, *Financial Times*, January 23, 1998, at 20 (“Telewest Communications, the UK’s second biggest cable company, yesterday blamed price increases by BSkyB, its main supplier of television programmes, for a rise in the number of customers failing to renew their subscriptions last year”).

<sup>57</sup> Marc Gunther, *Murdoch’s Prime Time*, *Fortune*, February 3, 2003.

a less-than-national footprint, then News Corp. would have an incentive to charge lower prices in its out-of-region areas. In this case, the non-discrimination condition would impose a real constraint on News Corp. In order to charge a high price to in-region rivals and maximize its in-region profits, it would also have to charge an equally high price to out-of-region MVPDs which would reduce its out-of-region profits. Therefore, to the extent that News Corp. merged with an MVPD that had a less-than-national footprint, a non-discrimination condition might provide it with some incentive to keep programming prices lower.

The “problem” with the News Corp.-DirecTV case is of course that DirecTV has a national footprint so there will be no out-of-region MVPDs that News Corp. will want to charge low prices to. Therefore, it can charge as high a price as it wishes to its rivals simply by charging an equally high price to DirecTV.

## **VIII. POTENTIAL CONDITIONS TO REMEDY THE HARMS**

Although the main focus of my paper in this early stage of the proceedings is simply to identify the potential harms of the merger, I will briefly discuss some possible approaches to crafting conditions that might help remedy these harms.

### **A. Non-Discrimination in Retransmission Consent Pricing**

The most obvious and natural condition to consider is of course that News Corp. extend the same non-discrimination guarantees regarding the prices and terms it offers for its cable network programming to apply also to the prices and terms it offers for retransmission consent of its local broadcast stations. From the perspective of economic fundamentals there is very little difference between these two cases. In both cases, News Corp. is an upstream provider of an important programming input that it sells both to DirecTV and MVPDs that compete with

DirecTV. In my mind there is no economic reason for the Commission to treat these two situations differently. If the Commission determines that the non-discrimination condition is useful and necessary for the upstream product of cable networks then it seems to me that the Commission should be able to apply exactly the same reasoning to conclude that the same condition is useful and necessary for the upstream product of local broadcast signals.

The fact that the existing non-discrimination rules apply to cable network programmers that are vertically integrated with cable systems but do not apply to local broadcast stations that are vertically integrated with cable systems is easy to explain. This is simply because it has been, until very recently, illegal for a company to own a local broadcast station and cable system in the same region, so there has been no need to have a non-discrimination condition for local broadcast stations vertically integrated with cable systems.<sup>58</sup> Now that it has become legal for local broadcast stations to vertically integrate with cable systems that serve the same region, consistency on the part of the Commission will require it to extend its non-discrimination rules to local broadcast stations that are vertically integrated with cable systems. Of course the other fairly recent development in the MVPD market is that DBS is now a significant enough competitor that consistency also requires that the non-discrimination rules should also be generally applied to DBS firms in the same way they are applied to cable systems.

From this perspective, then, in order to be consistent, the Commission should require News Corp. to agree to non-discrimination conditions on both cable network programming and retransmission consent of local broadcast signals. This would deal with the immediate case that has arisen. Then, to make its rules consistent, the Commission should extend its non-

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<sup>58</sup> See 47 U.S.C. § 613 (a)(1) (repealed); 47 C.F.R. § 76.501(a) (vacated).

discrimination rules to apply more generally to any cable network programmer or local broadcast station that is vertically integrated with any MVPD (where in the case of a local broadcast station, the local broadcast station and MVPD serve the same overlapping areas.)

### **B. Prohibitions Against Bundling**

A less obvious but still potentially worthwhile approach might be to consider limiting News Corp.'s ability to bundle certain "must have" programming such as its RSNs and retransmission consent for its local broadcast stations together with other programming. It is a widespread and pervasive practice in the industry for network programmers to require MVPDs that want to purchase their "must have" programming to also purchase less desirable programming. News Corp. has been particularly aggressive in bundling its more popular programming, including its local channels, with other less popular or startup channels.<sup>59</sup> However, it is by no means alone in this respect.<sup>60</sup> Therefore network programmers generally find it optimal to exercise whatever market power they have over their "must have" programming both by charging higher prices and by bundling their "must have" programming together with less desirable programming.

From this perspective, one approach to counteracting the increase in market power over "must have" programming that this merger will convey to News Corp. might be to limit the extent it can be exercised by restricting News Corp.'s ability to bundle. The FTC, for example,

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<sup>59</sup> A description of these practices is set forth in the comments to which this analysis is attached.

<sup>60</sup> See, e.g., Linda Moss & Mike Farrell, *Viacom Buys Custody; Comedy Central Joins MTVN Stable*, Multichannel News, April 28, 2003, at 1 ("MTVN has a history of buying networks and bundling them with MTV or Nickelodeon, raising the service's rates in the process..."); Linda Moss, *Primer on Dropping Nets Could Draw Lots of Ops*, Multichannel News, October 14, 2002, at 1 (describing small cable operators' efforts to evade programmer bundling and other requirements).

followed this approach in the conditions it placed on the Time Warner Turner merger by prohibiting the merged firm from engaging in certain types of bundling.<sup>61</sup>

### CONCLUSION

The proposed merger between News Corp. and DirecTV will give News Corp. both the incentive and ability to charge higher programming prices to MVPDs that are rivals of DirecTV. In the short run this will harm consumers because these price increases will be passed through to them in the form of higher subscription prices. In the long run, price increases to MVPDs will harm competition at the MVPD level -- especially in less dense regions of the country where the business case for multiple MVPDs is more tenuous -- as DirecTV's rivals will be driven out of business or fundamentally weakened. In those markets, DirecTV will eventually be able to increase prices even more. The non-discrimination condition proposed by News Corp. does not apply to retransmission consent and is weakened by allowing quantity discounts. More fundamentally, the condition imposes a limited constraint on News Corp. even if these problems could be solved because News Corp. can simply respond by charging high programming prices to all MVPDs including DirecTV.

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<sup>61</sup> See Decision and Order, *In the Matter of Time Warner Inc., a corporation; Turner Broadcasting System, Inc., a corporation*, 123 F.T.C. 171 at Section V (February 3, 1997) ("*Time Warner/Turner*") (prohibiting the merged entity from bundling each firm's most popular networks with other, less popular networks).

I declare that the foregoing is true and correct:

  
William P. Rogerson

Dated:

June 13, 2003

## EXHIBIT 1

### Curriculum Vitae of William P. Rogerson

#### Personal

Date of birth: November 7, 1955

Citizenship: American

Addresses: (Home): 494 Ash Street  
Winnetka, IL 60093  
(847) 441-8160

(Office): Department of Economics  
2003 Sheridan Road  
Northwestern University  
Evanston, IL 60208  
phone: (847) 491-8484  
fax: (847) 491-7001  
e-mail: wrogerson@northwestern.edu

#### Education

B.A., Economics, University of Alberta, 1976

Ph.D., California Institute of Technology, 1980

#### Current Employment

Professor of Economics, Northwestern University

**Honors, Awards and Research Grants**

Graduated from the University of Alberta with distinction, 1976

Earl C. Anthony Fellowship, 1976-77

Canada Council Doctoral Fellowship, 1979-80

Shelby Cullom Davis Fellowship, 1979

NSF Grant SES-8320451, "Moral Hazard, Reputation, and Product Quality,"  
March 1984 - March 1985

NSF Grant SES-8504304, "Moral Hazard, Reputation, and Product Quality,"  
April 1985 - September 1987

NSF Grant IRI-8705477, "Contracting Under Asymmetric Information,"  
July 1987 - December 1989

Named to Household International Professorship in Economics, September  
1987 - August 1989

Lynde & Harry Bradley Foundation Research Grant, "An Economic Analysis  
of Defense Procurement Regulations," June 1989 - December 1991.

NSF Grant SES-8906751, "Profit Regulation of Defense Contractors," August  
1, 1989 - July 31, 1991.

Olin Fellow at The Center for the Study of the Economy and the State,  
University of Chicago, October 1, 1989 - June 30, 1990.

Smith Richardson Foundation, Inc. Research Grant, "Economic Incentives and the Defense  
Procurement Process," March 1, 1993 - May 31, 1995.

Elected a Fellow of the Econometric Society, 1999.

### **Research and Teaching Interests**

Industrial Organization, Regulation, Telecommunications, Cost Accounting, Defense Procurement, and Health Care.

### **Employment History**

Research Assistant to Canadian Member of Parliament, Arnold Malone,  
June 1975 - September 1975

Teaching Assistant at University of Alberta, September 1975 - June 1976

Economist, Department of Industry, Trade and Commerce, Government of Alberta, June  
1976 - September 1976

Research Assistant, Environmental Quality Laboratory, Caltech,  
June 1977 - September 1977

Economist, Long Range Planning and Structural Analysis Division, Department of  
Finance, Government of Canada, June 1978 - September 1978

Teaching Assistant to Professor Charles R. Plott, Division of Humanities and Social  
Sciences, Caltech, September 1979 - June 1980

Assistant Professor of Economics, Stanford University, September 1980 - August 1984

Associate Professor of Economics, Northwestern University, September 1984 - May 1990

Professor of Economics, Northwestern University, May 1990 - Present

Chair, Economics Department, Northwestern University, September 1996 - August 1998.

Chief Economist, Federal Communications Commission, June 1, 1998-May 31, 1999 (on leave  
from Northwestern for this year.)

Director, Northwestern Program in Mathematical Methods in the Social Sciences, September  
2000- present.

### **Professional Activities**

Editor of Defense and Peace Economics, January 1995 - December 1998.

Member of the editorial board of Defense and Peace Economics, September 1991 -  
December 1998.

Member of the editorial board of Review of Accounting Studies,  
September 1993 to present.

Member of the editorial board of Journal of Industrial Economics, October 1995- Sept. 1998.

Chief Economist of Federal Communications Commission, June 1, 1998 - May 31, 1999.

Member of the Illinois Economic Policy Council, September 1999 to September 2000

Consultant to: Federal Communications Commission, Federal Trade Commission, Institute for  
Defense Analysis, Logistics Management Institute, Office of the Secretary of Defense  
(Program Analysis and Evaluation), RAND Corporation, US Department of Justice

### **Referreed Publications**

"Aggregate Expected Consumer Surplus As a Welfare With an Application to Price  
Stabilization," *Econometrica*, 49, No. 2, (March 1980), pp. 423-436.

"Agriculture in Development: A Game-Theoretic Analysis," with Robert Bates, *Public Choice*,  
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"The Social Costs of Monopoly and Regulation: A Game-Theoretic Analysis," *Bell  
Journal of Economics*, 13, No. 2, (Autumn 1982), pp. 391-401.

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- "Consumer Misperceptions, Market Power and Product Safety," with Mitchell Polinsky, *Bell Journal of Economics*, 14, No. 2, (Fall 1983), 581-589.
- "A Note on the Incentive for a Monopolist to Increase Fixed Costs as a Barrier to Entry," *Quarterly Journal of Economics*, 396, May 1984, 399-402.
- "Efficient Reliance and Damage Measures for Breach of Contract," *Rand Journal of Economics*, Spring 1984, 39-53.
- "Repeated Moral Hazard," *Econometrica*, 53, January 1985, 69-76.
- "The First-Order Approach to Principal Agent Problems," *Econometrica*, 53, November 1985, 1357-1368.
- "Robust Trading Mechanisms" with Kathleen Hagerty, *Journal of Economic Theory*, 42, June 1987, 94-107.
- "The Dissipation of Profits by Brand Name Capital and Entry When Price Guarantees Quality," *Journal of Political Economy*, 95, August 1987, 797-809.
- "A Note on the Existence of Single Price Equilibrium Price Distributions," *Review of Economic Studies*, 54, April 1987, 339-342.
- "Price Advertising and the Deterioration of Product Quality," *Review of Economic Studies*, 55, April 1988, 215-230.
- "Profit Regulation of Defense Contractors and Prizes for Innovation," *Journal of Political Economy*, 97, December 1989, 1284-1305.
- "Quality vs. Quantity In Military Procurement," *American Economic Review*, 80, March 1990, 83-92.
- "Excess Capacity in Weapons Production: An Empirical Analysis," *Defence Economics*, 2, 1991, 235-250.
- "Optimal Depreciation Schedules for Regulated Utilities," *Journal of Regulatory Economics*, 4, 1992, 5-33.
- "Contractual Solutions to the Hold-Up Problem," *Review of Economic Studies*, 59, October 1991, 777-794.
- "Incentives, the Budgetary Process, and Inefficiently Low Production Rates in Defense Procurement," *Defence Economics*, 3, 1991, 1-18.
- "Overhead Allocation and Incentives for Cost Minimization in Defense Procurement," *The Accounting Review*, 67, 1992, 671-690.
- "Choice of Treatment Intensities by a Nonprofit Hospital Under Prospective Pricing," *Journal of Economics and Management Strategy*, 3(1), Spring 1994, 7-52..
- "Economic Incentives and the Defense Procurement Process," *Journal of Economic Perspectives*, 8(4), Fall 1994, 65-90.
- "Inter-Temporal Cost Allocation and Managerial Investment Incentives," *Journal of Political Economy*, 105(4), 1997, 770-795.
- "The Regulation of Broadband Telecommunications, The Principle of Regulating Narrowly Defined Input Bottlenecks, and Incentives for Investment and Innovation," *University of Chicago Legal Forum*, 2000, 119-147.
- "The Use of Simple Menus of Contracts in Cost-Based Procurement and Regulation," *American Economic Review*, June 2003, *forthcoming*.

### **Other Publications**

- "Electric Generation Plants" Appendix F.1 in *Implementing Tradable Emissions Permits for Sulfur Oxides Emissions in the South Coast Air Basin*, Vol. II, by Glen R. Cass, Robert W. Hahn, Roger G. Noll, ARB Contract No. A8-141-31, June 30, 1982.
- "A Comment on Political Institutions and Fiscal Policy: Evidence from the U.S. Historical Record," *Journal of Law Economics and Organization*, 6, Special Issue, Conference on "The Organization of Political Institutions", 1991, 155-166.
- "Inefficiently Low Production Rates in Defense Procurement: An Economic Analysis," Leitzel, Jim and Jean Tirole, eds., *Incentives in Defense Procurement*. Boulder: Westview Press, 1993.
- Profit Regulation of Defense Contractors and Prizes for Innovation*, RAND, R-3635-PA&E, 1991.
- An Economic Framework for Analyzing DoD Profit Policy*, RAND, R-3860-PA&E, 1991.
- Overhead Allocation and Incentives for Cost Minimization in Defense Procurement*, RAND, R-4013-PA&E, 1992.
- "Review of 'A Theory of Incentives in Procurement and Regulation,'" book review, *Journal of Political Economy*, 102, 1994, 397-402
- On the Use of Transfer Prices in DoD: The Case of Repair and Maintenance of Depot Level Repairables by the Air Force*, Logistics Management Institute Paper PA303RD2, January 1995, Logistics Management Institute, McLean, VA.
- "Incentive Models of the Defense Procurement Process," in Hartley, Kieth, and Todd Sandler, eds., *The Handbook of Defense Economics*, North Holland, 1995, 309-346..
- "The Economics of University Indirect Cost Reimbursement in Federal Research Grants," (with Roger Noll) in Roger Noll, ed., *Challenges to the Research University*. Washington: Brookings Institution, 1997.
- "New Economic Perspectives on Telecommunications Regulation," (review of *Competition in Telecommunications*, by Jean-Jacques Laffont and Jean Tirole), *University of Chicago Law Review*, 67, Fall 2000, 1489-1505.

**EXHIBIT B**

Before the  
**FEDERAL COMMUNICATIONS COMMISSION**  
Washington, DC 20554

In the Matter of:	)	
	)	
General Motors Corporation, Hughes	)	
Electronics Corporation, and the	)	
News Corporation Limited Application	)	MB Docket No. 03-124
To Transfer Control of FCC	)	
Authorizations And Licenses Held By	)	
Hughes Electronics Corporation	)	
To The News Corporation Limited	)	

**AFFIDAVIT OF LYNN A. STOUT**

1. My name is Lynn A. Stout. I hold the position of Professor of Law at the University of California at Los Angeles (UCLA) School of Law, where I teach basic and advanced courses in securities regulation and corporate law. I have also taught at the Georgetown University Law Center, George Washington University's National Law Center, Harvard Law School, and the New York University School of Law. A copy of my current *curriculum vitae* is attached.

2. I have been asked by the Joint Cable Commenters to examine the Consolidated Application for Authority to Transfer Control (Application) filed by General Motors Corporation (GM), Hughes Electronics Corporation (Hughes), and The News Corporation Limited (News Corp.) in this proceeding. Specifically, I have been asked to examine the proposed corporate structure of Hughes and to analyze whether the potential for self-dealing transactions between Hughes (including affiliates of Hughes) and News Corp. (including affiliates of News Corp.) can be addressed by a Hughes board

of directors with a majority of "independent" directors and an Audit Committee comprised only of "independent" directors.

3. As described in greater detail below, I conclude that, under Delaware law, the potential for self-dealing transactions between Hughes and News Corp. is not addressed by a Hughes board of directors with a majority of "independent" directors and an Audit Committee comprised only of "independent" directors." Nor is the problem of controlling shareholder self-dealing addressed by provisions of the Sarbanes-Oxley Act designed to deter officer and director self-dealing (e.g., provisions restricting corporate loans to officers and directors), or by New York Stock Exchange (NYSE) proposed listing requirements for majority-independent boards and independent audit committees.

4. My analysis is based on the facts described in the May 2 Application and its Attachments B, C, D, E, and G, as well as Appendixes C and D (the proposed Hughes Charter and By-laws) filed with the Securities and Exchange Commission on June 5, 2003.

5. These documents describe the proposed governance structure of Hughes as follows. Hughes' present shareholder, GM, will split off Hughes and divest itself of its interest in Hughes. Hughes will become a publicly-traded Delaware corporation. Hughes will continue to own indirectly all interests in DirecTV Enterprises, LLC (DirecTV). (Application at page 4.) News Corp. will acquire, through its subsidiary Fox Entertainment Group, Inc., a 34% interest in Hughes. As a result, News Corp. will become the single largest shareholder of Hughes. Rupert Murdoch, the Chief Executive Officer (CEO) of News Corp., will become the Chairman of the Hughes Board of Directors. (Application at pages 1-2, 10-13.) The Hughes CEO will be Chase Carey, a

former News Corp. co-Chief Operating Officer (COO). (Application at page 13.) Hughes' board will consist of eleven members, six of whom are described in the Application as "independent." (Application at page 13, Attachment D at D-3.) In addition, the board will have an Audit Committee comprised entirely of "independent" directors. (Application at page 13.)

6. The meaning of "independent" is not defined in the Application. However, the proposed Hughes Charter states that the meaning of independent "may be defined from time to time in the By-Laws." (Charter at Article V, Section 5.) The proposed Hughes By-Laws, which can be amended at any time by the Hughes board of directors (Charter at Article VII), define an independent director as a director who qualifies as such under the rules and regulations of the New York Stock Exchange or, if such rules are not in effect, a director who, "as determined in good faith by the Board," has no relationship to Hughes "that may interfere with the exercise of his or her independence from management of [Hughes] and [Hughes] and no material relationship with any member of the Purchaser Group ..." For purposes of this Affidavit, I use that definition.

7. The Application states that any subsequent transactions entered into between Hughes and its controlling shareholder News Corp., such as a programming contract between Hughes' subsidiary DirecTV and a News Corp. programming affiliate, "may be subject to review and approval by the independent Audit Committee." (Application at page 14, emphasis added.) The Application then concludes that this potential for audit committee review will "ensure that such contract is on arm's length terms." (Application at page 59.)

8. This conclusion is incorrect.

**I. UNDER DELAWARE LAW, NEWS CORP. WOULD BE THE DE FACTO CONTROLLING SHAREHOLDER OF HUGHES**

9. As a result of the proposed transactions, News Corp. will become the single largest shareholder of Hughes, with a stake amounting to 34% of Hughes' outstanding shares. The next-largest shareholder, a collection of trusts established under various GM employee benefit plans, will hold only about 20%. The remaining 46% of Hughes shares will be widely held by the public at large. (Application at page 13.)

10. This ownership structure makes a compelling case that News Corp. will be the *de facto* controlling shareholder of Hughes. The case for *de facto* control is further strengthened by the facts that the Hughes CEO will be Chase Carey, a former News Corp. co-COO, that Hughes' board will be Chaired by News Corp.'s present CEO, Rupert Murdoch, and that five members of Hughes' eleven-member board will be "interested" directors.

11. The Application concedes that, in light of these factors, "the Commission may deem News Corp. to exercise *de facto* control over Hughes under its totality of the circumstances test for purposes of the Communication Acts." (Application at page 14.) For similar reasons, News Corp. would likely be deemed the *de facto* controlling shareholder of Hughes for purposes of Delaware corporate law. *Solomon v. Armstrong*, 747 A.2d 1098, 1116 n.53 (Del Ch. 1999).

**II. A TRANSACTION BETWEEN A CONTROLLING SHAREHOLDER AND A PARTIALLY-OWNED SUBSIDIARY IS SELF-DEALING UNLESS THE CONTROLLING SHAREHOLDER CAN PROVE "ENTIRE FAIRNESS"**

12. Delaware law treats any transaction or contract between a controlling parent corporation and its partially-owned subsidiary as an "interested" transaction.

Sinclair v. Levien, 280 A.2d 717 (Del. 1971). Such interested transactions are intrinsically suspect, on the straightforward theory that a controlling parent can use its influence over a partially-owned subsidiary (including its influence over the subsidiary's directors) to pursue deals that extract wealth from the subsidiary in a fashion that benefits the controlling shareholder exclusively, while sharing the harm between the subsidiary's controlling and noncontrolling shareholders.

13. The classic example of this is the case where a parent uses its influence to cause a partially-owned subsidiary to enter a contract requiring the subsidiary to buy or sell goods or services from the parent on terms that are less favorable than those the subsidiary could obtain in arm's length transactions. This is the archetype of "self-dealing," because it allows a controlling shareholder to extract a benefit from the subsidiary firm "to the exclusion of, and detriment to, the minority shareholders of the subsidiary." *Sinclair v. Levien*, 280 A.2d 717, 720 (Del. 1971).

14. Recognizing the unavoidable conflict of interest presented by transactions between a parent and a partially-owned subsidiary, Delaware corporate law treats such transactions as intrinsically suspect and subject to challenge by the subsidiary's noncontrolling shareholders, who can bring suit against the controlling shareholder alleging self-dealing in breach of the shareholder's fiduciary duty of loyalty. The controlling shareholder accused of self-dealing will be found liable unless it can prove that the transaction was entirely "fair" to the subsidiary. "Fairness" requires a demonstration of both "fair dealing" (that is, a fair negotiating process) and a "fair price." *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).<sup>1</sup>

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<sup>1</sup> The burden of showing entire fairness normally rests on the controlling shareholder. However, in some circumstances, if the interested transaction is approved after full disclosure by the vote of a majority of the

15. Notwithstanding the fact that a noncontrolling shareholder can, in theory, sue a controlling shareholder for self-dealing, in practice there are substantial barriers to doing this. Noncontrolling shareholders cannot be expected to know of self-dealing transactions in advance, nor even always to detect them when they occur. Even if self-dealing is detected, noncontrolling shareholders may lack the resources or inclination to undertake the litigation involved in trying to establish breach of duty. Moreover, it can be extremely difficult to establish damages in cases where controlling parents and partially-owned subsidiaries enter complex agreements, because of the difficulties of establishing what a "fair price" should be.

16. Moreover, transactions between parent and subsidiary corporations often give rise to common economic benefits (through economies of scope, tax offsets, etc.) that are not available in transactions between unrelated corporations. Delaware law does not require a controlling shareholder to share these common benefits with the subsidiary or the subsidiary's noncontrolling shareholders, because it does not treat a failure to share as a detriment to minority shareholders. *Sinclair v. Levien*, 280 A.2d 717, 720 (Del. 1971); *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883 (Del. 1970).

17. For these reasons, noncontrolling shareholders' theoretical standing to bring lawsuits challenging self-dealing transactions cannot be expected to deter all such transactions, nor to prevent a controlling shareholder from retaining for itself the benefits from parent-subsidiary transactions.

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firm's noncontrolling shareholders, the burden of showing unfairness will shift to the noncontrolling shareholders challenging the transaction. *Williams v. Geier*, 671 A. 2d 1368, 1382 (Del. 1996). It should be noted however that such noncontrolling shareholder ratification does not immunize a controlling shareholder from liability for self-dealing, but merely shifts the burden to the plaintiff to show unfairness in the transaction. *Solomon v. Armstrong*, 747 A.2d 117, 1116-17 (Del. Ch. 1999).

**III. "INDEPENDENT" DIRECTOR APPROVAL DOES NOT REMEDY A SELF-DEALING TRANSACTION BETWEEN A CONTROLLING SHAREHOLDER AND A SUBSIDIARY**

18. The Application suggests that interested transactions between News Corp. and Hughes "may be subject to review and approval" by an Audit Committee comprised only of Hughes' "independent" directors. (Application at page 14.) The Application then suggests that the potential for review will ensure that any interested transactions occur only on "arm's length terms." (Application at page 59.)

19. These statements do not paint an accurate picture of the legal effect of independent director approval on controlling shareholder liability under Delaware law. The concept of the "independent" director developed in corporate law not to address the problem of controlling shareholder self-dealing, but a different problem: officer and director self-dealing. Directors and officers of a firm may be tempted to extract wealth from the firm through self-interested transactions that harm all the firm's shareholders, controlling and noncontrolling alike. (Lavish executive compensation contracts are an example).

20. A variety of legal rules and doctrines address the problem of director and officer self-dealing, often by encouraging contracts between the firm and officers or directors to be negotiated or approved by "independent" directors who do not themselves have a personal interest in the transaction. Such solutions can be found, *inter alia*, in Section 144 of the Delaware corporate code, which addresses interested transactions between the firm and its directors; in certain provisions of the Sarbanes-Oxley act, for example rules prohibiting loans between the firm and its officers and directors; and in the NYSE's proposed listing requirement of a board with a majority of independent members and an audit committee comprised entirely of independent directors.

21. However, the problem of officer and director self-dealing is not particularly relevant to the proposed acquisition of a controlling block of Hughes by News Corp. As discussed above, the primary problem raised by the proposed acquisition is controlling shareholder self-dealing.

22. As a result the potential for controlling shareholder self-dealing raised by the proposed acquisition is not well addressed by the sorts of solutions offered in Section 144, Sarbanes-Oxley, or the NYSE's proposed listing rules. These solutions were not developed to prevent a controlling stockholder from exerting influence over a partially-owned subsidiary, and do not remedy that problem.

23. Delaware Section 144, Sarbanes-Oxley, and the NYSE's proposed rules for independent directors do not remedy the problem of controlling shareholder self-dealing because, in a very basic sense, no director reliably can be "independent" of a controlling shareholder's influence. Each director owes a fiduciary duty to that shareholder, and each also must recognize that if he goes against the controlling shareholder he will likely lose his position on the board. The result is that even "independent" directors may, as a practical matter, be dominated by and defer to a controlling shareholder. *Kahn v. Lynch Communications Systems*, 638 A.2d 1110, 1115 (Del. 1994). For this reason, Delaware law does not mandate "independent" director review and approval of transactions between a controlling shareholder and the firm: such review and approval cannot suffice to give a clean bill of health to transactions that are by their very nature tainted with conflict of interest. (It is worth noting that the Application only claims that transactions between News Corp. and Hughes "may be subject to review

and approval" by the Audit Committee; this careful phrasing correctly recognizes that nothing in Delaware law requires this).

24. Review and approval of transactions between the firm and a controlling shareholder by a board committee comprised of directors who are not themselves employees of the controlling shareholder can, perhaps, help towards establishing the "fair dealing" prong of the two-prong "entire fairness" test. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 n.7 (Del. 1983). However, it is important to note that this arrangement alone does not guarantee a judicial finding of fair dealing, because directors who are nominally "independent" may nevertheless defer to a controlling shareholder. *Kahn v. Lynch Communications Systems*, 638 A.2d 1110, 1115 (Del. 1994). Moreover, a finding of fair dealing does not address the issue of fair price. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983). Finally, even in a case where a controlling shareholder could establish both fair dealing and fair price, the result would not be to immunize the controlling shareholder from liability, but simply to shift the burden to the plaintiff of showing unfairness. *Kahn v. Lynch Communications Systems*, 638 A.2d 1110, 1117 (Del. 1994).

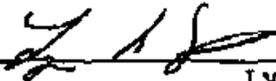
25. The net result is that Delaware law does not mandate that the "independent" directors of a partially-owned subsidiary review and approve self-dealing transactions between the subsidiary and its controlling shareholder. Even if review occurs, it does not insulate such transactions from challenge but only contributes to a showing of the "fair dealing" aspect of the "entireness fairness" Delaware law seeks in such transactions, or, at most, shift the burden to noncontrolling shareholders to establish unfairness. Similarly, neither the Sarbanes-Oxley Act nor the rules of the New York

Stock Exchange remedy the potential for controlling shareholder self-dealing that would arise in connection with transactions between News Corp. and Hughes

#### CONCLUSION

26. For the reasons stated above, I conclude that the proposed acquisition by News Corp. of a controlling block of Hughes would raise problems of controlling shareholder self-dealing that cannot be addressed by a Hughes board with a majority of "independent" directors, nor by the existence of an Audit Committee comprised only of independent directors.

I declare that the foregoing is true and correct:

  
\_\_\_\_\_  
Lynn A. Stout  
Professor of Law

Dated: 5/13/03

## **LYNN A. STOUT**

University of California at Los Angeles School of Law  
405 Hilgard Ave., Los Angeles, CA 90095-1476  
Phone: (310) 206-8402; FAX: (310) 267-1895  
E-mail: stout@law.ucla.edu

### **PROFESSIONAL POSITIONS**

**University of California at Los Angeles School of Law, Los Angeles, CA**  
Professor of Law, July 2001 to present

Courses taught, 1990 to present: corporate law; securities regulation; law and economics; international securities markets; finance theory and capital markets seminar; jurisprudence of law and economics seminar. Administrative positions, 2001-02: Faculty Appointments committee, 2001-02.

**Eaton Vance Mutual Funds, Boston, MA**  
Director/Trustee, 1998 to present

Independent director/trustee of mutual fund family with \$50 billion under management.

**Georgetown University Law Center, Washington, DC**  
Director, Georgetown-Sloan Project on Business Institutions, 1999 to 2001; Professor of Law, 1991 to 2001; Associate Professor, 1990 to 1991

**Harvard Law School, Cambridge, MA**  
Visiting Professor, Spring 2000

**The Brookings Institution, Washington, DC**  
Guest Scholar, 1995

**New York University Law School, New York, NY**  
Visiting Professor, Fall 1994

**George Washington University National Law Center, Washington, DC**  
Professor of Law, 1986 to 1990 (tenured 1989)

**Williams & Connolly, Washington, DC**  
Attorney, 1983 to 1986

**U.S. District Court for the District of Columbia, Washington DC**  
Judicial Law Clerk to the Hon. Gerhard A. Gesell, 1982-1983

## EDUCATION

**Yale Law School**, New Haven, CT

J.D., May 1982

Senior Editor, *Yale Law Journal*

**Princeton University**, Princeton, NJ

Master of Public Affairs, Woodrow Wilson School, May 1982

Woodrow Wilson Fellow

**Princeton University**, Princeton, NJ

A.B., May 1979

*Summa cum laude*, Phi Beta Kappa, Woodrow Wilson School Senior Thesis Prize, National Merit Scholar

## PUBLICATIONS

### Books

CASES AND MATERIALS ON LAW AND ECONOMICS (with David Barnes, West 1992)

Supplemental Series (all with David Barnes, West 1992):

THE ECONOMICS OF CONSTITUTIONAL LAW AND PUBLIC CHOICE

THE ECONOMICS OF CONTRACT LAW

THE ECONOMIC ANALYSIS OF TORT LAW

THE ECONOMICS OF PROPERTY RIGHTS AND NUISANCE LAW

THE ECONOMIC FOUNDATIONS OF REGULATION AND ANTITRUST LAW

### Articles and Book Chapters

*The Shareholder As Ulysses*, U. Pa. L. Rev. (forthcoming 2003)

*On The Proper Role of the Corporate Director (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board)*, Del. J. Corp. L. (forthcoming 2002) (17th Annual Francis G. Pileggi Distinguished Lecture in Law)

*On the Export of U.S.-Style Corporate Fiduciary Duties to Other Cultures: Can A Transplant Take?*, in GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS (Columbia University Press, forthcoming 2003) (Curtis Milhaupt, ed.)

*Do Antitakover Defenses Reduce Shareholder Wealth? The Ex Ante/Ex Post Measurement Problem*, 55 Stan. L. Rev. 845 (2002)

*Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. Cal. L. Rev. 1189 (2002)

*The Investor Confidence Game*, 68 Brooklyn L. Rev. 407 (2002) (Ninth Annual Abraham L. Pomerantz Lecture)

*In Praise of Procedure: An Economic and Behavioral Defense of Van Gorkom and the Business Judgment Rule*, 96 Nw. U. L. Rev. 765 (2002) (Symposium on *Van Gorkom* and the Corporate Board)

*Judges As Altruistic Hierarchs*, 43 Wm. & Mary L. Rev. 1605 (2002) (2001 George Wythe Lecture)

*Director Accountability and the Mediating Role of the Corporate Board*, 79 Wash. U. L. Q. 403 (with Margaret Blair) (2001) (Symposium on Corporate Accountability)

*Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. Penn. L. Rev. 1735 (2001) (with Margaret Blair) (Symposium on Norms and Corporate Law)

*Why The Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 Duke L. J. 701 (1999) (Reprinted in CORP. PRACTICE COMMENTATOR (West Group, 1999))

*A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247 (1999) (with Margaret Blair) (selected in Corporate Practice Commentator's annual poll as one of the ten best corporate and securities law articles published in 1999) (reprinted in 24 J. Corp. L. 743, Symposium on Team Production in Business Organizations) (Reprinted in CORP. PRACTICE COMMENTATOR (West Group, 1999))

*Irrational Expectations*, 3 Legal Theory 227 (1997) (Symposium on Rationality and Cognition)

*How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 Cardozo L. Rev. 475 (1997) (Symposium on the Essays of Warren Buffett)

*Technology, Transactions Costs, and Investor Welfare: Is a Motley Fool Born Every Minute?* 75 Wash. U. L. Q. (1997) (Symposium on Markets and Information Gathering In An Electronic Age: Securities Regulation in the 21st Century)

*Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 Va. L. Rev. 611 (1995) (selected in the Corporate Practice Commentator's annual poll as one of the ten best corporate and securities law articles published in 1995) (Reprinted in CORP. PRACTICE COMMENTATOR (West Group, 1995))

*Betting The Bank: How Derivatives Trading Under Conditions of Uncertainty Can Increase Risks and Erode Returns in Financial Markets*, 21 J. Corp. L. 53 (1995) (Symposium on Derivative Securities)

*Strict Scrutiny and Social Choice: An Economic Inquiry into Fundamental Rights and Suspect Classifications*, 80 Geo. L. J. 1787 (1992) (Symposium on Positive Political Theory and Public Law)

*Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 Yale L. J. 1235 (1990)

*The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 Mich. L. Rev. 613 (1988)

### **Shorter Essays, Notes, and Commentaries**

Book Review, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic*, 39 J. Econ. Lit. 1248 (2001).

*The Mediating Board: An Alternative View of Directors' Duties*, Corp. Governance Advisor (Jan/Feb 2001) (with Margaret Blair)

*Introduction: Team Production in Business Organizations*, 24 J. Corp. L. 743 (1999) (with Margaret Blair) (Symposium on Team Production in Business Organizations)

*Response to Kostant's "Exit, Voice, and Loyalty in the Course of Corporate Governance and Counsel's Changing Role"* (1999) 28 J. SocioEcon. 251 (1999) (with Margaret Blair)

*Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 Arizona L. Rev. 711 (1996) (Symposium on the Private Securities Litigation Reform Act of 1995)

*Insurance or Gambling? Derivatives Trading In A World of Risk and Uncertainty*, 1996 Brookings Rev. 39 (Winter)

*Agreeing To Disagree Over Excessive Trading*, 81 Va. L. Rev. 751 (1995) (Reply)

*Some Thoughts on Poverty and Failure in the Market for Human Capital*, 81 Geo. L. J. 1947 (1993) (Symposium on Poverty Law and Policy)

Note, *The Case for Mandatory Separate Filing by Married Persons*, 91 Yale L. J. 363 (1981)

### **RECENT SPEECHES, TESTIMONY, AND PUBLIC COMMENTARY**

2002: American Association for Law and Economics, Annual Meeting  
Brooklyn Law School, 2002 Abraham L. Pomerantz Lecture  
Columbia Law School, Conference on Global Markets, Domestic Institutions: Corporate  
Law and Governance in a New Era of Cross-Border Deals  
Vanderbilt University Law School, 2002 Law and Business Conference

Association of American Law Schools, Annual Meeting of the Securities Regulation  
Section

2001: Delaware Journal of Corporate Law and Widener School of Law, 2001 Francis G. Pileggi  
Distinguished Lecture in Law

University of Southern California Law School, USC/UCLA 2001 Corporate Law  
Roundtable

Georgetown University Law Center, Georgetown-Sloan Conference on Corporations as  
Producers and Distributors of Rents

American Association for Law and Economics, Annual Meeting

University of Michigan Law School, Conference on Judging Business: The Role of  
Judicial Decisionmaking in Corporate and Securities Law

University of Delaware, Center for Corporate Governance, Symposium on *Van Gorkom*  
and

the Corporate Board

College of William and Mary School of Law, 2001 George C. Wythe Lecture

University of Washington School of Law Center for Interdisciplinary Studies, Summary  
Conference on Norms and the Law

University of Washington School of Law, Institute for Law and Economic Policy,  
Symposium on Corporate Accountability

Institute for Law and Economic Policy, Conference on Corporate Accountability

University of California at Berkeley Law School, Law and Economics Workshop

2000: University of Pennsylvania Law School, Conference on Norms and Corporate Law

University of Chicago Law School, Law and Economics Workshop

University of Washington School of Law Center for Interdisciplinary Studies, Preliminary  
Conference on Norms and the Law

Harvard Law School, Guest Speaker

Harvard Law School, Law and Economics Workshop

New York University Law School, Workshop on Labor and Employment Law

1999: University of Southern California Law School, Guest Speaker and Visiting Olin Scholar

Duke University Global Capital Markets Center, Conference on Reexamining the  
Regulation of Capital Markets for Debt Securities

University of Georgia, Conference on Teaching Corporate Law

Georgetown University Law Center, Olin Conference on Evolution and Legal Theory

Georgetown University Law Center, Sloan Conference on Team Production

New York University Stern School of Business, Roundtable Conference on the Year 2000  
Computer Problem

Fordham Law School, Guest Speaker

Association of American Law Schools, Annual Meeting of the Socioeconomics Section

1998: Testimony before the U.S. Senate Banking Committee, Subcommittee on Financial  
Services and Technology, on Disclosing Year 2000 Readiness

American University Law School, Guest Speaker

Columbia Law School, Sloan Conference on Corporate Governance

American Association for Law and Economics, Annual Meeting  
Association of American Law Schools, Business Associations Workshop  
Association of American Law Schools, Annual Meeting of the Socioeconomics Section

### **PROFESSIONAL ASSOCIATIONS**

ABA Committee on Federal Regulation of Securities  
AALS Section on Law and Economics (Chair, 1994)  
AALS Section on Business Associations (Executive Council 1992-94 and 1997-99, Chair Elect for 2004)  
American Law and Economics Association  
Bars of the District of Columbia and the Commonwealth of Virginia (associate member)