ECONOMIC ANALYSIS OF THE NEWS CORPORATION/DIRECTV TRANSACTION

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TABLE 1

INTRODUCTION

1. I, Dennis W. Carlton, am a Professor of Economics at the Graduate School of Business of The University of Chicago. I received my A.B. in Applied Mathematics and Economics from Harvard University and my M.S. in Operations Research and Ph.D. in Economics from the Massachusetts Institute of Technology. I have served on the faculties of the Law School and the Department of Economics at The University of Chicago and the Department of Economics at the Massachusetts Institute of Technology. I specialize in the economics of industrial organization, which is the study of individual markets and includes the study of antitrust and regulatory issues. I am co-author of the book *Modern Industrial Organization*, a leading text in the field of industrial organization, and I also have published numerous articles in academic journals and books. In addition, I am Co-Editor of the *Journal of Law and Economics*, a leading journal that publishes research applying economic analysis to industrial organization and legal matters. I have served as an Associate Editor of the *International Journal of Industrial Organization* and *Regional Science and Urban Studies*, and have served on the Editorial Board of *Intellectual Property Fraud Reporter*.

2. In addition to my academic experience, I am a consultant to Lexecon Inc., a consulting firm that specializes in the application of economics to legal and regulatory issues. I have provided expert testimony before various U.S. state and federal courts, the U.S. Congress, a variety of state and federal regulatory agencies and foreign tribunals. I have served as a consultant to the Department of Justice on the Horizontal Merger Guidelines (1992) of the Department of Justice and Federal Trade Commission, as a general consultant to the Department of Justice and Federal Trade Commission on antitrust matters, and as an advisor to the Bureau of the Census on the collection and interpretation of economic data.

3. I, Janice H. Halpern, am a Senior Vice President of Lexecon Inc. I received a B.A. degree from the University of Rochester and a Ph.D. from the Massachusetts Institute of Technology. I have published articles in scholarly journals including *The Journal of Public Economics* and *The New England Economic Review.*

4. I, Gustavo E. Bamberger, am a Senior Vice President of Lexecon Inc. I received a B.A. degree from Southwestern at Memphis, and M.B.A. and Ph.D. degrees from the University of Chicago Graduate School of Business. I have provided expert testimony to the U.S. Senate, the U.S. Federal Energy Regulatory Commission, the U.S. Department of Transportation, the U.S. Federal Communications Commission, the U.S. International Trade Commission, the Canadian Competition Tribunal, state regulatory agencies and federal courts.

5. The News Corporation Limited ("News Corp.") intends to acquire an interest in DIRECTV, the direct broadcast satellite ("DBS") service owned by Hughes Electronics Corporation ("Hughes"). DIRECTV provides DBS service to approximately 11.4 million subscribers in the United States. News Corp. is a multinational media company, with interests in broadcast, cable and satellite programming, as well as in satellite direct-to-home ("DTH") television platforms outside the United States.

6. Through this transaction, News Corp. will become a provider of DBS service in the United States. News Corp. is active in televised programming in the United States, owning and having ownership interests in a broadcast television network, a variety of cable networks, 35 broadcast television stations, and other program content, such as movies. News Corp. has been innovative in introducing new and successful services throughout the world, often in competition with well-established incumbents that successfully deterred challenges from entrants in the past.

7. News Corp. intends to bring efficiencies and innovation to DIRECTV and to compete aggressively with other multichannel video program distributors ("MVPDs") in the

United States. News Corp. will bring to DIRECTV a wealth of experience and a historical willingness to take risks in using technology and program content in new ways to attract and satisfy consumers. News Corp. expects to achieve significant cost savings at DIRECTV, despite the lack of horizontal overlap between the companies. Those savings, along with the acceleration of new DBS service offerings, likely will result in significant growth in DIRECTV and increased competition among MVPDs.

8. Based on the analysis that we present in this report, we have concluded that this transaction raises no significant competitive concerns. Our report is organized as follows. We begin by noting that the transaction is vertical, not horizontal. We then explain in Part II why vertical mergers typically are procompetitive. We explain that critics that have complained about the transaction have ignored the possible benefits of vertical mergers and have improperly relied on the economic literature on vertical foreclosure that they claim supports their concerns. In Part III, we explain why the critics' claims that News Corp.'s networks are "essential" programming, without which DIRECTV's rivals cannot compete, are inconsistent with the empirical evidence. In Part IV, we explain that, even if News Corp. is assumed to have market power in programming, the critics have provided no evidence that this transaction would change its incentives to engage in complete or partial foreclosure.

9. We then explain in Part V that the program access rules, the limited control that News Corp. has over many of the networks in which it has a financial interest, as well as its fiduciary duty to partners in its networks and in DIRECTV would constrain it from foreclosing MVPDs from access to programming, even if it had an economic incentive to do so. Finally, in Part VI, we describe the efficiencies that the parties expect to result from the transaction.

I. THE TRANSACTION IS VERTICAL AND CREATES NO SIGNIFICANT HORIZONTAL MARKET POWER

10. This transaction raises no significant horizontal concerns. DIRECTV distributes video programming, all of which is supplied by third parties, typically under nonexclusive contracts.[1] In contrast, News Corp. does not distribute multi-channel video programming in the United States, but rather provides video programming to U.S. distributors. It has ownership interests in a number of cable networks and owns the FOX broadcast network. The cable networks are distributed on cable as well as on DIRECTV and EchoStar, and the FOX broadcast network is available over the air. Because News Corp. supplies video programming to DIRECTV, as well as to DIRECTV's competitors, the transaction is almost entirely vertical.[2] In the rest of our report we explore vertical concerns that have been raised by a number of parties that have submitted comments on this transaction ("the critics").

II. CONCERNS RAISED BY CRITICS OF THE TRANSACTION IGNORE THE ECONOMIC THEORY OF VERTICAL FORECLOSURE AND ITS APPLICATION TO THIS TRANSACTION

11. A number of DIRECTV competitors and other commentors have expressed concerns that this transaction is anticompetitive. These comments generally claim to rely on the economic theory of "raising rivals' costs" to support their concerns. As we now explain, the

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1. DIRECTV currently is the exclusive distributor of a package of NFL games. Its contract to distribute these games exclusively ends in 2005, at which time the NFL will be able to offer the package to cable. DIRECTV's exclusive satellite rights expire in 2007, and there is no guarantee that the contract will be renewed. We also note that DIRECTV has a five percent passive interest in the Hallmark Channel.

2. We understand that Liberty Media Corporation ("Liberty"), a passive minority News Corp. shareholder, owns a cable system in Puerto Rico. News Corp. has no financial interest in the Puerto Rican cable system. We do not analyze Liberty's ownership stake in that cable system. (We also understand that News Corp. is treated as an "integrated programmer" under the FCC's program access rules because of Liberty's stake in News Corp.)

critics improperly rely on this literature and on the economic theory of vertical foreclosure, and they provide no evidence that supports their speculative claims of harm. None of the critics explains why the conduct that they claim will result from this transaction could not occur today if it were in the firms' interest, and none provides empirical support for the proposition that the conditions required under the economic theory of harm from vertical mergers apply to the facts of this transaction. Based on our review of their comments, we conclude that none of the critics has offered any basis to question the presumption that this vertical transaction, like most vertical transactions, is procompetitive.

A. VERTICAL TRANSACTIONS GENERALLY ARE PROCOMPETITIVE

12. Vertical integration generally is procompetitive.[3] Firms vertically integrate for a variety of reasons. For example, firms sometimes vertically integrate in order to avoid externalities, such as those that arise when a firm's reputation depends on the quality of its inputs, yet unaffiliated input suppliers fail to take this effect into account. Vertical integration also can facilitate the transfer of expertise between parties when it is difficult to write contracts that protect both parties.[4]

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3. "Most of the reasons that firms choose to vertically integrate have to do with reducing costs or eliminating a market externality. Firms choose the least costly approach: Only if a firm can perform most of the necessary production steps less expensively than if it relied on other firms does it vertically integrate." *See* Dennis W. Carlton and Jeffrey M. Perloff, *Modern Industrial Organization* (3rd. Ed. 2000), p. 378 ("Carlton and Perloff").

4. Contracts may be particularly difficult to write when the transaction involves transfer of expertise from one party to the other. This would require writing a contract that specifies the scope of the information and knowledge that will be transferred and the price to be paid for that assistance. In practice, however, such arrangements sometimes can be complicated, because it may be difficult to monitor performance or to specify in advance the type of assistance that will be provided (e.g., because there is substantial uncertainty about the type of assistance that will be needed). For example, it may be hard to write and monitor performance of a contract under which a firm that has developed an efficient manufacturing

13. Economists who study possible competitive harm from vertical transactions generally acknowledge that most vertical transactions are procompetitive. For example, economists Michael H. Riordan and Steven C. Salop have noted that

> [b]ecause many vertical mergers create vertical integration efficiencies between purchasers and sellers, many if not most vertical mergers are either procompetitive or competitively neutral. Potential efficiency benefits involve improved coordination in pricing, production, and design that can reduce costs and improve product quality. They also involve more efficient input usage and promotion.[5]

14. One procompetitive reason for vertical mergers is to eliminate the double markup that occurs when both merging parties sell at prices that include a markup over marginal cost. When firms integrate, they take into account the misallocation of resources that results from their independent pricing decisions. That inefficiency arises because the two independent parties do not internalize the effect of their combined markups, and the resulting higher consumer price, on output and total profit (this occurs because the independent downstream firm takes the upstream firm's price as its marginal cost, and then adds its own markup). The consequence is that consumer prices are higher and output is lower than they are when the firms vertically integrate and require the downstream division to add no downstream markup over marginal cost in order to maximize the combined firm's profits.[6]

15. Because mergers that eliminate the double markup can be procompetitive, regulators should take care that they do not enjoin mergers that are efficient. The potential

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(...continued)
process for widgets agrees to assist a manufacturer of gadgets in improving its gadget-manufacturing process. Contingencies such as inappropriate appropriation by the widget manufacturer of technology or trade secrets proprietary to the gadget maker may be difficult to identify in advance, difficult to prevent and hard to detect.

5. Riordan and Salop, "Evaluating Vertical Mergers: A Post-Chicago Approach," 63 *Antitrust Law Journal* 513 (Winter 1995), p. 519.

6. *See* Carlton and Perloff, pp. 398-400.

benefits from eliminating double markups should not be ignored based on theoretical models of harm that do not apply to the particular merger under consideration.

B. CRITICS IMPROPERLY RELY ON THE ECONOMIC LITERATURE ON RAISING RIVALS' COSTS

16. Vertical integration generally is procompetitive. In a straightforward economic model with homogeneous goods and market power at one stage of production, no incremental market power is gained through vertical integration. This follows because, with market power at only one stage, the firm with market power generally can obtain all its supracompetitive profit by restricting supply and raising price of the product it sells. It gains nothing by vertically integrating and also raising margins in the other market. Rather, it benefits from the competitiveness of the other market, because this increases the number of units it can sell at its supracompetitive margin. It cannot, and has no desire to, reduce competition in the competitive market.[7] This is the implication of our earlier discussion, in which we explained that the monopolist makes more profit when there is a single monopoly markup. It follows that if there were market power at the downstream level, then the monopoly upstream firm would want to vertically integrate (or enter into a contract) to capture the monopoly profit from its downstream distributors. In this case, too, the elimination of double markups leads to higher profits for the monopolist and lower prices to consumers.

17. In the theoretical model that we believe is motivating the critics, vertical integration can reduce competition when each party operates at only one stage of production and has market power at each stage. Some critics cite the economic theory of "raising rivals' costs" as developed in the economics literature on vertical foreclosure to support their claims that, after

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7. *See* Carlton and Perloff, Chapter 12.

the acquisition, News Corp. will foreclose DIRECTV's competitors from some News Corp. networks and DIRECTV will foreclose or refuse to carry networks that compete with those of News Corp. For example, Professor William P. Rogerson, in an Exhibit to joint comments submitted by several cable companies, says:

> 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. [Footnote: *See, e.g.,* Michael H. Riordan & Steven C. Salop, *Evaluating Vertical mergers*[sic]*: 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).] I believe that the facts of this case fit these circumstances.[8]

Professor Rogerson adds that this literature "explains why a vertically integrated supplier will *generally* have an incentive to 'raise rivals' costs'."[9]

18. To the extent that Professor Rogerson claims that this literature shows that vertical mergers generally are anticompetitive, he is wrong. Instead, this literature discusses the specific conditions under which a vertical merger can be anticompetitive and can provide incentives for the integrated firm to "raise rivals' costs" to extend or enhance market power. However, rather than providing a basis for skepticism about the typical reasons for vertical transactions, this literature acknowledges that most vertical transactions are motivated by efficiencies and are procompetitive. Only under very specific circumstances, as explored by

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8. *See* William P. Rogerson, "An Economic Analysis of the Competitive Effects of the Takeover of DIRECTV by News Corp." Exhibit A to *Comments of Advance/Newhouse Communications, Cable One, Cox Communications, and Insight Communications,* Docket No. MB 03-124 (filed June 16, 2003) (hereafter, "Rogerson"), p. 2.

9. Rogerson, p. 22 (emphasis added).

Professor Salop and others, can a vertical transaction injure competition. In particular, the literature acknowledges that firms typically can achieve through contract the exclusionary effects that critics claim are motivating a particular transaction.

19. The "raising rivals' costs" literature describes specific market structures and strategic "games" that can lead to anticompetitive concerns. The critics make no attempt to determine whether the assumptions of that literature apply to this transaction. For example, one article cited by Professor Rogerson is by Ordover, Saloner and Salop ("OSS").[10] In this model, before the merger two independent upstream firms (such as two cable programming networks) supply their input to two independent downstream firms (such as MVPDs). OSS assume that the two independent upstream firms engage in competition to supply a homogeneous input at marginal cost – that these two firms compete and have no pre-existing market power. OSS also assume that, after the merger of one upstream firm with one downstream firm, the unintegrated downstream firm can obtain its input from either the integrated or unintegrated upstream firm. OSS then show that, under certain circumstances, a vertical merger in which one of the upstream firms merges with one of the downstream firms may increase downstream market power.

20. Professor Rogerson makes no attempt to determine whether this theoretical model of competition applies to this transaction. For example, in the OSS model, there is no market power at the upstream level; this is equivalent to an assumption that News Corp. has no market power in the supply of cable networks. Yet this contradicts the critics' contention that News Corp. networks are "essential" programming, which implies that these networks have substantial market power. The critics cannot have it both ways.

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10. Janusz A. Ordover, Garth Saloner and Steven C. Salop, "Equilibrium Vertical Foreclosure," 80 *American Economic Review* 127 (1990).

21. The critics also fail to consider how the strategy – or "rules of the game" – affects the outcome in the theoretical models, and they make no attempt to determine what "rules of the game" are in place here. In the OSS model, the outcome depends critically on the choice of strategy. For example, in the OSS model, the anticompetitive harm results when the downstream competitors sell differentiated products and engage in "Bertrand" competition (a form of competition in which each competitor takes other competitors' prices as given and responds optimally). If this assumption is changed, so that the downstream firms engage in "Cournot" competition (a form of competition in which each competitor takes other competitors' quantities as given and responds optimally), then there is no incentive to raise rivals' costs through vertical merger and the anticompetitive effects disappear.

22. Moreover, OSS explicitly note that, if firms can enter vertical contracts, a vertical merger to raise rivals' costs is both unnecessary and undesirable.[11] Firms generally can achieve the effects of vertical integration through contract. This means that if there is no barrier to entering into exclusionary vertical contracts, but we do not see such contracts today, then there is no reason to expect vertical integration to result in exclusion. Yet the critics have not attempted to determine whether the anticompetitive exclusionary conduct that they fear will result from this merger could be achieved today through contract.[12]

23. Over a decade ago, one of us (Carlton) noted in commenting on an article by Professors Oliver Hart and Jean Tirole on vertical integration and market foreclosure (cited by Professor Rogerson) that blind application of theoretical models of possible harm to real-life

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11. "[W]here it is possible for firms to enter into alternative contractual relationships with their input suppliers, these may appear to be preferable to a merger" (p. 139). This article is cited by Professor Rogerson at p. 2.

12. We understand that the program access rules do not preclude News Corp. or other integrated programmers from signing exclusive contracts with DIRECTV or EchoStar.

situations where the assumptions do not hold can result in erroneous findings of harm to competition:

> If the point of a paper is to show that something is theoretically possible – for example, that socially undesirable vertical foreclosure could occur – then the paper is interesting only as long as the strategy space is not too outlandish. If the point of a paper is to show that foreclosure is not only theoretically possible but actually occurs and if the paper will be used for policy recommendations, then it matters very much what the strategy space is. I am especially wary when I know that the results may change significantly if there are changes in the strategy space.[13]

We believe that this warning applies to critics of the News Corp./DIRECTV transaction.

24. In their article, Hart and Tirole note that vertical mergers can be motivated by procompetitive goals, such as the desire to encourage investments by reducing the "holdup problem" (i.e., the possibility of opportunistic behavior), thereby increasing competition and resulting in lower prices. The authors then specify conditions under which vertical mergers instead can be anticompetitive, in particular, when firms have difficulty entering into binding contracts. Their analysis is based on a theoretical model with two upstream firms selling homogeneous products and two downstream firms also selling perfect substitutes. This model may not apply to this transaction because, among other differences, it relies (in one of its versions) on the inability of the firms to enter into binding contracts to exclude other firms or raise their costs. None of the critics has presented any evidence that firms in this industry could not contract for the type of exclusionary conduct that they claim will result from the transaction.

25. Thus, parties that have submitted comments expressing concerns about vertical foreclosure or raising rivals' costs as a consequence of this transaction cite to economic literature that relies on very specific assumptions about market structure, the ability to contract and the nature of competition to derive conditions under which vertical mergers create competitive

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13. Dennis W. Carlton, "Comments on Hart and Tirole," *Brookings Papers on Economic Activity*, 1990, p. 278.

injury. But these parties have made no effort to determine whether the assumptions needed to obtain anticompetitive effects in those models actually apply here. Moreover, they ignore the fact that there can be important procompetitive effects of vertical mergers when, as the critics appear to claim, both the upstream and downstream firms have some market power.

C. CONCLUSIONS

26. In their comments, the critics of this transaction offer no support for their concern that the transaction will result in competitive harm. Professor Rogerson cites economic literature on vertical foreclosure, without making any attempt to determine whether the specific assumptions of the theoretical models apply to this transaction. The critics discount the procompetitive benefits from vertical mergers that arise from production and other efficiencies from integration. And they ignore the elimination of double markups that must occur if their implicit but unsupported assumptions about market power and the inability to contract are correct.

III. SOME CRITICS CLAIM THAT NEWS CORP. HAS MARKET POWER IN PROGRAMMING, BUT EVIDENCE SUGGESTS THAT THIS CONCERN IS OVERSTATED

27. News Corp. has financial interests in a variety of different programming. These include general entertainment cable networks, such as FX, a cable movie channel (Fox Movie Channel), a cable news channel (Fox News), and several regional sports networks. News Corp. also owns the FOX broadcast network.

28. In most programming categories there are several competitors, often attracting more viewers than does the News Corp. network of that type. For example, there are many movie channels, including pay channels like HBO and Showtime, as well as basic cable

networks like American Movie Classics and Turner Classic Movies. Similarly, there are several other cable news networks, including CNN and MSNBC, as well as a large variety of general entertainment cable networks (USA, Lifetime, TBS and others). And the FOX broadcast network is only one of six broadcast networks.

29. Critics of the proposed transaction claim that News Corp. has market power in programming. They cite in particular the number and breadth of the FOX regional sports networks ("RSNs") and the FOX owned and operated broadcast stations (the "O&Os"). News Corp., through its Fox Entertainment Group ("FEG"), owns ten and has interests in nine more networks that exhibit sports programming of regional and national interest.[14] These RSNs have contracts with many sports teams to broadcast some or all of their games; other team games typically are shown on broadcast television or other cable networks. News Corp also owns and operates 25 broadcast stations affiliated with the FOX broadcast network, nine O&Os affiliated with the UPN broadcast networks and one independent station.

30. In particular, the critics contend that News Corp.'s regional sports networks are "essential" programming. They imply that a MVPD without these networks would be crippled as a competitor, because enough consumers would refuse to subscribe to a MVPD that did not offer these networks. Consequently, these critics fear that after this transaction News Corp. will distribute these sports networks only through DIRECTV or will increase the license fees charged to other distributors, forcing them in turn either to increase their subscription rates to cover the increased cost or to drop the networks. They assert that this will make DIRECTV's competitors less attractive, and therefore be profitable for News Corp. and DIRECTV. The critics make a

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14. News Corp. holds a minority financial interest and its partner has management control of seven RSNs. As we discuss in Part VI, News Corp. would be constrained from favoring DIRECTV in licensing any RSNs over which it lacks management control or in which it has partners with financial interests.

similar claim about the FOX O&Os; they claim that News Corp. will have an incentive to deny retransmission consent to or demand discriminatorily high retransmission payments from competing MVPDs.

31. Gregory Sidak, on behalf of the National Association of Broadcasters, makes the further claim that the proposed transaction would give News Corp. an incentive to "bypass" its affiliates by providing FOX network programming to DIRECTV via a national satellite feed.[15] But Mr. Sidak's claim must be dismissed because it is based on his implicit – and unwarranted – assumption that News Corp. derives no value from having a national network of affiliates. Furthermore, if Mr. Sidak's claim were valid (and it is not), News Corp. would have an incentive today to "bypass" its affiliates by entering into a contract with DIRECTV to provide FOX programming in all or selected areas only by national feed.

32. We now address the critics' claims that News Corp. owns "essential" programming over which it exercises market power.

A. THE SPORTS TEAMS AND NOT NEWS CORP. HAVE THE ULTIMATE POWER TO CONTROL SPORTS PROGRAMMING

33. Critics suggest that News Corp.'s RSNs are "essential" programming and face no significant competition. Presumably, the critics believe that entry into the regional sports network business is impossible, because they believe that News Corp. has entered into exclusive arrangements with virtually all the sports teams and leagues that are the essential input to a regional sports network. We explain later that this characterization of News Corp.'s arrangements with sports teams is inappropriate. But, we begin by explaining that, even if we

15. *See* "Declaration of J. Gregory Sidak," Exhibit 1 to *Comments of the National Association of Broadcasters,* Docket No. MB 03-124 (filed June 16, 2003), p. 2.

accept this characterization of exclusivity, it does not follow that the FOX RSNs must have market power.

34. Assume that the ability to watch televised games of a local sports team is highly valued by a city's residents. For illustrative purposes, assume that each person is willing to pay an extra $10 per month for the right to view these games. The team recognizes that its fans value the games and will take this into account in choosing and negotiating with the network that is granted the rights to televise those games. If several networks compete for the rights, or, indeed, even if the team can form its own network to broadcast its games, then networks will be willing to offer the team a license fee that gives the team virtually the entire value of the broadcasts (in this hypothetical, about $10 per subscriber minus the competitive return on the services provided by the network). The result will be that the network that wins the rights will earn only a competitive return, because its activities in providing network services are widely available. It is the team that will earn economic rents, because those rents derive from its uniqueness. Moreover, if the team's televised games attract more subscribers, the teams also could obtain the profits earned from these additional subscribers. Sports teams and leagues frequently auction the rights to exhibit their games. The competition among would-be programmers ensures that the team obtains economic rents associated with its scarcity value.

35. Although in the past the FOX RSNs have successfully competed for television rights and have provided consumers with popular regional sports programming, their historical success does not mean that they have significant market power. Indeed, in recent years the owners of several teams have awarded sports rights to non-News Corp. networks, or have established their own networks. Examples of new regional sports networks include the YES Network in New York (with the New York Yankees and New Jersey Nets); Comcast's Philadelphia SportsNet (with the Philadelphia Flyers, 76ers, Phillies and other teams); Cox

Sports Television (with the New Orleans Hornets); Channel 4 San Diego (with the San Diego Padres); and Cox 9 (with the Phoenix Suns). Some leagues have established their own network (e.g., the NBA), and some have sold their broadcast rights directly to an MVPD (e.g., NFL Sunday Ticket distributed by DIRECTV), rather than to a network. Finally, teams or other sports entities can elect to sell broadcasts directly on a pay-per-view basis, which is common for boxing matches, or to broadcast networks (as, for instance, the NCAA does for college football).

36. Market power – the ability to price profitably above marginal cost – derives from scarcity and lack of substitutes.[16] Sports teams may need network programming expertise and MVPD distribution in order to maximize the value of the team's televised games, but these resources are presumably widely available. Indeed, none of the critics has presented evidence to suggest otherwise. As long as there are several potentially competing networks bidding for the rights to broadcast sports programming (including the possibility that the team will vertically integrate to provide its own network), the network that obtains these rights should earn only a competitive return. That is, competition can exist to broadcast a monopolist's games. In contrast, there is, and generally only can be, a limited number of, and often only one, team in a particular sport in a given city. The team will exercise its market power by selling its rights to the programming service that offers the highest bid in order to capture the value of its scarcity.[17]

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16. It is, of course, possible for a firm, such as a network or program distributor, to have some market power in the sense that price exceeds its marginal cost. However, in industries with high fixed costs and low marginal costs, the ability to set price above marginal cost does not necessarily imply that price is set at a level that generates supracompetitive profits. Thus, one can have market power in the sense that price exceeds marginal cost, but not in the sense that price is so high that profits are excessive (i.e., supracompetitive). In this case, the relevant issue is whether the parties to the transaction have sufficient market power to merit concern that vertical foreclosure would become profitable as a result of the transaction and lead to consumer harm; for the reasons explained in this report, we conclude that they do not.

17. There may be spillover effects between a team's broadcast arrangements and other sources of revenue. A team's live attendance and souvenir and memorabilia sales may increase the more widely its televised games are distributed. For this reason, a team may not accept the

The networks that obtain broadcast rights will only earn a return sufficient to cover their costs of doing so.

B. FOX'S CONTRACTS WITH TEAMS AND LEAGUES HAVE LIMITED TERMS AND MANY SOON EXPIRE

37. FOX's contracts with sports teams typically have multiple-year terms. In the next two years, many of those contracts will expire. Although the FOX RSNs likely will bid to retain these broadcasting rights, they will face competition from other networks. The threat of losing broadcast rights to other competitors when contracts expire constrains FOX from acting against the teams' interests.

38. A recent article noted that many Major League Baseball teams, whose contracts with a FOX RSN expire soon, are considering exploiting their television rights themselves, modeled on the recent YES Network experience of the New York Yankees.[18] Thus, the sports teams and leagues that are the primary input of a RSN have alternative ways of reaching viewers and need not contract with a FOX or other unaffiliated RSN.

39. News Corp.'s ongoing competition for broadcast rights constrains its incentive to favor any MVPD, including DIRECTV, if this were not in the teams' best interests, even during the remaining term of its current contracts. If, after this transaction, News Corp. were to license its RSNs exclusively to DIRECTV, this might increase DIRECTV's subscribership. However, if it reduced the number of subscribers to other MVPDs and resulted in a smaller audience for the

(...continued)
highest price offered for its broadcast rights if the contract requires limited distribution, because the cost in foregone profits from other sources may exceed the premium paid for exclusive or limited distribution of televised games. The team is interested in maximizing its total profits, not profits earned from any individual source, and may believe that broader distribution at a lower price will produce the greatest overall returns.

18. "Baseball Seeks Key For the Fox TV Lock," *Broadcasting & Cable*, March 31, 2003, p. 31.

team's broadcasts, such action could injure the team. Such action also would cause enormous loss in viewership, given that DIRECTV has only a small share of total MVPD subscribers. Many subscribers to MVPDs that no longer carry the team's games might attribute their inability to see televised games to the team, and not to the RSN, causing ill-will between the team and its fans. If fans lose interest, the team's other revenue sources may decline, including ticket sales and sales of licensed team clothing and memorabilia. The result would be that News Corp. would be less likely to win the next round of bidding, having acted in unanticipated ways to injure the team during its contract.

40. Moreover, many sports teams seem to view their "best interests" as widespread broadcast, rather than limited distribution. In New York, neither EchoStar nor Cablevision reached an agreement with the YES Network for carriage during the 2002 baseball season. Both companies wanted to make YES a premium network, rather than including it in the basic package, while the YES Network insisted on being part of the more widely distributed basic package and thereby available to all subscribers. EchoStar still has not reached an agreement to carry the YES Network during the 2003 baseball season. Cablevision reached agreement only recently.[19]

41. Thus, News Corp. will be constrained from favoring DIRECTV during the remainder of the term of its existing contracts, because doing so could endanger its ability to renew its rights, or win new rights, to televised sports broadcasts.

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19. Empirical evidence suggests that, contrary to the critics' claims, regional sports networks are not "essential" programming. In Philadelphia, Comcast's Philadelphia SportsNet is exclusively available from terrestrial cable systems and not from DIRECTV or Echostar. Yet both DBS companies continue to provide service in Philadelphia. In New York, the YES network failed to reach agreement in 2002 with Cablevision, the largest cable company in the New York area, and with EchoStar. Cablevision reported losing only 30,000 subscribers as a consequence, or about one percent of its subscribers.

C. THE CRITICS' CONCERNS ABOUT FORECLOSURE OF FOX O&OS ARE EXAGGERATED

42. Some of the commentators claim that, after this transaction, News Corp. will deny DIRECTV's competitors access to the FOX O&O stations, or will demand enormously high fees for the right to retransmit these signals. Again, the critics fail to explain why vertical integration increases News Corp.'s incentive to engage in foreclosure.[20] Some critics assume that News Corp. will be able to discriminate against DIRECTV's rivals after this transaction. If it were in News Corp.'s interest to favor one distributor today, and if it were possible for News Corp. to discriminate against other distributors, News Corp. might be able to do so through its retransmission contracts, obtaining from the favored distributor retransmission payments and other commitments that reflected the value of the favored position. The critics have not explained why a contract that reflected the value of exclusivity or partial exclusivity could not be negotiated today with DIRECTV or another distributor.

D. CONCLUSIONS

43. Critics claim that News Corp. has market power in programming, primarily because of its regional sports networks and its ownership of the FOX O&Os. Economic theory and empirical evidence suggest that this claim is overstated. Indeed, economic theory shows that market power from sports programming typically would belong to the sports teams and leagues that are the scarce resource, and not to the cable networks that have contracted for rights to exhibit the team's games for a limited number of years. These sports interests may benefit from obtaining the maximum possible exposure of their televised games, because this has spillover

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20. For purposes of our analysis we ignore, as do the critics, the possible procompetitive benefits from exclusive contracts that are explained in the economic literature, such as providing incentives for greater marketing efforts and incentives, for example by eliminating the possibility of free riding. *See* Carlton and Perloff, Chapter 12.

benefits in greater fan interest. Cable networks are constrained from acting against a team's interest during the terms of their contracts, because doing so could cause them to lose the rights to exhibit the team's games when the contract expires and also could make other teams wary of contracting with that network. In addition, it appears from empirical evidence we have examined that lack of regional sports programming has not historically had a substantial adverse effect on MVPD subscriber growth. The same is true for the FOX O&Os, since both DIRECTV and EchoStar were a growing presence before they could offer local broadcast stations.

IV. EVEN IF NEWS CORP. IS ASSUMED TO HAVE MARKET POWER IN PROGRAMMING, ITS INCENTIVES TO LICENSE ITS PROGRAMMING TO MVPDS THAT COMPETE WITH DIRECTV ARE UNAFFECTED BY THE PROPOSED TRANSACTION

44. We now consider the critics' concerns that this transaction will create incentives for News Corp. to refuse to license, or to discriminate in licensing, its networks to EchoStar, cable companies and other MVPDs that compete with DIRECTV. As we now explain, the critics present no evidence that News Corp. will have a greater incentive to foreclose DIRECTV's competitors after this transaction than it does today if, through contract, it could obtain now any of the critics' hypothesized benefits of exclusivity. Since it does not license its networks on an exclusive basis today, there is no evidence, nor have the critics presented any, that it will have an incentive to do so after this transaction. Furthermore, we explain in Part V that News Corp. has agreed to program access commitments that constrain it from foreclosing or discriminating against any competing MVPD.

A. VERTICAL INTEGRATION INTO DISTRIBUTION DOES NOT CHANGE NEWS CORP.'S INCENTIVES REGARDING EXCLUSIVE DISTRIBUTION

45. Some critics have expressed concern that, after the acquisition of DIRECTV, News Corp. will foreclose its MVPD rivals by refusing to license, or raising the price of, its networks to rival MVPDs.[21] Their theory seems to be that any subscriber that News Corp. can convince to drop a competing MVPD and subscribe to DIRECTV instead will provide News Corp. with an incremental profit – its share of the margin earned from an incremental subscription to DIRECTV. The critics must believe that, when it was not vertically integrated, News Corp. was indifferent between a subscriber to cable or EchoStar and a subscriber to DIRECTV; it earned the same license fee per subscriber for each of its networks, whether an individual subscriber chose EchoStar, the local cable company or DIRECTV.[22] But, critics appear to fear that the RSNs and other News Corp. programs are "essential" networks and that after this transaction News Corp. can expand DIRECTV's subscribership, and its own profits, by making these networks exclusive to DIRECTV.[23]

46. There is no economic support for this concern. As presented above, the critics' argument is that DIRECTV's profits would expand greatly today if it were the exclusive distributor of certain networks, but because the companies are not affiliated this benefit to

21. We ignore in this discussion the fact that such conduct is prohibited by the program access requirements and would be limited further by the undertakings that News Corp. has agreed to observe as a condition of approval of this transaction. Our discussion in this section assumes for purposes of argument that these restrictions on News Corp.'s conduct do not exist.

22. This is not strictly true, since News Corp. obtains different license fees for some networks from different MVPDs, consistent with the FCC's program access rules.

23. We consider in the next section whether this transaction creates an incentive to disadvantage DIRECTV's MVPD competitors by imposing a uniform increase in license fees for the News Corp. networks.

DIRECTV is ignored by News Corp. However, if the critics' characterization were accurate, then DIRECTV likely would have sought an exclusive contract from News Corp. to exhibit those cable networks.[24] That is, DIRECTV would have been willing to offer News Corp. a license fee that reflected its incremental profits from obtaining the exclusive license, which would include, as explained above, any incremental profits earned by adding subscribers to the entire DIRECTV package.

47. Whether entering into such contracts would be profitable for News Corp. today, when it is independent of DIRECTV, depends on whether News Corp. would lose more in license fees from other MVPDs if it granted exclusivity to DIRECTV. If it would lose more than it would gain from DIRECTV, then it would have no economic incentive to agree to an exclusive arrangement with DIRECTV; but if it would lose less, then it would have an economic incentive to grant DIRECTV exclusive rights today. The same is true for other non-cable MVPDs – for example, EchoStar could contract for an exclusive license from News Corp. (or any other cable programmer) today if EchoStar would earn more additional profit than News Corp. would lose from foreclosing other MVPDs.

48. Thus, if an exclusive arrangement were really in the collective financial interests of DIRECTV and News Corp., it likely would have already occurred through contract. Yet it has not occurred; News Corp.'s networks are licensed nonexclusively to cable and to both of the DBS companies. From this, we infer that, even if News Corp. has market power in

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24. The FCC's restrictions on exclusive contracts apply solely to cable operators, and thus do not prohibit an exclusive arrangement between a DBS operator and a cable programmer, even if the programmer is vertically integrated with a cable operator. *See* 47 C.F.R. § 76.1002(c). *See* also *Implementation of the Cable Television Consumer Protection and Competition Act of 1992*, 10 FCC Rcd. 3105 (1994) (upholding exclusive contracts between DBS operator and several vertically integrated programming vendors). The Commission's rules prohibit exclusive retransmission consent agreements. *See* 47 C.F.R. Section 76.64(l). We address the critics' concerns about O&O programming in our discussion of a possible uniform price increase.

programming, it will be better off after the transaction if it does not make DIRECTV the exclusive distributor of its networks. In other words, evidence from current licensing practices shows that News Corp. earns greater profit from widespread distribution across all MVPDs than it could earn by offering rights to exhibit its RSNs or other networks on an exclusive basis to DIRECTV or any other non-cable MVPD.

49. This general economic principle is confirmed by the numerical analysis of foreclosure performed by Charles River Associates ("CRA"). In their report, they show quantitatively that the benefit to DIRECTV from foreclosure does not outweigh the cost to News Corp. of reduced license fees from competing MVPDs. Put simply, given DIRECTV's small share of total MVPD subscribership, the required growth in DIRECTV's subscribership for a foreclosure strategy to be profitable is so large that it is unlikely to result if News Corp. foreclosed the other MVPDs from its networks. Thus, CRA's analysis supports a conclusion that there is no incentive for News Corp. to foreclose other MVPDs from access to its networks, either through contract or vertical integration.

B. THERE IS NO EVIDENCE THAT TRANSACTIONS COSTS HAVE PREVENTED EXCLUSIVE CONTRACTS

50. We explained above that vertical integration could be an efficient solution to high transactions costs. If firms are deterred from profitable transactions because the cost to negotiate the transaction between unaffiliated parties exceeds the benefits that would be realized, vertical integration may permit efficiency-enhancing exchanges to occur.

51. As explained above, economic theory shows that, all else equal, any benefit to News Corp. and DIRECTV from an exclusive cable network licensing arrangement could be achieved today through contract. The absence of such an arrangement and the infrequency of exclusive licensing arrangements generally suggest that exclusivity typically is not a profitable

strategy. At least in theory, however, it is possible that exclusivity is profitable, but that transactions costs of achieving exclusivity exceed the benefit to be gained. Assuming that this were true, then despite the absence of such arrangements today, after the transaction reduces or eliminates those costs, News Corp. might have an incentive to license its networks to DIRECTV exclusively. Thus, we now consider whether transactions costs associated with exclusive licensing of a network to an MVPD are so high that such transactions do not occur today, even though they would be profitable if transactions costs were eliminated.

52. There is considerable indirect evidence that the transactions costs of forming exclusive contracts for license of cable networks to MVPDs cannot be very high. First, we note that sports teams and leagues frequently enter into exclusive contracts with a programming service for all or some of their games. Although these negotiations typically do not involve an MVPD, the nature of the transaction is similar and involves negotiating a price for exclusivity that is satisfactory to both parties and makes them better off than would a non-exclusive arrangement. Second, as discussed above, DIRECTV has entered into one exclusive arrangement – for NFL Sunday Ticket. This transaction is similar to a negotiation between a network and the MVPDs that might compete for exclusive rights. Finally, negotiation of an exclusive arrangement by comparing bids from alternative purchasers is a transparent way of determining whether exclusivity is profitable. A network could ask each MVPD to submit two bids – one for exclusive rights and one for nonexclusive rights – and then determine which is the more profitable arrangement. The bidding contest would force the MVPDs to reveal the value of exclusivity.[25]

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25. The transactions costs of negotiating contracts for distribution of a programming service differ significantly from the transactions costs associated with providing expertise in operating a business. Transactions costs likely are much greater for transfer of human capital, particularly when proprietary knowledge must be shared. Thus, there could be a significant efficiency from vertically integrating News Corp.'s expertise in operating DBS

53. Thus, transactions costs likely would not prevent exclusive licensing of networks to MVPDs if such arrangements were profitable.

C. THE CRITICS OFFER NO EVIDENCE THAT THIS TRANSACTION WILL PROVIDE AN INCENTIVE FOR NEWS CORP. TO RAISE PRICE OF ITS CABLE NETWORKS OR O&OS AFTER THE MERGER

54. We now consider whether this transaction gives News Corp. an incentive to raise the price of its networks to MVPDs that compete with DIRECTV, as some critics claim. If it were to do so for its cable networks, it would have to raise prices uniformly because of the program access rules and the commitments it has agreed to honor (described more fully in Part V, below) that prevent discriminatory license fees and terms. There are similar, though less specific, constraints with respect to retransmission consent involving the obligation to bargain in good faith and to vary terms based only on "competitive marketplace conditions."[26]

55. As explained above, vertical integration will not result in foreclosure if the firm could have accomplished through contract any exercise of market power before it was integrated, but it did not do so. A similar theoretical argument applies when we consider whether this transaction creates incentives for News Corp. to raise price uniformly to competing MVPDs. Consider News Corp.'s incentives if it were not subject to the program access rules or retransmission consent requirements today, or if, as some critics contend, these rules are ineffective. In this case, News Corp. would be able to license each network to each individual MVPD at a license (or retransmission) fee that reflected the network's value to that MVPD. In other words, News Corp. today would be able to price discriminate among different MVPDs and

(...continued)
systems and its innovativeness in introducing new products and services with DIRECTV, as we discuss in Part VI.

26. *See* C.F.R. Section 76.65(a).

charge each one a different license fee, extracting through contract the "rents" associated with any market power, without being constrained to charge prices that vary only because of market-based distinctions permitted by the FCC.

56. Whatever market power News Corp. might have in any programming market would not be enhanced by this transaction since, by assumption, News Corp. already could obtain from each MVPD the rents associated with exhibition of the network. These rents do not increase when News Corp. vertically integrates, because there is no change in the horizontal competitive structure at either the network or distributor level.

57. Indeed, by agreeing to greater restrictions on its licensing activities as a condition of this transaction, News Corp.'s ability to discriminate in pricing among MVPDs based on the value to each MVPD of its programming becomes more limited. This implies that, if the News Corp. networks had significant market power, as the critics claim, then News Corp. might not want to engage in this transaction and the associated program access commitments and thereby limit further its ability to exercise that power.

58. Assume, however, that it is not possible for News Corp. to enter into contracts to extract from each MVPD the economic rents from the News Corp. networks. (This critical but unstated assumption is implicit in the critics' arguments.) By analogy, this suggests that News Corp. also cannot enter into contracts to eliminate double markups. In other words, if we assume that it is not possible for a network and distributor to contract to share the incremental profits from vertical integration, then this suggests that they also cannot contract to increase their aggregate profits by avoiding the inefficiency of double markups. As explained above, the elimination of a double markup can be a benefit of vertical mergers when firms cannot contract to eliminate this inefficiency.

59. As explained in detail in the CRA report, when contracting cannot occur, the result of vertical integration is theoretically ambiguous, because it can have both pro- and anticompetitive effects. The critics of this transaction have ignored the procompetitive benefits that result if firms cannot contract to achieve the coordination that results from vertical integration. CRA shows that, assuming that contracting cannot occur, the procompetitive benefits from vertical integration can outweigh the anticompetitive effects under one tractable theoretical model of oligopoly conduct. Thus, the critics have no basis in economic theory and have presented no empirical evidence for concluding that the net effect of vertical integration, even if contracting were impossible today, would be anticompetitive.

V. EVEN IF IT HAD MARKET POWER IN PROGRAMMING, AND EVEN IF IT HAD AN ECONOMIC INCENTIVE TO LEVERAGE THIS MARKET POWER INTO DISTRIBUTION, NEWS CORP.'S FIDUCIARY DUTIES, PARTIAL OWNERSHIP RIGHTS, AND PROGRAM ACCESS COMMITMENTS WOULD CONSTRAIN IT FROM ABUSING VERTICAL ARRANGEMENTS

60. We explained above that News Corp. would have no greater incentive to distribute its networks through exclusive distribution after this transaction than it does today. But even if this were not true, there are three reasons why such exclusive or discriminatory licensing would be constrained.

61. First, News Corp. and DIRECTV have agreed to abide by program access restrictions that are similar to those that apply to cable operators. They also are subject to the same program access rules that apply to "vertically integrated" programming services in which a cable operator has an ownership interest. The FCC already has determined that these rules adequately constrain cable operators and vertically integrated cable programmers from disadvantaging MVPD competitors. Moreover, the parties in this transaction have agreed to additional restrictions on their conduct that are in some respects greater than currently apply to

vertically integrated cable programmers or cable operators, including a commitment to offer any current or future national or regional programming service on a non-exclusive basis to all MVPDs, as well as a commitment not to engage in exclusive arrangements with or improperly influence affiliated programming entities, such as Liberty.

62. Second, News Corp. only has partial ownership rights in and lacks management control of many of its networks. It holds a minority, noncontrolling interest in some networks; the incentives of the firms managing these networks will be unchanged by this transaction, since they derive no financial benefit from increased profits at DIRECTV. In some of its other programming services, News Corp. has minority partners. Again, these partners have no financial stake in DIRECTV after the transaction, and would be injured if News Corp. denied programming to other MVPDs or imposed a "price squeeze" on DIRECTV's competitors. Therefore, News Corp's fiduciary duty to its partners and the partners' self-interested oversight of their network investments would constrain News Corp. from licensing those networks on discriminatory or exclusive terms that benefit DIRECTV at the expense of the profitability of the networks.

63. Finally, News Corp. has a fiduciary duty to Hughes' other owners. News Corp. is acquiring only a 34 percent interest in Hughes, entitling it to only 34 percent of its profits. Any actions that News Corp. takes that benefit its networks at the expense of the profits of the shareholders with 66 percent of Hughes could subject News Corp. to sanctions for violating its fiduciary responsibilities. We also understand that News Corp.'s operation of DIRECTV will be subject to review by an audit committee of outside directors. These provisions constrain News Corp.'s ability to act to against DIRECTV's interests.

VI. THE TRANSACTION WILL RESULT IN SIGNIFICANT COST SAVINGS, IMPROVED SERVICES AND CONSEQUENT GROWTH IN SUBSCRIBERSHIP

64. Transfer of expertise may be facilitated through common ownership. Incentives can be better aligned when the party possessing the expertise has a direct interest in the success of the party needing the expertise. Such considerations, namely the ability to use News Corp.'s expertise to improve DIRECTV's operations, have been identified as a benefit of this transaction. Although News Corp. has no experience operating a DBS system in the United States, it has been very successful in Europe. Moreover, News Corp. believes that its history of launching the FOX broadcast network, the Fox News Channel and other programming services in the United States shows that it can challenge incumbents successfully, and that the company is willing to make long-term commitments to doing so.

65. The economic benefits expected from the proposed transaction are described in the Declaration of Peter Giacalone, which is Attachment E to the Consolidated Application for Authority to Transfer Control filed by the parties with the FCC on May 2, 2003. Mr. Giacalone identifies savings from synergies and efficiencies of \$605-\$760 million per year on a recurring basis after three years. He classifies the savings into three categories:

- Increased operating efficiencies of \$65-135 million, primarily achieved by transferring to DIRECTV News Corp.'s expertise obtained by operating DTH satellite services outside the United States;
- The benefits of improved customer satisfaction, valued at \$450-525 million, achieved by providing better service and a more compelling product to DIRECTV subscribers; and
- Development of innovative products and services for DIRECTV, such as interactive television ("ITV"), valued at \$90-100 million annually.

66. We reviewed the analysis presented by Mr. Giacalone, as well as information about News Corp.'s BSkyB satellite service. This evidence provides reasons for confidence that this transaction will benefit consumers in the ways described by Mr. Giacalone. In particular, the

evidence shows that some functions at News Corp.'s United Kingdom BSkyB satellite company are performed at lower cost than is true at DIRECTV. As shown in Table 1, BSkyB's cost per subscriber is lower than DIRECTV's near-term projected costs for customer service, SG&A and broadcast operations.[27] Moreover, we understand that the parties have identified key overlapping distribution facilities that can be consolidated to achieve cost savings.

67. Historical evidence also shows that News Corp. has been highly innovative in introducing popular new networks and services, both through its own distribution platforms as well as by licensing its content to third-party distributors. This suggests that the company may accelerate DIRECTV's development and provision of new services and programs that will attract incremental subscribers and will reduce subscriber churn. For example, News Corp. plans to introduce ITV services through DIRECTV.

68. The efficiencies of this transaction likely will benefit consumers. For example, the introduction of new services that otherwise would not be available, or would not be available until a later time, provides clear consumer benefits and expanded output.

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27. Of course, this evidence is only suggestive, because the United States and United Kingdom are different markets.

Table 1

Cost Comparisons for DIRECTV and News Corp.'s BSkyB

	DIRECTV	BSkyB
Customer Service	$5.41	$2.86
SG&A	$3.28	$3.04
Broadcast Operations	$1.82	$1.36

Note: All costs are calculated on a per subscriber per month basis

Source: Document and analysis prepared by News Corp.