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Federal Communications Commission
Office of the Secretary

November 10, 2010

VIA HAND DELIVERY

Marlene H. Dortch, Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: *In the Matter of Applications of Comcast Corporation, General Electric Company and NBC Universal, Inc. for Consent to Assign Licenses or Transfer Control of Licensees*, MB Docket No. 10-56
REDACTED – FOR PUBLIC INSPECTION

Dear Ms. Dortch:

The attached report by Drs. Mark Israel and Michael Katz addresses Professor Kevin Murphy's August 19 Report[1] purporting to show that the Comcast-NBCU transaction would lead to significant increases in license fees charged to other MVPDs for NBCU's cable networks. As Drs. Israel and Katz demonstrate, Dr. Murphy's method (the "Murphy method") is unsound because it relies on questionable assumptions and is inconsistent with actual marketplace evidence. In fact, contrary to the unreliable predictions from the Murphy method, Drs. Israel and Katz have shown in previous submissions that there was no evidence that this transaction would increase cable network affiliate fees.[2] Thus, the Murphy method provides no basis to impose a program access arbitration condition for NBCU's national cable networks.[3]

Specifically, the Murphy method relies on several faulty assumptions. For example, Dr. Murphy assumes, without evidence, that networks and MVPDs have sufficient information to precisely calibrate license fees against potential subscriber losses. Similarly, contrary to marketplace evidence, the Murphy method depends on the assumption that network/MVPD

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[1] *See* Kevin Murphy, Response of Professor Kevin M. Murphy to Reply Report of Mark Israel and Michael L. Katz, MB Docket No. 10-56 (Aug. 19, 2010). Commission Staff noted Professor Murphy's findings in a meeting and teleconference with Drs. Israel and Katz on October 29, 2010.

[2] *See* Mark Israel and Michael L. Katz, Economic Analysis of the Proposed Comcast-NBCU-GE Transaction, MB Docket No. 10-56, ¶ 86 (July 21, 2010).

[3] *See* Letter from Michael H. Hammer, Willkie Farr & Gallagher LLP, Counsel for Comcast Corporation, to Marlene H. Dortch, Secretary, FCC, MB Docket No. 10-56 (Nov. 1, 2010)

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negotiations over the license fees paid for cable networks and the retransmission consent fees paid for broadcast networks are not interconnected. As Drs. Israel and Katz show, plausible changes to these and other assumptions yield starkly different conclusions. This demonstrates that the Murphy method is fundamentally flawed and should not be relied on by the Commission.

The Murphy method's deficiencies are further exposed when applied to the 2004 News Corp./DirecTV transaction. As Drs. Katz and Israel demonstrate, the Murphy method would have predicted price increases that contradict both the Commission's predictions in that proceeding and subsequent pricing data. The Murphy method is equally vulnerable when applied to the recent rapid increase in broadcast retransmission consent fees; the Murphy method would conclude that the subscriber departure rate from the loss of a broadcast network must also be increasing rapidly. Yet as Drs. Israel and Katz observe, this conclusion is highly unlikely given broadcast networks' reduced viewership.

Pursuant to the Protective Order[4] and Second Protective Order,[5] Comcast submits two copies of the redacted version of the filing. The Confidential and Highly Confidential versions are being filed simultaneously under separate cover. Parties interested in obtaining access to the Confidential or Highly Confidential versions of this filing should contact Brien Bell, Willkie Farr & Gallagher LLP, 1875 K Street NW, Washington, DC 20006, (202) 303-1164, bbell@willkie.com.

Sincerely yours,

Michael H. Hammer/BCB

Michael H. Hammer
Counsel for Comcast Corporation

Enclosures

cc: Vanessa Lemmé

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4 *Applications of Comcast Corporation, General Electric Company, and NBC Universal Inc. for Consent to Assign Licenses or Transfer Control of Licensees*, Protective Order, MB Docket No. 10-56, DA 10-370 (MB Mar. 4, 2010).

5 *Applications of Comcast Corporation, General Electric Company, and NBC Universal Inc. for Consent to Assign Licenses or Transfer Control of Licensees*, Second Protective Order, MB Docket No. 10-56, DA 10-371 (MB Mar. 4, 2010).

Responses to "Murphy Method" for Calculating Departure Rates for Cable Networks

Mark Israel and Michael L. Katz

November 10, 2010

In our October 29, 2010 meeting, Commission Staff identified a methodology developed by Professor Kevin Murphy on behalf of DirecTV (the "Murphy method") as the only evidence in the record suggesting significant, adverse transaction-related effects on the prices of national cable networks.[1] In particular, calculations based on the Murphy method are the only available evidence that purport to show that the loss of one or more NBCU cable networks would cause an MVPD to lose a significant number of subscribers to Comcast and, thus, that vertical integration of these networks with Comcast would lead to significant increases in the license fees charged to rival MVPDs.[2]

In this memorandum, we establish two points about the Murphy method:

- First, the Murphy method, particularly when applied to national cable networks, is fundamentally unsound. It relies on a series of questionable and unsubstantiated assumptions. Changing these assumptions in plausible ways yields starkly different conclusions. Hence, calling calculations based on the Murphy method "empirical evidence" would be tantamount to calling assumptions empirical evidence.
- Second, predictions from the Murphy method fail to match basic empirical patterns in the pricing of cable and broadcast networks. For example, contrary to the Commission's determination that the News Corp./DirecTV transaction would not lead to anti-competitive price increases—a determination that has been borne out by subsequent experience—the Murphy method would have predicted price increases for the national cable networks in that transaction approximately as large as the price increases it predicts for the networks in the proposed Comcast/NBCU/GE transaction. In addition, when applied to the recent, rapid increase in retransmission consent fees, the Murphy method implies that the departure rate induced by loss of a broadcast network must also be increasing rapidly. We see no basis for this conclusion, which stands in contrast to the increasing breadth of entertainment options and declining ratings of broadcast networks.

A. The Murphy method is fundamentally unsound.

In our July 20, 2010 report (¶¶ 44 – 52), we outlined several reasons why the Murphy method is fundamentally unsound. These reasons include the facts that the details of MVPD/network

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1 Kevin Murphy, "Response of Professor Kevin M. Murphy to Reply Report of Mark Israel and Michael L. Katz," August 19, 2010 (hereinafter, *Murphy Reply Report*), particularly Exhibit 4.

2 In order to focus on the specific issue of the validity of the Murphy method, the present memorandum will not discuss the fact that, even if the Commission Staff's estimated departure rates and diversion ratios were correct, the elimination of double marginalization due to the proposed transaction would lead to *net* price effects that would raise consumer welfare. (Mark Israel and Michael L. Katz, "Responses to Professor Rogerson's Comments on Double Marginalization," October 25, 2010, at 16-19.) From the perspective of economics, the net price effects are what should be considered in assessing whether the proposed transaction would be in the public interest.

negotiations do not conform to the assumptions of the Nash bargaining model underlying the Murphy method and that, even if one adopts the Nash bargaining framework, the predictions of the Murphy model depend entirely on a series of highly questionable and unsubstantiated assumptions. Here, we highlight four key assumptions underlying the Murphy method that are especially questionable, particularly when applied to national cable networks:

- First, the Murphy method relies on the foundational assumption that the magnitudes of negotiated affiliate fees bear a precise relationship to the negotiating parties' estimates of departure rates as of the time of the negotiations. A predicate for this assumption to be valid is that the parties form such estimates. In repeated discussions with Comcast executives responsible for negotiating carriage decisions, we have been told that they do not attempt to form precise estimates of the departure rates that would follow from loss of particular cable networks. Hence, if the Murphy method were to be believed, it would allow the Commission to develop precise predictions of Comcast estimates that do not, in fact, exist.

  Similarly, we have seen no evidence that, in the context of carriage negotiations, DirecTV or any other MVPD develops departure-rate estimates or, when dealing with vertically integrated suppliers, diversion ratio estimates. Yet, for the Murphy method to be valid, such estimates must exist. If they do not, then the Murphy method is an attempt to infer parameter values from the behavior of parties who themselves do not know those values.

- Second, the Murphy method relies on the assumption that the negotiations for jointly-owned broadcast and cable networks are distinct from one another. In particular, to conclude that national cable networks are powerful enough to induce significant subscriber departures, the method requires one to assume that the license fees paid for each cable network do not reflect any implicit payments for a commonly-owned broadcast network (above and beyond any explicit retransmission payments). Such an assumption stands in contrast to common industry practice, in which some or all of the value of retransmission consent has generally been captured via affiliated cable networks' license fees.[3] Given such a practice, it is possible that true "standalone" license fees for many national cable networks are less than the fees reported by SNL Kagan or set forth in carriage agreements. Consequently even if, for the sake of argument, the other assumptions of the Murphy method were valid, the true departure rate induced by withholding a given national cable network would be small (consistent with the previous Commission statements on the matter).[4]

  Note that this logic is not contradicted by the fact that Professor Murphy found plausible departure rates ({{   }} percent) for broadcast networks by assuming a simple $0.50 per subscriber per month retransmission fee for broadcast networks. In particular, to

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[3] Henry Ahn, Executive Vice President TV Networks Distribution (NBC Universal Networks Distribution), interview, February 19, 2010.

[4] Memorandum Opinion and Order, *In the Matter of General Motors Corporation and Hughes Electronics Corporation, Transferors, and Te News Corporation Limited, Transferee, For Authority to Transfer Control,* 19 FCC Rcd 473 (2004) (hereinafter, *News-Hughes Order*), ¶¶ 86, 129.

compute the {{ }} percent departure rate, Professor Murphy also *assumed* equal bargaining power for networks and MVPDs, meaning that he *assumed* that profits are divided evenly between the network owner and the MVPD. One could just as well assume instead that some or all of the license fees paid for national cable networks are actually attributable to the broadcast network *and* that network owners have more bargaining power than MVPDs. Even in the hypothetical case in which the standalone license fees for the NBCU cable networks would be zero and 100 percent of the observed license fees represented implicit payments for NBC retransmission rights, one could generate a plausible departure-rate prediction for NBC by selecting an appropriate bargaining power parameter.[5]

- Third, even if, for the sake of argument, one accepts in its entirety the Nash bargaining framework underlying the Murphy method, the observed affiliate fee only reveals the amount of profit that the MVPD would lose if it did not have the network in question. To map the lost profits into a prediction of the departure rate induced by loss of that network—a key parameter for predicting the pricing effects of the proposed transaction—requires information or assumptions drawn from outside the model on the extent to which lost profits come from subscriber departures, price reductions, or other effects. For the case of broadcast networks, Professor Murphy assumes only two potential sources of lost profits—subscriber departures and price reductions—and assumes (based on prices observed in previous cases in which an MVPD did not retransmit one or more broadcast networks) that approximately {{ }} percent of the profits lost from the absence of broadcast networks is caused by price reductions offered by the MVPD, with the rest caused by subscriber departures.

  Critically, for all of his calculations of departure rates for national cable networks, Professor Murphy maintains these assumptions, without justification, even though there is substantial reason to believe they do not hold for national cable networks. Most fundamentally, unlike broadcast networks, a substantial portion of the value to an MVPD from carrying a national cable network may come from the ability to encourage subscribers to pay for higher-service tiers ("expanded basic" or above) on which those networks are carried. This factor is important because subscriber switching among a rival MVPD's tiers does not benefit Comcast and, thus, does not give rise to vertical pricing effects of the sort posited by the Murphy method.

  In summary, much of the profit lost to an MVPD from loss of national cable networks may derive both from reductions in the prices of the MVPD's various service tiers and from fewer subscribers' purchasing higher-service tiers. To the extent that these losses from price reductions and tier switching total more than {{ }} percent of the total decline in profits following loss of a national cable network, departure rates estimated using the Murphy method will be too high.

5 In Exhibit 1 of his Reply Report, Professor Murphy shows that by increasing the bargaining power NBCU, one achieves a lower estimated departure rate under his model. By also increasing the implicit payment for NBCU (by attributing some of the license fees for cable networks to NBCU), one could restore this figure to the original {{ }} percent.

Applying the Murphy method to HBO/Cinemax illustrates this point clearly. According to SNL Kagan data, license fees for HBO/Cinemax average [[ ]] per subscriber per month, implying a strikingly (and implausibly) high departure rate from loss of HBO/Cinemax of approximately {{ }} percent.[6] In fact, however, much of the value of HBO/Cinemax to MVPDs very likely stems from the ability to sell this high-margin product to existing subscribers, rather than from departure effects. Although premium networks may be an extreme case, the same logic applies to any cable network on a tier above limited basic (including all of the cable networks at issue in this proceeding), as the primary value these networks provide to MVPDs may be to increase the per-subscriber margin rather than the overall number of subscribers.

- Fourth, the Murphy method does not allow for the possibility that an MVPD is paying for the "rights" to use content in ways that are costly to networks. However, in practice, MVPDs negotiate for rights to use content in multiple ways (*e.g.,* in video-on-demand offerings or on websites). {{ }}[7] And because network/MVPD contracts do *not*, in general, {{ }}[8] In such cases, the departure effects computed via the Murphy method are overstated.

B. **The Murphy method fails to match basic empirical patterns in network pricing**

Professor Murphy himself acknowledges that one cannot properly rely on the predictions that come out of his simplified, theoretical bargaining model without verifying them empirically. In particular, in his August 19, 2010 report, Professor Murphy argued that:[9]

> …my analysis did not rely on economic theory alone, but provided a framework for deriving testable implications, which I supported with empirical evidence from related historical events. These comparisons provided evidence that my bargaining model, combined with the parameter assumptions that I make, provides a useful framework for understanding the outcomes of real-world retransmission negotiations and for predicting how market forces would affect retransmission rates after the proposed transaction.

Hence, Professor Murphy acknowledges that his method provides "a framework for deriving testable implications" that can then be supported or refuted by empirical evidence. He also

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6 For this calculation, we adopt Professor Murphy's assumptions that {{ }}

7 Ronald Lamprecht, Senior Vice President, Business Development & Sales (Digital & Affiliate Distribution), NBC Universal, interview, February 19, 2010.

8 Matt Bond, Executive Vice President of Content Acquisition, Comcast Cable, interview, July 19, 2010.

9 *Murphy Reply Report*, ¶ 12.

argues that he has provided supporting evidence in the context of retransmission negotiations for broadcast networks. Notably, no one, including Professor Murphy, has presented any empirical evidence on departure rates from "related historical events" for national cable networks.[10]

In the remainder of this section, we show that, in fact, the predictions of the Murphy method do not match the historical record on the pricing of *either* cable or broadcast networks, meaning that the method is not a valid basis for inferences regarding pricing effects from the proposed transaction. We demonstrate this fact by considering available evidence on: (a) pricing effects from the News Corp./DirecTV transaction, and (b) recent trends in payments for retransmission consent.

First, application of the Murphy method to the News Corp./DirecTV transaction yields price predictions that contradict both the Commission's own predictions and post-transaction price data:

- Following its detailed review of the News Corp./DirecTV transaction, the Commission concluded that there was no evidence that loss of the national cable networks involved in that transaction would induce significant subscriber departures and, thus, no evidence that there would be significant anti-competitive effects for national cable networks.[11] This conclusion is consistent with the Commission's determination that News Corp.'s national cable networks "participate[d] in a highly competitive segment of programming market with available reasonably close programming substitutes."[12]
- The Commission's conclusion has been borne out by available evidence on actual prices since the News Corp./Direct TV transaction (and subsequent spin-off). In particular, in our July 20, 2010 reply report, we presented a combined analysis of previous network/MVPD vertical integration events (including the News Corp./DirecTV transaction and subsequent spin-off) and showed that there was no evidence that vertical integration increases affiliate fees.[13] Then, in our October 25, 2010 memorandum, we applied the same methodology, but restricted its application to those networks involved in the News Corp./DirecTV transaction and subsequent spin-off.[14] We again showed that there was no significant increase in affiliate fees due to vertical integration.[15] Thus, empirical analysis of actual prices supports the Commission's conclusion that the national cable networks involved in the News Corp./DirecTV transaction were unlikely to generate significant price effects.

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10 Commission Staff are aware of the lack of empirical evidence for departures due to loss of a national cable network. During our October 29, 2010 meeting, Commission Staff noted the absence of previous events in which an MVPD lost access to a cable network.

11 *News-Hughes Order*) ¶¶ 86, 129-130.

12 *News-Hughes Order*, ¶ 129.

13 Mark Israel and Michael L. Katz, "Economic Analysis of the Proposed Comcast-NBCU-GE Transaction," July 20, 2010, ¶ 86.

14 Mark Israel and Michael L. Katz, "Responses to Commission Econometrics Questions," October 25, 2010, at 2.

15 *Id.*

- In contrast to this historical record, the Murphy method would have predicted price increases for the national cable networks involved in the News Corp./DirecTV transaction. To demonstrate this fact, we apply the Murphy method to that transaction using data from the time of the transaction.[16] For purposes of this analysis, we adopt the approach from Professor Murphy's Exhibit 4 with one change—we compute diversion rates (from potentially foreclosed MVPDs to DirecTV) based on the specific details of the transaction. In particular, we analyze effects on cable MVPDs and DISH Network (because there was little or no telco video presence at the time of the transaction). For cable MVPDs, the primary alternatives would have been DirecTV or DISH Network, and we assume proportional diversion to each. For DISH Network, alternatives would have been DirecTV or cable, and we conservatively assume proportional diversion from DISH Network to DirecTV, even though diversion from one DBS provider to another was very likely to have been significantly more than proportional (which would generate larger predicted fee increases). Table 1 shows that the Murphy method would have predicted price increases for the various networks ranging from {{ }}.[17]

- Indeed, the Murphy method's predicted price increases for the networks involved in the News Corp./DirecTV transaction are very similar to its predicted price increases for the proposed Comcast/NBCU/GE transaction. To demonstrate this, we compute diversion from AT&T, DirecTV, DISH Network, and Verizon to Comcast based on each MVPD's market share within its footprint and an assumption that diversion from DBS providers to Comcast is {{ }} percent of proportional, while diversion from telco MVPDs to Comcast is proportional to market shares.[18] Table 2 shows the predicted price effects. In dollar terms, the range of predicted price increases across networks and MVPDs from the proposed transaction is {{ }}, relative to {{ }} in the News Corp./DirecTV transaction. In percentage terms, the ranges are {{ }} for the proposed transaction as compared to {{ }} for News Corp./DirecTV.

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16 We draw estimated affiliate fees and net advertising revenue per subscriber for 2002 from SNL Kagan. We also assume an MVPD margin of $29.30 based on a reported ARPU for DirecTV of $59.80 and variable costs amounting to 51 percent of ARPU. (Hughes Electronics Corporation form 10-K for 2002, at 9.) This margin is similar to the margin that Cablevision proposed that the Commission use for this transaction. The Commission instead relied upon redacted numbers based on internal DirecTV data. (*News-Hughes Order*, Appendix D, ¶ 3.)

17 We convert all predicted price changes to 2010 dollars.

18 Note that Professor Murphy assumed that Comcast negotiated with an MVPD with a market share of 10 percent. (*Murphy Reply Report*, Exhibit 4.)

In Exhibit 2 of the *Murphy Reply Report*, Professor Murphy presents survey data that implies diversion from DBS to Comcast that is {{ }} percent of proportional (in the relevant cases in which subscribers depart DirecTV due to dissatisfaction with programming). Although we believe the average of these figures—{{ }} percent of proportional—is a more appropriate figure to use, for these calculations we follow Professor Murphy's Exhibit 4 by using {{ }} percent of proportional diversion. Lacking other evidence, we use proportional diversion for telco providers.

> The conclusion from this comparison is clear. The Murphy method would have predicted price increases of up to {{ }} on the national cable networks at issue in the News Corp./DirecTV transaction. These increases are not supported by available empirical evidence. Hence, there is no basis to assume that the very similar predictions from the Murphy method for the proposed Comcast/NBCU/GE transaction would actually come to pass.

Second, we note the following about the Murphy method's predictions with respect to departure rates following loss of a broadcast network:

- Although assuming a $0.50 retransmission payment and equal bargaining power may provide a plausible estimate of the departure rate ({{ }} percent) at a single point in time, a much more informative test is what the Murphy method says about patterns over time.
- A recent white paper on retransmission consent fees by SNL Kagan indicates that, prior to 2005, cash retransmission consent deals were extremely limited. In 2009, CBS became the first O&O group to negotiate retransmission consent deals with cash payments, estimated to be worth approximately [[ ]] per subscriber per month.[19] Most recently, in the just-completed deals between News Corp. and Cablevision and DISH Network, News Corp. was reportedly able to obtain retransmission consent fees in the range of [[ ]] per subscriber per month.[20] Thus, the evidence indicates that retransmission consent fees are increasing dramatically.
- Under the Murphy method, this trend in retransmission fees would imply that departure rates due to loss of a broadcast network must also be *increasing*, which seems highly unlikely given that the increasing range of entertainment options is very likely reducing the power of broadcast networks. The decline in importance of broadcast networks is reflected in the declining ratings for broadcast networks, shown in Figure 1.[21]
- Hence, when looking at a broader set of data (rather than one predicted departure rate at a single point in time), the predictions of the Murphy method for broadcast networks are inconsistent with observed trends.

As a final note, we respond to the Commission Staff's claim that the Murphy method produces a "reasonable" ranking of the departure rates for the NBCU national cable networks. It is not clear to us precisely what identifies a "reasonable" ranking for departure rates beyond the simple observation that the ranking by predicted departure rates is fairly similar to a ranking by ratings. Assuming that this (or some similar intuition for a reasonable ranking) is what Commission Staff is referring to, this is a test with effectively no power. Many models of negotiations, including

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19 SNL Kagan, "The Economics of Retransmission for Broadcasters and Cable MSOs," June 2010, p. 4.

20 Marci Ryvicker and Timothy Schlock, "FOX Signs Agreements with DISH and CVC," Wells Fargo Securities Equity Research, November 1, 2010, at 1.

21 Although average advertising revenue per television household per month fell during the recession by about [[ ]], it appears to be recovering with a projected increase from 2009 to 2010. Meanwhile, as discussed above, retransmission consent fees have increased by as much as [[ ]] and are projected to continue to increase.

those fundamentally inconsistent with the Murphy method's assumptions—such as models in which MVPDs' value cable networks as a means to encourage existing subscribers to move to higher tiers, models based on MVPDs' compensating networks for VOD or online rights (which presumably impose larger lost-advertising costs on larger networks), or models with any possible relative MVPD/network bargaining power and thus any split of surplus—would yield the same (or very similar) implications for a predicted ranking as the Murphy method. Hence, this test cannot distinguish between alternative explanations for observed license fees and, thus, cannot justify using the Murphy method to derive estimates of departure rates.

Table 1
Estimated Increase in License Fees
News Corp. National Cable Networks (2002)

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Table 2
Estimated Increase in License Fees
NBCU National Cable Networks (2009)

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Figure 1
Average Combined Primetime Rating of the Big Four Broadcast Networks

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