PREPARED STATEMENT OF KEVIN J. ARQUIT[1] BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON THE JUDICIARY, OVERSIGHT HEARING ON DIRECT BROADCAST SATELLITE SERVICE IN THE MULTICHANNEL VIDEO DISTRIBUTION MARKET

KEVIN J. ARQUIT
SIMPSON THACHER & BARTLETT LLP

MAY 8, 2003

I. INTRODUCTION

Mr. Chairman, thank you for the invitation to express my views on the antitrust issues presented by the proposed acquisition of 34% of Hughes Electronics, Corporation ("Hughes") by News Corporation Limited ("News Corp."). The most specific questions arise from the vertical integration of News Corp.'s Fox media group with Hughes' DirecTV direct broadcast satellite ("DBS") service. Although any acquisition of this size, and involving a market so vital as the media, requires some careful thinking before regulatory approval, this particular transaction does not appear to raise any significant potential for the lessening of competition, such as to trigger antitrust concerns.

When analyzing the antitrust implications of a transaction, it is critical to distinguish between the consequences that flow as a result of any horizontal overlap (i.e., direct competition), and the effects that may result from a vertical relationship between two companies. In the case of horizontal overlap, there is no need to search for potential effects on competition; some impact is inevitable and immediate. Of course, that does not mean that the transaction is unlawful; there may be valid efficiencies created by the combination of assets, and in the vast majority of situations there are sufficient remaining competitors in the marketplace to overwhelm, and thereby neutralize, any attempt to restrict output by the merging entities. The point remains, however, that a horizontal transaction, by definition, always eliminates at least some competition, and is thus more apt to raise antitrust issues.

---

1 Mr. Arquit was General Counsel of the Federal Trade Commission from 1988-1989, and Director of the FTC's Bureau of Competition from 1989-1992. He is presently a partner in the law firm of Simpson Thacher & Bartlett. This testimony reflects the individual views of Mr. Arquit. Neither he nor the law firm represents any party to the transaction, and the preparation of this testimony was not financed in whole or in part by any client.

By contrast, vertical combinations do not inevitably, or even commonly, reduce competition. To the contrary, vertical integration generally yields some level of efficiency – i.e., the streamlining and rationalizing of processes by which products or services are delivered to consumers. I hasten to add that vertical combinations are not always good for competition. They can facilitate the ability of the combined entity to place a chokehold on competition at multiple levels, by creating the wherewithal and incentive to refuse to deal. The result can be the cutting off of the competition's air supply. This potential exists in any number of industries, involving the combination of complementary assets. This is as true in the context of beverages and bottlers, and software and hardware providers, as it is for video programming and distribution. However, when a transaction is vertical in nature, the starting point is that the transaction does not necessarily decrease competition and the presumption is that some efficiencies result.

With that introduction, I explain my conclusion that this essentially vertical transaction is not likely to foreclose competitors of News Corp. or DirecTV, and does not raise significant antitrust concerns.[2] As we all know, this is not the first proposed transaction involving the DirecTV assets. Approximately six months ago, the Department of Justice ("DOJ") sought to block the proposed merger of EchoStar and DirecTV assets, resulting, ultimately, in the abandonment of the acquisition. As I will discuss in a moment, that proposed combination stands in stark contrast to this transaction.

II. <u>COMPETITIVE ANALYSIS</u>

The first step in an analysis of competitive effects, is identification of the relevant product and geographic markets. The DOJ consistently has analyzed the competition between and among cable operators and DBS operators as a market composed of all multichannel video programming distribution ("MVPD") systems.[3] Although there may be some room to argue that the relevant market should not include low-capacity cable systems, it is difficult to articulate a conclusive economic rationale as to why consumers would not perceive all cable operators and DBS operators as reasonable enough substitutes.[4]

2 This testimony focuses on the MVPD and programming businesses. I have not reviewed other lines of business the parties may have, such as the satellite services provided by PanAmSat or the broadband services provided by Hughes Network Services.

3 *See, e.g.,* Complaint at ¶¶ 24-29, *United States v. EchoStar Communications et al*, (D.D.C. filed Oct. 31, 2002) ("EchoStar Complaint").

4 *See, e.g., EchoStar Communications Corporation, Hughes Electronics Corporation, and General Motors Corporation,* Hearing Designation Order, 17 FCC Red. 20559, 20609 (2002) *("EchoStar/Hughes").*

In any event, for purposes of this transaction, the distinction is insignificant. No matter how narrow or wide the MVPD market is defined, there is no direct overlap between the parties.[5] Therefore, the discussion that follows is premised on an "all MVPD systems" market. Further, consistent with precedents in this area, the relevant geographic market is presumed to be the franchise area of a local cable operator, since customers within that territory have the choice between the incumbent franchised cable company and the two DBS providers. In such a market, depending on the geographic location, DirecTV faces competition from one (or occasionally more) cable operators, as well as EchoStar Communications (owner of the DISH network). In areas where cable is unavailable, MVPD competition is largely between EchoStar and DirecTV.

A. Horizontal Effects

The transaction does not eliminate any direct horizontal competition between DirecTV and EchoStar or any cable operator. The number of competitors in the MVPD market and their relative market shares are not altered by the transaction. So an analysis focusing solely on horizontal issues would yield the conclusion that the transaction does not alter the status quo, let alone the competitive landscape.

If anything, reference to the Government's Horizontal Merger Guidelines,[6] suggests that the transaction likely will increase the competitive vigor of DirecTV. It is widely accepted that News Corp. has historically been a maverick in the media industry. The company regularly has chosen to "shake up" the business segments it has entered. Whatever industry participants or others may think of such market behavior (or whether it causes political delight or dismay) antitrust analysis looks favorably towards such maverick firms, and for sound policy reasons.[7]

---

5 It is my understanding that any MVPD horizontal overlap is indirect and certainly de minimis. Liberty Media, which has a passive stake in News Corp., also has an ownership in the cable operator Cablevision of Puerto Rico. However, according to the parties' FCC Application, filed on May 2, 2003, Liberty Media's stake will be no more than 19% in News Corp., and less than 1% in Hughes after the proposed transaction. Further, the News Corp shares held by Liberty have no voting rights except in limited issues. Therefore, Liberty Media does not and will not have any decision-making authority in News Corp. or Hughes. By the same token, DirecTV has a 5% passive equity stake in the Hallmark Channel, which does not create any meaningful horizontal overlap in the programming space.

6 United States Dept. of Justice and Federal Trade Comm'n. Horizontal Merger Guidelines (1992) ("Merger Guidelines").

7 Merger Guidelines §§ 2.12 and 4.

When an industry is characterized by increasing levels of concentration, the tendency is for firms to start behaving oligopolistically. In other words, the fewer the competitors, the more likely each competitor will start making competitive decisions with some level of understanding as to how the remaining competitors will react. Although there is nothing unlawful, in and of itself, about such rational business decision making, it can curtail competitive vigor. But when there exists a competitor that does the unexpected, the conditions more nearly approximate that of a perfectly competitive market, where uncertainty abounds. In short, although the proposed transaction does not change the number of competitors in the MVPD market, any impact of News Corp. on the business decisions of DirecTV may well increase competition at the MVPD level.

1. The present transaction does not raise the same antitrust issues that were present in the abandoned *EchoStar/DirecTV* transaction

In October 2002, the DOJ, joined by 23 states, the District of Columbia and the Commonwealth of Puerto Rico, filed a lawsuit to block the acquisition of Hughes by EchoStar. In short, this transaction proposed the combination of the nation's two largest DBS providers, and, in my view created one of the most obvious and compelling cases for Government challenge in recent history.

The DOJ's argument in opposing the transaction was straightforward.[8] The merger would have reduced the number of competitive choices available to consumers in the MVPD market from three (Hughes' DirecTV, EchoStar's DISH network, and cable) to two where cable is available. In non-cable areas, DOJ alleged that the proposed transaction was quite simply a merger to monopoly, resulting in one company controlling all three full continental U.S. satellite positions, and making it virtually the exclusive gatekeeper for nationwide direct broadcast satellite services.[9]

Clearly, the proposed partial acquisition of Hughes by News Corp. does not present the same issues. *EchoStar/Hughes* was a horizontal concentration between two competitors in a highly concentrated market. By contrast, the *News Corp./Hughes* transaction is a vertical integration of a supplier and a distributor. Thus, while the DOJ predicted in *EchoStar/Hughes* that the beneficial products of the intense competition between DirecTV and DISH (for example, reduced programming prices, more attractive programming packages, reduced equipment costs,

---

8 *See* EchoStar Complaint at ¶¶ 37-59.

9 The merger proponents argued forcefully that the combination of the two primary DBS services would in fact spur even more horizontal competition vis-à-vis cable, by creating a larger, more robust, DBS, and would bring together resources that would foster further innovation.

and free installation) would be lost post-merger, there are no similar concerns here. DirecTV will still compete head-to-head with DISH and, where available, cable. The market position of competitors in the MVPD market will therefore be unaffected by the proposed transaction.

B. Vertical Issues

What remains to be examined is the possible anticompetitive effect that could flow from the vertical affiliation between the programming business of News Corp. and the distribution business of DirecTV. Therefore, the antitrust inquiry needs to focus on any incentive or ability that News Corp. or DirecTV will have as a result of a partial overlap in ownership between these businesses. Will DirecTV have the incentive or the ability to favor programming from News Corp. such that News Corp.'s programming competitors will be at a competitive disadvantage? In the alternative, will News Corp. have the incentive or the ability to favor DirecTV at the expense of other MVPDs such that DirecTV will have an anticompetitive advantage?

Under the facts of this case, neither of these theories appears to present a realistic antitrust concern. Given the resulting market structure, neither News Corp. nor DirecTV appears to have the incentive or the ability meaningfully to discriminate against competitors

1. Would DirecTV favor programming from News Corp.?

I would like to start by outlining a theoretical antitrust concern from the vertical affiliation: if DirecTV favors programming from News Corp. and either refuses to carry programming from competitors or carries competing programs under onerous terms, News Corp.'s programming would gain an advantage against such competitors. Whereas News Corp.'s programming would be free to contract for access on all distribution channels available, its competitors would be denied the ability to reach the DirecTV subscribers on competitive terms. Therefore, depending on the market strength of DirecTV, News Corp. would be able to decrease competition in the market or markets for programming.

This theoretical construct, however, breaks down when one factors in present market conditions. By refusing to deal with competing programmers on competitive terms, DirecTV takes the risk that consumers will find its service less valuable because it does not carry the programming sought by consumers. Therefore, for this concern to materialize, News Corp. and DirecTV need to be convinced that the strategy will result in increased profits for News Corp. and that these profits will not be offset by an even larger detrimental effect on DirecTV.

If DirecTV were a monopolist, I would tell you that the inquiry would have to dig deeper because under those circumstances, a strategy to foreclose News Corp.'s competitors might actually pay off. It might turn out that even as a monopolist, DirecTV and News Corp. do not in fact have the ability or the incentive to engage in a foreclosure strategy, but it certainly is a theoretical and mathematical possibility. As a monopolist, DirecTV likely would not lose that many subscribers by refusing to carry some programming desired by consumers; and News Corp.'s programming would have a significant competitive advantage by having unhindered access to the monopolist distributor.

Of course, the marketplace, as it exists, presents a very different picture. The FCC recently concluded in its Annual Report to Congress that cable distribution still constitutes over 75% of the MVPD market and that "cable television still is the dominant technology for the delivery of video programming to consumers in the MVPD market place."[10] With approximately 12% of the MVPD market,[11] it appears unlikely that DirecTV could effect a successful anticompetitive programming foreclosure strategy here.

Indeed, the concern about the strength of <u>cable</u> distribution underlies the program access rules[12] adopted by Congress and the FCC to prohibit cable operators from discriminating against non-affiliated programmers: as long as cable operators dominate delivery of programming, a vertically integrated programmer will have the ability to foreclose its programming competitors from the market.[13]

These FCC findings also support the observation that DirecTV has no apparent incentive to discriminate against non-affiliated programming, because it would undermine any chance DirecTV has in competing against the dominant cable operators. DirecTV is not immune to competition in any area of the country, and overall, it controls only 12% of the national MVPD market. Even in areas where DirecTV does not face an incumbent cable operator, DirecTV faces competition from EchoStar. DirecTV needs to provide competitive quality and selection of programming to compete successfully against the incumbent cable operators and EchoStar. If DirecTV foregoes servicing its subscribers' demand for quality and selection in order to pursue a News Corp. battle against other programming vendors, it will be sacrificing the DirecTV business to deliver little more than a glancing blow to the unaffiliated programming vendors. In short, DirecTV and News Corp. do not appear to have the incentive to engage in conduct that will be detrimental to the non-affiliated programming vendors.

---

10 *See* Federal Communications Commission, Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, Ninth Annual Report, 17 FCC Rcd. 26901. ¶ 4 (2002) ("Ninth Cable Competition Report").

11 Ninth Cable Competition Report, ¶ 131.

12 *See*, 47 CFR §§ 76.1000-1003.

13 *See* Federal Communication Commission, Implementation of the Cable Television Consumer Protection and Competition Act of 1992 – Sunset of Exclusive Contract Prohibition, 17 FCC Rcd. 12124, 12144-45 (2002).

Even if DirecTV and News Corp. feel compelled to follow what appears to be an irrational strategy, DirecTV does not have the ability to inflict harm on non-affiliated programming vendors by refusing to deal with them. DirecTV alone, with only 12% of the market, certainly cannot dictate terms to the programming vendors; the programming vendors simply would refuse to accept unreasonable terms because they have close to 90% of the cable and DBS subscribers still available to them.

2. Would News Corp. Favor Distribution Through DirecTV?

The vertical integration of News Corp. programming with DirecTV theoretically could create an incentive for News Corp. to advantage DirecTV by denying News Corp. programming to DirecTV competitors at competitive terms. However, the ability to engage in such anticompetitive behavior is constrained by programming competitors, who would likely seize the opportunity to supply more programming to the market. MVPD operators choose to carry programming that will facilitate their market penetration: it is unclear that Fox has any essential or unique programming in that regard. Moreover, News Corp. programming does not in aggregate represent a significant percentage of the programming market. Indeed, competitors such as AOL Time Warner, Viacom, and The Walt Disney Co. each possess a greater share of the media programming business. The wide availability of substitute programming therefore greatly minimizes the risk of foreclosure in the programming market.

Another flaw with this theoretical concern is the premise that, in the U.S. market, News Corp. has an incentive to cease distribution of its programming through competing MVPDs. Viewership is the key asset for News Corp.; viewership determines not only the fees collected from the MVPDs but also the advertising revenue. It is not clear why News Corp. would disrupt its current distribution system, significantly risk a reduction in viewership and revenue for the distant promise that subscribers might switch to DirecTV. In any event, whatever the desire of News Corp. to unfairly promote DirecTV may be, it would have to factor in that News Corp. will own only 34% of DirecTV. Therefore, while News Corp would absorb 100% of the lost programming and advertising revenue from denying programming to competing MVPDs, it would recoup only about a third of any unlawful rents that result from advantaging DirecTV.

Take the Fox News Channel. News Corp. entered this segment of programming challenging a dominant incumbent, i.e. CNN, and, contrary to the prediction of many, has turned the channel into the most watched cable news provider.[14] If News Corp. refuses to provide this programming to DirecTV's competitors, it risks losing significant share back to CNN, without any guarantee that consumers would switch to DirecTV simply because they prefer Fox News

[14] Application of General Motors Corporation, Hughes Electronics, and News Corporation Limited, Consolidated Application for Authority to Transfer Control at 25, filed May 2, 2003

Channel over CNN. Even with respect to regional sports programming, News Corp. appears to have strong incentives to continue to distribute through DirecTV competitors. In the regional markets where News Corp. has sports programming, to the extent DirecTV's market share is roughly the same as elsewhere (i.e., 12%), News Corp. would have to risk 88% of the market to discriminate against DirecTV's competitors.

With a 12% market share, DirecTV does not have – and is not likely to gain – sufficient subscribers to enable Fox to sustain its current level of license fees, and the related advertising revenue, should the distribution of Fox programming be in any way curtailed post-merger.

3. Commitment to be Bound by Program Access Rules

Of course, all of these discussions about the vertical issues may prove to be merely academic. I understand that the parties to the transaction have expressed their willingness to abide by the program access rules of the FCC and incorporate appropriate terms into a consent decree with the regulatory agencies.[15] The program access rules are designed to protect non-cable MVPDs like DBS providers, and technically apply only to cable operators and to programming vendors that are affiliated with cable operators – not DBS operators. (It is my understanding, however, that as a result of Liberty Media's minority stake in News Corp. and in some cable operators, News Corp.'s programming is subject to the program access rules.)

The rules prohibit vertically-integrated programming vendors from discriminating in the prices or terms and conditions of sale of programming to cable operators and other MVPDs. The rules also prohibit any cable operator that has an attributable interest in a programming vendor from improperly influencing the decisions of the vendor with respect to the sale or delivery, including prices, terms, and conditions of sale or delivery of satellite-delivered programming to any competing MVPD. Finally, under the rules, cable operators generally are prohibited from entering into exclusive distribution arrangements with vertically-integrated programming vendors.

Of course, since the rules apply only to "cable operators" and their affiliates, these restrictions presumably would not otherwise apply to DirecTV, or to News Corp. in the event Liberty Media divests its interest in News Corp. or the cable operators. However, according to their FCC application, the parties are willing to subject their operations to the antitrust safeguards provided by these rules irrespective of Liberty Media's stake in News Corp. or cable operators, and more generally undertake to subject DirecTV to all of the restrictions that apply to cable operators. Also, again according to the application to the FCC, the companies agree to the following in addition to the program access rules:

15 *Id.* at Attachment G.

1. Neither News Corp. nor DirecTV will discriminate against unaffiliated programming services in the selection, price, terms or conditions of carriage.

2. News Corp. will not offer any of its existing or future national and regional programming services on an exclusive basis to any MVPD and will continue to make such services available to all MVPDs on a non-exclusive basis and nondiscriminatory terms and conditions.

3. Neither News Corp. nor DirecTV (including any entity over which either exercises control) shall unduly or improperly influence: (i) the decision of any Affiliated Program Rights Holder to sell programming to an unaffiliated MVPD; or (ii) the prices, terms and conditions of sale of programming by any Affiliated Program Rights Holder to an unaffiliated MVPD.

In light of the lack of incentives or ability to engage in vertical foreclosure, the companies' commitments may be unnecessary. However, they provide added assurance that there will be no anticompetitive effects, i.e., that News Corp. would foreclose other MVPDs or DirecTV would freeze out other programmers. The parties thus appear to commit that neither News Corp. nor DirecTV will enter into any exclusive deals or discriminate against any MVPD or programming vendor.

Of course, the commitments not to discriminate against other programmers or other MVPDs inevitably will be criticized by some as leaving a loophole for News Corp. to raise prices to all MVPDs and "reimburse" DirecTV for the price hike through either some distribution or other internal accounting mechanism. Putting aside the facts that News Corp. will own only 34% of DirecTV,[16] and that, as discussed above, News Corp. lacks the power to raise fees to MVPDs, such an argument assumes that the FCC regulations and the administrative adjudication procedures provided by the program access rules cannot effectively prevent abuse. The FCC has considered a number of other cases involving vertical issues in MVPD transactions, and has consistently found that its program access rules are a sufficient protection against potential abuse.[17]

16 The financials of DirecTV likely will be kept separate from News Corp. making any circumvention of the program access commitments harder to implement and easier to detect.

17 *See, e.g., Comcast Corporation, AT&T Corp., and AT&T Comcast Corporation*, 17 FCC Rcd 23246, 23286 (2002)*; Telecommunications, Inc. and AT&T,* 14 FCC Rcd 3160, 3180 (1999).

III. POTENTIAL EFFICIENCIES RESULTING FROM THE PROPOSED TRANSACTION

In addition to injecting a maverick firm into the MVPD market, the companies have identified expected synergies not only in reduction of operating expenses but also in the form of implementation of new service and better customer service. In particular, the companies expect to benefit from News Corp.'s extensive experience abroad in the field of DBS and implementation of new related services such as interactive television applications. Similarly, News Corp. has a history of making local programming a central element of its business model. Therefore, it would not be surprising to see DirecTV accelerate its local-into-local programming as a way to expand customer service and quality of programming.

The combination of News Corp.'s DBS business outside of the United States with the DirecTV business likely will also create economies of scale with respect to research and development of new and innovative technologies. Further, the ability to coordinate development, marketing and delivery of new programming likely will streamline and rationalize the service to the consumer.

IV. CONCLUSION

As I mentioned before, a transaction of this size always requires an informed inquiry into the antitrust implications. However, the facts of this transaction dispel concerns as to any substantial antitrust issues. First, the lack of any horizontal overlap and the likely immediate efficiencies argue for cautious regulatory scrutiny. Second, any potential for vertical foreclosure appears unlikely because the parties do not have the incentive or the ability (market power), to engage in conduct that would foreclose other MVPDs or programming vendors. Finally, the parties have expressed a willingness to enter into a consent decree that tracks and adds to the regulations the FCC put in place to tackle the same antitrust concerns that arise when cable companies vertically affiliate with programming vendors. Therefore, there appears to be no reason to oppose the transaction on antitrust grounds.