The Free State Foundation's Claims Fail to Weaken the Case for the Department of Justice to Investigate Competitive Harm Caused by Comcast/NBCU

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On November 29th, the Free State Foundation (FSF) released a report contending that the American Cable Association's (ACA) call for the U.S. Department of Justice (DOJ) to investigate the anti-competitive acts and practices of Comcast-NBCU was unwarranted because of changes in the market alleviating any possibility of competitive harm. As demonstrated herein, FSF's report is based on flawed reasoning and no hard evidence.

1. Introduction

On November 6, 2018, the ACA sent a letter[1] to Assistant Attorney General Makan Delrahim, calling for the Antitrust Division of the DOJ to open an investigation into the harms to competition and consumers created by the vertical combination of distribution and programming assets owned or controlled by Comcast-NBCU. In 2011, when the DOJ and the Federal Communications Commission (FCC) reviewed the Comcast-NBCU merger, they determined that the vertical combination of Comcast's distribution (cable network) assets together with NBCU's programming assets would harm consumer welfare and the public interest, and they only allowed the merger to proceed subject to a series of remedies meant to safeguard competition. However, the remedies recently expired even though, as ACA pointed out in its letter, the threats to competition and consumers posed by the vertically integrated Comcast-NBCU remain as real and significant as ever. In fact, ACA demonstrated that these harms are unambiguously greater than the competitive harms generated by the recent AT&T-Time Warner (TW) transaction, which the DOJ attempted to block completely.[2] While AT&T-TW managed to convince a court to allow its merger to proceed, it succeeded primarily by preemptively committing to abide by the same sort of binding arbitration remedy that no longer applies to Comcast-NBCU. This has led to the anomalous result that, while Comcast-NBCU poses a far greater threat to competition and consumers than does AT&T-TW, only the latter entity is subject to a remedy meant to limit its ability to engage in anti-competitive behavior.[3] Thus, while the coyote has been put on a leash, the wolf is allowed to roam free.

[1] Letter from Matthew M. Polka, President & CEO, American Cable Association, to The Honorable Makan Delrahim, Assistant Attorney General, Antitrust Division, U.S. Department of Justice (Nov. 6, 2018), available at http://www.americancable.org/wp-content/uploads/2018/11/181106-DOJ-Letter-re-Comcast-NBCU-w-Appendix-FINAL-1.pdf ("ACA Letter").

[2] *See* ACA Letter, Appendix (explaining why the Comcast-NBCU merger threatens greater competitive harm than the AT&T-TW transaction).

[3] Matthew M. Polka, *AT&T/Time Warner Will Face Binding Arbitration Threat, but Not Comcast/NBCU*, Morning Consult (July 9, 2018), https://morningconsult.com/opinions/att-time-warner-will-face-binding-arbitration-threat-not-comcast-nbcu/.

In response to ACA's letter, the FSF issued a report[4] that attempts to downplay the concerns raised by ACA, arguing that recent changes in the competitive structure of the video distribution and programming industry imply that vertical integration in this industry no longer creates any significant competitive concerns. The purpose of this note is to explain why the arguments raised in the FSF Report fall far short of demonstrating that vertically integrated giants such as Comcast-NBCU no longer pose any threat to competition or to consumers.

The Theory of Harm

Before describing and evaluating the arguments made in the FSF Report, it will be useful to first review the basic theory of harm explaining why a vertically integrated distributor/programmer with a significant market share at the distribution level and control over "must have" programming at the programming level has both the incentive and ability to create significant competitive harm. The key idea is that if a programmer vertically integrates with a distributor, the programmer's bargaining leverage over rival distributors increases because its threat to withhold programming becomes more credible. It's more believable because some of the customers of the rival distributor that would switch to other providers in response to a programming blackout will switch to the vertically integrated distributor, thereby providing offsetting profits to the firm that a non-vertically programmer would not obtain. As a result of its increased bargaining leverage, a vertically integrated programmer can raise the prices it charges rival distributors for programming. This harms consumers because a share of these price increases are passed through to them. Furthermore, when its rivals are forced to raise their prices, the vertically integrated distributor can raise its own prices, which further harms consumers.

Three key factors affect the magnitude of the competitive harm created by a vertical merger. The first is how important ("must have") the programming is to consumers, which affects the number of consumers that will leave the rival if programming is withheld. The second is the market share of the vertically integrated distributor, which determines the share of its rival's departing customers that will switch to the vertically integrated firm. The third is the profit margin that the vertically integrated distributor earns on each new customer. Any argument that the competitive harm threatened by Comcast-NBCU is no longer significant must necessarily provide convincing evidence that one or more of these factors have significantly diminished in importance.

The FSF Arguments

Now that we understand what drives competitive harm, we can analyze the FSF Report's two basic arguments that changes in market structure imply that the vertical integration of distribution and programming assets within Comcast-NBCU no longer poses any significant threat of competitive harm.[5]

[4] Theodore Bolema, *Revisiting the Comcast/NBCU Merger: Antitrust Claims Have Even Less Merit Than in 2011*, 13 PERSPECTIVES FROM FSF SCHOLARS (2018), http://www.freestatefoundation.org/images/Revisiting_the_Comcast-NBCU_Merger_-_Antitrust_Claims_Have_Even_Less_Merit_Than_in_2011_-_112918.pdf (last visited Dec 12, 2018) ("FSF Report"). FSF Report.

[5] In addition to the two arguments discussed below, the FSF Report also makes one additional argument (in Section IV of the report) that can be even more easily dismissed. The report notes that ACA represents firms that compete with Comcast-NBCU in distribution markets and that the simple fact that Comcast-NBCU's actions are damaging competitors

1. FSF Contends that Programming Today is a Questionable Source of Leverage

As discussed above, for a vertically-integrated distributor/programmer to create significant competitive harm, it needs to control access to "must have" programming that is so highly valued by viewers that a significant share of them would switch providers if the programming became unavailable from their current provider. The FSF Report claims that Comcast-NBCU programming is no longer important enough for significant numbers of multichannel video distributor (MVPD) customers to consider switching providers if the programming becomes unavailable from their current provider, with the result that the theory of harm described above no longer induces any significant effect.[6] It offers two pieces of "evidence" to support its claim.

The first piece of "evidence" is the verbal observation that the increased presence of on-line video distributors (OVDs) that produce some of their own programming has resulted in a greater variety and quantity of programming being available. While the fact that somewhat more programming is available perhaps suggests in the abstract that any particular piece of programming may become somewhat less important to viewers, this qualitative observation falls far short of providing any quantitative basis for concluding that there has been a significant change in the extent to which viewers would switch providers if Comcast-NBCU programming became unavailable. Furthermore, on-line programming so far appears be a particularly poor substitute for two key blocks of programming owned by Comcast-NBCU - its eleven NBC owned and operated local broadcast stations (O&Os) and its seven regional sports networks (RSNs). RSNs carry live sporting events that are generally completely unavailable from any on-line source. Broadcast networks also carry significant amount of live sports as well as coverage of other live events, such as the Academy Awards, that are also generally not available from on-line sources.[7]

The second piece of "evidence" consists of a description of one incident involving the negotiation of Comcast-NBCU with one multichannel programming distributor (MVPD) for one minor network (The Weather Channel) where the MVPD was apparently able to resist an attempt by Comcast-NBCU to raise the license fee for that network by the full amount that Comcast-NBCU initially demanded. Even in this minor instance, it may well be the case the Comcast-NBCU was still able to negotiate a higher license fee than NBCU would have been able to negotiate on its own if the merger with Comcast had not occurred. More importantly, one anecdote about Comcast-NBCU negotiations over one minor network with one MVPD provides no reasonable basis for drawing any meaningful conclusions about Comcast-NBCU's bargaining leverage over the set of key programming that it controls, such as the signals of its eleven NBC O&Os, its seven RSNs, and its

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does not, in and of itself, necessarily demonstrate that the actions in question are anti-competitive and harm consumers. This is a correct observation, but it is completely irrelevant to evaluating ACA's claims. ACA is providing a coherent theory of harm explaining why Comcast-NBCU's actions harm consumers and is calling for the DOJ to investigate Comcast-NBCU on this basis.

[6] FSF Report at 8-9.

[7] For example, see Crider, Michael, *Cord Cutting is Losing Its Luster*, September 26, 2017, https://www.howtogeek.com/327215/cord-cutting-is-losing-its-luster/, (reporting that "if you want the best options for live sports, cable or satellite is the only option."); *see also* Darren Heitner, *Why Live Sports Could Help Shield Cable Networks from Cord Cutting Pain*, INC. (Aug. 13, 2017), https://www.inc.com/darren-heitner/why-live-sports-may-save-cable-networks-from-cord-.html.

bundle of major national cable networks such as USA, MSNBC, Bravo, and SyFy.

2. FSF Contends that OVDs Provide Additional Competition at the Distribution Level

The FSF Report observes that the increased presence of OVDs means that traditional distributors such as Comcast-NBCU face more competition at the distribution level than they used to face, and it argues that this increase in competition at the distribution level somehow implies that Comcast-NBCU no longer has any incentive or ability to raise programming prices to increase its own profit.[8] This is completely incorrect.

As explained above, vertical integration between a distributor and programmer creates a significant competitive harm to the extent that the three factors discussed above are present. Given this basis, now consider how a modest increase in competition by OVDs at the distribution level will affect these factors. Most importantly, competition at the distribution level does not affect the nature of the programming owned by the vertically integrated firm and therefore does not change the share of consumers that will leave a rival if the programming becomes unavailable. To the extent that OVD's begin to capture market share, this will reduce the share of switching customers that switch to the vertically integrated distributor and may also reduce the profit margin that the vertically integrated distributor earns on new customers. However, given the relatively small share of consumers who have completely cut the cord, the extent to which OVDs reduce diversion of switching customers to a large distributor such as Comcast-NBCU is still relatively minor.[9] Furthermore, distributors such as Comcast-NBCU still earn significant profit margins on switching customers because profit margins on video services have not been completely competed away and because many customers that switch to Comcast/NBCU for their video service will also switch to it for their internet and telephone service, which significantly increases the profit from switching customers.

Therefore, it is doubtful (and by no means proven by FSF) that the modest increase in competition at the distribution level due to OVDs has significantly reduced the incentive or ability of vertically integrated MVPDs such as Comcast-NBCU to raise programming prices to rival providers. Rather, this is the type of empirical issue the DOJ should fully investigate in examining the competitive harms that Comcast-NBCU can cause to consumers and rivals.

In fact, the presence of a new class of distributors in the marketplace creates a new class of rival distributors that vertically integrated programmers such as Comcast-NBCU have an incentive to disadvantage. Thus, to the extent that Comcast-NBCU's incentive and ability to harm distribution rivals remains unchecked, this enables it to impede the continued growth and success of OVD's as well as rival traditional distributors.

3. Conclusion

The FSF Report's assurances that "all is well" and that there is no need for the DOJ to

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[8] FSF Report at 5-8.

[9] See Appendix for an illustrative example showing that the share of cord-cutters in the population is still too small to have had a significant effect on diversion rates.

investigate the potential for vertically integrated Comcast-NBCU to damage competition and harm consumers ring hollow. Comcast-NBCU still controls significant “must have” programming that its rivals, including OVD rivals, need to compete. Furthermore, Comcast-NBCU still has the incentive and ability to raise the prices that it charges rivals for this programming. Vague assurances that the programming carried by Comcast-NBCU is no longer that important or that a modest increase in competition at the distribution level provided by OVDs has solved the problem should not dissuade DOJ from conducting a full investigation of this issue. In any event, given its belief that its reasoning and evidence are sound, the FSF should have nothing to fear from an investigation by the DOJ of Comcast-NBCU.

Appendix

The Effect of Cord-Cutters on Diversion Rates

As explained in the body of this paper, the presence of cord-cutters in the population will reduce the profit that Comcast-NBCU can earn from withholding programming from rival distributors to the extent that it reduces the share of customers leaving the rival that switch to Comcast. This share is often referred to as the diversion rate. The purpose of this appendix is to provide an example illustrating that this effect on the diversion rate is still very modest given the small share of cord-cutters in the population, which in turn implies that the extent to which the presence of cord-cutters in the population has reduced the vertical competitive harm caused by Comcast-NBCU because of its effect on the diversion rate is also still very modest.

As discussed in detail in ACA's original letter, the most significant vertical competitive harm caused by Comcast/NBCU occurs in regional programming markets where Comcast-NBCU is the primary incumbent cable operator and also is the provider of "must have" local and regional programming because the local NBC broadcast station is an NBC O&O station and/or Comcast-NBCU owns a major RSNs serving the region. The effect of the presence of cord cutters on diversion rates in such markets will now be illustrated and shown to be relatively modest.

First consider the situation before there were any cord cutters. As described in detail in ACA's original letter, because Comcast-NBCU is the primary incumbent cable operator in such markets, its share of MVPD subscribers is generally well over 50%. Comcast-NBCU's average market share over all nine such markets identified by ACA is 55%. Suppose for purposes of this illustration that Comcast-NBCU's market share is 55%. Now suppose that Comcast-NBCU is considering withholding programming from a rival with a 20% market share. It is normally assumed that the share of customers leaving the rival that will divert to any particular distributor is proportional to the distributor's market share. Since the rival's market share is 20%, this means that the market share of all other distributors except for the rival (including Comcast-NBCU) is equal to 80%. Since Comcast-NBCU's market share is 55%, this means that the share of consumers leaving the rival that will divert to Comcast-NBCU is equal to (55/80) x 100% or 68.8%.

Now consider how the situation changes in the presence of cord-cutters. We will follow the same procedure as above to determine the diversion rate, only now it will be assumed that customers switching away from the rival distributor also have the alternative of cutting the cord and subscribing to a virtual MVPD (vMVPD).[10] As before, diversion to various alternatives will be assumed to be proportional to the market share of each alternative. At the end of the third quarter of 2018, approximately 6.9 million households subscribed to a vMVPD and 91 million households subscribed

[10] OVDs can be divided into two different groups. One group, usually referred to as subscription video on-demand distributors (SVODs) makes libraries of on-demand content available to subscribers. Examples of SVODs include Netflix and Amazon Prime. The other group, usually referred to as virtual MPVDs (vMVPDs) provides subscribers access on live streaming video channels over the Internet. Examples of vMVPDs include Sling and DirecTV Now. While SVODs provide services that are complementary to those provided by traditional MVPDs, vMVPDs provide services that are direct substitutes for the services provided by traditional MPVDs. Thus the share of households in the population that subscribe to vMVPDs is generally viewed as a reasonable estimate of the share of households that have cut the cord and substituted an OVD for a traditional MVPD.

to traditional MVPDs.[11] This implies that approximately 7% of households that subscribed to some sort of MVPD (either traditional or virtual) subscribed to a vMVPD. The market shares considered above will now be adjusted to allow for this. In particular, it will be assumed that the market share of vMPVDs among all households subscribing to some sort of MVPD (traditional or virtual) is equal to 7%. It will also be assumed that the relative shares of traditional MVPDs remain unchanged from the above example. This means that the market share of each traditional MVPD is multiplied by .93. This yields a market share of 51.2% for Comcast-NBCU and a market share of 18.6% for the rival. In this case, the total market share of all MVPDs other than the rival is equal to 81.4%. Therefore, the diversion rate to Comcast-NBCU is equal to (51.2/81.4) x 100% or 62.9%. So the effect of the presence of cord cutters is to reduce the diversion rate to Comcast from 68.8% to 62.9%.

Since the new diversion rate is reduced by 9%[12] and since the expected price rise due to the vertical competitive effect is proportionate to the diversion rate, the presence of cord-cutters will reduce the programming price increase due to vertical integration by the same 9%. Put another way, even with the presence of cord cutters, 91% of the vertical competitive harm still remains. Thus, the presence of cord cutters did not reduce the diversion rate by a significant enough amount to significantly reduce the vertical competitive harm.

[11] Ian Olgeirson, Tony Lenoir and Neil Barbour, *Q3'18 multichannel video subscriptions fall despite virtual services lift*, KAGAN (Nov. 12, 2018), https://platform.mi.spglobal.com/web/client?auth=inherit&newdomainredirect=1&#news/article?id=47764955&KeyProductLinkType=6 (subscription required).

[12] 0.09 = (68.8 – 62.9)/68.8.