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November 24, 2010

BY HAND DELIVERY

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Room TW-A325
Washington, DC 20554

Vanessa Lemmé
Industry Analysis Division
Media Bureau
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

Re: **REDACTED — FOR PUBLIC INSPECTION**

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

Dear Mses. Dortch and Lemmé:

Attached is a redacted version of a report of Professor Kevin Murphy responding to the report of Drs. Mark Israel and Michael Katz, which Comcast filed on November 10. Please note that redacted Confidential Information and Highly Confidential Information are designated by the symbols [[ ]] and {{ }}, respectively.

As required by the Protective Orders in this proceeding, we are also hand delivering unredacted copies of this filing and Dr. Murphy's backup calculations under separate cover.

Respectfully submitted,

William Wiltshire

Enclosure

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REDACTED – FOR PUBLIC INSPECTION

COMMENTS OF PROFESSOR KEVIN M. MURPHY ON THE NOVEMBER 10, 2010 REPORT OF DRS. MARK ISRAEL AND MICHAEL L. KATZ

November 24, 2010

Kevin M. Murphy*

* George J. Stigler Distinguished Service Professor of Economics, Department of Economics and Booth School of Business, University of Chicago, and Principal, Navigant Economics (formerly Chicago Partners)

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I. Introduction

1. On November 10, 2010, Drs. Mark Israel and Michael L. Katz ("Israel and Katz") submitted a report to the Federal Communications Commission[2] critiquing the methodology and findings described in my August 19, 2010 submission.[3] In their report, Israel and Katz claim to demonstrate two types of flaws in the "Murphy method." First, they claim that my theoretical framework is unsound, "particularly when applied to national cable networks." Second, they argue that the model's predictions about the likely impact of the Comcast-NBCU transaction on rates charged by Comcast for NBCU programming "fail to match basic empirical patterns in the pricing of cable and broadcast networks."[4] However, as I explain, the Israel and Katz critiques are without merit and/or likely to be quantitatively unimportant, and do not cause me to change the opinions set forth in my previous reports or my ultimate conclusion that the acquisition by Comcast of NBCU's owned and operated ("O&O") broadcast stations and national cable networks would create conditions that make higher carriage rates likely.

II. My Methodology is Appropriate for Analyzing the Impact of the Proposed Transaction

2. Israel and Katz claim that my bargaining framework – which as I noted in an earlier report was used by Katz in his submission to the Commission at the end of 2009[5] – is "fundamentally unsound" and "relies on a series of questionable and unsubstantiated assumptions." They claim that there are "four key assumptions underlying the Murphy method that are especially questionable, particularly when applied to national cable networks."[6] However, as I explain below, their claims provide no basis for me to revise my conclusions.

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[2] Mark Israel and Michael L. Katz, *Responses to "Murphy Method" for Calculating Departure Rates for Cable Networks*, November 10, 2010 ("Israel and Katz Response to Murphy").
[3] Kevin M. Murphy, *Response of Professor Kevin M. Murphy to Reply Report of Mark Israel and Michael L. Katz*, August 19, 2010 ("Reply Report").
[4] Israel and Katz Response to Murphy, p. 1.
[5] Katz, Michael L. et al. "An Economic Analysis of Consumer Harm from the Current Retransmission Consent Regime," GN Docket Nos. 09-47, 09-51 and 09-137. November 12, 2009. ¶¶ 16-29.
[6] Israel and Katz Response to Murphy, pp. 1-2.

A. The Validity of My Model Does Not Depend on Evidence that Comcast Executives Form Precise Estimates of Departure Rates

3. Israel and Katz claim that my "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," and that Comcast executives' representation that they do not attempt to form "precise estimates" is inconsistent with this "foundational assumption."[7] However, no such assumption underlies my model. Rather, my framework provides a way of using data on market outcomes – in particular, retransmission rates and license fees – to shed light on the departure rate, which is the degree to which MVPDs' subscribership is sensitive to their provision of broadcast stations and cable networks. Consistent with economic logic, my framework assumes that the size of negotiated retransmission and network license fees reflects, among other things, NBCU's and MVPDs' assessment of the programming's value to MVPDs, and that their valuations depend on the "constant price" departure rate. All else equal, higher fees indicate that NBCU and MVPDs believe that this departure rate is higher, and economic theory predicts that this relationship holds whether or not participants "form precise estimates" of the departure rate. Just as economics teaches that consumers maximize their utility without requiring that consumers quantify exactly how much their utility differs for different choices, economics shows that companies and their executives maximize profits, bargain and decide on their willingness to pay without formally quantifying many of the relevant parameters, including the departure rate.

4. Indeed, Israel and Katz's critique of my model would apply equally to their calculations of the claimed welfare effects of the proposed transaction.[8] They assume that Comcast will adjust its prices and other conduct to internalize the benefits to NBCU, even though they provide no evidence that Comcast and/or NBCU "precisely" quantify these benefits. Similarly, Israel and Katz assume that Comcast sets its prices to maximize its profits before and after the transaction, and that it does so based on demand elasticities for its programming. Indeed, the

[7] Israel and Katz Response to Murphy, p. 2.

[8] Mark Israel and Michael L. Katz, *Economic Analysis of the Proposed Comcast-NBCU-GE Transaction,* July 20, 2010. ¶¶ 75, 77, Table IV.1 ("Israel and Katz Opposition Report"); Mark Israel and Michael L. Katz, *Response to Professor Rogerson's Comments on Double Marginalization*, October 25, 2010, pp. 15-19.

assumption that firms maximize profits by equating marginal revenue (which depends directly on the demand elasticity) to marginal cost has a long tradition in economics, even though it is commonly recognized that most firms do not have precise estimates of the demand elasticity.

5. My assumption about the economic rationality of parties negotiating license fees is consistent with the approach taken in countless empirical economics papers that help inform policy decisions. I assume that businesses make decisions consistent with profit-maximizing behavior, even if they do not perform the formal calculations an economist might use to describe the profit-maximizing decision.

B. Departure Rates Predicted by My Model are Not Substantially Lower When I Assume Negotiations for Jointly Owned Broadcast and Cable Networks are Interrelated

6. In my analysis of the effect of the transaction on license fees for NBCU national cable networks, I assumed that negotiations for each of the NBCU cable networks were independent of negotiations for retransmission fees for NBC's owned and operated stations. Israel and Katz claim that "the value of retransmission consent has generally been captured via affiliated cable networks' license fees," and that "[g]iven 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."[9] Put simply, they argue that the license fees for NBCU national cable networks that I used as inputs in Exhibit 4 of my Reply Report are inflated, because they include compensation NBCU receives for retransmission consent.

7. In order to evaluate this critique, I performed an analysis in which I incorporate the possibility that negotiations for retransmission consent and licensing NBCU national cable networks are interrelated. The retransmission fees received by NBC stations that are not owned by NBCU provide market evidence of the negotiated retransmission fees we would expect for NBC's O&O stations if NBCU did not collect value in other forms (such as carriage for their national cable networks). In principle, the difference between these fees and those received by

[9] Israel and Katz Response to Murphy, p. 2.

NBCU for comparable O&O stations provides an estimate of the value taken in other forms. In any case, since retransmission fees for NBCU O&O stations are non-negative, the fees received by NBC stations that are not owned by NBCU serves as an upper bound on the implicit retransmission fee that MVPDs pay to NBCU in other forms.

8. Exhibit 1 shows that my estimated departure rates are only slightly affected by this adjustment. I assume an implicit retransmission fee for NBCU O&O's of {{ }} per subscriber (the highest retransmission fee DIRECTV pays to any station group for retransmission rights for an NBC affiliate).[10] About 28 percent of U.S. MVPD subscribers reside in a DMA with an NBC O&O, so an upper bound for the implicit retransmission fees to NBCU, averaged across all U.S. MVPD subscribers, equals {{ }}.[11] I deduct these "standalone" retransmission fees proportionally from the license fees for NBCU's national cable networks[12] and report the estimated departure rates, increases in license fees, and percent increases in license fees based on these adjusted license fees for national networks (original fees net of estimated standalone retransmission rates) in Exhibit 1. These estimates are only slightly smaller than my original estimates (even when making the aggressive assumption that *all* the value of O&O carriage is received through higher fees for national cable networks), {{

}}, and because DMAs with NBCU O&Os account for only about one quarter of U.S. MVPD subscribers.[13] Based on these results, I conclude that the effect cited by Israel and Katz has no quantitative significance.

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[10] From conversations with Counsel for DIRECTV, it is my understanding that the maximum retransmission fee DIRECTV pays for an NBC-affiliated station is {{ }}.

[11] Calculation provided in backup materials. *See,* SNL Kagan, "US Multichannel Market Subscriber Summary," Q2 – 2010 and Mark Israel & Michael L. Katz, *Application of the Commission Staff Model of Vertical Foreclosure to the Proposed Compact-NBCU Transaction,* February 26, 2010, Table 1.

[12] For example, USA Network's [[ ]] license fee is [[ ]] of the [[ ]] total license fees for NBCU's national cable networks, so I attribute [[ ]] of the retransmission fee (or roughly {{ }} per subscriber) to USA Network.

[13] There is so little difference in the changes in the license fees that they round to the same amount in cents for most networks. Compare Exhibit 1 to Murphy Reply Report, Exhibit 4.

C. Tier Switching is Unlikely to Have an Empirically Important Effect on Departure Rates

9. Israel and Katz note that I incorporate in my analysis an assumption about the extent to which the reduction in an MVPD's profit from losing a network comes through adjustments in quantity (number of subscribers) as opposed to changes in the subscription price.[14] In my Initial Report, I explained that empirical evidence of DISH's and DIRECTV's responses to the absence of local broadcast channels from their channel lineups supported an assumption that {{ }} of an MVPD's decreased profit is accounted for by price decreases and {{ }} by quantity reductions.[15] In my Reply Report, I used the same assumption in analyzing changes in license fees for NBCU's national cable networks from the transaction.[16]

10. Israel and Katz claim that I improperly applied this assumption, derived from evidence on local broadcast stations, to national cable networks. They argue that "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...on which those networks are carried."[17] They claim that I would overstate departure rates and the resulting impact of the transaction on license fees if subscribers respond to the absence of a national cable network from an MVPD's tier by downgrading to a lower tier.

11. However, tier-switching is unlikely to be empirically important for NBCU's cable networks because NBCU's most important networks typically are on the lowest programming tier promoted by Comcast's MVPD competitors.[18] USA, CNBC, SyFy, Bravo, MSNBC, and the

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[14] Israel and Katz Response to Murphy, pp. 3-4.

[15] Kevin M. Murphy, *Economic Analysis of the Impact of the Proposed Comcast/NBCU Transaction on the Cost to MVPDs of Obtaining Access to NBCU Programming*, June 21, 2010, ¶¶ 39-40 and Appendix A. ("Initial Report")

[16] Reply Report, Exhibit 4.

[17] Israel and Katz Response to Murphy, p. 3.

[18] I noted in my November 19, 2010 submission that DIRECTV, like other MVPDs, also has a "family package" that is not heavily promoted that contains a limited set of "G-rated" networks. Customers are unlikely to downgrade to this package in response to the unavailability of a NBCU network on its "Choice" tier, both because they are not likely to be aware of this package, and because they would be losing access to many networks including those that are close substitutes to the missing NBCU network. DIRECTV also has "base" Spanish and international packages that do not include these networks. *See,* Kevin M. Murphy, *Comments of Professor Kevin M. Murphy on Supplemental Submissions by Drs. Mark Israel and Michael L. Katz on Double Marginalization and Econometrics*, November 19, 2010, ¶¶ 11 and 26-27.

Weather Channel are all on DIRECTV's "Choice" tier, along with over 100 other networks.[19] Verizon's FiOS service's "Prime" tier includes these NBCU networks as well as Oxygen,[20] and DISH's "America's Top 120" tier also includes all of these networks.[21] Removing one of NBCU's most important national cable networks from these MVPDs' lowest promoted tier is unlikely to lead subscribers to switch tiers. In principle, removing a network from the lowest tier could even induce some subscribers to upgrade to higher tiers in order to replace the lost programming, which would reverse the sign of Israel and Katz's hypothesized effect. Furthermore, even if some customers do downgrade, Israel and Katz provide no evidence that my assumption that {{ }} of the lost value to the MVPD comes from customers that do not switch MVPDs (and hence do not contribute to the departure rate) is too low.

D. My Departure Rates are Not Overstated, Even if it is Possible in Theory That an MVPD "Pays" for the Right to Use Content in Video on Demand Offerings

12. Israel and Katz's last critique of my method is that I overstate departure rates because observed license fees reflect not only traditional linear distribution rights, but also rights to other forms of distribution.[22] They claim that "MVPDs negotiate for the rights to use content in multiple ways (*e.g.*, in video-on-demand offerings or on websites). {{

}}"

13. However, this critique reflects a misunderstanding of my model and the economics of the negotiations more generally. Any {{ }} due to viewing though alternative methods will be reflected in the {{ }} by NBCU, which is what I use in my calculations of the implied departure rate (specifically, I do not use what {{ }} would be absent these other uses). Thus, my calculated departure rates

[19] *See*, "DIRECTV 'Choice' Package Channel Lineup," available at, http://www.directv.com/DTVAPP/new_customer/base_packages.jsp?footernavtype=-1.
[20] "Verizon FiOS TV Channel Lineup – Effective June 2010 Prime HD," available at, http://www22.verizon.com/NROneRetail/NR/rdonlyres/8524407F-FC2A-4C21-A111-9662F97119AD/0/Ultimate_Nat_Online_062310.PDF..
[21] "Dish Network Channel Lineup America's Top 120," available at, http://www.dishnetwork.com/packages/detail.aspx?pack=AT100.
[22] Israel and Katz Response to Murphy, p. 4.

already reflect the degree to which this effect {{ }}. If MVPDs are representative of the mix of uses for these cable networks in the market, the effect of the lower value claimed by Israel and Katz will be fully accounted for by the {{ }} received by NBCU. Contrary to Israel and Katz's claims, no further adjustment is required.

14. In fact, any remaining adjustment that accounts for {{ }} associated with alternative forms of distribution would lead me to estimate *greater*, not smaller, departure rates than the estimates I previously reported (although the magnitude of this effect is likely to be small). {{ }}. This is because the share of NBCU {{ }} that depends on coming to terms with the MVPD will be greater than my formula implies ({{ }}).[23]

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[23] {{ }} affect my estimate of the departure rate through the term *(1-a)b*, where *a* is the share of an MVPD's "stayers" (those who do not switch MVPDs if the MVPD no longer carried a particular network) who watch this network through other means (*e.g.*, online), and *b* is the per subscriber {{ }} of this network (see equation (14) of my Initial Report). In my formula, *(1-a)* is the share of advertising revenues derived from this MVPD's subscribers that is dependent on coming to terms with the MVPD (Initial Report, ¶ 27). As a result my estimated departure rate is increasing in *(1-a)*. In my Reply Report, I assumed (following Israel and Katz's assumptions for O&Os) that *a*={{ }} and that there was no difference in {{ }} when programs are viewed through traditional and "alternative means." (Reply Report, Exhibit 4 note [2]). If I assume instead that {{ }} per viewer from viewers that watch a cable network through alternative means are θb (rather than b) and that a share ρ of MVPDs' customers watch the network through alternative means, then the share of NBCU's {{ }} that is dependent on coming to terms with the MVPD is $(1 - a\theta/[\theta + (1-\theta)(1-\rho)])$. If, as Israel and Katz indicate, $\theta \leq 1 -$ {{ }} -- then the adjustment factor $\theta/[\theta + (1-\theta)(1-\rho)]$ is less than or equal to one (and is only equal to 1 if $\theta = 1$ or $\rho = 1$). Thus, incorporating this adjustment factor will lead to an estimate of the share of networks' revenues that are dependent on coming to terms with an MVPD to be greater than they were before. However, as I noted above, the difference is quantitatively small.

III. Israel and Katz Wrongly Claim that My Model is Inconsistent with Historical Evidence of Network Pricing

15. Israel and Katz claim that "predictions of the Murphy method do not match the historical record on the pricing of *either* cable or broadcast networks." They claim that this means that my framework cannot be applied to predict pricing impacts from the transaction.[24] However, as I demonstrate below, their claim is false and evidence they use to support it fails to account for important factors that determine retransmission and cable network fees.

A. Israel and Katz Wrongly Claim that My Estimates are Inconsistent with Their Previous Empirical Analysis of the Effect of Integration on Pricing

16. Israel and Katz note that, in reviewing the News Corp./DIRECTV transaction, the Commission found no reason for concern that the transaction would lead to temporary or permanent foreclosure of national cable networks. They claim that the Commission's conclusion is supported by their own regression analysis of the effect of vertical integration on pricing, which found no statistically significant price increase associated with vertical integration.[25] However, the confidence intervals associated with their estimates are so large that only an extremely large price increase would fall outside of these intervals. The price increases presented in my earlier report fall within the range of these intervals.

17. Israel and Katz's initial regression yielded a coefficient estimate on an "Integrated" dummy variable of {{ }} with a standard error of {{ }}. Given the large standard error, a confidence interval of two standard errors around the point estimate includes values between {{ }} and {{ }}, or about plus or minus {{ }} per subscriber. Given their estimated constant ({{ }}), this implies a confidence interval for their point estimate of {{ }}. In other words, any change in price between {{ }} would be consistent with their regression results.[26]

[24] Israel and Katz Response to Murphy, pp. 5-6.
[25] Israel and Katz Response to Murphy, p. 5.
[26] Israel and Katz Opposition Report, ¶ 86 and Table IV.5.

18. Israel and Katz presented a new vertical integration analysis in their October 25 econometrics submission,[27] in which they restricted the regression to networks that were involved in the News Corp./DIRECTV transaction and subsequent spin-off. Again, they find "no significant increase in affiliate fees due to vertical integration"[28] because of the large standard errors for their estimated coefficients. Their point estimates of the pricing impact resulting from vertical integration range from {{ }} to {{ }}, implying an increase of between about {{ }} per subscriber for the networks that they study. Since these point estimates correspond to percentage increases in network fees of between {{ }}, these results cannot be interpreted as evidence against the hypothesis that integration has substantial effects on network fees. Since Israel and Katz's estimates are very imprecise, they result in confidence intervals in their three specifications of {{ }}.[29]

19. In my original analysis of increases in license fees for NBCU cable networks, my point estimates ranged from {{ }} to {{ }}.[30] These are within the range of the confidence intervals in Israel and Katz's initial and more recent analysis, and are similar to their most recent *point estimates* of {{ }} from their three specifications.[31]

20. In their November 10 critique, Israel and Katz applied my framework to the News Corp/DIRECTV transaction, and found it predicts increases of {{ }} and {{ }} for license fees to DISH, and {{ }} and {{ }} for license fees to cable firms.[32] The predicted increases for DISH are within the confidence intervals of estimates from their own regressions. Most estimates for the increases to cable firms are as well.

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[27] Mark Israel and Michael L. Katz, *Responses to Commission Econometric Questions*, October 25, 2010 ("Israel and Katz Econometrics Response").
[28] Israel and Katz Response to Murphy, p. 5.
[29] Israel and Katz Econometrics Response, Table 1.
[30] Reply Report, Exhibit 4.
[31] Israel and Katz Econometrics Response, Table 1. Dividing the coefficient on "Integrated" by the estimated constant generates values of 0.128, 0.199, and 0.273 in the "News Corp./DirecTV Event" regressions in columns (4)-(6).
[32] The exception is the TV Guide network. *See,* Israel and Katz Response to Murphy, Table 1.

21. Israel and Katz also extend my analysis to estimate increases in license fees for DIRECTV, DISH, UVerse, and FiOS using estimates of these firms' market shares, rather than assuming (as I did) a hypothetical MVPD with a 10 percent market share. They predict license fee increases across MVPD and network from {{ }} to {{ }}.[33] Once again, these estimates are within the confidence intervals associated with their own regression estimates and they illustrate that my predictions based on a hypothetical MVPD with a 10 percent market share are informative.

B. My Method Predicts Changes in Retransmission Rates Consistent with Observed Trends

22. Israel and Katz claim that while "a $0.50 retransmission payment and equal bargaining power may provide a plausible estimate of the departure rate…at a single point in time, a much more informative test is what the Murphy method says about patterns over time."[34] They note that retransmission fees recently increased substantially, and claim my method must attribute this to increased departure rates from the loss of a broadcast network. Israel and Katz say that increased departure rates "seems highly unlikely given that the increasing range of entertainment options is very likely reducing the power of broadcast networks" and therefore they conclude that "the predictions of the Murphy method for broadcast networks are inconsistent with observed trends."[35]

23. However, the recent increases in retransmission rates are explained by another industry trend that I incorporate in my model – the reduction in advertising revenues per viewer for broadcast stations.[36] My model predicts that declines in advertising revenue will lead to increases in retransmission fees for broadcast networks, which is precisely the trend that Israel

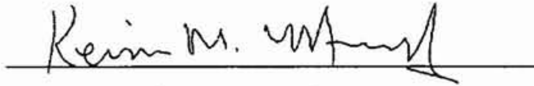
[33] Israel and Katz Response to Murphy, Table 2.
[34] Israel and Katz Response to Murphy, p. 7.
[35] Israel and Katz Response to Murphy, p. 7.
[36] In real dollar terms, the 'big four' networks advertising revenues per television household have declined since 2006. Because local advertising revenues have declined relative to network advertising revenues during this time, it follows that broadcast (network plus local) advertising revenues per television household have declined during this time. Calculations demonstrating these trends are included in my backup. *See,* SNL Kagan's "TV Network Summary – Broadcast Networks By Net Advertising Revenue," "U.S. Advertising Revenue By Sector, 2000-2009," and "Basic Cable Network Gross Billings, 1980-2019." CPI adjustments use U.S. Department of Labor Consumer Price Index for all items. Available at, ftp://ftp.bls.gov/pub/special.requests/cpi/cpiai.txt.

and Katz recognize. As my model makes clear, contrary to the assumptions underlying Israel and Katz's claims, more competition and declining viewership for broadcast networks has an ambiguous effect on retransmission fees. If, as viewership falls, advertising revenues decline modestly faster than the departure rate, retransmission fees will rise rather than fall.[37] This result helps explain the seemingly anomalous empirical phenomenon that retransmission fees for network stations have increased even as viewership has declined. Israel and Katz provide no alternative explanation for this widely recognized empirical pattern.

[37] This results because NBCU's gain from getting carriage is roughly proportional to its advertising revenues per subscriber and the MVPDs gain is proportional to the departure rate. The fact that both gains are large relative to the retransmission fee implies that the direction of change in the fee will be determined largely by the relative rates at which the two gains decline.

I declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge, information, and belief.

Executed this 24th day of November, 2010.



Kevin M. Murphy

Exhibit 1
Estimated Departure Rate and Increase in License Fees
Adjusted for Israel and Katz's 'Implicit' Retransmission Fee Component
NBCU National Cable Networks

Assumptions[1]	USA Network	CNBC	Universal HD	SYFY	Bravo	MSNBC	The Weather Channel	Oxygen	Chiller	Sleuth	MUN2	CNBC World
{{												

}}

CERTIFICATE OF SERVICE

I hereby certify that, on this 24th day of November, 2010, a copy of the foregoing Letter of DIRECTV, Inc. was sent by courier service to:

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