Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Comment Requested on a La Carte and Themed	)	
Tier Programming and Pricing Options for	)	MB Docket No. 04-207
Programming Distribution on Cable Television	)	
And Direct Broadcast Satellite Systems	)	

REPLY COMMENTS OF CONSUMERS UNION and THE CONSUMER FEDERATION OF AMERICA

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SUMMARY

The large cable operators and dominant national programmers have painted a doomsday scenario for *a la carte* choice that bears no relationship to reality. They have vastly overstated the costs and completely ignored the benefits of an environment in which consumers are allowed to choose to purchase either bundles of networks or individual networks. They fail to take into account the migration to digital technology that is already under way. A policy that requires mixed bundling for digital subscribers would enhance consumer sovereignty and invigorate competition without raising consumer costs.

With respect to network economics, the industry analyses suffer from the following flaws:

- Generally, their analysis rests on an assumption of massive loss of subscribers and shift of subscribers from bundles to *a la carte*, which will not occur in a mixed bundling environment.
- They assume a dramatic loss of advertising revenue, even though there will be little if any loss of viewing.
- They assume a threshold for success for networks of 50 million subscribers, over three times the level they claimed was necessary for success just two years ago.
- They assume subscribers have the same value to advertisers as viewers, and that subscribers to a channel in a bundle value the channel the same as if a consumer picked it themselves.
- They assume an increase in marketing costs vastly out of proportion to the loss of subscribers in a mixed bundling environment.

With respect to cable operator economics, the analyses suffer from the following flaws:

- They assume a massive increase in set top box costs and customer care expenses. However, because the digital transition is already under way, they have vastly overstated these costs. Their set-top box analysis is a $500 solution to a $50 problem.
- With almost half of all MVPD subscribers already being served by digital technology, the ramp up in customer care costs has already taken place.
- They assume an opportunity cost of spectrum that is inconsistent with the existence of excess capacity and their own willingness to devote spectrum to networks that are barely watched and add little if any value.

The industry studies ignore the economic and social problems that result form the current system of forced bundles and ties.

- Contrary to fact, they assume that there is neither inefficiency, nor abuse of market power in the current prices paid by consumers. The greater competition in a mixed bundling environment would squeeze these artificially-inflated costs out.

- They ignore the complete domination of the dial by six large entities that that has resulted from the leveraging of carriage rights to exclude truly independent programmers. These six entities account for 80% of viewer, program budgets, and advertising revenue.

We estimate that the costs for *a la carte* programming would be in the range of $1 to $3 per month. More importantly, the mixed bundling environment will better serve consumer and programmer needs.

Given choice, consumers will sort themselves into three categories – devotees, grazers and captives

- Devotees have relatively inelastic demand and would be most likely to buy a channel *a la carte*.
- Grazers, who really value the bundle with its wide range of choices would be most likely to subscribe to bundles
- Captives, who under the current system are forced to buy a network (or multiple networks) that they never watch in order to have access to other networks that they do watch

If they had the chance, captives would not buy certain networks, but they wouldn't decrease viewership since they never watched the channels to begin with.

Advertisers pay to reach people. In cable TV, advertisers pay to reach viewers. In a mixed bundled world what advertisers lose in reach (the number of subscribers with access to a network) they make up for in effectiveness (the greater probability that someone is watching)

Truly independent programmers will find a much less hostile environment.

- It would expand the market, since some consumers who are priced out of the market by the massive bundle would be brought in.
- It would also lead to greater diversity, as competition among channels, including independents forced onto digital cable, begins after a $20 price and 16 channels—not the current roughly $65 and 90 channels.
- Cable operators could feel pressures to be more responsive to consumer needs in an *a la carte* environment.
- Cable operators extol the virtues of Video On Demand to independents, but it's not where they launch their new affiliated networks,
- NCTA bemoans the cost of going digital but members tell programmers a complete conversion is only 2-3 years away

I. INTRODUCTION

The Consumer Federation of America[1] and Consumers Union[2] respectfully submit these reply comments in the Federal Communications Commission (FCC) investigation of *a la carte* pricing of cable and satellite service. In our initial comments, we focused on the problems with the current structure of the industry as the predicate of reform of bundling practices. In these reply comments we focus on why mixed bundling – the requirement that cable operators offer consumers the opportunity to purchase themed-tier packages and individual channels *a la carte* – will not cause the sky to fall; on the contrary, it will lead to a more competitive and efficient marketplace.

The cable industry has painted a doomsday scenario of a death spiral in the industry resulting from *a la carte* choice – rising prices, declining viewership, eroding quality – which rests on a series of assumptions that with respect to mixed bundling are often unrealistic and sometimes completely wrong.[3] The comments from *a la carte* opponents gloss over the dramatically rising price of the bundle, ignore that a handful of programmers wholly dominate

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[1] The Consumer Federation of America is the nation's largest consumer advocacy group, composed of over 280 state and local affiliates representing consumer, senior, citizen, low-income, labor, farm, public power an cooperative organizations, with more than 50 million individual members.

[2] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education and counsel about goods, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with more than 4 million paid circulation, regularly carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

[3] Most of the industry-funded analyses devote almost no attention to the mixed bundling approach. For example, Bruce M. Owen and John M. Gale, *Cable Networks, Bundling, Unbundling, and the Cost of Intervention,* July 15, 2004 (Viacom), devote one paragraph in over 50 pages to mixed bundling. Robert D. Willig, Jonathan M. Orszag, and Jay Ezrielev, *Declaration of Robert D. Willig, Jonathan M. Orszag, and Jay Ezrielev Regarding A La Carte,* July 15, 2004 (Liberty), provide no empirical analysis of mixed bundling. Their empirical example (p. 17) assumes an extremely low take rate, consistent only with a pure unbundling scenario. Michael Katz, *Slicing and Dicing: A Realistic Examination of Regulating Cable Programming Tier Structures,* July 15, 2004 (Comcast), has no empirical analysis. Booz Allen Hamilton, *The a la Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity: An Economic Analysis of the Implications of Cable Pricing on Cable Customers*, July 2004 (NCTA), includes a mixed bundling scenario, which is the focal point of these reply comments.

current bundles by leveraging their market power, and do not acknowledge that most consumers are forced to pay for programming they do not watch and, in some cases, find offensive. In fact, contrary to the dire predictions of the large cable operators and dominant national programmers, these comments show that moving toward mixed bundling actually would make the cable market more competitive and more responsive to consumer tastes and would lead to greater diversity of programming.

These comments are divided into two sections. The first explores the conflict between the simplistic theory presented by the large cable operators and dominant national programmers and the empirical reality of the industry. The second dismantles their doomsday scenario in light of the reality of the industry. The comments conclude by reiterating our position that, although *a la carte* is not a panacea to the myriad problems in the cable industry, it is a first step toward creating a more competitive market that will engender lower prices and greater diversity of programming for consumers.

II. THEORY VS. FACT IN THE *A LA CARTE* DEBATE

CONSUMER, PRODUCER AND TOTAL SURPLUS

THEORY

The sliver of theory that the industry analysts present to the Commission is inadequate to address the public policy issues that confront the Congress and the FCC. The best that can be said of the current take-it-or-leave-it bundles imposed on consumers is that, in a static analysis, they may expand total social surplus while they reduce consumer surplus.[4] In other words, producer surplus may increase more than consumer surplus declines, increasing total surplus. Even the conclusion to this static analysis is dubious, as it is unclear whether producer surplus has increased more than consumer surplus has fallen.

REALITY

Under a dynamic analysis, the enrichment of producers is not random. The current system favors a small number of dominant producers and creates barriers to entry for small, independent outlets, resulting in little diversity in ownership. Leveraging their market power through forced bundling, the large operators and dominant programmers not only reduce diversity, but also diminish competition, leading to inefficiencies in the market. Bundling reduces competitive pressures and therefore limits the total surplus. When reality is injected into the theory, the cable industry argument falls apart even faster. There is no reason to believe that prices will skyrocket in an environment where consumers are allowed to choose between bundles and individual programs. In a more competitive, consumer-friendly environment, total surplus might well be higher.

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[4] This observation has been well established in the economics literature for two decades. Recent works extends it to information goods in theory (Yannis Bakos and Erik Brynolfsoson, "Bundling Information Goods: Pricing Profits and Efficiency," *Management Science*, December 1999, p. 1) and cable in reality (Gregory S. Crawford, *The Discriminatory Incentives to Bundle in the Cable Television Industry,* April 2, 2004, p. 20).

DISCRIMINATION, LEVERAGE AND DIVERSITY

THEORY

The theoretical discussions presented by the industry ignore the problem of anticompetitive and discriminatory leveraging of market power by a few dominant firms.[5] The industry economists and analysts resort to a claim that because large cable operators and dominant national programmers have insisted on bundling, it must be efficient.[6]

This claim ignores several decades of development in economic thinking. Over the past two decades, the anticompetitive potential of bundling has been explored and documented in detail. Indeed, almost immediately after the Chicago school of economic analysis tried to conclude that all bundling be deemed, *per se*, benign,[7] the potentially anticompetitive effects of bundling reemerged in the literature. This literature concluded that bundling engenders market efficiency only when the market is characterized by extreme conditions (i.e., permanent monopoly in one product, perfect competition in the other), firms whose market power is neither total, nor permanent, can use bundling to defend or extend their market power, leading to further inefficiencies in the market. Under a wide range of assumptions, the dynamic[8] ability of bundling to undermine competition has been demonstrated through a number of mechanisms including inducing exit,[9] creating barriers to entry,[10] relaxing price competition,[11] distorting investment,[12] retarding innovation,[13] and extending market power into new markets.[14]

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[5] Barry Nalebuff, "Bundling as an Entry Barrier," *The quarterly Journal of Economics,* February 2004, p. 159, points out that "[a]lthough price discrimination provides a reason to bundle, the gains are small compared with the gains from the entry-deterrent effect."

[6] Owen and Gale, p. 12; Willig, Orszag and Ezreilev, pp. 12, 23.

[7] Richard Posner *Antitrust Law: An Economic Perspective* (Chicago: University of Chicago Press, 1976), Robert Bork, (*The Antitrust Paradox: A Policy At War With Itself,* (New York: Basic Books, 1978).

[8] J. Kaplow, "Extension of Monopoly Through Bundling," *Columbia Law Review,* 85:1985; J. A. Sykes, Ordover, A. Sykes and R.D. Willig, "Nonprice Anticompetitive Behavior by Dominant Firms Toward the Producers of Complementary Products," in (F.M. Fisher, ed.,) *Antitrust and Regulation: Essays in Memory of John J. McGowen* (Cambridge, MA, The MIT Press, 1985).

[9] M. Whinston, "Tying Foreclosure and Exclusion," *American Economic Review,* 80: 1990.

These concerns about anticompetitive effects of bundling are especially relevant to the goals of public policy as expressed in the Communications Act of 1996, which defined "diversity" not by the variety of programs available, but by the number of independent producers.[15] The ability of dominant firms to add programs to bundles and exclude independent firms may increase variety, but it does not contribute to diversity. Simply put, the current system lacks diversity. The Center for Creative Voices in the Media's filing (p. 6 and 8) makes this point nicely:

> The so-called '500 Channel Universe' provides no relief from this concentration and lack of diversity of viewpoints and voices. Evidence in the Biennial record shows that of the 91 major cable television networks each available in more than 16 million homes, fully 80 percent (73 networks) are outlets owned or co-owned by the same five media giant conglomerates that control a 75% share of the national audience, plus Liberty Media. ... Using the principles the Commission laid down in the 2002 Biennial, the inescapable conclusion is that television today is excessively concentrated and viewpoint diversity is inadequate.

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[10] O.E. Williamson, "Assessing Vertical Market Restriction: Antitrust Ramifications of the Transaction Cost Approach," *University of Pennsylvania Law Review,* 127:1979; B. Nalebuff, "Bundling as an Entry Barrier," *Quarterly Journal of Economics,* 2004, "Bundling," Manuscript, School of Management, Yale University, 1999; Y. Bakos and Eric Brynjolfsson, "Bundling and Competition on the Internet: Aggregation Strategies for Information Goods," *Marketing Science,* 19:2000.

[11] J. Carbajo, D. de Meza and D. Seidman, "A Strategic Motivation for Commodity Bundling," *Journal of Industrial Economics,* 38: 1990; Y. Chen, "Equilibrium Product Bundling," *Journal of Business,* 70: 1997.

[12] J. P. Choi and C. Stefanadis, "Tying, Investment, and the Dynamic Leverage Theory," *Rand Journal of Economics,* 32:2001.

[13] J. P. Choi, "Tying and Innovation: A Dynamic Analysis of Tying Arrangements," *The Economic Journal* 114: 2004; J. P. Choi, "Preemptive R&D, Rent Dissipation, and the 'Leverage Theory'," *Quarterly Journal of Economics,* 110:1996.

[14] D. W. Carlton, "The Strategic Use of Tying to preserve and Create Market Power in Evolving Industries," *Rand Journal of Economics,* 33:2002;

[15] This definition makes intuitive sense. As stated in the comments of the Center for Creative Voices in the Media (CCVM) comments, pp. 4-5, "few would suggest that Chevrolet and Cadillac are separate automotive company 'viewpoints.' Rather, the 'viewpoint' is that of their conglomerate owner, General Motors. The same principle holds true in television with regard to conglomerates that own multiple distribution outlets positioned to appeal to different segments of the viewing audience, just as Chevrolet and Cadillac are positioned by GM to appeal to different segments of the car market. The 'viewpoint' is that of the owner – the conglomerate – and not of its subsidiary distribution outlet."

Opponents of *a la carte* programming dismiss the existence of (and, in some cases, the possible existence of) this type of anticompetitive behavior. As the Comcast-funded economist, Michael Katz, puts it on page 26 of his filing:

> Under a leverage motivation, a supplier uses it[s] market power with respect to one product to gain an advantage in the sale of a second product by tying sales of the two together. Leverage can take the form of driving rivals out or excluding entrants.
> The leverage theory clearly is irrelevant to the analysis of bundling cable programming: there is no evidence that tiers have been created to make entry by new networks or new operators more difficult. In fact, tiers have the opposite effect.[16]

REALITY

Katz's statement is contrary to empirical reality.[17] When large cable operators carry networks in which they have an ownership interest, but refuse to carry competing networks from unaffiliated programmers, they distort the marketplace. When dominant national programmers tie niche and emerging networks to their popular programming during retransmission negotiations, they leverage their market power to gain an advantage over independent, competing programming.

The record is rife with solid evidence from smaller and independent MVPD operators, independent content producers, local cable commissions and independent programmers that discrimination takes place with the largest programmers bundling to force cable operators and consumers to take networks that would not be taken in the absence of leverage.[18] The GAO has

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[16] Katz, p. 26.

[17] Willig, Orszag and Ezrielev, provide a perfect example of the blind spot in the industry-funded analyses. They cite the dispute between YES and cablevision as testimony to the fact that profits are higher through widespread distribution, but ignore the fact that Cablevision was attempting to leverage its control over distribution to force YES onto a separate tier, while its own vertically-integrated competing sports programming remained on the expanded basic tier. Our initial comments examined the YES lawsuit and dispute with Cablevision as solid evidence of discrimination and leverage, which these analysts have ignored entirely.

[18] Numerous examples may be found in the initial comments filed in this proceeding. For example, CCVM (p. 9) quotes an Echostar press release: "Among Viacom's strong-arm tactics is the demand that the DISH Network carry Viacom-owned channels of little or no measurable appeal to viewers in exchange for the rights to carry the 16

found that cable operators are 64 percent more likely to carry networks in which they have an ownership interest.[19] Broadcasters do it too, using their retransmission rights, they force cable operators to bundle networks together, [20] and have created networks that are 46 percent more likely to gain carriage.[21] This finding is consistent with earlier econometric analyses.[22]

It's telling that the first meeting that upstart programmers have with Comcast is not with Matt Bond, Executive Vice-President for Programming. It's with Amy Banse, Executive Vice-President for Programming Investments.[23]

Bundling favors dominant programmers and allows them to fill up the analog tiers with their own shows. Smaller players in the market, and consumers, ultimately bear the burden of this practice.

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owned-and-operated CBS stations. Viacom also threatened to withhold the Super Bowl from the DISH Network customers until a federal judge intervened." According to the Pioneer Telephone Association's filing (p. 6), "Many broadcast networks have begun to demand regular monthly licensing fees for access to 'free' over-the-air broadcast signals. … One local broadcast network affiliate even went so far as to demand that our small cable system would have to agree to purchase a fixed and substantial amount of advertising on the broadcaster's station, in exchange for consent to retransmit their broadcast system. The American Cable Association's filing states (p. 30) "ACA has described the smaller cable sector's increasing concern about the use of retransmission consents by network owners and affiliate groups. The principal tactic – requiring carriage of affiliated satellite programming as a condition of access to local broadcast signals. As a result, smaller cable companies and their customers must pay for programming that they would not otherwise choose, solely to receive a free, over-the-air local broadcast station." Echostar's comments (p. 1) state "MVPD's flexibility to offer a la carte and tiered services is inhibited today by many factors. First and foremost among them is the practice of large media conglomerates of bundling their must-have programming, including in particular the local network broadcast stations and the most popular cable networks, with programming that consumers do not want. Faced with widespread bundling, MVPDs currently have little choice but to offer broad packages [to consumers]." This is just a small sample of the myriad examples in the initial comments filed, this is not a competitive market.

[19] Government Accountability Office, *Issues Related to Subscriber Rates in the Cable Television Industry,* October 2003, Appendix V.

[20] The Alameda Power & Telecom Filing (page 2) states "In the San Francisco/Oakland/San Jose DMA, three of the four 'Big Four' network affiliates are directly owned and operated by the network. … As a result, securing retransmission agreements typically requires the forced carriage of new cable networks." The National Telecommunications Cooperative Association's comments (page 3) state that "tying arrangements –whereby a network requires a carrier to take additional networks in order to have access to a flagship network – are rampant. ESPN and FOX are two prime examples of this practice. The end result is that the small carrier must pay a higher price in order to insure access to the desired flagship network."

[21] GAO, 2003, appendix V.

[22] Tasneem Chipty, "Horizontal Integration for Bargaining Power: Evidence from the Cable Television Industry," *Journal of Economics and Management Strategy,* 1995; David Waterman and Andrew A. Weiss, "The Effects of Vertical Integration of Cable Systems and Pay Cable Networks," *Journal of Econometrics,* 1996, *Vertical Integration in Cable Television* (Cambridge: The MIT Press, 1997).

[23] "Editor's Letter: The Plight of the Diginets" *CableWorld,* John P. Ourand, June 21, 2004.

Although the industry terms bundles "program suites,"[24] in reality, they are anticompetitive bundles that limit consumer choice to all or nothing. Bundling serves to lock in the market power of a handful of dominant programmers. Exhibit 1 shows the bundles that each of the big five programmers identified in the comments of the American Cable Association comments have forced into the expanded basic tier. It categorizes the networks based on the 6 types of channels developed by the NCTA-funded analysts. Each of the big five has forced cable operators to take a bundle of channels that covers most of the categories. Of the 32 shows identified, the big five have substantial ownership in 23 of them. Liberty Media, which has a large ownership interest in News Corp and sweetheart carriage deals with Comcast, the largest cable operator,[25] owns stakes in six of the remaining channels.

The NCTA-funded experts did not make available a complete list of the networks that were classified in each category, but there are there are others that would fill out the bundles of each of the programmers. For example, Time Warner's TOON and Toon Disney would fit in the Younger Trending category and Fox's Fox Sports would fit in the General category. ABC News would fill that slot for Disney in news, particularly as it has sought to use it as a local news product. CBS news provides a similar function for Viacom. Disney's Soapnet would fit in the older trending category. After failing to acquire Disney, Comcast is also rapidly leveraging its dominant position in distribution to deploy its own bundle across these categories.

The dominance of the big five spans both cable and broadcast, as evidenced by Exhibit 2. As calculated by Deutsche Bank, the big five account for over 85 percent of prime time household viewership. This is based on the top 39 cable networks, so it undercounts the total

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[24] Deutsche Bank Securities Inc., *Walt Disney Company: After Further Review… ESPN Still Has The Leverage Over Distributors,* October 27, 2003.

[25] See our initial comments in this proceeding.

prime time audience slightly. However, the Mediacom data filed in this proceeding show that the next 23 networks have just one million prime-time viewers, and account for little more than 1 percent of the total.[26] The Mediacom data also show that the Big Five are equally dominant in the cumulative weekly audience figure; Exhibit 3 shows that they account for over 70 percent of cable network total. More importantly, the top 25 or so channels account for 80 percent of the advertising revenue. These networks have changed little since 1993 and their owners have changed even less. There is even less diversity in advertising dollars than in programming.

EFFICIENCY

THEORY

The claim that ever-expanding bundles increase total social surplus rests on the assumption that the net marginal value of the additional channels is positive; i.e., the marginal benefits exceed the marginal costs. In the case of information goods, the marginal costs are assumed to be zero or close to zero, so it is hard to see how making the bundle bigger can hurt consumers. We question the assumption of value of the marginal costs and marginal benefits. There are economic costs (both traditional and opportunity) to infinitely expanding bundles. In addition, using a static analysis, if households have a budget constraint and/or products included in the bundle are substitutes, then the value of expanding the bundle is constrained.[27] Under a dynamic analysis, if bundling has anticompetitive effects, decisions about which products to produce and the costs of production cannot be assumed to be optimal or efficient. Total social surplus may be smaller than it would have been without the distortion of excessive bundling.

[26] Mediacom, *Cable… A La Carte or Basic: An Advertiser Perspective,* p. 23, July 29, 2004.
[27] Bakos and Brynolfsson, 1999, p. 1622.

It should be noted that the numerous examples of the bundling of physical goods that litter the cable industry comments are irrelevant to the issues before the Commission.[28] Instead of trying to confound the record with petty debates between whether cable bundles are like packaged eggs versus milk and broccoli, we recognize that comparing physical goods like newspapers or groceries with information goods like cable television channels is even more extreme than comparing apples to oranges. The physical world examples involve complementarities and have very different costs of distribution than information goods.

REALITY

The theoretical discussions presented by the experts repeatedly incants the observation that program distribution has zero marginal cost once it is produced. As the Comcast funded economist puts it on page 7:

> Once programming has been created, allowing an additional subscriber to watch that programming does not trigger any additional costs of producing programming. Stated in economic terminology, the marginal programming costs of an additional viewer are zero… A given household's decision to purchase the right to view programming, as well as its decision to watch programming, has absolutely no effect on the resources needed to create programming.[29]

This view misses the point that the decision of the cable operator to include a program is one that affects the marginal cost. That is, it raises the price of the bundle to the consumer. The cable operators certainly make this point:

> In either case, consumers are significantly affected by increases in programming costs. Such costs typically comprise a large portion – more than one third – of the total operating expenses of cable operators. So, when programming costs – for both cable operators and their competitors – increase by amounts substantially exceed inflation, prices for consumers tend to follow.[30]

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[28] Katz, p. 22; Owen and gale, p. 22; Willig Orszag and Ezrielev, p. 7.
[29] Katz, p. 7; see also Willig, Orszag and Ezrielev, p. 10.
[30] NCTA, *Cable Pricing, Value and Cost,* May 2003, p. 10.

In addition, there is an important opportunity cost that the opposition to *a la carte* does not acknowledge. Cable, particularly the analog tier, can support a limited number of channels. According to the American Cable Association's filing (page 37), "Media conglomerates use market power over popular channels and local broadcast stations to require carriage of many additional affiliate channels on basic or expanded basic. This eliminates 'shelf space' where the cable operator could carry independent programming, programming that could compete with Big Five controlled channels for viewers and advertising revenues.[31]

An example of this is the Outdoor Channel, which is popular in rural markets served by ACA members. Yet according to page 37 of the ACA filing, "ACA members report difficulties in launching the Outdoor Channel in many rural systems for one reason – programming affiliated with the Big Five has absorbed available analog channel capacity, regardless of consumer demand for the channels." Thus, when large conglomerates tie together popular and unpopular networks, there is an opportunity cost for small, independent programmers – and for consumers.

Moreover, the decision to produce a channel or incur its costs is repeated continuously. Therefore bundling can lead to distorted incentives that create externalities borne by society. For example, such a situation may lead to inadequate incentives to control costs (gold plating), incentives to create barriers to entry, and excess profits (paid by consumers through higher rates) resulting from the exercise of market power.

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[31] CCVM also makes this point in page 9 of its filing: "While there may be more networks created, inevitably they are affiliated with the conglomerates who want to control as much 'shelf space' as possible on the cable system." Many other examples abound in the comments. For example, the Mattox/Woolfolk filing (page 2) states that "a properly constructed a la carte system has the potential to provide African American programmers access to a marketplace from which they have long been denied." Pages 3-4 of that filing provide a list of some of the African American programmers who have been denied access to distribution under the current system. The Christian Television Network's filing states that the largest problem for religious programmers is access and concludes that "*a la carte* actually seems to be <u>most</u> beneficial to an ethnic or minority market" because it increases access to carriage.

Cable experts assume that increases in the cost of programming equate to increases in quality, except for the case of sports programming. This is the perpetual refrain of the cable operators:

> In the case of much cable programming… the increases in programming costs reflect increases in program quality that enhance the value of programming to operators and consumers. But even where, as in the case of much sports programming, the higher costs stem from rising salaries and other factors that do nothing to improve the quality of the programming, consumer demand and competition necessitate that cable operators carry the programming.[32]

This statement is incorrect at three levels. First, the claim that consumer demand requires cable operators to carry astronomically expensive sports programming is dubious at best. Consumers are not given the choice to express their demand for sports programming and many say that if they were given the choice, they would not pay for it. Our initial comments presented extensive discussions of this point involving the most expensive sports programming.[33] The National Telecommunications Cooperative Association's filing (page 6) states "While choice is generally a good thing, being forced to take and pay for programming options for which a customer has little or no interest is hardly beneficial. Allowing for *a la carte* programming would provide rural customers with meaningful choices."

Second, and in a somewhat subtler way, skyrocketing salaries are driven by TV dollars, not vice versa. As long as sports programmers know they can pass the costs through in huge bundles, professional leagues make huge profits and players demand high salaries. Exposing the sports programmers to the discipline of consumer choice will lower costs without reducing quality.

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[32] NCTA, Cable Pricing, p. 10.
[33] Deutsche Bank, *Walt Disney Company*, October 27, 2003, p. 16.

Third, the claim that cost increases for non-sports programming should be equated with improvements in quality is vastly overstated by the cable operators and their experts. Members of the public access community who produce content on a shoestring might be offended that the cable industry is saying that because their productions are low-budget, they are inherently low-quality.

The cable industry's assumptions about the marginal cost of each channel are clearly overly optimistic, and so are its assumptions about the marginal benefits of these channels. The cable industry incorrectly claims that forcing networks into large bundles, without offering channels *a la carte*, adds value. It does not.

With reference to Exhibit 4, the NCTA funded experts state that "[O]ver time, more networks were added to operators' tiers, which helped fuel the growth of cable subscribers. With the introduction of digital broadcast satellite (DBS) in the 1990s, the breadth of channels offered to consumers increased further still."[34] A quick glance at its data shows that this is not the case. For example, on average, the expanded basic tier has grown by 26 networks since 2000, but penetration has not increased. The reason is obvious: Once the number of networks in the bundle vastly exceeds the number of channels watched, you are just slicing and dicing a relatively fixed amount of viewing time (Exhibit 5).

The marginal value of a channel that no one wants to watch is zero (and may even be negative if a parent must take the time to block out a channel that is inappropriate for children), even though it lowers the average cost of each channel in the tier. It raises the average cost of viewing, and to the extent that it keeps out independent programming, it may make consumers *worse* off. For example, CCVM's filing (page 10) notes: "In the case of Bravo, NBC replaced

[34] Booz Allen, p. 13.

much of Bravo's original programming with repeats of shows broadcast earlier on the NBC broadcast network – usually shows which failed on the NBC network – thus disenfranchising Bravo's former audience and reducing viewpoint diversity." The value of the programming added to bundles declines rapidly (see Exhibit 6).

The NCTA-funded analysts' statement on page 16 that, "While consumer prices have increased, real costs per viewing hour have actually fallen significantly" is factually incorrect. In fact, even in real terms, the cost per hour of viewing has increased by about 30 percent. Total viewing has increased only slightly, but the price of the bundle has doubled (see Exhibit 7). The NCTA funded analysis conveniently forgets to include the viewing of broadcast TV in its calculation of viewing hours, which of course has zero cost.

Cable penetration has been relatively stagnant since 1995. Households view less than one quarter of the networks they are forced to buy in the bundle. Moreover, because the same people own the shows that are viewed, diversity has decreased, not increased (see Exhibit 8). The most watched channels have not changed. The same owners account for three quarters of the viewing. The increase in media concentration has, in some cases, led to decreased quality of programming.

Interestingly, if we look at the marginal value of adding channels, we find that it peaked in the 1990 to 1995 period (Exhibit 9), when cable rates were regulated. With regulated rates, cable operators with market power could not increase profits by raising rates; they had to scramble to increase profitability by increasing penetration by increasing the size of the bundle. However, given the concentration in viewing, the bundle became too large for the average viewer; the excess baggage crammed into the bundle became a burden, not a benefit for many

consumers. Since the 1996 deregulation of cable rates, industry players with market power have been able to resort to raising prices once again.

The two empirical observations offered above, that rising prices impose pain on consumers and that bundles of programs compete within clearly defined categories, adds further grounds for questioning whether the bundling promotes efficiency. Substitutability within program categories exists and puts constraints on the claim that larger bundles are better. A significant number of people, in fact, have been priced out of the market. These two issues get to the one of the critical weak points in the overall cable analysis, the question of how much "value" is added by increasing the bundle to a huge size.

CONSUMER SOVEREIGNTY

THEORY

As noted in our initial comments, "[T]he whole concept of efficient resource allocation is built upon the fundamental belief that the consumer is sovereign – that individual preferences are what count."[35] The previous section discussed the supply-side reasons one might want to restrict consumer choice through bundling and demonstrated that its validity is suspect, given the current state of the industry. But there are few economic-efficiency reasons to restrict consumer choice on the demand side.

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[35] Scherer and Ross, p. 29, offer this observation in the context of identifying social situations and market imperfections that raise questions, other than pure allocative efficiency. These include factors such as society's recognition that there are some members of society "whose preferences cannot be trusted to generate rational choices," that "tastes may (assumed in standard theory of consumer behavior to be stable) have been remolded under a barrage of advertising message," that "there are external diseconomies in consumption" that may not be factored into individual choices. "All this warns us that the theory of welfare economics are erected upon sandy foundations. This does not mean that their conclusions are wrong. The demonstration of a competitive system's allocative efficiency makes considerable sense even when complications related to advertising, ignorance, and the like are introduced. But blind faith is also uncalled for."

As noted in our initial comments, externalities (spillover effects of individual choice that have societal implications that cannot easily be reflected in the transactions between rational individuals) are one economic justification. For example, we support a basic tier that includes broadcast and PEG channels, because doing so creates a positive externality – it creates a more informed citizenry, adds cultural diversity, and ensures access to issues of local significance. Beyond this, however, we believe consumers should have choice with respect to cable.

REALITY

Unable to defend the restriction of choice from the demand side, the cable industry and its experts have maintained that consumers are given a wide range of choice by glossing over the fundamental constraints that the industry imposes on them. Here, it is important to understand how narrow the choices offered by cable operators are. The large cable operators and dominant national programmers offer choices that are fundamentally constrained by bundling and tying (Exhibit 10). As described in our initial comments, aside from the buy through option, which Congress mandated, the consumer gets very little choice and generally must buy dozens of channels to receive the few that he or she actually will watch.

The consumer must buy the entire expanded basic package if he or she wants any of the networks included in it (averaging almost 50 networks) (see Exhibit 11). In most cases, the consumer must buy the expanded basic package just to get the ability to pay additional money for digital services. The consumer must buy into a digital tier if he or she wants any of those individual networks (consisting of around 30 networks). And in some cases, the consumer must buy into digital to watch premium services, such as HBO and Showtime, even exclusively marketing the two together, as if a consumer can't get premium networks without buying into

digital.[36] Consumers therefore cannot have access to premium channels on an *a la carte* basis until they typically have already bought dozens of channels, 65-90, at a cost of $45-$60.

Our proposal provides choice in a much broader range. It liberates about $25 billion from the web of bundles and ties (see Exhibit 20). We believe that consumer choice will result in a modest shift in subscribership, but little change in viewing because of two key characteristics of the television audience – heterogeneity of households and strong viewing preferences.

Television is sold to advertisers and purchased by consumers on a household basis. Households are made up of heterogeneous populations – men, women and children (see Exhibit 11). Fifty-eight percent of American households are made up of men and women. Thirty-one percent of American households are made up of adults and children. Since there is overlap between the two, about two-third of American households are made up of heterogeneous viewing populations. They are probably good candidates for the purchase of bundles.

At the same time, viewing is highly concentrated. The NCTA-funded analysts state that 20 to 30percent of the viewers account for 60 to 80 percent of the viewing (see Exhibit 14). The Discovery-funded economists claim that twenty percent of its viewers account for 85 percent of its viewing. The Viacom-funded experts provide a hypothetical in which 62.5 percent of the viewers account for 100 percent of the viewing.

Given the opportunity to choose programs on an *a la carte* basis, consumers will sort themselves into three categories (see Exhibit 15). ***Devotees*** have relatively inelastic demand and would be most likely would buy a network *a la carte*. ***Grazers***, who really value the bundle with its wide range of choices, would be most likely to subscribe to bundles. Of course, many of the

[36] Cable Advisory Council of Enfield Tier Buy-Through Complaint against Cox Communications, CSR 6313-B

devotees will be found in households with heterogeneous members. Finally, ***captives***, who under the current system are forced to buy a network (or multiple networks) that they never watch in order to have access to other networks that they do watch, would be liberated. In an *a la carte* world, captives would not subscribe to certain networks, but this would not decrease viewership, since they never watched the channels to begin with.

The intersection of heterogeneous households and concentrated viewing is the key reason why a mixed bundling strategy will not cause the sky to fall. The claim that viewership will decline sharply under a policy that requires cable operators to also make available programs that they bundle on an *a la carte* basis does not stand close scrutiny. Most subscribers receive dozens of channels that they do not watch, and they should not be considered part of the market for that channel; those who watch today, however, are very likely to continue to be viewers under a mixed bundling system. Those who are currently priced out of the market might enter the market in an *a la carte* system. Under a mixed bundling system, these people could actually increase the size of the market.

III. THE IMPACT OF MIXED BUNDLING

AUDIENCES

PENETRATION AND VIEWING UNDER BUNDLING WITH *A LA CARTE* CHOICE

The NCTA-funded experts assume that under a voluntary *a la carte* system with mixed bundling, 50 percent of TV viewers would take the bundle. They assume that an additional 10 to 30 percent of the subscribers choose networks *a la carte.* Thus, penetration is assumed to be between 60 and 80 percent of that found in the bundled environment (see Exhibit 16). The remaining 20 - 40 percent are captives who would escape, given *a la carte* choice. Generally, the most popular networks are assumed to have higher *a la carte* take rates. This assumption is derived from an examination of the concentration of viewing and brand awareness. Interestingly, devotees are assumed to have a much higher concentration of viewing for the less popular shows. That is, small percentage of subscribers is assumed to account for half the total viewing. In the case of the emerging shows, 15 percent of subscribers account for half the total viewing. In the case of the more popular shows, 30 percent of subscriber account for half the viewing. Therefore, even though they lose more subscribers, they should not be assumed to lose more viewers.

In the rational actor assumption that underlies economic theory, advertisers pay for those who watch their advertisements – viewers, not all subscribers. If advertisers were paying for blank TV screens, they would not be serving as rational actors; paying to air ads when nobody is watching makes no sense. In a mixed bundled world, what advertisers lose in reach (the number of subscribers with access to a network), they make-up in effectiveness (the greater probability that someone is watching).

In fact, the evidence in this proceeding shows quite strongly that advertisers are really and primarily paying for viewers, which is, of course, a subset of the larger group of subscribers (Exhibit 17). Ratings points show a very strong linear relationship to advertising dollars -- stronger than the relationship between subscribership and advertising revenues. With such a high percentage of viewing carried into the *a la carte* environment, there is little reason to assume that advertising revenues would be lost. Interestingly, in the Bear Stearns[37] analysis the assumption was that networks would lose a smaller percentage of advertising revenue than percentage of subscribers.

This analysis of audiences hardly seems to portend the disaster that the large cable operators and the dominant programmers predict. The reason is two fold. On the one hand, they assume that a loss of subscribers, without a substantial loss of viewers, undermines network economics. On the other hand, the cable industry has concocted a witch's brew of increasing transaction costs, which they claim will drive prices through the roof. Both of these are based on a series of assumptions that are dubious at best.

NETWORK SUCCESS

The analysts for the large cable operators predict that "widespread network failure and consolidation would likely occur"[38] even under the mixed bundling scenario we have discussed. The critical assumption is that advertisers will not support networks that do not reach 50% to 70% of the nation's TV households – around 50-70 million subscribers.[39] As a result, they are doomed to fail:

> Historically, advertisers have been less willing to support networks with less than 50% to 70% coverage of TV households… Those advertisers that do support

[37] *A La Smart,* March 29, 2004.
[38] Booz Allen, p. 37.
[39] Owen and Gale, p. 31, also assume 50 million subscribers is the minimum necessary.

networks before they reach 50%-70% distribution do so because they want to "get in early" and develop relationships with networks they expect to grow significantly, and typically pay lower advertising rates than for established networks.[40]

Two years ago, the largest cable operators told the Commission a very different story. One set of experts funded by the second largest cable operator objected that:

> …the Commission adopted the conclusion that a new programmer needs 15 million subscribers to insure viability. At that time, 15 million amounted to about 20 percent of MVPD subscribers. The total number of MVPD subscribers continues to increase. There is no indication that new cable services require an increasing number of subscribers, or a constant percent of the increasing total number of MVPD subscribers….
>
> Actual successful entrants follow varied and dynamic expenditure and carriage patterns….
>
> At least nine of the entrants did not reach 15 million subscribers in their first four years, but are still in existence.[41]

And now, a few years later, all nine of those networks still exist. Six of those nine that were identified have an average of 24 million subscribers, far fewer than the 50 million the industry now claims. The remaining three have grown to close to 50 million.

The expert testifying on behalf of the largest cable operator at the time concluded that "program services can be, and are, viable even if they reach fewer that 15 million United States MVPD subscribers. Indeed, a number of services have been in existence for more than five years with fewer than 15 million subscribers."[42] **The 15 million subscriber figure, which the cable industry experts claimed was too high as a standard for ensuring the viability of networks just two years ago, could be reached by the bundled subscribers alone, for every category identified by the cable industry experts in this proceeding.**

[40] Booz Allen, p. 12.

[41] Joskow, Paul L. and Linda McLaughlin, *An Economic Analysis of Subscriber Limits,* January 2003, p. 17.

[42] *Declaration of Stanley M. Bessen on Behalf of AT&T Broadband,* January 2, 2002, p. 1.

Regardless of how many subscribers are necessary to attract advertising revenue, the large cable operators and dominant national programmers ignore that the *a la carte* environment will be much more friendly for programmers who are not part of the big five. The issue is not that networks have to grow – they certainly do – but that the bundled environment favors the dominant national programmers and forces entrants to sell ownership to cable operators to get carriage. Page two of the America Channels' filing states: "The [current] practice by content conglomerates, of bundling of networks with marginal value, results in reduction of available capacity. This diminished capacity prevents high-quality independent networks from securing carriage agreements."

An *a la carte* system would free up shelf space limited by cable operators through bundling, which restricts out capacity for innovative independent programmers to gain rights of carriage. Because the current system is so discriminatory against independent programming, *a la carte* could expand the opportunity for independent programming.[43] Programmers who achieved a significant *a la carte* following could gain considerable leverage with advertisers, since they could deliver a dedicated and perhaps distinctive audience with inelastic demand.

An *a la carte* system would temper the power of the big five, making independent programmers more competitive. A mixed bundling system would have several specific advantages for independent programmers not tied to the big five:

- First, it would expand the market, since some consumers who are priced out of the market by the massive bundle would be brought in. Independent and niche programmers

[43] CCVM also comes to this conclusion on page 8 of its filing: "If cable and satellite operators provide consumers with the voluntary option of ordering channels *a la carte*, the extreme concentration in television will be significantly amerliorated and the Commission's 'retail' goal of viewpoint diversity will be substantially advanced."

therefore would have a higher probability of success, which would likely lead to increased diversity.

- Second, increased access to consumers for independent programmers would also lead to greater diversity. Mixed bundling allows independent programmers to compete for consumer resources and consumer attention sooner. As we established in our initial comments, cable giants aren't looking for new linear networks—they want them on Video on Demand. Under the current model, in which cable operators drive new entrants into the VOD space, the consumer must buy the basic, expanded basic and digital tiers. Under mixed bundling, they are able to compete after a basic tier and a digital box have been purchased. Competition begins after a $20 price and 16 channels—not the current roughly $65 and 90 channels.
- Third, cable operators could feel pressures to be more responsive to consumer needs in an *a la carte* environment. In all likelihood, cable operators would still want to sell bundles – and we would encourage them to do so – but they would have to guard against overpricing them and including networks that have no marginal benefit, since consumers could buy networks they did want *a la carte*. Cable operators would come under pressure to remove their own shows from bundles, if the number of consumers who selected *a la carte* for networks not owned by the cable operators was significant.

In short, the market would become more competitive. Large, vertically integrated national programmers would be less likely to force large packages of channels into the expanded basic bundle when consumers could choose channels *a la carte*. Programmers would have incentives to create smaller themed tiers, with which consumers could enjoy the efficiencies of

tiered packages without the burden of the current system, such as subscribing to many networks that remain unwatched.

Some have proposed a "free tier" of networks that make their programming available to operators at no charge, which could be delivered to consumers with an appropriate margin for cable operators. If channels are provided at no or low cost to operators, it makes sense to get that channel into as many homes as possible by keeping the cost low to every consumer, whether they select the current offering of channels or not, so that the operator can sell local advertising on that channel. These innovative ideas of flexible packaging, of course, should be offered in conjunction with anything else. But the premise of this flexibility rests on unbundling the current take-it-or-leave-it expanded basic and digital tiers.

COSTS OF A LA CARTE

Large cable operators and dominant national programmers predict large increases in the cost and price of video services. Even the few analyses that examine mix bundling project substantial increases of 15 to 20 percent. As discussed below, these are excessive.

CABLE OPERATOR COSTS

By far the largest identifiable cable operator cost in the NCTA analysis is the transaction cost of adding set top boxes to allow *a la carte* choice.[44] The cost is vastly overestimated. A sensible approach to mixed bundling would tie *a la carte* to digital service, but would not force migration – those who wanted to stick with analog service could continue to do so, but without an *a la carte* option. Under these circumstances, there is no reason to attribute any significant increases in set top box burden on the industry as a result of this proposal, since digital

[44] Note that not everyone agrees that set-top boxes are required for *a la carte* choice. In its comments, Blonder-Tongue notes the possibility of using Interdiction technology to control programming.

subscribers already must utilize set-top boxes. If NCTA members are concerned with the cost of rolling a truck out to give consumers choice and control over their channels,[45] then they should offer it digitally from the headend. It's telling however, that Buford Media Group proposed doing just that to implement consumer choice and control.[46]

It's just as telling that even though NCTA complains about the cost of going digital, and moans about channel capacity, its members are saying that problem goes away with the transition from analog to digital, and is less than three years away.[47]

It is also important to remember almost half of all MVPD subscribers are already digital (See Exhibit 18), and the world is moving toward an all-digital environment. The digital set-top boxes are addressable, since system operators are selling VOD. To the extent that there is a question of multiple sets within a household, the solution is a single box and a router.[48] The solution is relatively simple. In short, the cable operators assume a $500[49] solution to a $50 problem,[50] because they are opposed to the policy of real choice.

Of course, if an operator wanted to move their system to all-digital now or in the future, that is their right. If MVPD operators choose to offer consumer choice over digital, then one reasonable outcome is that consumers will naturally help speed the digital transition that Congress and the Commission have articulated is so vital.

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[45] NCTA, page 27.

[46] Buford Media Group, July 29, 2004, Symposium On "A la Carte" MVPD Pricing

[47] Amy Banse, Comcast EVP, Programming Investments, "That may be a limited constraint only; as our systems move to completely digital, capacity may open up. So it may be a short-term two-to-three-year constraint, but for now, it's definitely there" "Attention New Networks! Here's everything you need to know about how to get a carriage deal with Comcast...step by step from Amy Banse and Matt Bond." *CableWorld*, Shirley Brady, June 21, 2004.

[48] One example of this is Vigoto, which announced a "Digital Set-Top Box Serving Multiple TVs." Surely there will be others.

[49] Booz Allen, p. 18; Owen and Gale, p. 38; Willig, Orszag and Ezrielev, p. 13.

[50] Matt Stump, "Coming Soon: The $50 Digital Set-Top: Comcast Gellows, Others Say Less Pricey Chipsets are Already on the Way," *Multichannel News,* July 26m 2004. Kip Compton, Ran Oz, "Digital Simulcast Transition of the All-digital Network," *Bigband Networks,* June 16, 2004, outline a variety of network based solutions on the horizon with much lower costs as well.

The second largest cost assumed in the NCTA study is related to customer care costs, which are expected to increase substantially under an *a la carte* system. We are skeptical about this assumption, since almost half of all MVPD subscribers are already buying digital and one-third of all cable subscribers are doing so as well. The start-up costs of selling the added tiers, which the VOD component has already imposed, do not have to be incurred again. Between 1995 and 1998, before advanced video and Internet services were being widely sold to the public, operating expenses increased by about 4.5 percent per year. Between 1998 and 2002, operating costs increased by over 14 percent per year, more than three times the rate prior to the aggressive marketing of advanced and Internet services. More recently they have stabilized.

The NCTA study assumes that customer care costs increase by more than 75 percent in a pure *a la carte* scenario, where 100 percent of subscribers are choosing individual networks. They assume that 80% of these costs will be incurred in a mixed bundling environment, where half as many customers choose *a la carte.* In other words, the fact that the majority of households are likely to continue to choose bundles is given little weight in the customer care costs calculation.

The cable operators' claim that there is a significant opportunity cost of spectrum is equally dubious. This claim rests on the assumption that the systems are fully utilized, which is not the case particularly with respect to digital. It also assumes that networks with virtually no viewers generate revenues for the operators either directly through sale of local advertising (which is highly unlikely, since there are dozens of channels that get no revenue) or indirectly through increasing penetration, which we have shown is not the case. Given the remarkably sparse viewership of most channels, the failure of increasingly large bundles to add subscribers,

and the large opportunity costs of spectrum assumed, cable operators should be dumping networks to make room for the much more lucrative pay-per-view business.

As large cable operators claim they are running out of capacity, even for digital channels on rebuilt systems, they are attempting to convince independent programmers to make their content exclusively available as Video on Demand. "I try to impress on them how extraordinarily excited we are by the prospect of VOD content," says one executive.[51] Another from the same company says that it is "a fantastic product and superior to a TiVo-type solution."[52]

But apparently they're not excited enough to launch any of their new affiliated networks on the VOD platform. So while Comcast launches a couple independents on VOD, it launches all of its affiliated programming on linear networks. Even the Toddler Channel, an ad-free network Comcast will have a significant stake in, is being hyped as a 24-hour channel.[53] While big cable companies hype independents on VOD, it's clear they are holding themselves to a different standard.

NETWORK COSTS

The largest cost increase assumed by the experts for the large cable operators and dominant national programmers flows from the need for networks to market more to the public and less to the ever shrinking club of owners of distribution facilities. The target audience of startups is composed of a handful of operators, so the economic cost of marketing are relatively small in this respect. We believe the social costs of lost diversity are large. Today, cable operators are the gatekeepers, controlling what channels consumers get to see and pay for.

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[51] *CableWorld*, Shirley Brady, June 21, 2004.
[52] "Comcast decides to 'Get Local'," *CableWorld*, Shirley Brady, October 6, 2003.
[53] "Comcast Eyes Toddler Network" *Multichannel News*, Mike Reynolds, June 14, 2004.

Because the industry has been allowed to become so concentrated, the top eight owners account for almost 80 percent of the subscribers.

The experts for the large cable operators and dominant programmers assert and assume that basic cable networks spend less than a quarter of what sellers of consumer goods normally spend. Premium networks and package goods sellers spend 15 to 27 percent of their revenue on advertising, compared with basic cable networks, which spend only 2 to 6 percent.
In the cable-funded analysis, a massive increase in spending for marketing is assumed to occur, no matter how many consumers choose the bundle. Even when 50% of the subscribers take a bundle, the experts assume 100% of the advertising cost increase.[54]

There will certainly be a change in advertising and marketing as the target shifts from corporate executives to the public, but with the large number of bundles that are likely to be purchased, these estimates are too high. The current advertising that emphasizes tune-in will shift to sign-up and tune in. Free trial offers will become more prominent.

These costs are small as percentage of the total cost to consumers. Under the mixed bundling *a la carte* model, increases in programming are, on average about 6 percent of the bundled costs and this has been severely overestimated.

COST SAVINGS

The large cable operators and the dominant national programs ignore potential cost savings in their discussions. As noted above, the explicit assumption in all of the analyses is that there is neither inefficiency nor excess profits in either cable operations or network production. In our initial comments, we reviewed econometric and financial data that suggested the existence

[54] Showtime Network Research & Analysis, *The Impact of A La Carte Pricing on Multichannel Video,* July 2004.

billions of dollars of charges on traditional video services above competitive levels under the current system.

In an *a la carte* and mixed bundled world, owners of the most expensive channels would feel pressure to control costs and the elasticity of demand for individual channels would become apparent. The threat to remove channels from bundles, or segregate expensive channels into tiers, would expose programmers more directly to consumer preferences. As the dominant programmers lost their leverage in the *a la carte* world, investment resources would become more available to independent programmers, who would also benefit in the ways noted above.

All of the experts working against *a la carte* also assume that the cable operators will be "made whole" in the new environment; i.e., they assume that the cable operators will receive a very high mark-up on the wholesale price of programming.[55] They use the current average margin, which ignores that, as demonstrated in our initial comments, margins on traditional video services have increased through the abuse of market power and do not reflect reasonable margins that would be seen in a competitive market. To the extent that unbundling exposes cable operators more directly to the elasticity of demand for individual networks, those margins can be reduced. They may be forced to absorb the costs.

***A LA CARTE* PRICES IN A MIXED BUNDLE ENVIRONMENT**

The bottom line in network costs that would have to be recovered from *a la carte* customers is a truly modest price, even with the current mark-up (see Exhibit 17). Given that viewership will not change much in a mixed bundling world, the *a la carte* price of networks should not be high. There are four readily identifiable costs (see Exhibit 19). Lost subscriber revenues – the money cable operators pay to programmers for blank TV screens – would have to

[55] This is embodied in the assumption that all revenue will be made up and the mark-up on services remains the same at 69% (Booz Allen, p. 31; Willig, Orszag and Ezrielev, p. 18.

be replaced. We assume that the *a la carte* price must make up for lost advertising revenue, using Bear Stearns' assumption that advertising revenue falls one third as fast as subscriber rates . We also assume that advertising costs equal to 10 percent of total revenue would be incurred.[56] Finally, we assume a full cable mark up, following the Booz Allen assumption. The resulting monthly price necessary to cover these modest -- $1 to $3. This is what we observe in Canada.[57] Since devotees have inelastic demand, they would be willing to pick up this reasonable cost, particularly if they did not want to have access to the plethora of other channels now included in the expanded basic tier.

Conclusion

We use conditional words – would, could – to describe these possible effects of moving toward an *a la carte* system because the results will emerge from the interaction between three forces in the market: cable operator interests, programmer interests and, to a much greater extent than ever, consumer preferences. Smaller cable operators and independent programmers would be liberated to innovate in the video marketplace in both distribution and production.

We reject the claim that *a la carte* will fail to discipline cable behavior, like rate regulation did in the early 1990s and the claim that *al la carte* choice requires or is the same as price regulation.[58] The 1992 Cable Act gave regulators a weak set of tools and the rules were badly crafted.

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[56] Willig, Orszag and Ezrielev, p. 17, use this assumption. Implicitly, this puts total advertising expenditures in the range of 12 to 16 percent.

[57] When cable industry experts make reasonable assumptions about take rates and viewership, their own analysis move close to this range. For example, Owen and Gale (p. 44) show a price of $3.39 at a 30% subscriber retention and 80% advertiser retention and a 90% mark-up, which is well above the current level of 69 percent. With subscriber retention of 60% to 80 percent, retail prices would be in the $1 to $3 range. Bear Stearns (Exhibit 1) shows prices in the range of $.69 to $1.97, but $5.12 for ESPN (their client) with a 75% take rate.

[58] Katz, p. 22; Willig, Orszag and Ezrielev, p. 5.

A la carte rests on a much more powerful force, consumer sovereignty in the marketplace. It is undeniably pro-competitive and is much more consumer-friendly than the current system that is able to raise rates exponentially and offer consumers little control, choice and freedom.

EXHIBITS

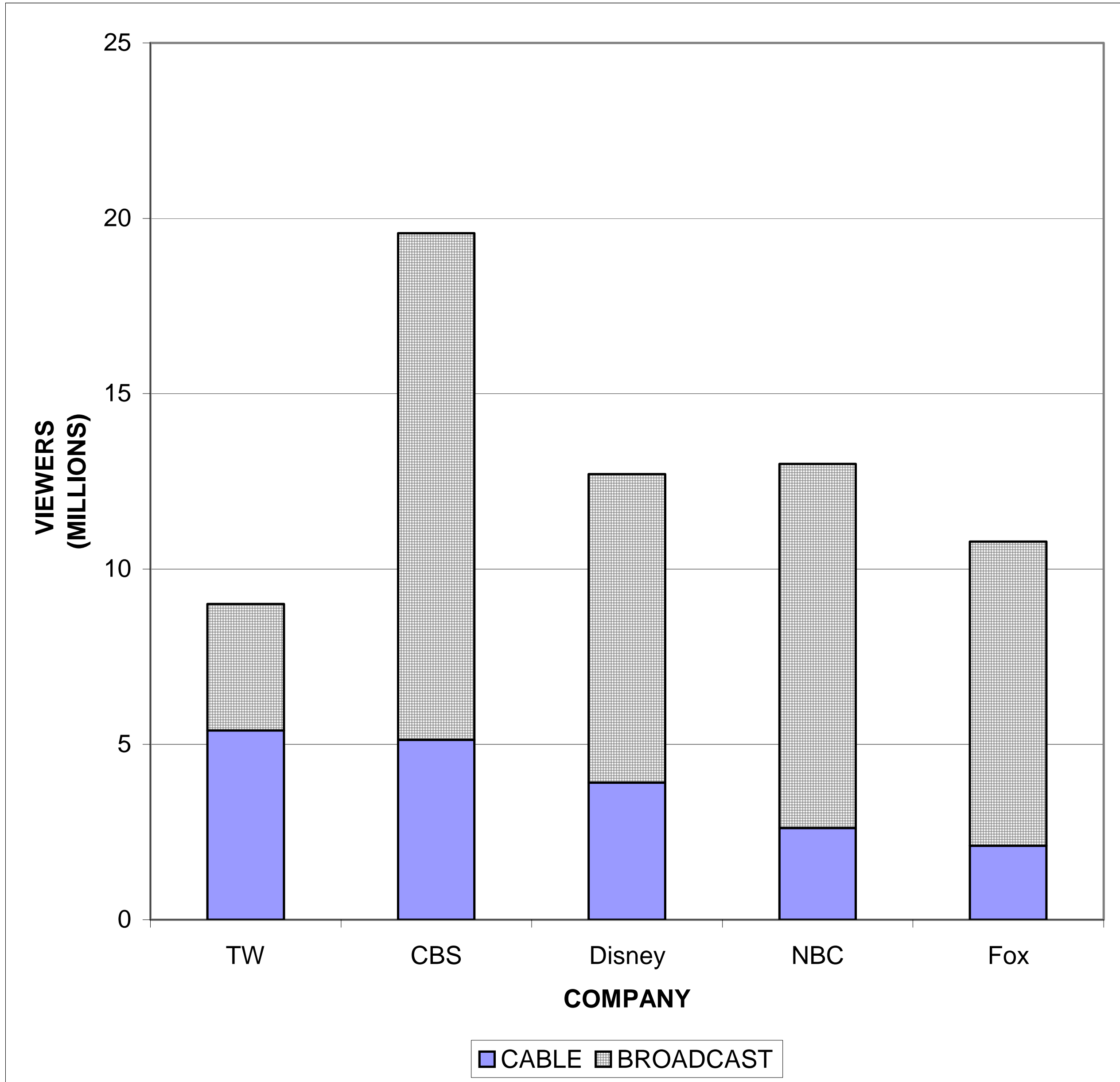
Exhibit 1:
Program Bundles of Big Five Programmers Cover the Major Types of Expanded Basic Programming

(Networks in Bold are categorized by Booz Allen)

	ABC	NBC	CBS	TW	FOX
GENERAL	**ESPN** **Lifetime**	**USA**	**NICK**	**TBS** **TNT**	(Fox Sports)
NEWS	(ABC news)	**CNBC** **MSNBC**	(CBS news)	**CNN**	**FOX News**
EMERGING MASS	**Family**	**SciFi**	**TV Land**	**Court**	(Nat. Geog.)
OLDER TRENDING	**A&E** **History** (shared ABC/NBC)	**Bravo**	(CMT)	(TCM)	(FMC)
YOUNGER TRENDING	**Disney** (Toon Dis)		**Comedy** **MTV** NickToons (VH1)	(Cartoon)	**FX**
EMERGING NICHE	(LMN) (Soapnet)	(Trio)	**BET Jazz**	**Oxygen**	**Speed** (Fuel)

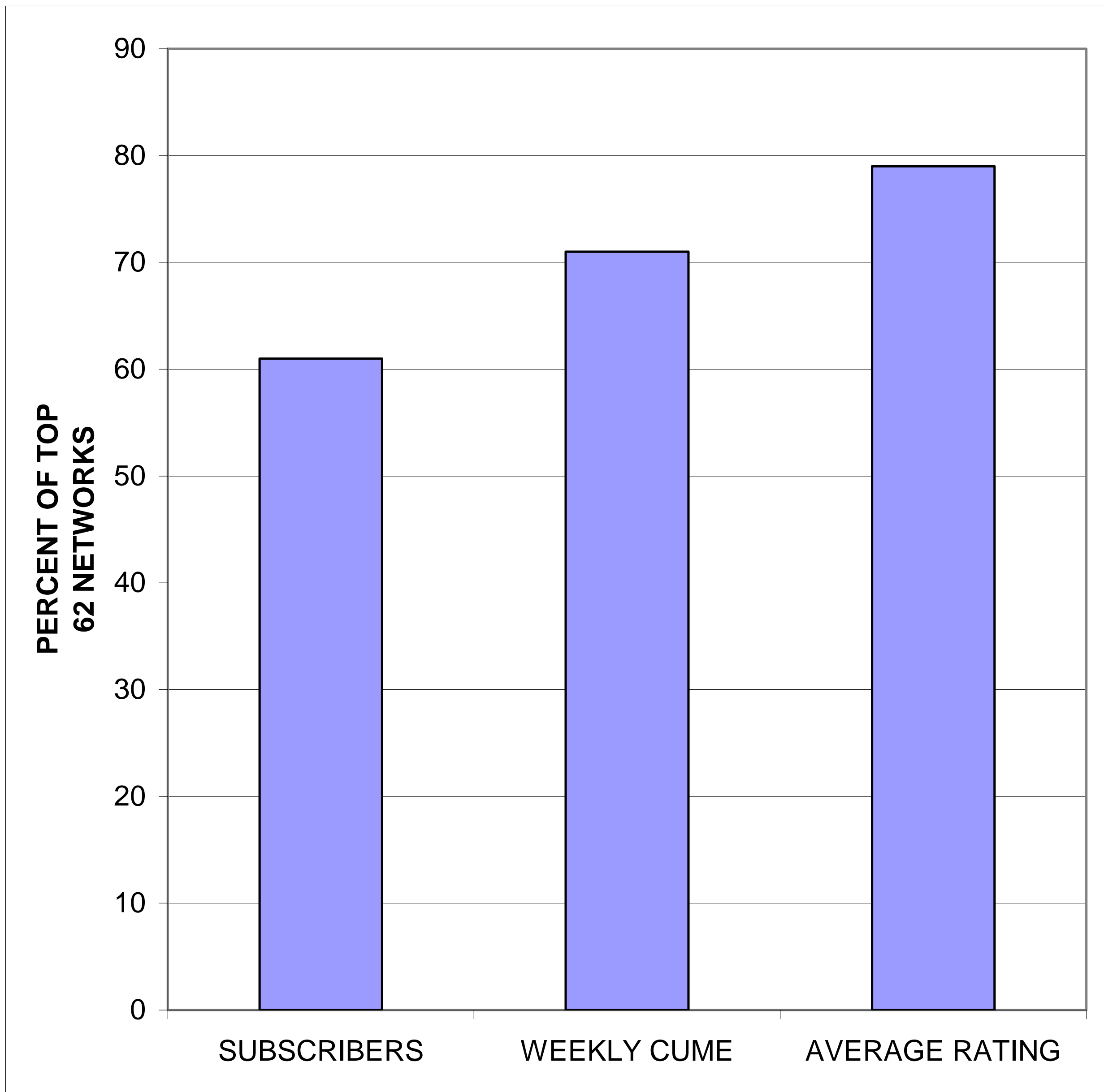
"Comments of American Cable Association," *Inquiry Concerning A La Carte, Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems,* MB Docket No. 04-207, July 12, 2004; Booz Allen, Hamilton, *The A La Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity,* July 2004, p. 20.

Exhibit 2:
Top Network Suites By Prime Time Household Viewership



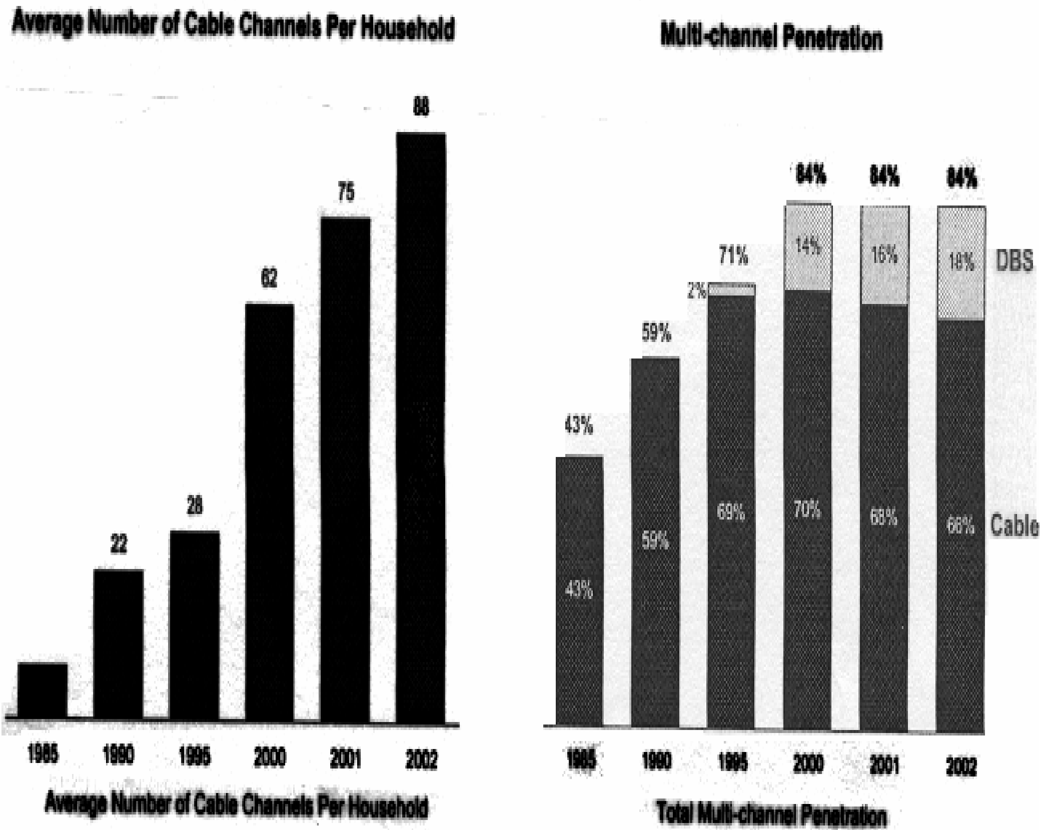
Source: Deutsche Bank Securities Inc., *Walt Disney Company: After Further Review… ESPN Still Has The Leverage Over Distributors,* October 27, 2003.

Exhibit 3:
The Big Five Dominate Basic Cable Network Reach and Viewing



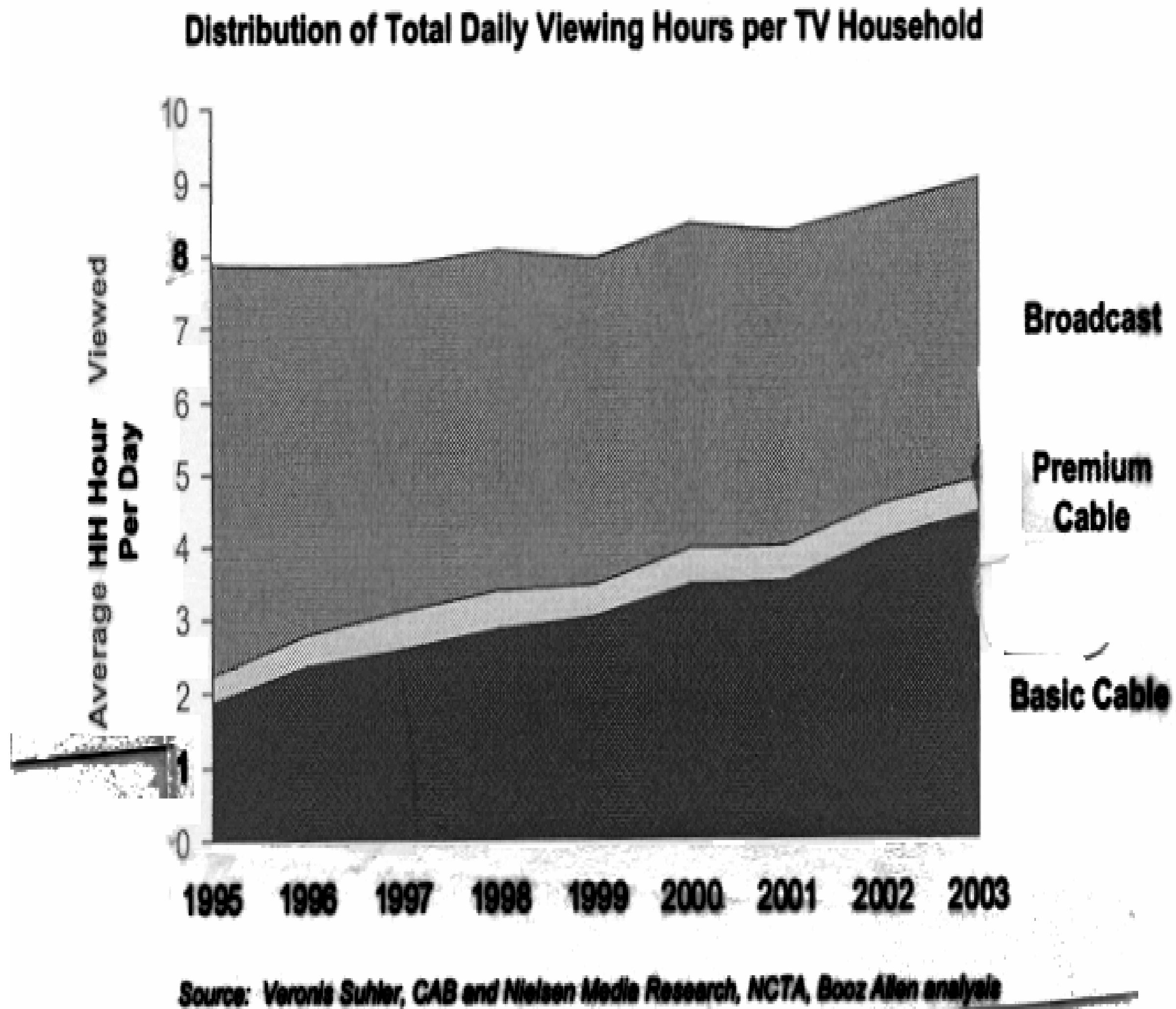
Source: Mediacom, *Cable… A La Carte or Basic: An Advertiser Perspective,* p. 23, July 29, 2004.

Exhibit 4:
Because Bundles Have Gotten So Large, Adding Channels No Longer Drives Penetration



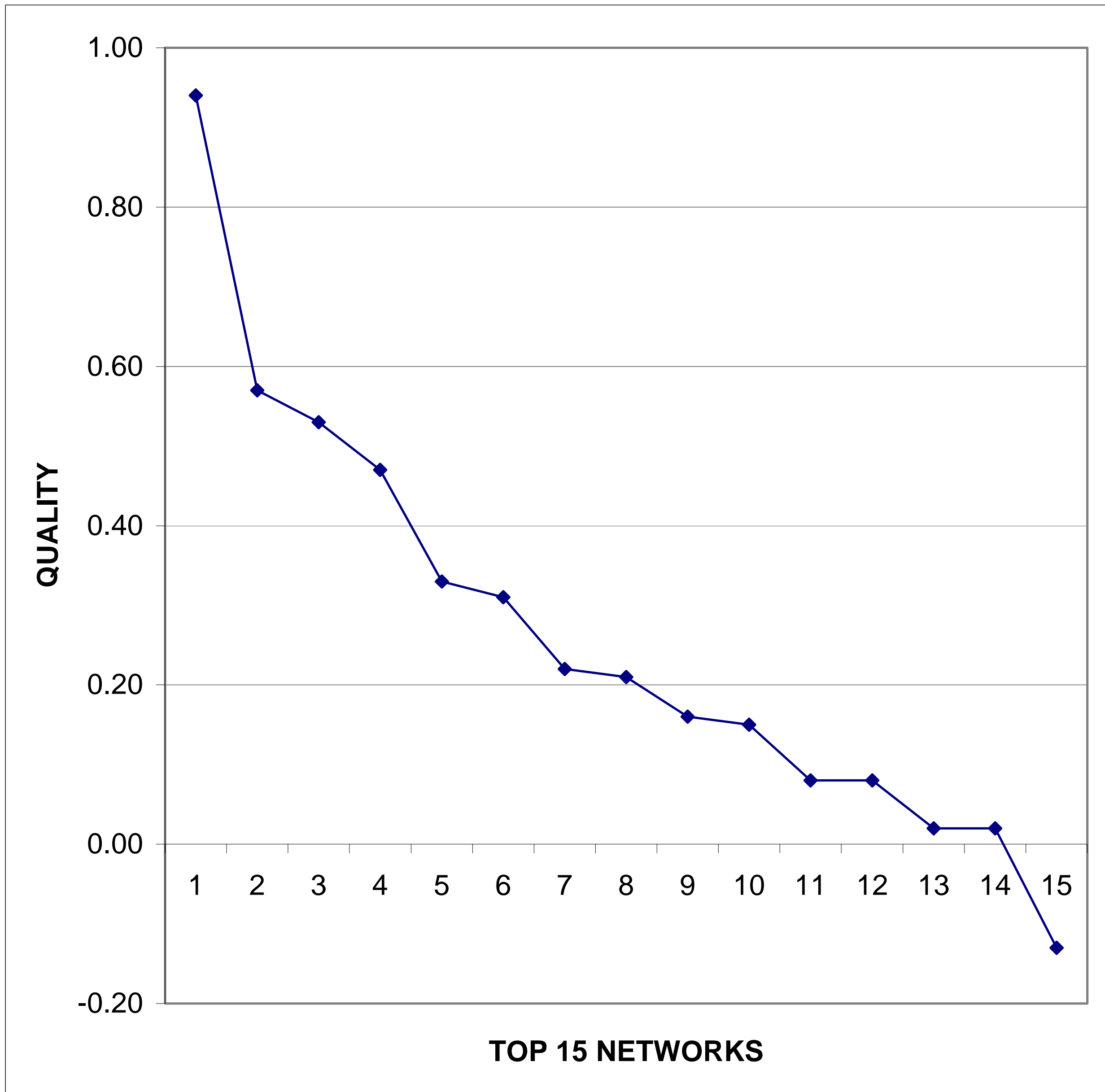
Source: Booz Allen, Hamilton, *The A La Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity,* July 2004, p. 13.

Exhibit 5:
Total Viewing Time Has Increased Slightly, In Spite Of The Huge Growth In The Bundle



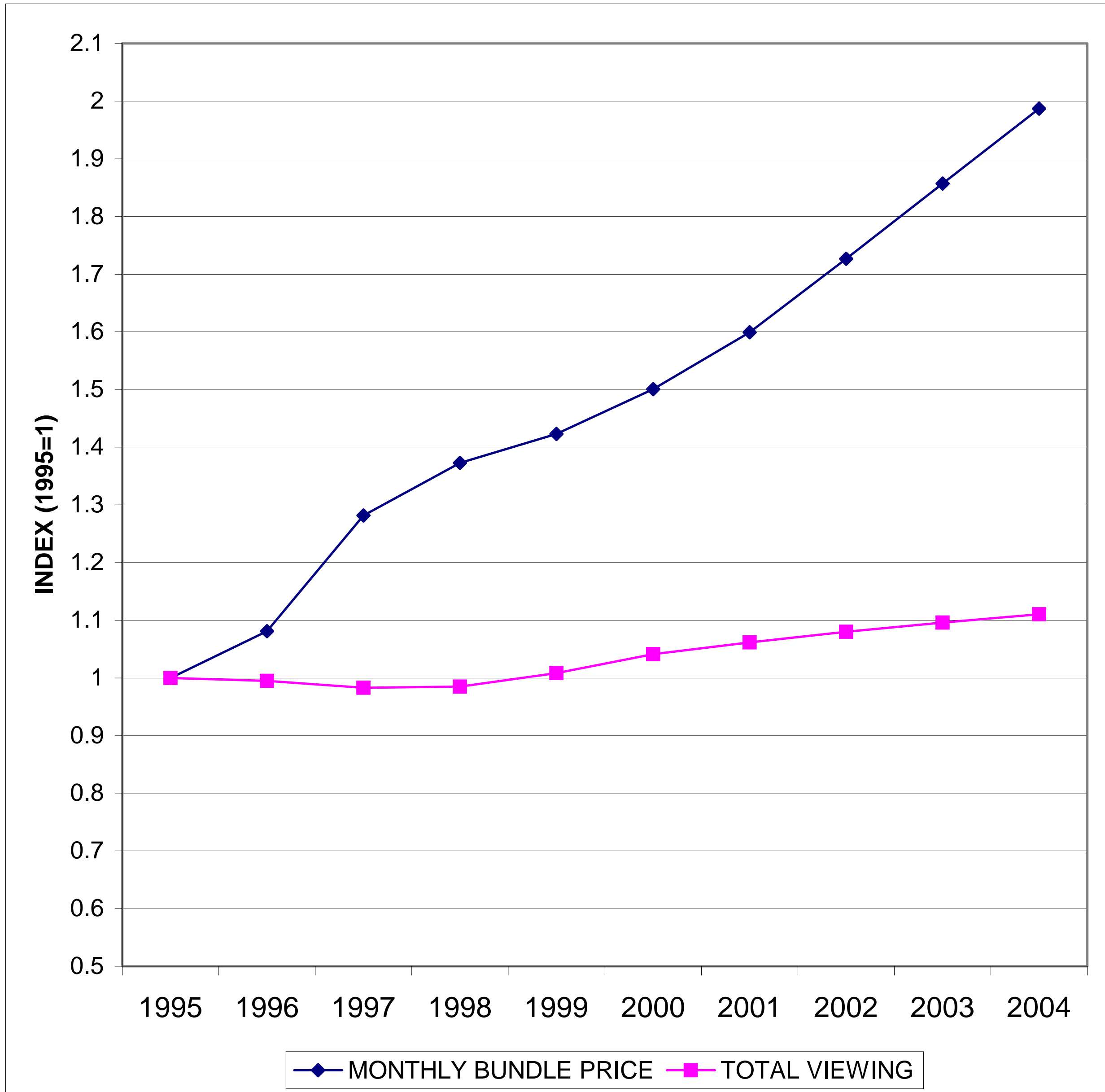
Source: Booz Allen, Hamilton, *The A La Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity,* July 2004, p. 14.

Exhibit 6:
Estimated Quality Levels for Top Networks



Source: Gregory S. Crawford and Matthew Schum, *Monopoly Quality Degradation in Cable Television*, July 24, 2003, Figure 3 and Table $.

Exhibit 7:
Bundle Prices Have Increase Much Faster Than Viewing



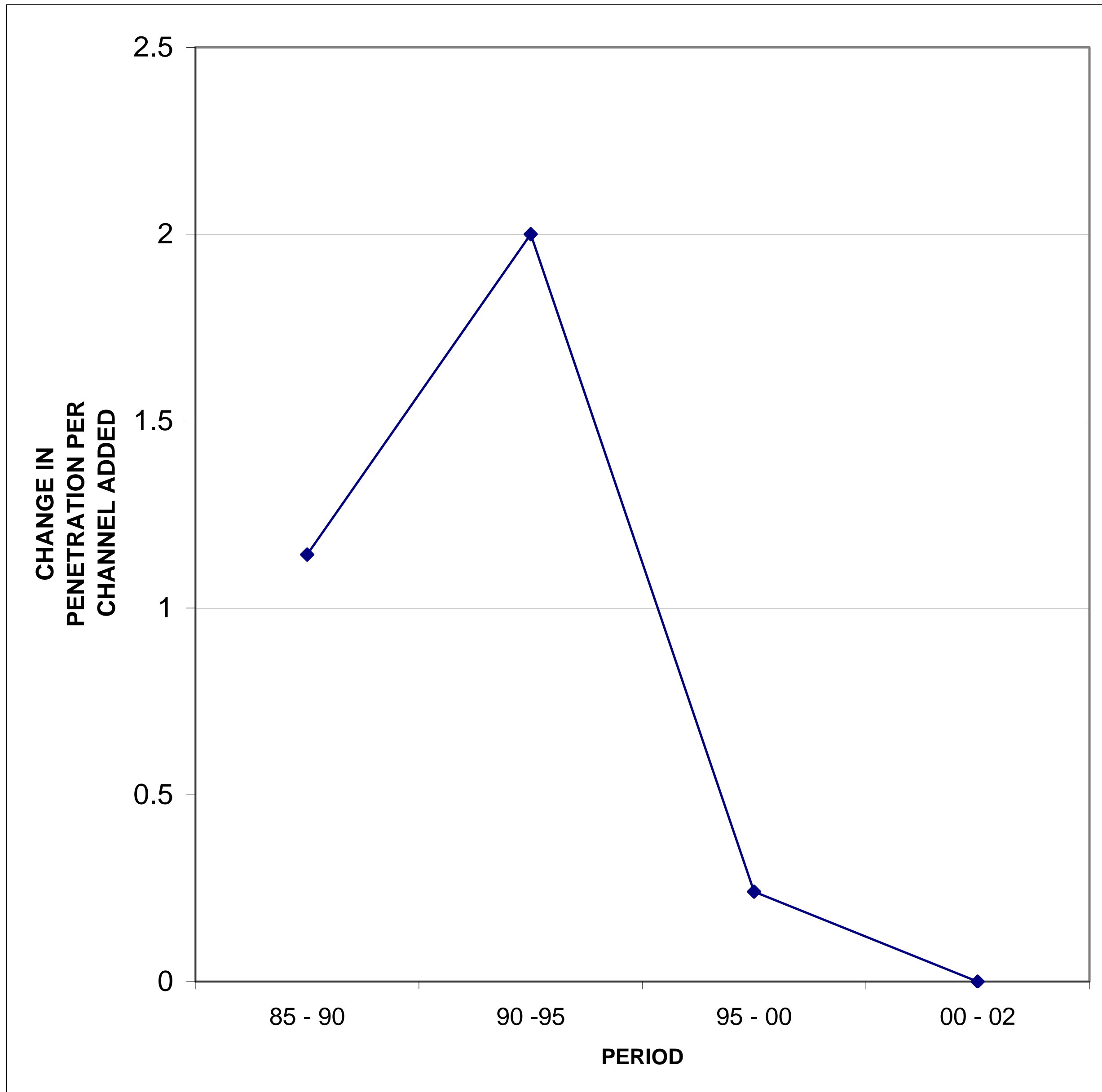
Source: Kagan Associates, *History of Cable TV Subscribers and Revenues;* Federal Communications Commission, *Report on Cable Prices,* various issues; Veronis Suchler Stevenson, *Communications Industry Report Summary, 2003.*

Exhibit 8:
Top Channels, 1992-2003 Networks Marquee Programming and Concentration of Ownership Stay Constant

Network	1993 Subs	2003 Subs		1993 Prime-time Ratings	2003 Prime-time Ratings	2004 Ownership
ESPN	1	2		5	14	ABC-Disney
CNN	2	6		7		TimeWarner
TBS	3	1		2	5	TimeWarner
USA	4	5		1	7	NBC-GE/Liberty
Discovery	5	4		8	10	Liberty/Cox
TNT	6	6		3	1	TimeWarner
C-SPAN	7	3				Cable Consortium
Nickelodeon	8	8			4	CBS-Viacom
TNN/Spike	9	11		11	13	CBS-Viacom
Family	10	6		10		ABC-Disney
Lifetime	11	8		4	2	ABC-Disney/Hearst
A&E	12	10		9	8	ABC-Disney/NBC
MTV	13	13			11	CBS-Viacom
Weather	14	12				Landmark
Headline News	15	17				TimeWarner
CNBC	16	18				NBC-General Electric
AMC	17	19				Cablevision
QVC	18	13				Liberty
VH-1	19	20				CBS-Viacom
BET	20	12				CBS-Viacom
TLC	21	14			12	Liberty/Cox
Cartoon				6	6	TimeWarner
Sci-Fi				13	15	NBC-GE
E!				15		Comcast
Disney					3	ABC-Disney
Fox News					9	Fox-News Corp

Sources: FCC, *In the Matter of the Status of Competition in the Market for the Delivery of Video Programmin*g, First and Tenth Reports. Some rankings are equal

Exhibit 9:
The Marginal Value Of Adding Channels To Drive Penetration Has Evaporated With The Huge Size Of Bundles



Source: Derived from Booz Allen, Hamilton, *The A La Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity,* July 2004, p. 13.

Exhibit 10:
How The Cable Industry Bundles And Ties Content

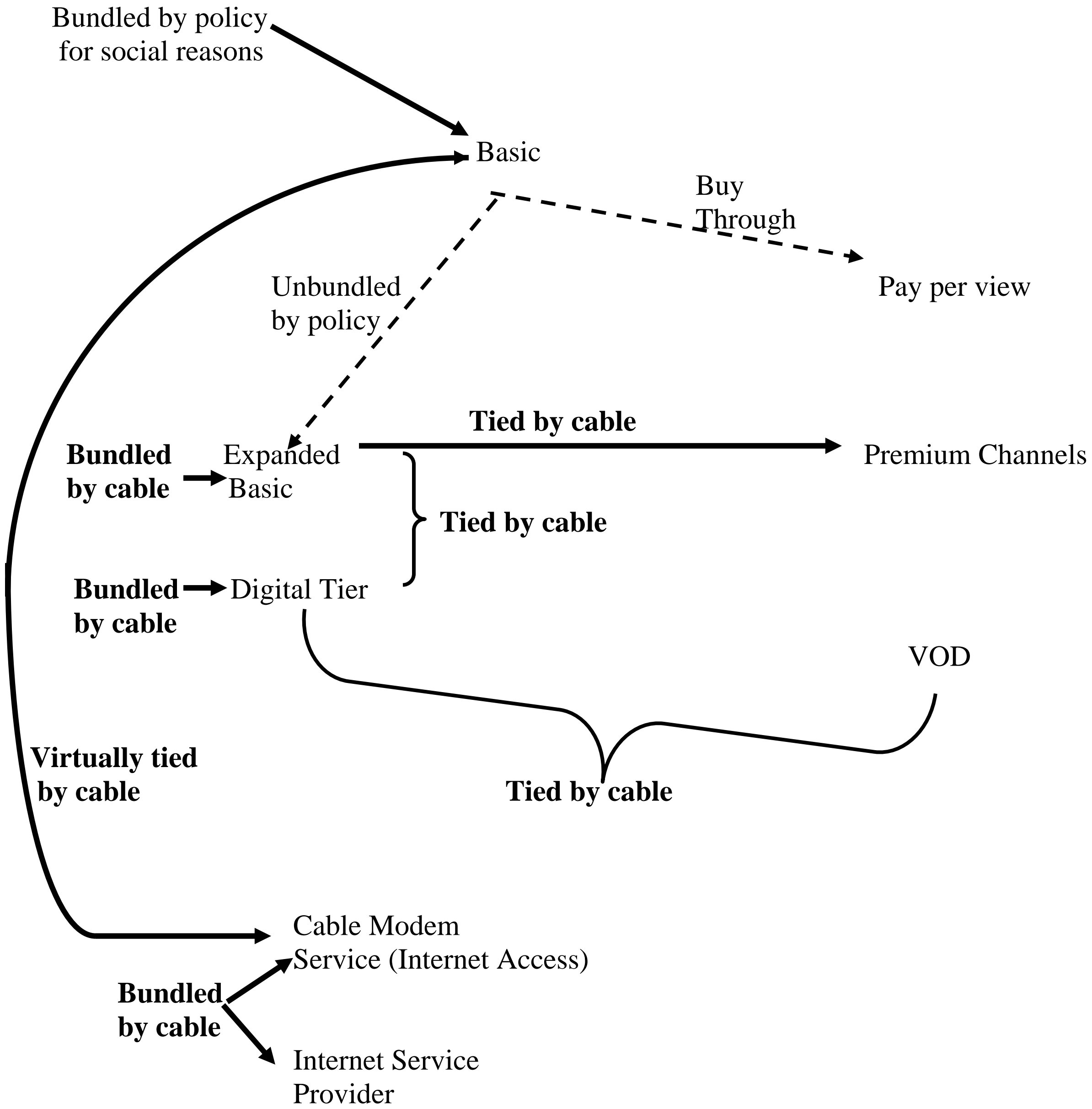


Exhibit 11:
The Cable Industry's Bundling And Tying Strategy And The Stakes Of *A La Carte* (Estimated For 2004)

	BUNDLED SERVICES					**A LA CARTE SERVICES**		**TOTAL REV.**
	Service	Price/ Month	Subs	Channels	Annual Rev.	Service	Rev.	
Bundled by policy for social reasons	Basic	$15	70m	16	$13b			$13b
Buy Through						Pay per view	$1b	$1b
Bundled by Cable						Premium	$6b	**$6b**
Unbundled by policy	Expanded Basic	$24	60m	**48**	**$17b**			**$17b**
Tied by cable	Digital Tier	$15	21m	**30**	**$3b**			**$3b**
Bundled by Cable						VOD	$1b	$1b
Virtually tied by cable; Tied by cable	Cable modem & Internet Service	$45	16m	na	$9b			$9b
Total services								$49b
Total including equipment, advertising and miscellaneous								$56b

Exhibit 12:
***A La Carte* Liberates $25 Billion From Cable Industry Bundles And Ties**

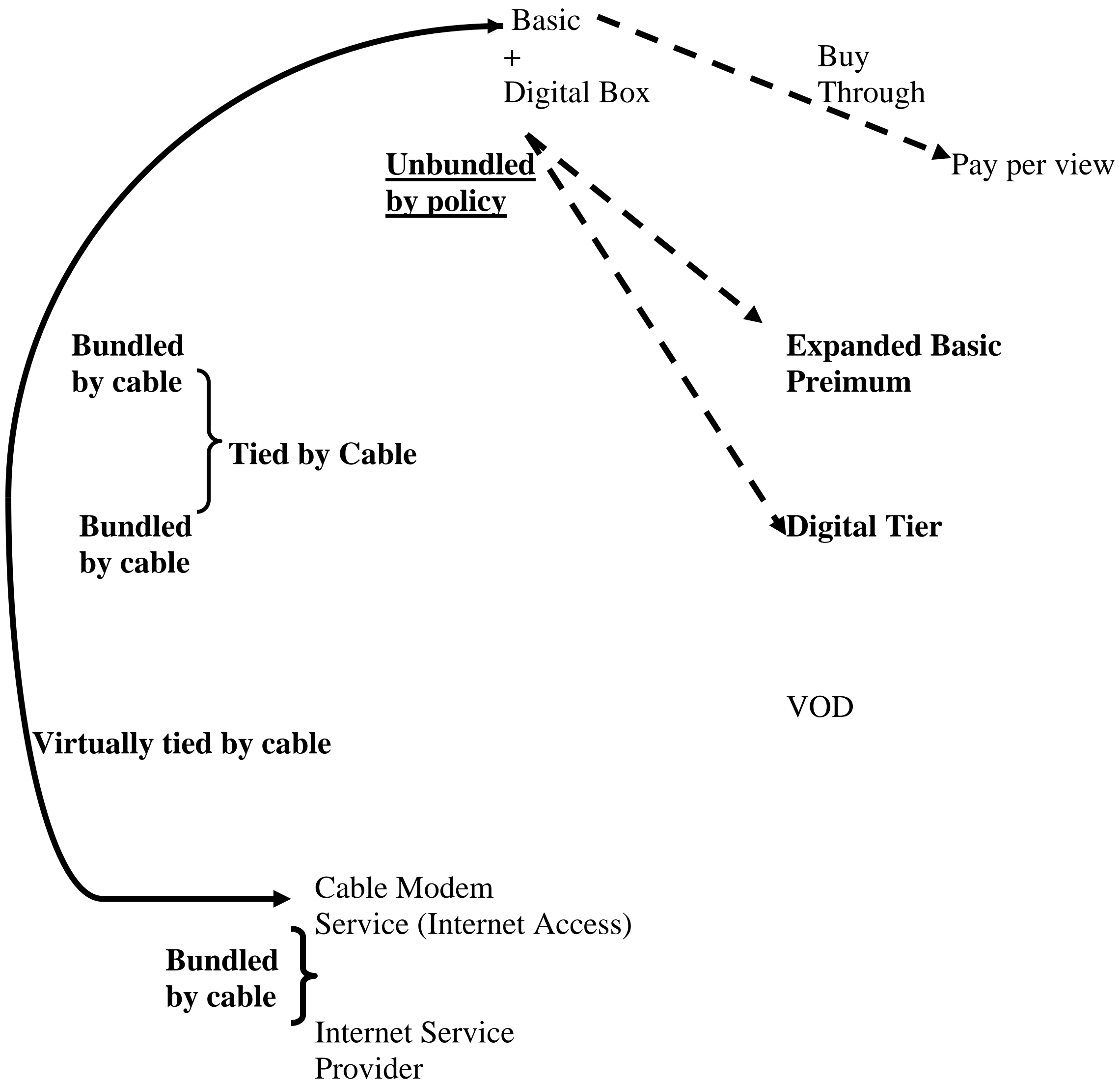
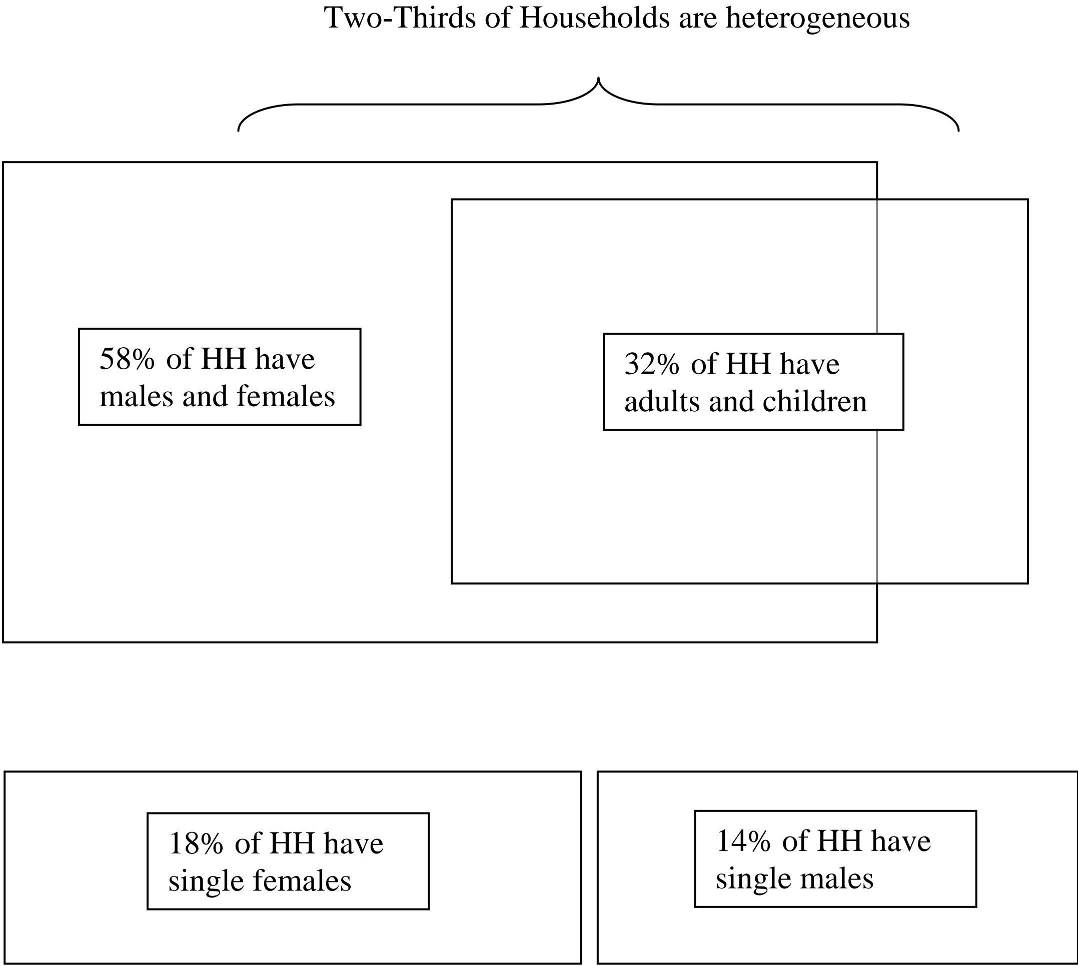
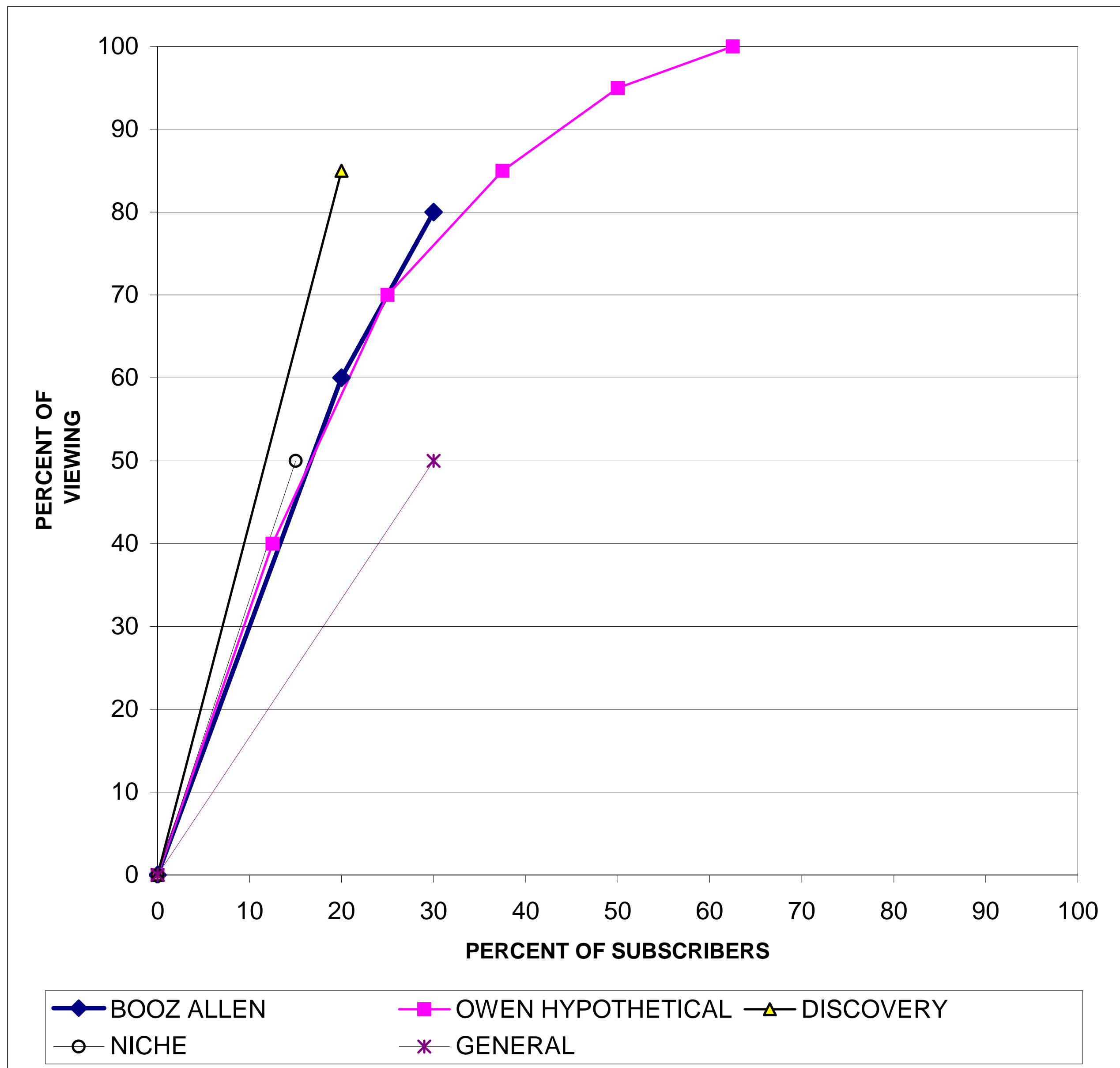


Exhibit 13:
Heterogeneous Households Provide a Large Base for Bundled Sales in a Mixed Bundle Environment



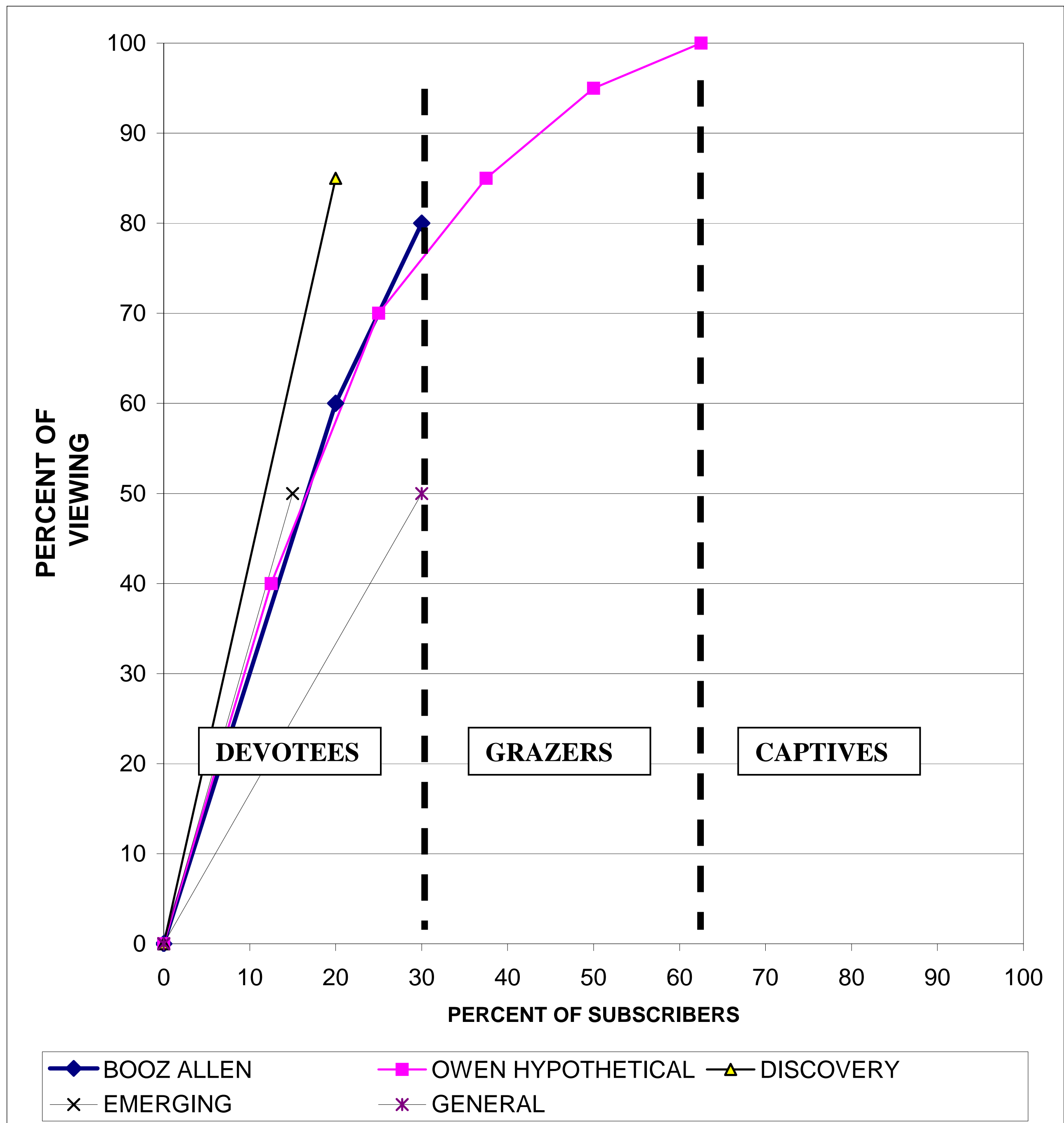
Source: U.S. Bureau of the Census, *Statistical Abstract of the United States: 2002* Tables 56-59, based on 2000 census.

Exhibit 14:
Viewing Is Highly Concentrated In A Small Subset of Subscribers



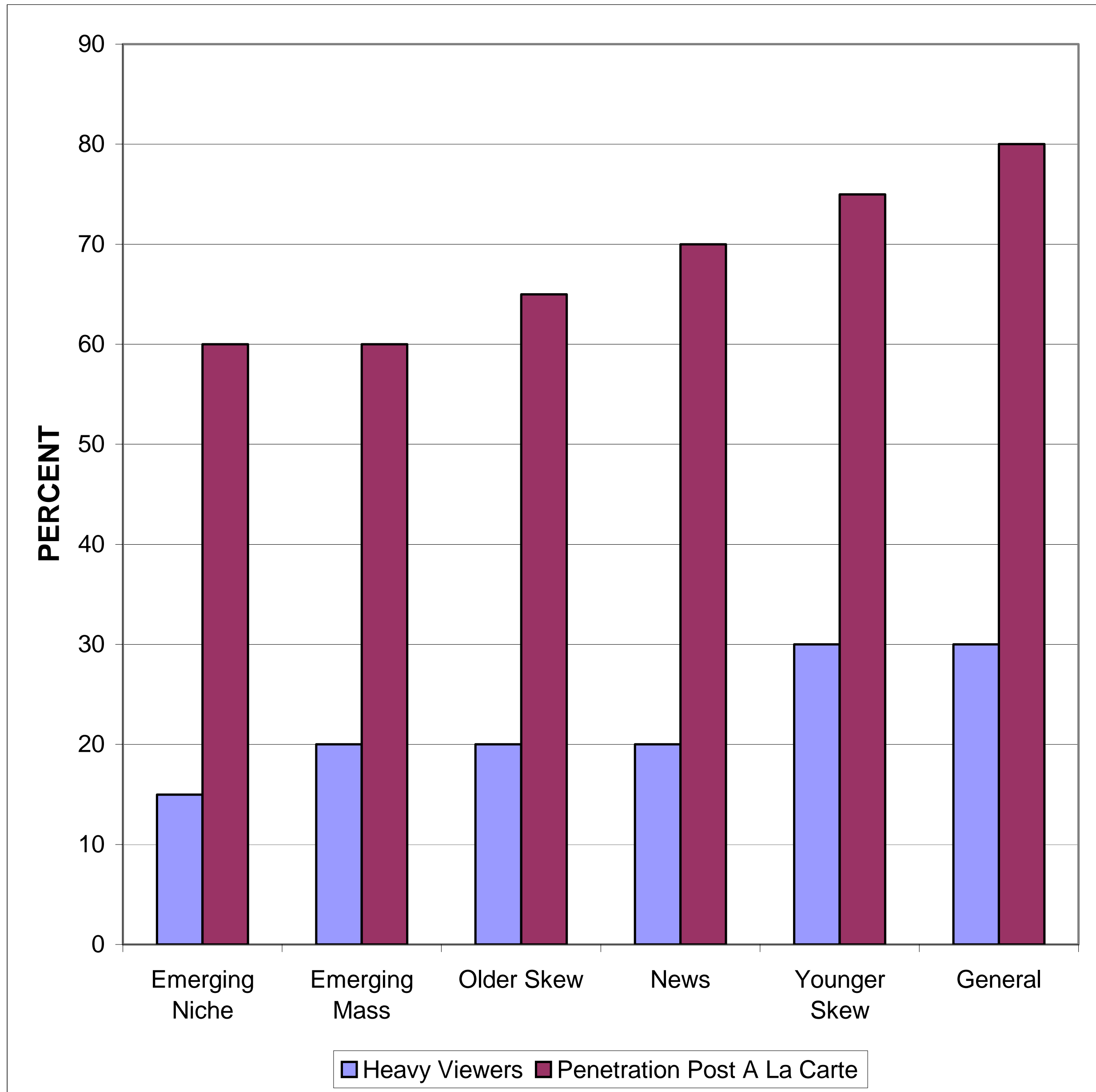
Source: Booz Allen, Hamilton, *The A La Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity,* July 2004, p. 5, for Booz Allen, p. 23 for Niche and General; Bruce Owen and John M. Gale, *Cable Networks: Bundling, Unbundling, and the Cost of Intervention,* July 15, 2004, p. 34; Declaration of Robert Willig, et. al., *Regarding A La Carte Pricing,* July 15, 2004, p. 17.

Exhibit 15:
Under Mixed Bundling Approach To A La Carte, Subscribers Will Segment Themselves and Networks Will Lose Few, If Any, Viewers



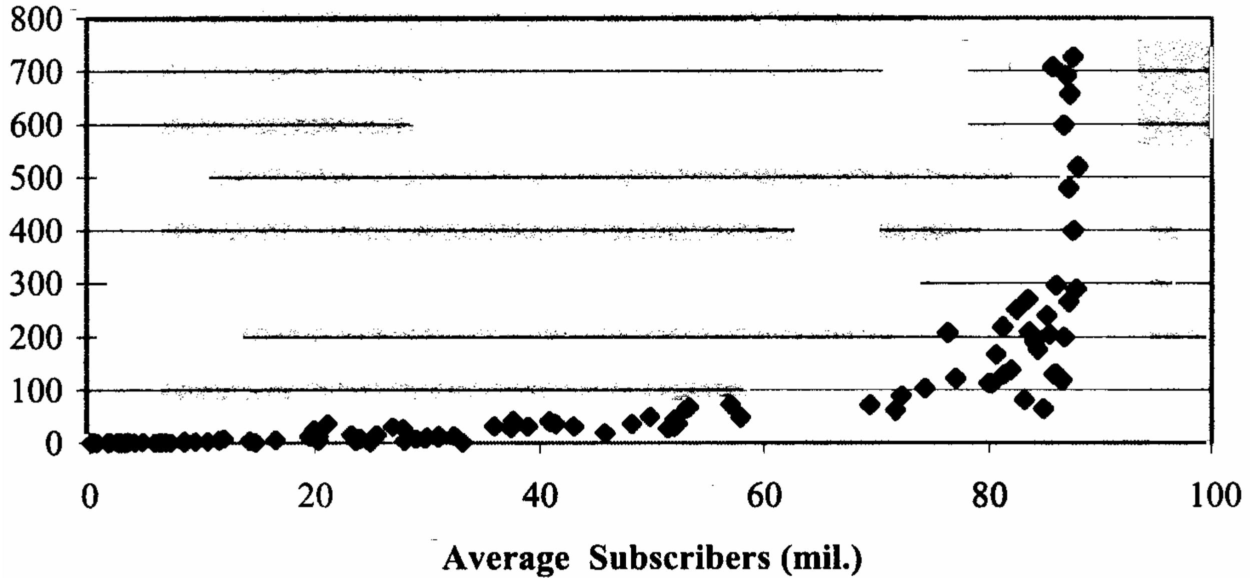
Source: Booz Allen, Hamilton, *The A La Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity,* July 2004, p. 5; Bruce Owen and John M. Gale, *Cable Networks: Bundling, Unbundling, and the Cost of Intervention,* July 15, 2004, p. 34; Declaration of Robert Willig, et. al., *Regarding A La Carte Pricing,* July 15, 2004, p. 17.

Exhibit 16: Viewing And Penetration Of Networks In A Mixed Bundle Environment

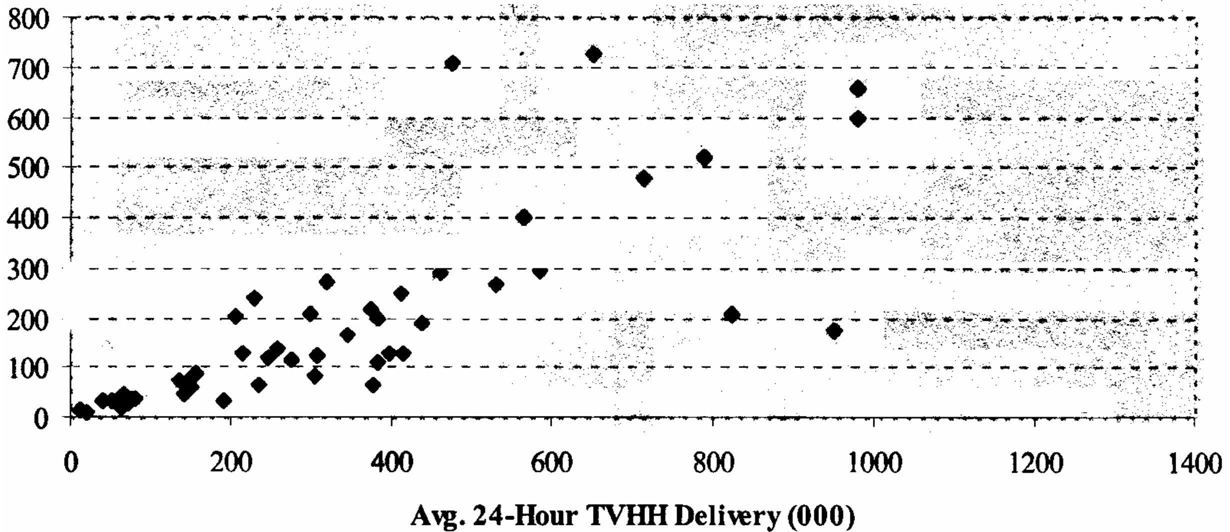


Source: Booz Allen, Hamilton, *The A La Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity,* July 2004, pp. 23-24.

Exhibit 17:
Viewing Determines Ad Revenues and is Highly Concentrated
The Top 25 Networks Account for 80% of Ad Revenues

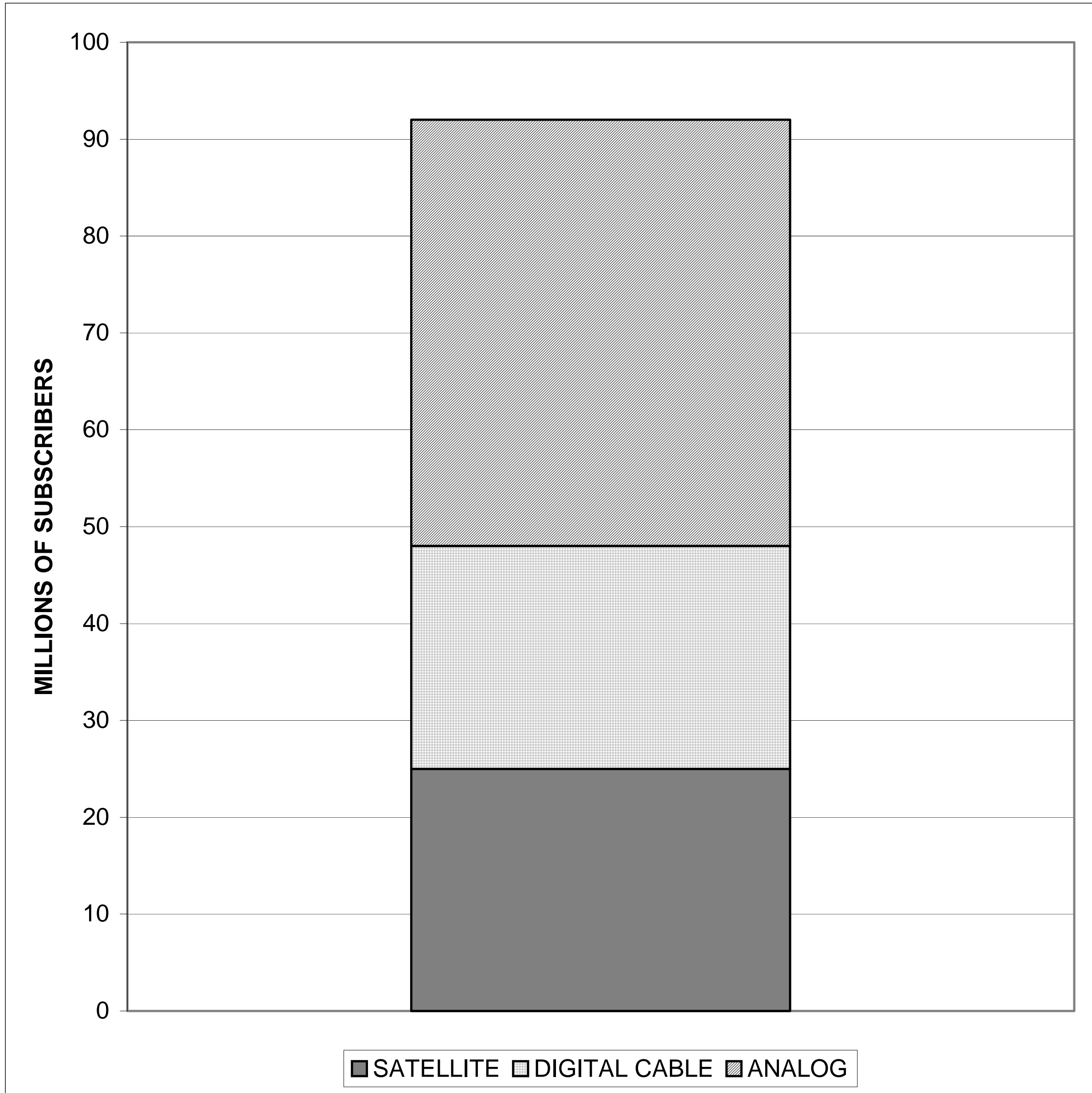


Ratings Are A Much More Important Determinant of Advertising Revenues Than Subscribers



Source: Bruce Owen and John M. Gale, *Cable Networks: Bundling, Unbundling, and the Cost of Intervention,* July 15, 2004, p. 32-33.

Exhibit 18:
Digital Subscribers Make Up Half The MVPD Market



Source: George Winslow, "systems are Growing by Offering Services from DTV to Telephony," Broadcasting *and Cable,* August 9, 2004.

Exhibit 19:
A La Carte Pricing in a Mixed Bundle Environment

NETWORK TYPE	SUBSCRIBERS BUNDLED (000,000)	MIXED BUNDLE (000,000)	BUNDLED REV/ MNTH	BUNDLED AD REV/ MTNH	MONTHLY A LA CARTE FEE NEEDED to REPLACE LOST NETWORK REVENUE				SUBSCRIBER PRICE (with Cable mark-up)
					Subscriber	Ad	Mkting	Total	
GENERAL	87	70	$0.67	$0.48	$1.12	$0.11	$0.38	$1.61	$2.72
NEWS	86	60	$0.20	$0.20	$0.50	$0.10	$0.16	$0.76	$1.28
OLDER	80	52	$0.18	$0.12	$0.60	$0.09	$0.20	$0.89	$1.50
YOUNGER	84	63	$0.25	$0.24	$0.50	$0.08	$0.20	$0.78	$1.32
E. NICHE	34	20	$0.09	$0.06	$0.45	$0.07	$0.15	$0.67	$1.13
E. MASS	64	38	$0.08	$0.09	$0.40	$0.12	$0.17	$0.69	$1.16

Source: Calculate by Author, see Text.