HARRIS, WILTSHIRE & GRANNIS LLP

1200 EIGHTEENTH STREET, NW
WASHINGTON, DC 20036

TEL 202.730.1300 FAX 202.730.1301
WWW.HARRISWILTSHIRE.COM

ATTORNEYS AT LAW

November 6, 2007

BY ELECTRONIC FILING

Marlene H. Dortch
Office of the Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Re: ***MB Docket No. 07-18***

Dear Ms. Dortch:

A handful of broadcasters have called for the Commission to impose new regulatory obligations on The DIRECTV Group, Inc. ("DIRECTV") as the "price" of approving the Transaction proposed in this proceeding. In response, DIRECTV submitted a detailed economic study prepared by LECG, LLC to demonstrate exactly how high that price would be. LECG found that requiring DIRECTV to provide local-into-local ("LIL") service in all 210 DMAs would have a net present value cost conservatively estimated at $251 million.[1] Last week, however, an *ad hoc* group of four television station licensees serving the Minot-Bismarck-Dickinson DMA in North Dakota (collectively, the "Minot Broadcasters") submitted a critique of certain aspects of the LECG Study, supported by comments from a consultant.[2]

As discussed in the attached rebuttal by LECG, the Minot Broadcasters' critique ignores elementary economic, financial, and statistical principles. When properly analyzed, there can be no doubt that such an additional regulatory obligation would

---

[1] *See* Letter from William M. Wiltshire to Marlene H. Dortch (dated Aug. 23, 2007) (attaching Benjamin Klein, Andres V. Lerner, and Emmett Dacey, "An Economic Analysis of DIRECTV providing Local-Into-Local Service via Satellite in All 210 DMAs" ("LECG Study")).

[2] Letter from George R. Borsari, Jr. to Marlene H. Dortch (dated Oct. 29, 2007) ("Borsari Letter") (attaching Report of Dr. Bernhard Charlemagne (dated Oct. 22, 2007)).

impose a significant economic burden on DIRECTV and thereby place it at a significant disadvantage to its competitors.

Most importantly, the Minot Broadcasters and their consultant, Dr. Charlemagne, ignore one of the largest costs of the proposed regulatory requirement. They recognize that DIRECTV's scarce satellite capacity could be used more profitably for services other than providing LIL in the 60 remaining markets. Nevertheless, they assume this opportunity cost away because it would be imposed by a regulatory obligation. This is entirely backwards. Indeed, determining the cost of compliance with the proposed requirement is the very object of LECG's analysis.

Even setting aside this fundamental misconception, Dr. Charlemagne's comments are riddled with errors, including the following:

- Dr. Charlemagne bases his analysis in part upon a comparison of market penetration in 25 DMAs – 20 of which currently have LIL and 5 of which do not. He provides no rationale for why these particular markets were chosen. More importantly, he ignores the significant disparity in penetration that existed between those groups of markets *before* LIL was offered in any of them. Lastly, he attributes all projected growth in penetration for the 60 remaining DMAs to DIRECTV – even though EchoStar already provides LIL in 29 of those DMAs and may launch that service in others.

- In calculating incremental revenue per subscriber, Dr. Charlemagne uses figures derived by dividing EchoStar's market capitalization by the number of its subscribers. He does not explain why he used EchoStar data when DIRECTV also files public reports with the SEC. In addition, his approach ignores basic principles of finance by attributing to existing subscribers the entire component of market value comprised of the expected profits from future growth, resulting in a wildly inflated value.

- In criticizing LECG's discount rate assumption and terminal value calculation, Dr. Charlemagne makes the fundamental mistake of assuming that metrics appropriate to a firm as a whole are also appropriate for an individual project that can be significantly more risky.

Moreover, the Minot Broadcasters implicitly assume that DIRECTV's satellites will launch on time, as planned, and without problems. Given the many significant risks satellite operators face, neither the Commission nor any private party should lightly assume that planned launches and operations always go as expected. For example, in-orbit testing of DIRECTV 10 – one of the next generation Ka-band satellites DIRECTV intends to use to expand its HD services – determined that a portion of the satellite's anticipated spot-beam capacity may not be fully available.[3] DIRECTV does not have the

[3] *See* Press Release, "DIRECTV 10 In-Orbit Testing Underway" (Sept. 14, 2007) (available at http://phx.corporate-ir.net/phoenix.zhtml?c=127160&p=irol-newsArticle&ID=1051829&highlight).

luxury of simply assuming that satellite capacity is plentiful and costless. Additional carriage obligations would impose very real and significant burdens on DIRECTV.

Lastly, the cover letter to the Minot Broadcasters' submission contains an especially egregious factual assertion that cannot go uncorrected. Contrary to the Minot Broadcasters' assertion, nothing in the LECG Study "confirms" that DIRECTV abandoned its plans to use its satellite capacity to expand LIL service to additional DMAs as a result of the proposed Transaction.[4] To the contrary, the LECG Study consistently refers to the "remaining 60 DMAs in which DIRECTV does not now offer *or plan to offer* local-into-local via satellite."[5] Moreover, DIRECTV has previously demonstrated that the Minot Broadcasters' conspiracy theory is entirely unfounded, as DIRECTV determined its LIL plans prior to announcement of the proposed Transaction and without consideration of the interests of Liberty Media.[6]

In sum, the Minot Broadcasters' latest submission is fatally flawed, both on its facts and its economic analysis. The Commission should not accord it any weight in analyzing the public interest implications of the proposed Transaction.

Respectfully submitted,

/s/

William M. Wiltshire
Counsel for The DIRECTV Group, Inc.

Attachment

---

4 Borsari Letter at 1. The letter also asserts that, when asked by the Commission for economic studies on LIL service, "DirecTV denied that any such studies existed." *Id.* To the contrary, DIRECTV indicated that it was "searching its records for documents responsive to this request, and will provide responsive documents on a rolling basis until that process reaches completion" – and DIRECTV has done so. Letter from John C. Quale and William M. Wiltshire to Marlene H. Dortch, Attachment at 11 (dated July 10, 2007) (Response to Request II.J).

5 LECG Study at 1 (emphasis added).

6 *See* Letter from William M. Wiltshire to Marlene H. Dortch (dated Oct. 25, 2007).

cc: Mania Baghdadi
Tracy Waldon
Royce Sherlock
Rosemary Harold
William Beckwith
Debra Sabourin
Jim Bird
Joel Rabinovitz
Marilyn Simon

Reply to Dr. Charlemagne's Comment on "An Economic Analysis of DIRECTV Providing Local-into-Local Service via Satellite in All 210 DMAs"

BENJAMIN KLEIN, Professor Emeritus of Economics, UCLA and Director, LECG
ANDRES V. LERNER, Director, LECG
EMMETT DACEY, Senior Economist, LECG

We previously submitted a report commissioned by The DIRECTV Group, Inc. ("DIRECTV") which describes our economic analysis of the profitability of DIRECTV offering local-into-local (LIL) service via satellite to the remaining 60 DMAs where it currently does not provide such service.[1] Dr. Bernhard Charlemagne, retained by a group of North Dakota broadcasters, has commented on our report.[2] Dr. Charlemagne's criticisms ignore basic economic, financial, and statistical principles and, therefore, are fundamentally flawed. We briefly discuss some of Dr. Charlemagne's errors below.[3] None of Dr. Charlemagne's comments and criticisms change our conclusion that offering satellite LIL to the remaining DMAs would be very unprofitable for DIRECTV, resulting in an estimated cost net of revenues of $251 million.

Satellite cost: Dr. Charlemagne claims that it is incorrect to include the cost of a new satellite in assessing the profitability of offering LIL in the remaining 60 DMAs. He asserts that DIRECTV should instead use satellite capacity that it uses, or plans to use, for offering high definition (HD) programming and other advanced services.[4] However, as we discussed in our report, reallocating satellite capacity that DIRECTV uses, or plans to use, for other services entails an opportunity cost. From an economic perspective, an opportunity cost is not any different than other type of cost. DIRECTV could purchase a new satellite to offer satellite LIL service in the remaining markets. Alternatively, it could use a satellite being used (or planned for use) to offer HD or other services, which would necessitate the purchase a new satellite to offer the services supplied by that satellite. In either case, the incremental satellite cost of offering LIL service is the same and must be considered when determining costs.

Dr. Charlemagne does not seem to dispute that providing LIL in the 60 remaining DMAs with a satellite that would otherwise be used for HD and other services entails significant opportunity costs. However, he asserts that it is incorrect to take such opportunity costs into account in assessing the profitability of offering satellite LIL in the remaining DMAs because "using opportunity cost as opposed to actual cost is not

---

1 Benjamin Klein, Andres V. Lerner, and Emmett Dacey, "An Economic Analysis of DIRECTV Providing Local-into-Local Service via Satellite in All 210 DMAs."

2 Dr. Bernhard Charlemagne, Hermes Academic Research Institute, To: North Dakota Broadcasters, Re: LECG,LLC report in the DirectTV [sic] proceeding, Ref. # 07-08.759, October 22, 2007 ("Charlemagne Comment").

3 Dr. Charlemagne's comments contain numerous errors that we do not address in this reply, including, for example, his discussion and calculation of subscriber acquisition costs (SAC).

4 Charlemagne Comment, p. 2.

appropriate for meeting a promised obligation."[5] But this is the very question we sought to analyze – the cost of complying with such an obligation. One cannot estimate the costs of meeting such a claimed obligation without taking into account the opportunity costs of the required satellite capacity. A cost would be incurred whether undertaken as a business matter or imposed as a regulatory obligation.

Incremental subscribers from satellite LIL service: Although Dr. Charlemagne states that we use "standard economic methods" in our analysis, he asserts that our estimate of incremental subscribers from offering satellite LIL is understated.[6] We econometrically estimated the expected incremental subscribers from offering satellite LIL using historical market data when LIL service is introduced in a DMA. In contrast, Dr. Charlemagne provides a different estimate based on comparing the market penetration of alternate delivery systems (ADS) in DMAs ranked 140 to 164.[7] He provides no rationale for how this particular group of DMAs was chosen. Dr. Charlemagne compares the market penetration of ADS in the 5 DMAs without satellite LIL in this group with the 20 DMAs with satellite LIL in this group, attributing the entire difference in the ADS market penetration (9.5% of television households) to satellite LIL.

By attributing the entire difference in the ADS penetration between these particular DMAs to the provision of satellite LIL, Dr. Charlemagne's methodology ignores basic econometric methodology since he does not attempt to control for differences across his chosen DMAs in any way. One way to assess the severity of this fundamental flaw is to compare the penetration of ADS in his chosen DMAs before any of them had satellite LIL. The evidence shows that the difference in penetration between these groups existed even before the introduction of LIL. Specifically, the ADS penetration in Dr. Charlemagne's 5 DMAs without satellite LIL was lower than that in his group of 20 DMAs with satellite LIL in February 2003 (prior to the launch of satellite LIL in the first of his DMAs) by 5.5% of television households.[8] In other words, Dr. Charlemagne's 5 DMA group started with markedly lower penetration than his 20 DMA group before LIL was introduced in either group – a difference that obviously cannot be attributed to the subsequent launch of satellite LIL. Dr. Charlemagne nevertheless attributes the difference in ADS penetration between his chosen DMAs entirely to the provision of satellite LIL.

In addition, Dr. Charlemagne incorrectly attributes the entire growth in ADS penetration to DIRECTV, and none to EchoStar. Dr. Charlemagne dismisses the importance of this by claiming that "EchoStar does not currently provide LIL service in a majority of the markets to be served by DirectTV [sic]."[9] However, this is highly misleading. EchoStar currently offers satellite LIL in 29 of the 60 markets in which

5 Charlemagne Comment, p. 2.
6 Charlemagne Comment, p. 3.
7 Charlemagne Comment, p. 4. It is worth noting that ADS penetration includes service provided by programming distributors other than DBS satellite operators, which further overstates the potential gains to DIRECTV from providing LIL.
8 Nielsen Media Research, Cable and ADS Penetration by DMA (available at www.tvb.org/nav/build_frameset.asp).
9 Charlemagne Comment, p. 5.

DIRECTV does not offer the service. Because Dr. Charlemagne attributes the entire incremental satellite penetration from LIL to DIRECTV in these markets, the implication of this is that DIRECTV will get all incremental EchoStar subscribers once it offers satellite LIL in these DMAs. Obviously, this implicit assumption makes no economic sense in markets where EchoStar offers (or will offer) LIL. Moreover, Dr. Charlemagne's calculation of incremental subscribers assumes, without explanation, that EchoStar will not offer satellite LIL in the other 31 markets, despite his opinion that offering such a service would be highly profitable.

Incremental revenue per subscriber: Dr. Charlemagne also provides an alternative – and much greater – estimate of the revenue per subscriber than is derived from our model by dividing the market capitalization of EchoStar by the number of EchoStar subscribers.[10] He incorrectly assumes that this market capitalization per subscriber is equivalent to the incremental revenues that will be obtained per additional subscriber by providing LIL. However, basic principles of finance indicate that the market value of a firm not only incorporates the value of existing customers, but also expectations regarding the profitability of future customers. Dr. Charlemagne's estimate of the incremental revenues per subscriber, therefore, is wildly inflated by unjustifiably attributing all the expected profits from future subscribers to current subscribers.

Discount Rate / Terminal Value: Dr. Charlemagne criticizes our discount rate assumption by claiming that the rate of 12% we used "does not represent the current cost of raising capital in the industry and on international capital markets. EchoStar Communications, in its latest 10-Q, reports its cost of long-term capital to be approximately 7%."[11] It is not clear why Dr. Charlemagne uses EchoStar's financial estimates rather than those of DIRECTV, which is also a publicly traded company, other than the fact that using EchoStar's financials is more favorable to his calculations. DIRECTV's weighted average cost of capital (WACC) is, as we state in our report, about 8.7%. Moreover, the WACC is only the *minimum* required return on its investment. As we noted in our report, using a WACC that reflects the risks of a firm as a whole to estimate the discount rate for an individual project is typically incorrect since the incremental profitability of a given project can be significantly more risky than the firm as a whole. However, our profitability estimate did not increased significantly when we lowered the discount rate to DIRECTV's WACC.[12]

Dr. Charlemagne also disputes our terminal value assumption. In particular, he states that the terminal value is much greater than the 5 times cash flow that we assumed and suggests that the analysis should be recalculated with a terminal value of 7.8 times cash flow.[13] However, Dr. Charlemagne commits the same mistake of confusing a terminal value that one would use in valuing a firm with one that is appropriate for

[10] Charlemagne Comment, p. 4.
[11] Charlemagne Comment, p. 2.
[12] When we estimate profitability using a discount rate of 9 percent, the net present value of providing satellite LIL is negative $224 million, compared to negative $251 million using a 12% discount rate.
[13] Charlemagne Comment, pp. 2-3. Charlemagne does not state the source or rationale for this higher estimate.

assessing an individual project. As we discussed in our report, a perpetuity growth model that assumes cash flows continue to increase (or decrease) at some constant rate forever often is used to determine the terminal value when valuing a firm. In valuing individual projects rather than a firm as a whole, however, a perpetuity growth model may not be appropriate since individual projects may yield financial returns for only a finite period of time. In our model, we assumed a terminal value equal to 5 times the cash flows during the last year of our model (2014), which when discounted at a 12 percent rate, assumes that the profit impact of offering satellite LIL is expected to extend until the year 2022. Given the expected technological changes in this industry, this is a conservative assumption that likely significantly overstates the economic benefits of providing satellite LIL.

Conclusion: In sum, Dr. Charlemagne's critique of our profitability model is fundamentally flawed. His criticisms and calculations ignore basic economic, financial, and statistical principles. None of his comments alter our conclusion that DIRECTV would have to incur significant costs net of revenues to provide LIL service via satellite in the remaining 60 DMAs, which we have estimated at $251 million.