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August 20, 2003

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Ms Marlene H Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re Notice of Ex Parte Presentation
MB Docket No 03-124

Dear Ms Dortch

On August 19, 2003, on behalf of Cablevision Systems Corporation ("Cablevision"), Michael Olsen of Cablevision, Daniel Rubinfeld of the University of California at Berkeley, Duncan Cameron of LECG, LLC, James Olson of Howrey Simon Arnold & White; Howard Symons of Mintz, Levin and the undersigned met with Barbara Esbin, Tracy Waldon and Peter Alexander of the Media Bureau, C Anthony Bush of the Office of General Counsel; Doug Webbink of the International Bureau, and Simon Wilkie of the Office of Strategic Planning to discuss the above-referenced proceeding

Professor Rubinfeld and Dr Cameron explained that Charles River Associates' ("CRA") July 1, 2003 submission on behalf of GM/Hughes and News Corporation, purporting to show that a combined Hughes/News Corp would have no incentive to withhold access to Fox broadcast signals, was flawed because it examined only the effects flowing from a *permanent* withdrawal of a Fox broadcast signal from a cable system Applying CRA's own methodology, Professor Rubinfeld and Dr Cameron demonstrated that a strategy of *temporarily* withholding Fox broadcast programming would be profitable for News Corp. post-merger and therefore constituted a credible threat to cable operators that would enable News Corp. to exercise market power and hurt consumers by raising the costs of retransmission consent. Notably, the strategy would only need to be deployed in a few markets to present a credible threat to cable operators across the country.

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Using the attached slides, which were derived from publicly available data, Professor Rubinfeld and Dr. Cameron showed that applying the CRA methodology to a temporary withholding scenario demonstrates that only a very small (less than 1.5%) increase in DirecTV's market share would be required to make a temporary withholding strategy profitable Given the small increase required to implement such a strategy, anticompetitive behavior by the merged entity is not only possible, but likely The required increase in DirecTV's market share falls to less than 1% when the CRA methodology is adjusted to account for a variety of critical factors omitted in CRA's analysis of foreclosure These factors include (1) the fact that some viewers are able to receive Fox broadcasting signals over-the-air, which CRA itself recognizes, and thus must be excluded from lost advertising revenues; (2) the fact that even a temporary withholding affects the future growth of DBS because subscribers first selecting an MVPD or selecting a new MVPD after moving will consider access to programming in making that selection, (3) the fact that News Corp and DirecTV could easily jointly maximize profits, to act as if News Corp. had a 100% ownership interest in DirecTV, and (4) the fact that withholding programming from cable may confer significant marketing advantages on DirecTV, reducing its subscriber acquisition costs or increasing the effectiveness of subscriber acquisition cost expenditures.

We also discussed (in the absence of Michael Olsen of Cablevision) certain News Corp. documents in the record, numbered **[REDACTED]**
, supporting the arguments presented by Professor Rubinfeld and Dr. Cameron These documents **[REDACTED]**

Pursuant to section 1 1206(b)(2) of the Commission's rules and the terms of the Second Protective Order entered in this proceeding, the original and one copy of this letter and the handout are being filed with the Office of the Secretary. Copies are also being served on Commission personnel. One copy of the Highly Confidential version of this filing has been filed with the Office of the Secretary

Sincerely,

Tara M Corvo

Tara M Corvo

Attachment

cc. Barbara Esbin
Tracy Waldon
Peter Alexander
C Anthony Bush
Doug Webbink
Simon Wilkie

WDC 338093v2

An Economic Analysis of the News Corp/DirecTV Transaction

Daniel L. Rubinfeld
Duncan Cameron

Federal Communications Commission Presentation

August 19, 2003

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Cablevision's Concerns – Cable

- The proposed transaction is likely to create or enhance incentives for News Corp to withhold Fox Network programming from cable operators because News Corp's investment in DirecTV will reduce its cost of withholding retransmission consent.
- Even temporary loss of major network retransmission has proven extraordinarily harmful to cable providers.
- The ability to credibly threaten to withhold Fox Network programming will greatly increase News Corp's bargaining power – resulting in increased costs to Cablevision, and requiring Cablevision to increase subscriber rates and/or reduce service quality.

Temporary Withholding has Occurred

Disney/ABC & Time Warner-Houston Incident

- A retransmission consent dispute between Disney/ABC and Time Warner resulted in Time Warner cable subscribers losing the ABC network signal for 39 hours on May 1 and 2, 2000.
- The issue was most hotly contested in Houston, where the story was front-page news as early as March 1. Both Disney/ABC and Time Warner took out full-page newspaper ads and Disney/ABC offered $99 (later $198) rebate vouchers to Time Warner subscribers who signed up with DirecTV.

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Temporary Withholding (continued)

Disney/ABC & Time Warner-Houston Incident

- It is reported that Disney/ABC issued 20,000 or more rebate vouchers to Time Warner-Houston subscribers – about 3 percent of Time Warner's Houston subscriber base of about 665,000.
- Significantly, 15,000 or more of the Disney/ABC vouchers were issued before May 1– when the ABC signal was still available on Time Warner cable and Disney/ABC was suffering no advertising revenue losses.

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Temporary Withholding (continued)

Disney/ABC & Time Warner-Houston Incident

- Echostar also offered free equipment and installation to Time Warner subscribers enrolling with Echostar, and reported increased levels of subscribership activity during the period of the Disney/ABC - Time Warner dispute.
- Recent cable transactions indicate a value per subscriber as high as $3,400; the Houston episode therefore may have cost Time Warner over $65 million, while costing Disney/ABC virtually nothing.

Evaluating Foreclosure - Methodology

- CRA's basic methodology: Calculate the increase in DirecTV's share necessary for gains from foreclosure to offset losses.
- To apply this methodology appropriately, the calculation must reflect the likely foreclosure strategy, and utilize correct values for net margins, subscriber acquisition costs (SAC), and network advertising revenues.
- Applying the CRA methodology to a more likely scenario – a temporary withholding or threat of withholding – and using correct values, demonstrates that the increases in DirecTV's share necessary to make such a strategy profitable are small.[1]

[1] All parameter values used in our calculations are derived from public sources. See the Appendix for details.

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Temporary Foreclosure Strategy

CRA's Analysis Applies Only to a Permanent Foreclosure Strategy

The CRA equation below compares the contemporaneous losses and gains of a ***permanent*** foreclosure strategy. Using this equation CRA estimates that DirecTV would need to gain 40 share points for ***permanent*** foreclosure to be profitable.

$$\overbrace{(1 - DTV_{Share}) \cdot FOX_{Ad}}^{\textbf{Loss}} \leq \overbrace{S^* (DTV_{Net} \cdot P + FOX_{Ad})}^{\textbf{Gain}}$$

$$Loss \leq S^* (Gain)$$

DTV_{Share}	Initial MVPD Market Share of DirecTV	P	Fox Interest in DirecTV
Fox_{Ad}	Fox Monthly Per Viewer Advertising Revenue	DTV_{Net}	DirecTV Net Margin per Sub
S*	Implied DirecTV Share Gain to be Profitable		

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Temporary Foreclosure Strategy(continued)

Modifying the CRA Analysis

The CRA equation can be modified to assess a temporary foreclosure strategy. Assuming a one month loss equal to the CRA monthly loss, but a 60 month gain,[1] we can rewrite the CRA equation as follows:

$$Loss_0 \leq \hat{S}\left(Gain_0 + Gain_1/(1+r) + \ldots + Gain_{60}/(1+r)^{60}\right)$$

$$Loss_0 \leq \hat{S}\left(Gain_0 + Gain_1 D\right)$$

$$where:$$

$$Gain_0 = (DTV_{Net} \cdot P + FOX_{Ad})$$

$$Gain_{n=1-60} = (DTV_{Net} \cdot P)$$

$$D = \left(\frac{1}{1+r} + \frac{1}{(1+r)^2} + \ldots + \frac{1}{(1+r)^{60}}\right) = \left(\frac{1}{r} - \frac{1}{r(1+r)^{60}}\right)$$

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[1] 5.05 year sub life for DTV stated in SG Cowen Article "DBS Sector Upgrade" page 20 (document NCFCC06750) .

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Temporary Foreclosure Strategy(continued)

Modifying the CRA Analysis

We now solve the "Loss-Gain" equation, which yields the following expression for the market share gain necessary to make a temporary foreclosure strategy profitable:

$$(1 - DTV_{Share})FOX_{Ad} \leq \hat{S}(DTV_{Net} \cdot P + FOX_{Ad} + DTV_{Net} \cdot P \cdot D)$$

$$(1 - DTV_{Share})FOX_{Ad} \leq \hat{S}(DTV_{Net} \cdot P \cdot (1 + D) + FOX_{Ad})$$

$$\hat{S} \geq \frac{(1 - DTV_{Share})FOX_{Ad}}{(DTV_{Net} \cdot P \cdot (1 + D) + FOX_{Ad})}$$

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Temporary Foreclosure Strategy(continued)

Implied Market Share Gain for Profitability

Using this "basic" modified equation:

$$\hat{S} \geq \frac{(1 - DTV_{Share})FOX_{Ad}}{(DTV_{Net} \cdot P \cdot (1 + D) + FOX_{Ad})}$$

and estimates of DTV_{Net} and FOX_{Ad} (see Appendix), we derive a schedule relating the market share gain required to make a temporary foreclosure strategy profitable, given various discount rates (r):

r	D	$\hat{S}$
5%	53.13	**1.35%**
8%	49.64	**1.44%**
10%	47.54	**1.50%**

Note: NewsCorp reports a Weighted Average Cost of Capital of 7.9% [UBS Warburg]

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Temporary Foreclosure Strategy(continued)

- A temporary (1 month) withholding of Fox Network retransmission rights from cable companies would be profitable for News Corp if DirecTV's MVPD share were to increase by no more than 1.5 share points.[1]
- The Disney/ABC - Time Warner-Houston incident demonstrates that even a limited withholding – or publicized threat of withholding – of retransmission rights can have a very significant effect on subscriber movement to satellite.
- The profitability of a temporary withholding strategy makes it a "credible threat" and a powerful bargaining tool in retransmission consent negotiations between News Corp and cable providers.

1 "Share points" refer to share of MVPD subscribers throughout this presentation.

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Over-The-Air Reception Reduces "Loss"

- The calculations thus far have assumed that cable viewers have no alternative way to receive Fox broadcasts.
- However, some fraction of viewers are able to receive over-the-air network broadcasts. This reduces the "Loss" portion of the calculation.

Over-The-Air Reception (continued)

Implied Market Share Gain for Profitability

Modifying the basic equation to account for the portion of cable viewers substituting over-the-air broadcasts (w), we can use the following equation to calculate the share gain required for profitability:

$$\hat{S} \geq \frac{(1-w)(1-DTV_{Share})FOX_{Ad}}{(DTV_{Net} \cdot P \cdot (1+D)+FOX_{Ad})}$$

r	D	w=33%	w=50%
5%	53.13	**0.90%**	**0.68%**
8%	49.64	**0.96%**	**0.72%**
10%	47.54	**1.00%**	**0.75%**

Note: NewsCorp reports a Weighted Average Cost of Capital of 7.9% [UBS Warburg]

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Programming Affects DTV Growth

- The calculations thus far have also assumed that the future growth of DBS is unaffected by the temporary foreclosure strategy.
- However, access to programming is an important differentiator in consumer choice between DBS and cable.
- Consequently, a temporary withholding of network retransmission from cable rivals may increase the future growth of DirecTV subscribership.

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DTV Growth (continued)

Alternative formulation when growth is affected:

We can modify the basic model to account for increased DirecTV subscriber growth as follows:

$$Loss_0 \leq \hat{S}\left(Gain_0 + Gain_1/(1+r) + \ldots + Gain_{60}/(1+r)^{60}\right)$$

$$Gain_n = Gain_{n-1}(1+g)$$

$$where:$$

$$Gain_0 = (DTV_{Net} \cdot P + FOX_{Ad})$$

$$Gain_{n=1-60} = (DTV_{Net} \cdot P)$$

$$DG = \left(\frac{1+g}{1+r} + \frac{(1+g)^2}{(1+r)^2} + \ldots + \frac{(1+g)^{60}}{(1+r)^{60}}\right) = \left(\frac{1}{r-g} - \frac{(1+g)^{60}}{(r-g)(1+r)^{60}}\right)$$

[1] 5.05 year sub life for DTV stated in SG Cowen Article "DBS Sector Upgrade" page 20 (bates NCFCC06750) .

DTV Growth (continued)

Increased growth reduces the initial share gain necessary to compensate for loss:

Larger values of g increase DG, in turn reducing the required share gain.

$$\hat{S} \geq \frac{(1 - DTV_{Share})FOX_{Ad}}{(DTV_{Net} \cdot P \cdot (1 + DG) + FOX_{Ad})}$$

We calculate share gains necessary for profitability with a 3% enhanced growth rate of new subscriptions.

r	DG	$\hat{S}$
5%	57.02	**1.26%**
8%	53.18	**1.35%**
10%	50.87	**1.41%**

[1] 5.05 year sub life for DTV stated in SG Cowen Article "DBS Sector Upgrade" page 20 (bates NCFCC06750) .

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Alternative Ownership Interest

- CRA uses the proposed 34% News Corp interest in DirecTV in its calculations.
- CRA correctly acknowledges that News Corp has the option to increase its investment to 50%, and that this increased interest would affect the calculations.

Alternative Ownership Interest (continued)

- However, there are good reasons to conclude that the firms would be able to jointly maximize profits – effectively acting as if News Corp had a 100% ownership interest in DirecTV.
  - Joint profit maximization by News Corp and DirecTV benefit both DirecTV and News Corp shareholder interests provided there were a profit sharing mechanism between DirecTV and News Corp.
  - The Corporate Governance literature and learning suggest that mingling of ownership interests (and board participation) does affect the behavior of even less than fully integrated firms.[1]

[1] See, Besen, Murdoch, O'Brien, Salop & Woodbury, Vertical and Horizontal Ownership in Cable TV: Time Warner-Turner, in *The Antitrust Revolution*, Kwoka & White, eds. (1996).

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Alternative Ownership Interest (continued)

- Using values of DirecTV net margins and Fox advertising revenues inferred from publicly available information and the CRA calculations (see Appendix), we can modify the CRA model to account for differences in ownership interest.
- The following chart shows the effect on the share gain required under the temporary withholding scenarios to make foreclosure profitable given alternative News Corp interests in DirecTV.

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Alternative Ownership Interest (continued)

Required Share Gain as a Function of Investment Interest (P)

Again, using the basic equation:

$$\hat{S} \geq \frac{(1 - DTV_{Share})FOX_{Ad}}{(DTV_{Net} \cdot P \cdot (1 + D) + FOX_{Ad})}$$

r	D	50% Option	Joint Profit Max. (100%)
5%	53.13	**0.92%**	**0.46%**
8%	49.64	**0.99%**	**0.50%**
10%	47.54	**1.03%**	**0.52%**

Note: NewsCorp reports a Weighted Average Cost of Capital of 7.9% [UBS Warburg]

Subscriber Acquisition Cost Reduction

- CRA bases all of its calculations on historical SAC (amortized SAC is over $11/subscriber/month).
- However, withholding programming from cable may confer significant marketing advantages on DirecTV, reducing SAC or increasing the effectiveness of DirecTV's SAC expenditures.
- It is not appropriate to use the historical SAC values in assessing foreclosure incentives.
- The following chart illustrates the effect of reducing SAC by half under the temporary withholding scenarios.

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SAC Reduction (continued)

Effect of 50% Reduction in SAC

Again, using the basic equation:

$$\hat{S} \geq \frac{(1 - DTV_{Share})FOX_{Ad}}{(DTV_{Net} \cdot P \cdot (1 + D) + FOX_{Ad})}$$

		34% Interest	50% Option	Profit Max.
r	**D**	**P=34%**	**P=50%**	**P=100%**
5%	53.13	**1.02%**	**0.69%**	**0.35%**
8%	49.64	**1.09%**	**0.74%**	**0.37%**
10%	47.54	**1.13%**	**0.77%**	**0.39%**

DirecTV Constant Margin	\$17.88
50% Amortized SAC	\$5.98
Adjusted DTV_{Net}	**\$23.86**

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Incentive To Raise Price

- CRA admits that News Corp's interest in DTV may provide incentives to raise prices, but claims that such incentives may be more than offset by efficiencies resulting from the transaction, e.g., reduction in "double marginalization effect."
- CRA offers no analysis based on actual data to establish that efficiencies offset incentives to raise price ***in this case***.
- The "double margin" problem occurs when substantial market power exists at two vertically related levels – but, as News Corp has stated, DirecTV has no such power in the MVPD market.

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Incentive To Raise Price (continued)

- Moreover, even when there is market power at two vertically related levels, there is no consensus in the economic literature that the "double marginalization effect" generally outweighs an incentive to raise price.
  - Professor Salop has written that the net effect of efficiencies and incentives to raise price in vertical mergers is indeterminate.[1]
- It is at least questionable whether other claimed efficiencies (e.g., better management of churn rates) are achievable, transaction specific or affect pricing decisions.

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[1] See, Riordan & Salop, *Evaluating Vertical Mergers: A Post-Chicago Approach*, 63 Antitrust L.J. 513 (1995); Riordan & Salop, *Evaluating Vertical Mergers: Reply to Reiffen and Vita*, 63 Antitrust L.J. 943 (1995).

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Lexecon – Contracting

- Lexecon argues that foreclosure must not be a profitable strategy, otherwise content sellers would have been able to capture the benefits of exclusivity through contracts to sell programming exclusively.
- There is significant tension between this argument and News Corp's assertion that the efficiencies claimed to be associated with the transaction are merger-specific.
- More importantly, it would be difficult for independently owned and controlled private parties to enter into contracts to deliver exclusivity in programming and efficiently apportion the benefits.

Cablevision's Concerns – Rainbow DBS

- Currently, there are only two high power (small dish) DBS competitors: DTV and Echostar.
- The FCC has concluded that entry into DBS service is extremely difficult because the incumbents control all the transponders in the three CONUS slots (covering the continental US).
- Cablevision's Rainbow DBS venture, which has just launched its satellite, is the only foreseeable entrant into DBS.

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Rainbow DBS (continued)

- Rainbow DBS plans to offer a package of high quality programming to make best use of their limited capacity.
- Access to programming, whether network retransmission or other types of subscription programming, may be critical to Rainbow DBS's survival and ability to effectively compete.
- Because Rainbow DBS currently has no subscribers, denying programming to Rainbow DBS would have no current "cost," but may prevent Rainbow DBS from attaining critical mass.

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Appendix

- It is possible to derive the values of parameters used in the CRA analysis through a combination of public sources and inference from the CRA conclusions.
- The following describes such calculations, and derives the values used in this presentation to modify the CRA analysis to account for alternative foreclosure strategies, News Corp ownership interests in DirecTV, and subscriber acquisition costs (SAC).

Inferring DTV/Fox Margins & SAC

DirecTV Revenue, Variable Costs and SAC/Sub:

Use Public Data to Calculate DTV_{Net}:

ARPU	$60.90[1]
Variable Cost of Broadcasting	$31.06
Amortized SAC	$11.96
DTV_{Net}	**$17.88**

Broadcast programming and other costs represents 51% of revenues.[2]

Per sub SAC of $595[1] amortized over 5 years at 7.9%.[3]

1) 2nd Quarter 2003 DirecTV numbers from http://www.cableworld.com/ar/spending_subs/.

2) Ratio of "broadcast programming and other costs" over "direct broadcast, leasing and other services" from Hughes Electronics 10-Q June 30th, 2003.

3) WACC reported in "News Corporation" UBS Warburg Analyst Report dated June 6, 2003, at 6.

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Developing Variable Values

Ratio of Fox Ad Revenues and DTV Net Margin:

The CRA equation compares the **loss** and **gain** of attempting total foreclosure. Below the equation is converted into a ratio:

$$\overbrace{(1 - DTV_{Share}) * FOX_{Ad}}^{\textbf{Loss}} \leq \overbrace{S'*(DTV_{Net} * P + FOX_{Ad})}^{\textbf{Gain}}$$

$$(1 - DTV_{Share}) * FOX_{Ad} \leq S'\,DTV_{Net} * P + S'\,FOX_{Ad}$$

$$[(1 - DTV_{Share}) - S'] * FOX_{Ad} \leq S'\,DTV_{Net} * P$$

$$\frac{FOX_{Ad}}{DTV_{Net}} \leq \frac{S'P}{(1 - DTV_{Share}) - S'}$$

$$\frac{FOX_{Ad}}{DTV_{Net}} \leq \frac{.40 * .34}{(1 - .13) - .40}$$

$$\frac{FOX_{Ad}}{DTV_{Net}} = .29$$

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Fox Network Advertising Revenue

Fox Network Revenue per Sub:

Using publicly available data we can compute the per-sub advertising revenue accruing to Fox Network.

Starting with the CRA foreclosure equation:

$$(1 - DTV_{Share})FOX_{Ad} \leq S^*(DTV_{Net} \cdot P + FOX_{Ad})$$

Step One: We have calculated the ratio:

$$\frac{FOX_{Ad}}{DTV_{Net}} = .29$$

Step Two: *Using the estimate of* DTV_{Net}

$$\frac{FOX_{Ad}}{\$17.88} = .29 \quad \Rightarrow \quad FOX_{Ad} = \$5.19$$

DTV_{Share}	Initial MVPD Market Share of DirecTV	P	Fox Interest in DirecTV
Fox_{Ad}	Fox Monthly Per Viewer Advertising Revenue	DTV_{Net}	DirecTV Net Margin per Sub
S*	Implied DirecTV Share Gain to be Profitable		

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