

**An Economic Overview of the Implications for Online Video
of the Proposed Comcast-NBCU Transaction**

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Overview

The proposed Comcast-NBC Universal (NBCU) transaction is primarily a vertical merger that also has less significant horizontal components. The vertical aspect is the combination of a video producer (NBCU) and a video distributor (Comcast). The horizontal aspects are, first, adding NBCU's programming, including NBC, Bravo, and others, to Comcast's programming, including the Golf Channel, E!, and others and, second, adding NBC-owned broadcast stations to Comcast's terrestrial video delivery network. Because Comcast's national programming offerings are relatively small and because Comcast has promised to keep free over-the-air broadcasts of NBC,¹ most debate has focused on the vertical aspects of the transaction; I will focus on those vertical aspects today.

Vertical mergers can have pro-competitive, efficiency-enhancing effects, but they can also have anticompetitive effects. The pro-competitive effects include aligning incentives between the upstream and downstream firms in ways that promote innovation and investment, eliminating double-marginalization and therefore lowering costs and prices, and reducing transactions costs associated with negotiations in which the upstream and downstream firms must otherwise engage. The potential anticompetitive effects from foreclosure or raising rivals' costs arise if market power in the downstream market creates the incentive and ability to leverage that power into the upstream market.

The net effect of any vertical merger is, therefore, theoretically ambiguous. Empirical research of previous vertical transactions, however, tends to find positive outcomes. Professors Lafontaine and Slade (2007) conclude in a comprehensive survey article in the *Journal of Economic Literature* that

We are...somewhat surprised at what the weight of the evidence is telling us. It says that, under most circumstances, profit maximizing vertical-integration decisions are efficient, not just from the firms' but also from the consumers' points of view. Although there are isolated studies that contradict this claim, the vast majority support it.²

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¹ <http://blog.comcast.com/2010/01/comcast-ge-and-nbc-universal-file-public-interest-statement-with-fcc.html>.

The NBC affiliates have agreed to support the transaction subject to certain conditions, suggesting they believe this promise (Blake, Johnson, and Canter 2010).

² Lafontaine and Slade (2007, 608).

Nevertheless, as Dr. Leslie Marx points out in her filing on behalf of Bloomberg, the empirical research on the effects of vertical integration in cable TV firms is, like the theory, not dispositive.³

The challenge for antitrust authorities in a merger case is to determine which effect dominates and, possibly, to impose conditions that can mitigate anticompetitive effects that will not sacrifice more than they gain in terms of efficiency. Any merger review involves assumptions about the future, and the nascent nature of online video makes the effects of this transaction even more difficult to evaluate. Nobody knows what the future of online video will be. It is probably safe to say, however, that it will not be free. Indeed, it probably cannot be free, or even solely ad-supported, given that the costs of producing high-quality network shows runs about \$4 million an hour, plus distribution costs.⁴

Given the uncertainty about what business models may be successful, firms are experimenting with several online models today, including pay-per-view (iTunes, Amazon), subscription services (Netflix), advertising (Hulu), combinations of those (Hulu Plus, Fancast Xfinity), and at least one firm whose innovative business model includes over-the-air broadcast as part of its service (Sezmi). Because it is impossible to say with any certainty how online video markets will develop, let alone how they *should* develop, it becomes extremely difficult to know how the merger will affect that trajectory.

Nevertheless, in the context of this transaction and online video—the subject of this panel—we can enumerate the potential pro-competitive and anti-competitive features.

Let's look at each side in more detail.

Potential pro-competitive aspects of the merger

Pro-competitive effects of this vertical transaction include potentially increased incentives to invest in online content, experimentation with new content and new methods of distributing content, and investment in the delivery platform itself.⁵ Making new content available online often involves aggregating disparately-owned rights, which creates delays and slows innovation. A vertically integrated content and distribution company should have fewer such delays. Products that Comcast says could have emerged more quickly without the negotiations required under multiple owners include video-on-demand (VOD) services, DVD day-and-date release,

³ Marx (2010, para. 87) cites two studies of vertical integration in cable television. The first, Chipty (2001), finds net benefits of vertical integration due to its efficiency effects. The second, Ford and Jackson (1997), finds net losses of about \$0.60 per subscriber per year from vertically integrated cable systems. It is worth noting that Cooper, et al (2005) review 22 studies of antitrust-relevant vertical integration. Four of those, including Chipty (2001) and Ford and Jackson (1997), involved cable television systems. The other two are Waterman and Weiss (1996) and Vita (1997). Waterman and Weiss (1996) find that vertically integrated cable companies tended to favor affiliated programming over unaffiliated programming, but did not attempt to determine whether that outcome was driven by efficiency or foreclosure objectives. Vita (1997) finds that decisions by vertically integrated cable companies to drop unaffiliated programming were nearly always driven by efficiency considerations.

⁴ See Israel and Katz (2010, para. 10). Martin (2010, 8) estimates that CBS spends about \$3 billion per year producing content.

⁵ See Rosston (2010) filing for a full discussion of pro-competitive effects.

Fancast, and other interactive services. Comcast claims that the transaction will facilitate and speed the introduction of future services for the same reasons.⁶

The merger will also eliminate inefficient double-marginalization, which occurs because for each additional subscriber an independent NBC will charge a fee above marginal cost for each additional subscriber for the rights to carry its programming. As a merged entity, Comcast would internalize the extra fee and its marginal cost would become the true marginal cost of an additional subscriber to NBC.⁷ This effect is a standard benefit of vertical mergers, and economists generally recognize that it yields consumer benefits.

The analysis should probably also consider the effects of the merger on NBCU itself. Press reports suggest that GE no longer believes NBCU is a sufficiently profitable part of its portfolio and would prefer to invest its resources elsewhere.⁸ Comcast would presumably have strong incentives to invest heavily in NBCU as more and better content could increase demand for all of Comcast's products, including its would-be new venture.

Merger authorities must balance those potential positive effects against the potential negative effects of a merger, which I discuss next.

Potential anticompetitive effects of the merger

The key antitrust question with vertical mergers is whether a newly vertically-integrated firm can leverage the vertical relationship to raise rivals' costs anticompetitively and reduce output.⁹ In this case, does Comcast have the incentive and ability to deny NBCU content from competing MVPDs or online distributors? In other words, would foreclosure be profitable for the merged entity?

In the 2004 News Corp-DirecTV transaction the FCC adopted a commonsense approach to answering this question that economists on both sides of this merger acknowledge to be appropriate here.¹⁰ Stated simply, the merged entity has an incentive to foreclose if foreclosure yields net increased profits.

One factor in determining whether foreclosure would be profitable is whether online video is, or will soon be, a complement or a substitute for traditional television viewership. If, on the one hand, it is a complement, then by definition online video stimulates more demand for traditional viewing. In that case, Comcast has little incentive to foreclose since wider distribution increases

⁶ Rosston (2010, para. 48-50).

⁷ More accurately, these fees would decrease in proportion to the share of NBCU that Comcast owns. At first, when GE retains 49 percent ownership Comcast would, presumably, still pay 49 percent of the fees to GE that it currently pays.

⁸ Cox and Rosenbaum (2009) argue in the New York Times that "[NBC's profitability is] probably well below the internal thresholds that G.E. executives use when they allocate capital to acquisitions and new investments." James (2009) notes in the LA Times that although GE's "deep pockets" at one time allowed NBC to "secure high-profile contracts" for popular sitcoms and sports programming, now "GE is retrenching, and [NBC] has fallen on hard times."

Flint and James (2009) report in the Chicago Tribune that GE "no longer appear[s] to have the wherewithal to navigate the rapidly changing media landscape or the will to make the financial investment to revive [NBCU]."

⁹ See, for example, Cooper, et al (2005) and (2007).

¹⁰ See declarations by Israel and Katz (2010), Singer (2010), and Marx (2010).

profits no matter who shows Comcast-NBCU content online. If, on the other hand, it is a substitute or will become one soon, and online video causes people to cut the cord or reduce their subscription level, then foreclosure becomes a potentially profitable strategy.

Economists filing in the case disagree about whether online video complements or substitutes for traditional viewing.

Drs. Mark Israel and Michael Katz, filing on behalf of Comcast, argue that they are complements. They cite data from Wall Street analysts and Nielsen noting that in Q4 2009 traditional TV viewership continued to increase—to more than 8 hours per day, an all-time high. At the same time, online video accounted for only about one percent of all video watched, though it is growing.¹¹

Dr. Hal Singer, filing on behalf of the Communications Workers of America, does not contest the information on viewing habits, but points out that those trends do not necessarily mean that online and traditional viewing are complements in the sense of one stimulating demand for the other. He also questions whether online and traditional viewing are likely to remain complements even if they are today given that the traditional MVPDs themselves have claimed that online video is, at minimum, a potential substitute.¹²

For now, the data suggest that online video does not substitute for traditional video delivery. As Nielsen points out, the share of homes with broadband but no cable television has remained stable while the number with cable and broadband continues to grow,¹³ and that “online video is...not typically...a replacement for TV viewing.”¹⁴ For the purposes of thinking about the possible anticompetitive aspects of the deal, however, I will treat online video as though MVPDs believe it has the potential to become a substitute in the near future.¹⁵

Foreclosure would likely have opposing effects on the net profits of the joint company.

If Comcast limited content to its own platforms and consumers valued that content, this foreclosure could increase demand for Comcast’s MVPD service or for its Internet services if it also had online exclusivity. This increased demand resulting from foreclosure could increase Comcast’s profits.

At the same time, foreclosure means fewer people will have access to or view NBCU content, meaning less advertising revenue, less in affiliate fees, and fewer opportunities to promote related content or services. Less content available to others online could also reduce demand for Comcast’s own Internet service. Reduced viewership and demand for Internet service could decrease Comcast’s profits.

Whether Comcast-NBCU has an incentive to foreclose depends on whether it expects the effects that increases profits to offset the effects that reduce profits.

¹¹ Israel and Katz (2010, para. 23).

¹² Singer (2010, para. 201-204).

¹³ http://blog.nielsen.com/nielsenwire/online_mobile/busting-the-cord-cutting-myth-video-in-the-interactive-age/ (June 16, 2010, accessed July 9, 2010).

¹⁴ <http://blog.nielsen.com/nielsenwire/consumer/do-we-watch-the-web-the-same-way-we-watch-tv-not-really/> (February 4, 2010, accessed July 9, 2010).

¹⁵ If that assumption is wrong, the anticompetitive effects should be appropriately discounted.

Perhaps not surprisingly, economists filing in support and in opposition to the merger reach different conclusions as to whether the net effect of foreclosure on profitability would be positive or negative. Not having access to confidential data, which is redacted from all public versions of the filings, I cannot evaluate each side's calculations and assumptions.

Nevertheless, previous transactions may provide some guidance in how to think through the tradeoffs.

For example, when considering the vertical elements of the Comcast/Adelphia/Time Warner transaction in 2006, the Commission faced similar arguments about foreclosure from many of the same parties that have filed supporting or opposing the current transaction. The Commission recognized that foreclosure incentives differed depending on whether programming was national, regional, or regional sports. The Commission concluded that "the transactions are not likely to cause public interest harms relating to access to the Applicants' national or non-sports regional programming."¹⁶

While conditions are not identical in this merger, nearly all of the content Comcast would newly control is national in scope, while Comcast's infrastructure network covers about 25 percent of the U.S. population. Thus, Comcast would incur all of the losses described above but reap only 25 percent of the benefits.

Conclusions

Mergers have benefits and costs that, in theory, could lead either to net benefits or net harms. Estimating the net effects is inherently difficult, especially in this case because it involves the nascent and highly dynamic business of online video. But because theory does not provide much help in answering the question, the Commission must engage in careful, empirical analysis to weigh the pro-competitive effects against the probability of foreclosure times the harm if foreclosure is in the interest of the merged entity. And that analysis, moreover, must be tempered by the recognition that we cannot know with confidence how a decision will affect a rapidly evolving market such as online video.

While most empirical studies of previous vertical mergers show positive effects, proponents of this merger must show why they expect this transaction to yield similarly positive results. Opponents of the merger must show why they believe this merger is likely to yield a different outcome. The Commission, for its part, must show that any conditions it proposes in order to approve the transaction are likely to enhance consumer welfare.

While the Commission risks leaving consumers worse off no matter what it decides, a careful empirical analysis can at least ensure that it makes the right choice given the information available today.

¹⁶ Federal Communications Commission (2006, para. 167).

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