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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

SEP 25 2003

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September 25, 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 September 24, 2003, on behalf of Cablevision Systems Corporation ("Cablevision"),

Daniel Rubinfeld of the University of California at Berkeley, Duncan Cameron of LECG, LLC

(attending by telephone), James Olson of Ilowrey Simon Arnold & White, Howard Symons of

Mintz, Levin and the undersigned met with Barbara Fishin, Marcia Glauberman, and Tracy

Waldon of the Media Bureau, C. Anthony Bush and Joel Rabinovitz of the Office of General

Counsel; Marilyn Simon and JoAnn Lucanik of the International Bureau; and Simon Wilkie and

Donald Stockdale of the Office of Strategic Planning to discuss the above-referenced proceeding

Professor Rubinfeld and Dr. Cameron explained that ("CRA")

September 8, 2003 submission on behalf of GM/Hughes and News Corporation is flawed

because several of its revisions to the parameters of LECG's model are questionable. However,

even accepting CRA's modifications, CRA estimates that it would be profitable for DirecTV to

engage in a temporary withholding strategy if it can achieve a share gain of only three percent.

This is a significant concession from CRA's last report, which examined only the effects flowing

from a *permanent* withdrawal of a Fox broadcast signal from a cable system and maintained that

DirecTV would have to achieve a 31-40% share gain to make such behavior profitable

Using the attached slides, Professor Rubinfeld and Dr. Cameron showed that when the

CRA methodology is adjusted to account for a variety of critical factors omitted in CRA's

analysis -- many of which CRA itself has previously acknowledged are valid -- the increase in

DirecTV's market share required to make a temporary withholding strategy profitable is less

than 1%. These factors include (1) the fact that although CRA previously recognized that as

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many as 33% of viewers are able to receive Fox broadcasting signals over-the-air, and thus must be excluded from lost advertising revenues. CRA's temporary withholding analysis fails to account for this factor. (2) the fact that CRA has acknowledged that News Corp. has an option to increase its ownership interest in DirecTV to 50%, but its analysis fails to account for this option. (3) CRA's use of a "hurdle rate," instead of the weighted average cost of capital (WACC), as the proper discount rate, even though there is no evidence that deviation from the commonly used WACC is appropriate here. (4) CRA's use of a subscriber cancellation rate that is inconsistent with DirecTV's actual experience as reported by CRA, and (5) CRA's argument for use of a variable margin for DirecTV that is inexplicably inconsistent with its earlier report

We also discussed CRA's criticism of LECG's use of the ABC/Disney - Time Warner dispute in Houston. CRA emphasizes that the withdrawal in that case was initiated by the cable operator, but that fact is irrelevant to LECG's discussion of how many subscribers are likely to switch distributors in response to such a temporary withdrawal. Further, CRA's contention that ABC/Disney was harmed by that dispute is belied by contemporaneous advertising trade press articles emphasizing the lack of effect on ABC/Disney, as well as Nielsen's offer to drop the black-out period from its ratings analysis. In any event, Fox could control the timing of any signal withdrawal and so could minimize advertising revenue losses.

Finally, we discussed certain News Corp. documents that support the arguments presented by Professor Rubinfeld. Documents [REDACTED] demonstrate [REDACTED]

Documents [REDACTED]

demonstrate that [REDACTED]

like documents [REDACTED]

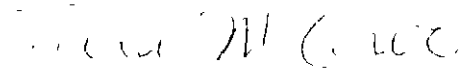
referenced in our ex parte of August 20.

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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

Attachment

cc Barbara Esbin  
Marcia Glauberman  
Tracy Waldon  
C. Anthony Bush  
Joel Rabinovitz  
Marilyn Simon  
JoAnn Lucanik  
Simon Wilkie  
Donald Stockdale

WDC 339519v1

# An Economic Analysis of the News Corp./DirecTV Transaction: Response to CRA/Lexecon Submissions of Sept. 8, 2003

Daniel L. Rubinfeld

Duncan Cameron

Federal Communications Commission Presentation

September 24, 2003

# Summary of LECG Response

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- A number of CRA's revisions to the parameters of LECG's model are at best questionable.
- Even with its modifications CRA estimates that a temporary withholding strategy would be profitable with a DirecTV share gain of only 3%. This is a significant departure from CRA's July 1, 2003 report, which estimated a 31-40% DirecTV share gain necessary for profitability of a permanent foreclosure strategy.
- CRA and Lexecon inappropriately criticize LECG's use of the Disney/ABC Time Warner Houston incident.

# LECG's Response

## *Issues Addressed*

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- 50% ownership option and 33% over-the-air broadcast recapture
- Proper discount rate
- Subscriber cancellation rates
- DirecTV variable margins
- Relevance of Disney/ABC Time Warner incident

## LECG's Response (continued) 50% Ownership Option & 33% Over-The-Air Recapture

- In CRA's July 1, 2003 report, CRA noted that News Corp. has an option to increase its ownership interest in DirecTV from 34% to 50% without further Commission review if the transaction is completed. (at ¶ 84)
- CRA also noted that some advertising revenues would be recaptured in the event network retransmissions were withheld from cable through use of over-the-air reception – CRA posits that such recapture could be as much as 33%. (at ¶ 74)

## LECG's Response (continued) 50% Ownership Option & 33% Over-The-Air Recapture

- The September 8, 2003 report does not incorporate the 50% ownership option and 33% over-the-air recapture assumptions.
- Reincorporating these assumptions into CRA's reformulation of the LECG model reduces the required DirecTV share gain for profitability to 1.4%.
- The required DirecTV share gain would be even lower if News Corp. and DirecTV adopted a mutually beneficial joint profit maximization strategy.



## LECG's Response (continued)

### *Discount Rate*

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- CRA objects to LECG's use of News Corp.'s publicly reported 7.9% Weighted Average Cost of Capital (WACC) as an appropriate discount rate.
- CRA uses instead a \_\_\_\_\_ "hurdle rate" that they claim DirecTV uses for investment decision making.
- Note that LECG reported results using real discount rates of 5%, 8%, and 10%. (There was no inflation adjustment.)

## LECG's Response (continued)

### *Discount Rate*

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- The WACC is commonly used for discounting and is appropriate to use when risk of a project is similar to the risk of the overall firm. (See Ross, Westerfield, and Jordan, Fundamentals of Corporate Finance, 5<sup>th</sup> Edition, 2000, at p. 430.)
- In contrast, a hurdle rate adjusts this baseline cost of capital for the risk of a particular project.
- Applying even a conservative 10% discount rate to the CRA reformulation (with 50% ownership interest and 33% recapture rate) further reduces the required DirecTV share gain to 1%.

## LECG's Response (continued)

### ***Subscriber Cancellation Rates***

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- CRA objects to the use of a uniform 60 month subscriber tenure in LECG's model of temporary foreclosure.
- The CRA formulation uses a one year contractual period in which no subscribers cancel, followed by \_\_\_% of all subscribers canceling, and \_\_\_% of remaining subscribers canceling in each subsequent month.
- This subscriber cancellation pattern is inconsistent with DirecTV's actual experience – CRA notes that only \_\_\_ of DirecTV subscribers have cancelled after the first year.

## LECG's Response (continued) ***Subscriber Cancellation Rates***

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- CRA asserts that subscribers who switched to DirecTV as a result of a temporary withholding strategy would be more likely than the typical DirecTV subscriber to cancel after the first year.
- However, it seems more plausible that subscribers who switched as a result of temporary withholding of Fox network retransmissions would be less likely than the typical DirecTV subscriber to cancel – they demonstrated an affinity for Fox broadcasts, which would be available with the DirecTV service.

## LECG's Response (continued) ***Subscriber Cancellation Rates***

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- Assuming that subscribers who gained as a result of temporary withholding would be no better or worse than the typical DirecTV subscriber (*i.e.*, the \_\_\_% end-of-first-year subscriber cancellation rate), the DirecTV share gain necessary for profitability falls to 0.88%.

## LECG's Response (continued)

### *Variable Margin*

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- LECG calculated a DirecTV variable margin from SEC filings (average subscriber revenues net of variable costs) of \$29.84. CRA claims that the DirecTV variable margin is \$\_\_\_\_\_.
- However, in CRA's July 1, 2003 report, CRA reported an \$\_\_\_\_\_ margin net of "amortized SAC." CRA also claims that SAC is \$\_\_\_\_\_ per subscriber, and should be amortized over \_\_\_\_\_ months at an annual discount rate of \_\_\_\_\_%. Such a calculation results in an amortized SAC of \$\_\_\_\_\_/month.

## LECG's Response (continued)

### *Variable Margin*

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- Subtracting the amortized SAC of \$\_\_\_\_\_ from the reported \$\_\_\_\_\_ variable margin yields a \$\_\_\_\_\_ margin net of amortized SAC – significantly different from the \$\_\_\_\_\_ figure reported by CRA in the July 1, 2003 report.
- LECG does not have access to the non-public information necessary to determine which figure is correct.
- Applying the margin figure implied by the July 1, 2003 report to the CRA reformulation of the LECG temporary foreclosure model further reduces the DirecTV share gain necessary for profitability to 0.7%.

# LECG's Response (continued)

## *Summary of Adjustments*

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<u>Scenario</u>	<u>Calculated DirecTV Share Gain Requirements</u>
1. CRA reformulation of LECG model with 33% over-the-air recapture and a 50% News Corp. ownership interest.	1.36%
2. Scenario 1 and adjust the discount rate to 10%.	1.02%
3. Scenario 2 and new subscribers are no more likely to cancel than typical DirecTV subscribers.	0.88%
4. Scenario 3 and use the variable margin from SEC filings.	0.7%



## LECG's Response (continued)

### *Disney/ABC & Time Warner-Houston Incident*

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- CRA and Lexecon argue that the Disney/ABC Time Warner Houston incident is inapposite because it “involved a cable operator’s decision to deny carriage over a programmer’s objection ....”
- LECG uses the Disney/ABC Time Warner incident to measure the potential magnitude of subscriber switching in response to temporary loss of network retransmissions – whether the programmer or cable operator initiated the loss of signal is irrelevant for this purpose.

## LECG's Response (continued)

### *Disney/ABC & Time Warner-Houston Incident*

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- CRA disputes LECG's statement that "the Houston episode cost Disney/ABC virtually nothing," and argues that the dispute could have affected ABC's advertising revenues and the rates it could charge in the future.
- The advertising trade press, however, contemporaneously reported that the dispute had no impact on ABC's advertising business, and noted that even if the dispute had lasted a week, the estimated audience drop-off was too minor to affect ratings meaningfully.
- ABC was further protected against future adverse affects on its advertising rates because Nielsen offered to drop the ratings for the 40-hour blackout period in each of the five affected markets.
- Fox can control the timing of any signal withholding, minimizing advertising revenue losses.

# LECG's Response (continued)

## *Other Issues*

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- News Corp.'s previous passive ownership interest in EchoStar is different from its controlling interest in DirecTV.
- The Disney/ABC Time Warner Houston experience suggests that subscribers did not wait out a temporary network broadcast withholding scenario.
- Capturing the benefits of temporary withholding by contract is difficult.
- Network retransmissions could be withheld from EchoStar as well, ensuring that subscribers leaving cable would go to DirecTV.