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The FCC's "a la Carte" Reports

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The FCC's "a la Carte" Reports

Summary

The Federal Communications Commission (FCC) has released two reports on a la carte pricing of cable television networks that reach contradictory conclusions. On November 24, 2004, then-chairman Michael Powell issued a report (Initial Report) that concluded that requiring cable and satellite operators to offer cable networks in an a la carte fashion – either as a replacement for the current expanded basic service tier or as an optional alternative to that tier – would likely increase the monthly cable or satellite bill for most households and reduce program diversity. On February 9, 2006, current FCC chairman Kevin Martin released a "Further Report" that appears to contradict the first one, concluding that for the 40% of cable households (and 100% of satellite households) that already receive digital service, a la carte purchasing is likely to lower the monthly bill. Neither of these reports was supported by the full Commission and each was released as an unofficial report. These inconsistent findings by the expert agency have caused some confusion.

Neither report is based on a model developed by the FCC itself. Rather, each made relatively minor modifications to a model and study performed by Booz Allen Hamilton Inc. for the National Cable & Telecommunications Association. Yet, as Booz Allen explicitly recognizes, there is significant "uncertainty involved in building an economic model for a la carte," partly because of the large number of potential interactions and responses by consumers, program networks, and cable and satellite operators that must be modeled, and partly because of the lack of empirical data, especially on the response of households to different a la carte prices per channel. Given the lack of data, Booz Allen was not able to use standard economic methodology; rather it had to employ an indirect approach and rely on a number of potentially challengeable assumptions about how households, cable and satellite operators, and program networks would behave. This indirect approach could not be avoided. But given their reliance on a host of assumptions that were of necessity formed in the absence of comprehensive empirical data, neither the Booz Allen study nor the two FCC reports should be viewed as providing definitive results. It appears, however, that most of the criticisms of the Initial Report that are presented in the Further Report either are not supported by available market data or cannot be proven one way or the other.

Large tiers generally benefit those households that prefer a wide variety of programming and/or niche programming; a la carte pricing generally benefits those households that watch only a small number of networks and prefer general interest programming, but could have serious implications for diversity. Requiring operators to offer all options might not meet the needs of all households, however, because the migration of some threshold number of households to a la carte pricing could undermine the economic feasibility of large tiers.

Technological change and the mandatory transition to digital television in 2009 are likely to precipitate new market dynamics and ultimately the current tiered business model may well give way to a video on demand approach that is akin to a la carte pricing. This report will not be updated.

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The FCC's "a la Carte" Reports

Overview

The Federal Communications Commission (FCC or Commission) has released two reports on a la carte pricing of cable television networks[1] that reach contradictory conclusions. On November 24, 2004, then-chairman Michael Powell issued a report (Initial Report) that concluded that requiring cable and satellite operators to offer

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[1] Under a la carte pricing, cable (or satellite) television subscribers could purchase individually each cable network carried by their cable (or satellite) operator. Currently, virtually all cable system operators make cable networks available to customers only in a limited number of large tiers. Although many cable and satellite operators that are not heavily vertically integrated backward into program networks or program production would like the discretion to offer networks in an a la carte fashion or in small tiers as well as in large tiers, they claim that the pricing imposed by the major programmers (demanding much higher per subscriber fees if the network is not provided to a high percentage of an operator's subscribers) makes it financially prohibitive to offer their subscribers a la carte or small tier options. (See, for example, the Testimony of James O. Robbins, president, Cox Communications, Inc., before the Senate Committee on Commerce, Science, and Transportation, March 25, 2004, and the Statement of Matt Polka, president, American Cable Association, before the Senate Committee on Commerce, Science, and Transportation, January 31, 2006.) As a result virtually all subscribers have the following choices:
– The **basic service** tier, typically consisting of a package of local stations (local broadcast stations and public, educational, and governmental (PEG) access programming) plus a few advertiser-supported cable networks.
– The **expanded basic service** tier, consisting on average of 36 advertiser-supported cable networks. This tier typically includes many of the most popular cable networks, ranging from Nickelodeon and the Discovery Channel to MTV. Since approximately 90% of subscribers purchase the expanded basic service tier, most customers have this enhanced basic service tier in mind when they talk of "basic service."
– Various **premium** tiers, typically consisting of a small package of "premium" program networks (such as HBO and Showtime), usually offered without commercial advertising.
– **Pay-per-view** channels with programming (first-run movies, live concerts, boxing matches, sexually-explicit programming) that subscribers pay for on a program-by-program basis.
– In addition, responding to congressional pressure, most cable operators have begun offering a **family** tier that is smaller and lower-priced than the expanded basic service tier and consists of networks with programming targeted to families with children.

Cable operators require subscribers to purchase the basic service tier in order to purchase any other tiers or channels. Most tiers are available in either analog or digital format, but digital tiers tend to offer additional purchasing options as well as high definition video. The direct broadcast satellite (DBS) distributors of multi-channel television also offer the bulk of advertiser-supported networks on a single tier, analogous to cable's expanded basic service tier, with additional premium tiers and pay-per-channel programming available.

cable networks in an a la carte fashion – either as a replacement for the current expanded basic service tier or as an optional alternative to that tier – would likely increase the monthly cable or satellite bill for most households and reduce program diversity.[2] On February 9, 2006, current FCC chairman Kevin Martin released a "Further Report" that appears to contradict the first one, concluding that for the 40% of cable households (and 100% of satellite households) that already receive digital service, a la carte purchasing is likely to lower the monthly bill.[3] Neither of these reports was supported by the full Commission and each was released as an unofficial report. These inconsistent findings by the expert agency have caused some confusion about whether imposing an a la carte regulatory requirement would benefit consumers. The purpose of this report is to explain how these two reports reached differing conclusions and to analyze the different assumptions and calculations used in each.

Neither report is based on a model developed by the Commission itself. Rather, the Initial Report made relatively minor modifications to some input values in a model and study performed by Booz Allen Hamilton Inc. (Booz Allen) for the National Cable & Telecommunications Association (NCTA), which submitted the study as an attachment to its filing in the Commission's proceeding on a la carte pricing.[4] The results presented in the Initial Report were prepared by re-running the Booz Allen study with the changed parameter values. The Further Report challenged some of the calculations and assumptions used in the Initial Report and re-ran part of the model to show the impact on the model results of changing several of those parameter values.

As a result, both the Initial Report and the Further Report are affected by the limitations of the Booz Allen study. Yet, as Booz Allen explicitly recognizes, there is significant "uncertainty involved in building an economic model for a la carte," partly because of the large number of potential interactions and responses by consumers, program networks, and cable and satellite operators that must be modeled, and partly because of the lack of empirical data, especially on the response of households to different a la carte prices per channel.[5] Given the lack of data, Booz Allen was not able to use standard economic methodology; rather it had to employ an indirect approach and rely on a number of potentially challengeable assumptions about how households, cable and satellite operators, and program networks would behave. This indirect approach could not be avoided. But given their reliance on a host of assumptions that were of necessity formed in the absence of comprehensive empirical data, neither the Booz Allen study nor the two FCC reports – which present results generated by re-running the Booz Allen study with minor calculation

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[2] Media Bureau, Federal Communications Commission, *Report on the Packaging and Sale of Video Programming Services to the Public*, released November 18, 2004, at p. 6.

[3] Media Bureau, Federal Communications Commission, *Further Report on the Packaging and Sale of Video Programming Services to the Public*, released February 9, 2006, at p. 4.

[4] Booz Allen Hamilton Inc., *The a la Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity* (Booz Allen study), July 2004, submitted to the FCC as Attachment A to Comments filed by NCTA on July 15, 2004, in MB Docket No. 04-207.

[5] Booz Allen study at pp. 18-19.

corrections and parameter values tweaked – should be viewed as providing definitive results.

Also, neither the Booz Allen study nor the two FCC reports attempt to perform quantitative analysis of alternative policy options that might affect the availability and pricing of cable networks. These include:

- requiring program networks to make their networks available to cable and satellite system operators on an a la carte basis, but continuing to give those operators the discretion to offer service as they see fit (i.e., in large tiers only, or with a la carte or small tier options).

- prohibiting broadcasters that also own cable networks from requiring cable and satellite operators to carry those cable networks in order to receive retransmission consent to carry the broadcast programming.

- prohibiting the current program network practice of contractually imposing strict non-disclosure requirements on cable and satellite operators concerning the subscriber fees they are charged. This practice denies operators access to information on the prices paid by other operators and therefore places them at a negotiating disadvantage vis-a-vis the networks.

Despite the limitations in the Booz Allen study, it is possible to compare the two FCC reports. As will be discussed below, it appears that most of the criticisms of the Initial Report that are presented in the Further Report either are not supported by available market data or cannot be proven one way or the other.

Conclusions of the Initial Report

In May 2004, leaders in both the House and Senate Commerce Committees asked the Federal Communications Commission to collect information and perform analysis relating to a la carte pricing of cable networks.[6] In response to these

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[6] On May 18, 2004, House Commerce Committee chairman, Joe Barton, ranking member, John Dingell, Telecommunications Subcommittee chairman, Fred Upton, Telecommunications Subcommittee ranking member, Edward Markey, and Representative Nathan Deal sent a detailed letter to then-FCC chairman Powell asking the FCC to perform a study, within six months, that would provide information needed to make an informed decision on the potential merits and drawbacks of proposals to allow cable and satellite operators to offer programming to their subscribers on an a la carte or themed-tier basis. They asked the FCC to determine the extent to which cable and satellite operators had the option of purchasing individual cable networks and of offering them to subscribers on an a la carte basis; to study the likely impact of a la carte and themed-tier offerings on retail rates; to investigate the likely impact of a la carte and themed-tier offerings on advertising

(continued...)

requests, the FCC initiated a docket seeking public comment on "factual questions regarding the provision of a la carte and theme-tiered services on cable television and direct broadcast satellite systems."[7] Substantive comments were filed by more than 70 interested parties; 12 economic analyses were attached to these comments.[8] The Initial Report summarized the comments and analysis submitted. It also incorporated statements made by expert witnesses at an a la carte symposium sponsored by the FCC's Media Bureau.[9] The FCC did not undertake an empirical study of its own; rather, it performed analysis by modifying some of the assumptions and parameter values in the Booz Allen study and reported how those changes affected the results. It did not, however, give a full explanation of all the changes it made to the Booz Allen study to reach its own empirical conclusions.

The major conclusions of the Initial Report (at pp. 6-7) were:

- an a la carte requirement likely would increase operational expenses for multichannel video program distributors (MVPDs) in three main areas: (1) equipment and infrastructure; (2) customer service operations; and (3) billing and back office support.

- unless constrained by regulation, many of these increased costs would likely be passed on to subscribers, resulting in higher subscriber fees.

- under an a la carte mandate, networks formerly sold in tiers would need to significantly increase their marketing expenses to induce consumers to affirmatively select the network.

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[6] (...continued)
revenues; to investigate the impact of the current retransmission consent process on consumers' ability to select their own programming; to investigate the likely impact of a la carte or themed-tier offerings on the diversity of programming; to study the unique characteristics of rural and smaller markets; to estimate how many households would have to invest in set-top boxes in order to receive a la carte or themed-tier offerings; and to study what legal issues might arise if Congress decided to mandate a la carte purchasing. (Letter dated May 18, 2004, from Reps. Barton, Dingell, Upton, Markey, and Deal to FCC Chairman Michael Powell.) On May 19, 2004, then-Senate Commerce Committee chairman John McCain sent a letter to then-chairman Michael Powell urging the FCC "to use any existing authority you have to promote, or to create incentives to promote, an a la carte pricing option, in conjunction with whatever tiers cable and satellite companies already offer." (Letter dated May 19, 2004, from Senator John McCain to FCC Chairman Michael Powell.)

[7] FCC Public Notice, "Comment Requested on a la Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems," MB Docket No. 04-207, DA 04-104, May 25, 2004.

[8] See Initial Report at Appendix C and Appendix D.

[9] FCC Public Notice, "Media Bureau Announces Speakers for Symposium on "a la Carte" MVPD Pricing," MB Docket No. 04-207, July 13, 2004.

- any type of a la carte requirement would have a significant negative effect on a program network's advertising revenues and license fee structure. This may cause many program networks to fail, thus adversely affecting diversity. The most likely to feel the brunt of such a mandate would be networks serving small niche interests, such as religious programming, programming aimed at minority interests, arts programming, and independently owned networks. The impact on program networks seems likely under either a mandatory or a voluntary a la carte regime.

- under a mandatory a la carte purchasing requirement, only those households that would purchase fewer than 9 advertiser-supported cable networks might see a reduction in their monthly cable bill. Households that purchase at least 9 such networks would likely face an increase in their monthly bills. Today, the average cable household watches approximately 11 advertiser-supported cable networks (plus 6 broadcast channels carried by their cable operator) in a week. If the average household purchased each of the 11 advertiser-supported cable networks under an a la carte regime, it likely would face an increase in its monthly bill under a la carte purchasing of between 14% and 30%.

- public policy should focus on creating incentives for more MVPD competition in the marketplace, and for fostering video on demand, digital video recorders, and video over internet protocol that give the public more control over their video choices.

- broadcasters that also are producers of cable programming, in their retransmission consent negotiations with cable and satellite operators, sometimes tie access to their popular broadcasting programming to the purchase and carriage of less attractive or less desired cable network, which may be anticompetitive and harm consumers. But the antitrust authorities, not the FCC, are best positioned to remedy this situation.

Conclusions of the Further Report

On February 9, 2006, current chairman Martin released the Further Report, which challenged many of the assumptions underlying the Initial Report and identified an alleged methodological error in the Initial Report. The Further Report, like the Initial Report, was not adopted by the full Commission. The Further Report presented results from rerunning the original model, but using parameter values reflecting different underlying assumptions and correcting for the alleged methodological error in the Initial Report. With these changes, the Further Report found (at pp. 4-5) that:

- under a la carte, the 40% of cable households and 100% of satellite households that already get digital service (and thus do not have to

make an additional payment for a set-top box) could receive as many as 20 channels (14 advertiser-supported cable networks plus 6 local broadcast stations) without seeing an increase in their monthly bills. This is 3 more than the 17 channels that the average household watches in a week.

- if a household already gets digital service, under a la carte pricing it could purchase 11 advertiser-supported cable networks (plus 6 local broadcast stations) and face a change in its bill ranging from a 13% decrease to a 4% increase, with a decrease in 3 out of 4 cases.

- a la carte pricing may be even more favorable to consumers than the model results suggest because the Booz Allen study incorrectly assumes that a shift to a la carte pricing would cause households to watch 2 hours less television per day, which would represent an almost 25% decrease in viewing. Under the more appropriate assumption that viewing would not decrease substantially, advertising revenues are unlikely to fall substantially, licensing fees are unlikely to increase substantially, and therefore households could purchase additional a la carte channels without paying more than under the current expanded basic tier regime.

- bundling may drive up retail prices, making video programming less affordable and causing some consumers not to purchase MVPD services. A la carte and increased themed tiers could give consumers the opportunity to lower their cable bills by purchasing fewer channels or smaller packages.

- a la carte pricing could make it easier for some new networks to enter the market because advertisers and cable distributors might find it easier to judge the value of smaller networks if consumers were able to express their interests through subscriptions.

- a la carte pricing might provide programming that households value more than tiered programming because it might result in more programming that is highly valued by a niche audience and/or more general interest programming that is widely valued.

The Further Report specifically concludes that a "mixed bundling" alternative, in which households that receive digital service could purchase on an a la carte or tiered basis while the households that get analog service continue to purchase on a tiered basis, is likely to benefit consumers.[10] While today approximately 40% of cable households (and all satellite households) subscribe to digital service, that penetration level will increase over time as households migrate to the new digital technology and

[10] Further Report at p. 6.

will reach 100% when the digital television transition is completed in 2009, as mandated by law.[11]

Points of Contention

What are the implications of the assumptions in the Booz Allen study that the program networks and cable and satellite operators could raise prices as needed to maintain their cash flow and that current levels of compensation are needed to maintain program quality?

Two key assumptions in the Booz Allen study are that both the program networks and the cable/satellite operators would take any pricing actions necessary to maintain their current cash flow if they were required to offer a la carte pricing or small tiers. In the model, to the extent that mandatory a la carte or small tier offerings would cause a decrease in advertising revenues and/or an increase in costs for program networks, those networks would be "made whole" by a commensurate increase in the subscriber fees charged to operators. In turn, operators would be made whole for any decrease in advertising revenues and increase in subscriber fees and other costs by commensurate increases in the prices subscribers pay for both a la carte and tiered options. These constant cash flow assumptions appear to preclude one of the potential benefits of a la carte pricing – creating market forces that might place downward pressure on program pricing at both the wholesale and retail level. This is significant because it is widely recognized that, while large tiers represent a potentially efficient way to distribute programming and may well result in consumer benefits, they also provide a way for networks to price discriminate, which is often an effective way for most of the benefits to flow to programmers (as what economists call "producer surplus") rather than to consumers ("consumer surplus"). That is, although the large tiers appear to provide an efficient marketing and distribution platform, they also may increase the ability of producers of "must have" television programming to squeeze additional "economic rents"[12] from consumers.[13]

The Booz Allen model further assumes that any decrease in network revenues would reduce program quality, which appears to be based on the implicit presumption that the talent creating the programming must continue to earn current levels of compensation or program quality would fall. But that talent (athletes, actors, directors, producers) today earns economic rents that might be eroded without

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[11] The mandate is in the Deficit Reduction Act of 2005 (P.L. 109-171).

[12] "Economic rents" are payments made to a factor that are in excess of what is required to elicit the supply of that factor.

[13] According to the Initial Report, however, Commission staff re-ran the Booz Allen model with the modified assumption that the cash flow of program networks was limited to 10% of revenues, and the results still showed the need to substantially increase subscriber fees. See the Initial Report at p. 91. This might suggest that the efficiency losses from an a la carte regime might overwhelm any reduction in economic rents. But, as discussed below, this result may be the consequence of the implicit assumption in the Booz Allen study that any reduction in compensation to programmers would reduce program quality.

harming program quality. Such erosion would be beneficial to consumers. For example, if market forces imposed limits on how much cable and broadcast networks could bid for the rights to baseball, basketball, and football games, club owners might not be able to maintain the current salary structure for athletes. But one might expect that virtually all of those athletes are likely to continue to play their sport at, say, half of their current salary, because that level would still far exceed what they could earn in any alternative occupation.

The Booz Allen study chose not to address another potential impact of a la carte pricing on economic rents. The study combines sports networks and general entertainment networks into a single network category (because some general entertainment networks offer some sports programming). But the subscriber fees charged for sports networks are many multiples of those for any other networks, including general entertainment networks. When the sports network fees are imposed on all subscribers to the expanded basic tier, those households that do not view the sports networks are almost certainly subsidizing sports viewers. Even some critics of mandatory a la carte pricing have conceded that a separate sports tier, or a la carte pricing of sports networks, might well benefit consumers overall.[14] Since the two FCC reports rely on the Booz Allen study, they were not able to address the impact of requiring separate sports tiers or a la carte pricing of sports networks on overall costs to households or on program diversity (i.e., whether the inclusion of sports programming on a large tier increases revenues that are used to support diverse programming or simply generates revenues that flow back to talent as economic rents).[15]

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[14] For example, in the March 25, 2004 Senate Commerce Committee Hearing on Escalating Cable Rates: Causes and Solutions, James Robbins of Cox Communications stated that he opposed any requirement that cable operators be required to offer networks on an a la carte basis, but that Cox would consider offering a separate sports tier. In that hearing, Mark Goldstein, director of physical infrastructure at the Government Accountability Office, indicated that sports programming represents the best choice of programming for a separate tier.

[15] Interestingly, although programming of major sports is viewed by cable and satellite operators as "must have" programming, the sports programmers report financial losses from winning the rights to these major sports. For example, News Corp. reported on February 12, 2002 that it took a $909 million operating charge in the second quarter because of its three major professional sports television contracts. According to Steve Sternberg, senior vice president and broadcast research director at TN Media: "There's a cachet to having sports, especially major sports. They're like a loss leader. Sports promote the networks' primetime lineups and sports are one of the things that drive people to their internet sites." Sports programmers apparently have made the strategic business decision to get into a competitive bidding environment to attain the rights to popular sports events even with the knowledge that, if they win the bid, they would be unlikely to recoup those costs directly from the sports programming shown. Rather, sports programmers may expect to benefit indirectly by exploiting the sports events to market their other programming to the highly desirable teenage and young adult male audience – both by cross-marketing their other programs and by "branding" their networks. Those programmers, of course, seek to recover as much of the costs as possible from program distributors – through the very high per subscriber fee imposed on cable operators and, for those sports programmers that own broadcast networks, through attempts to get their local stations affiliates to share the cost burden.

Do the Booz Allen study and Initial Report overstate the extent to which an a la carte requirement would reduce advertising revenues, as the Further Report alleges?

The Booz Allen study (and hence also the Initial Report) assume that an a la carte requirement would substantially reduce the advertising revenues of both program networks and cable/satellite operators for several reasons[16] – overall television viewing would fall because a la carte viewers would have more limited options for channel surfing; advertisers value potential audience reach as well as actual audience size and with a la carte no network would have as much potential reach since some households would no longer receive the network signal;[17] with a smaller average audience viewing each cable spot advertisement, advertisers would need to increase the number of cable spots purchased to reach the same audience, but this increases the risk of viewer "wear out" when a viewer sees too many repetitions of an advertisement; overall, cable advertising would be a less effective medium.

Based on these arguments, the Booz Allen study assumes that program networks would suffer a 10 to 20% decrease in advertising revenues per rating point that, coupled with a significant decrease in rating points as viewership falls, would result in a 20 to 30% decrease in advertising revenues. Under the assumptions of the model, this revenue loss would have to be countered by a dollar for dollar increase in subscription fees.[18] Similarly, it assumes a la carte pricing would result in a 13 to 23% reduction in local advertising revenues generated by the cable/satellite operators.[19] The model assumes that the operators would have to increase the a la carte prices charged to households (and, to a lesser extent, the tiered prices charged to households) to compensate for the increased costs associated with higher subscription fees and lower local advertising revenues. Thus the model's assumptions about the impact of a la carte pricing on advertising revenues have a significant impact on the a la carte prices charged and on the number of a la carte channels a household could purchase without paying more than under the current tiered system.

While there is merit to the Booz Allen analysis as far as it goes, it fails to recognize possible countervailing impacts of a la carte pricing on the advertising market that have been identified by others. A la carte pricing provides advertisers with more readily measurable data on the number and demographics of those households that value a network's programming sufficiently to purchase it.[20] Especially given that Nielsen Market Research does not currently collect ratings data for the vast majority of small cable networks, the data provided by a list of actual

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[16] Booz Allen study at pp. 26-27 and 30.

[17] According to the Booz Allen study (at p. 27), cable networks with lower distribution historically have generated less advertising revenues per rating point than those that have coverage of 50% to 70% of households.

[18] Booz Allen study at p. 49.

[19] Booz Allen study at p. 51.

[20] See the Further Report at p. 24.

purchasers could foster advertising on some of those networks. Also, under a la carte, networks might have an opportunity to raise advertising rates to advertisers of specialty products related to niche programming who seek a select audience with a high intensity of demand for the niche programming and for the specialty products advertised. Thus, it may well be that the Booz Allen study and Initial Report overstate the negative impact that a la carte pricing may have on both program networks and operators and, hence, the extent to which that effect might raise a la carte prices. It is not possible to estimate how significant this possible overstatement might be, but it suggests that the "breakeven" number of a la carte networks might be greater than indicated by the Booz Allen study or Initial Report.

Do the Booz Allen study and the Initial Report overstate the extent to which a la carte pricing would decrease average television viewing per household, as the Further Report alleges?

The Further Notice claims that the Booz Allen study and Initial Report assume "without any basis, that a shift to a la carte would cause consumers to watch more than 2 hours less television per day. That is, the study assumes consumers would watch nearly 25% less television...."[21]

This claim misinterprets the Initial Report. The Initial Report assumes that, overall, viewing of advertiser-supported networks would decrease by 23% because under an a la carte option fewer households would receive each of these networks, so casual viewing would be eliminated. At the same time, it assumes that households would increase their hours of viewing of those advertiser-supported networks they purchase on an a la carte basis, of the local broadcast networks carried by their cable or satellite operator, and of premium networks, pay-per-view networks, and video on demand. Although the Booz Allen study does not measure what those additional hours would be, it is assumed that total viewing would decrease but by significantly less than 23%. Thus, while one could challenge the assumption that viewing of advertiser-supported networks would fall 23%, the general thrust of this criticism of the Further Report does not appear to be accurate.

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[21] Further Report at p. 4.

Do the Booz Allen study and the Initial Report overstate the additional marketing costs imposed by an a la carte requirement, as the Further Report alleges?

The Booz Allen study assumes that, under mandatory a la carte pricing, on average advertiser-supported cable networks would have to increase their marketing expenditures from the 2-6% of total net revenues they are today to 15-25% of total net revenues.[22] The study claims that marketing expenditures are relatively small today because the networks can focus their marketing activities on reaching operators and can partner with those operators to market to viewers. Once a network is carried by a cable or satellite operator on the expanded basic tier, marketing to viewers is relatively limited because channel surfing is costless to the networks and cross-network marketing within the tier is a relatively low cost activity. Under a la carte, however, the marketing focus would have to shift to marketing directly to consumers. Reaching non-subscribers and convincing them to pay for a network poses a more significant challenge than most networks face today. Networks cannot gain viewers from among non-subscribers from channel surfing, and cross-network marketing is not efficient if the subscriber does not have immediate access to the second network (as it would have on the tier). Thus the marketing task, Booz Allen argues, is more akin to the marketing challenges of premium channels (such as HBO) and of consumer packaged goods companies. Those companies spend approximately 15-27% of their product revenues on marketing.

The Further Report challenges this assumption. It cites a study by the Cable and Telecommunications Association for Marketing that found that less than half of viewers find new channels through channel surfing, and thus argues that "networks are already confronting the problem of marketing themselves to non-surfers, even with bundling."[23]

This criticism is also open to challenge. Networks today do a lot of cross-network marketing. The efficiencies from such marketing is one of the market forces fostering the creation of brand identities and families of networks (ESPN, Discovery, FOX, etc.). Independent networks focus their marketing efforts on getting onto expanded basic tiers, not on consumer households. Virtually all the independent networks that filed comments in the FCC proceeding stated they would face very difficult marketing burdens in an a la carte environment. In addition to the costs of initially capturing paying viewers, cable networks would have to spend money to retain customers. There is general agreement that customer "churn" is lower for a bundle of services than for individually-sold services. All of these factors suggest that the Booz Allen study and the Initial Report made reasonable assumptions about the increase in marketing expenses if a la carte pricing were mandatory.

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[22] Booz Allen study at pp. 27-28.

[23] Further Report at pp. 26-27.

Is the methodological correction to the Booz Allen study proposed and calculated in the Further Report the appropriate correction?

There are two key calculations in the Booz Allen study. First, the price that the cable/satellite operator would charge for each a la carte advertiser-supported network is calculated. This is done by increasing current average video revenues per household ($55) by the percentage needed to recover the new programming, customer service, and other costs associated with a la carte pricing, then subtracting from that amount those revenues that are not generated by advertiser-supported networks (i.e., revenues generated from set top box rentals, premium networks, pay-per-view and video on demand services, and the broadcast channels offered over the basic tier). This figure is then divided by 11 – the average number of advertiser-supported networks viewed per household in a week – to obtain the a la carte price per network that the operator would charge to maintain its cash flow level. The second calculation attempts to determine the "breakeven" number of advertiser-supported networks that a household would purchase to keep its total spending at $55. This is calculated by subtracting from $55 all of the revenues that are not generated by advertiser-supported networks, and then dividing that figure by the a la carte price generated in the first calculation.

In 2005 (more than a year after the Initial Report had been released), the FCC staff noticed that the Booz Allen study had incorporated a methodological error by failing to exclude the revenues generated from the broadcast channels, premium channels, and pay-per-view and video on demand services from the first calculation. The Further Report claims that, upon correcting for this error, the model shows that, on average, those households that already have digital service would have lower costs under an a la carte regime because the a la carte price would be lower and thus households could purchase more than 11 a la carte networks without paying more than $55.[24]

But in a letter that Booz Allen sent to the FCC after being informed of the methodological error, but before the Further Report had been released,[25] Booz Allen explained that it had made the same methodological error – failing to exclude the revenues generated from the broadcast channels, premium channels, and pay-per-view and video on demand services – in the second calculation and that therefore the same correction had to be made to the second calculation as well. It further stated that when the corrections were made in both calculations the results were almost identical to those in its original study:

> When both these adjustments are made, the estimated number of cable channels that a consumer would be able to purchase on an a la carte basis does not differ significantly from the results in our 2004 report. The 2004 report estimated that

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[24] Further Report at p. 4.

[25] Letter from John Frelinghuysen, Vice President, Booz Allen Hamilton Inc., to Dr. Leslie Marx, Chief Economist, Federal Communications Commission, dated December 16, 2005, available in Electronic Filing Comment System on the FCC website (www.fcc.gov) under MB Docket No. 04-207.

> digital customers would be able to purchase 7 to 9 a la carte cable channels, while analog customers would be able to purchase 6 to 7. Making the two offsetting adjustments results in a range of 8 to 10 channels for digital customers, and 6 to 8 channels for analog customers.

The Further Report does not make any mention of this second methodological error and it appears that it did not correct for this error.[26] Booz Allen is correct that the correction must be made in both calculations. Thus, this criticism in the Further Report does not appear to have merit.

Do the Booz Allen study and the Initial Report overstate the extent to which a la carte pricing would decrease program diversity, as the Further Report alleges?

The Booz Allen study claims that mandating a la carte pricing would lead to less diverse programming than today and that the reduction would be larger the greater the number of households that migrate to a la carte.[27] It assumes that the program networks' substantial reductions in advertising revenues and increases in marketing costs would force them to significantly raise subscriber fees charged to operators and that the operators, in turn, would have to charge a la carte customers between $4 and $5 per network. They conclude that emerging networks, in particular, would not be able to attract sufficiently large audiences in this environment to survive, projecting that half to three-quarters of emerging networks would fail under a la carte and that new network launches would be extremely rare. Based on this analysis, the Initial Report concludes that "many program networks [may] fail, thus adversely affecting diversity. The most likely to feel the brunt of such a mandate would be networks serving small niche interests, such as religious programming, programming aimed at minority interests, arts programming, and independently owned networks."[28]

The Further Report questions these conclusions,[29] claiming that "a la carte could be preferable to bundling in providing diverse programming responsive to consumer demand" for two reasons. First, it agues that because their goal is to maximize the price and sales of the bundle, cable and satellite operators in many circumstances will have an incentive not to provide networks that have programs similar to existing programming, even if that programming would be valued by many customers. For example, some mainstream networks might not be carried because they might not increase total subscribership as much as a unique niche network might. Second, bundling can obscure signals regarding consumer valuations of individual networks. The first argument would seem relevant if the public policy goal were to best meet consumer demand, even if to do so would expand general interest programming at the expense of diverse programming. But diversity of voices is a fundamental goal of U.S. media policy and the Further Report does not refute the fact that niche networks could be significantly harmed by a la carte pricing. The second argument

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[26] See Further Report at p. 10, para. 4 and footnote 20.

[27] Booz Allen at pp. 35-38.

[28] Initial Report at p. 6.

[29] Further Report at pp. 30-36.

has merit to the extent that certain niche programming with small audiences that have high intensity of demand and demographics favorable to advertisers might benefit from an a la carte approach. But overall, due to the scale economies associated with program networks, niche networks tend to be placed at a disadvantage in an a la carte market.

At the same time, the conclusions in the Booz Allen study appear to be overstated. Those conclusions are based on assumed a la carte prices of $4 to $5 per network generated by that study. Although the subsequent corrections to the Booz Allen study continued to show that under a la carte pricing most households would receive fewer networks for the same price, they also yielded significantly lower a la carte prices – in the range of $2.54 to $3.37. The prices for niche networks and new networks would certainly be well below those averages.[30] Thus, Booz Allen's pessimistic projection that half to three quarters of emerging networks would fail, which is based in part on inflated $4 to $5 a la carte prices, appears to be an overstatement.[31]

Nonetheless, it is true that requiring households to commit to $2.50 per month or more for a new network, sight unseen, is likely to impede demand for new networks and make it especially difficult for independent networks that do not have any opportunity to "introduce" some of their programming on an existing sibling network (as a new Discovery or ESPN or FOX network would be able to do).

Can specific conclusions be reached from the two FCC Reports?

In the absence of key empirical information – on households' elasticity and intensity of demand for particular types of program networks,[32] program networks' license fees for providing networks on an a la carte vs. tiered basis,[33] and cable and satellite operators' retail charges for providing networks in an a la carte vs. tiered

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[30] The Further Report criticizes the Booz Allen study and Initial Report for making the simplifying assumption that the a la carte prices for all advertiser-supported networks would be the same. (Further Report at p. 8, para. 10.) This assumption excludes the scenario of a household purchasing a larger number of low-priced channels and still not increasing its total spending. But the assumption has an equal impact in the other direction – it excludes the scenario of a household purchasing fewer high-priced channels before increasing its total spending. Therefore this assumption appears to have a neutral impact.

[31] On the other hand, very low a la carte prices for some networks would place downward pressure on the per subscriber fees those networks charge operators and thus could undermine the viability of those networks.

[32] As long as networks have been provided to consumers on a tiered basis, without individual prices, such data are not available.

[33] In their contracts with operators, the program networks insist on strict non-disclosure clauses and the FCC has not required parties to provide such data, even under strict confidentiality agreements.

fashion[34] – none of the studies or reports issued to date can be deemed definitive, though an a la carte approach could have serious implications for diversity. Large tiers generally benefit those households that prefer a wide variety of programming and/or niche programming, while a la carte pricing generally benefits those households that watch only a small number of networks and prefer general interest programming. Requiring operators to offer all options might not meet the needs of all households, however, because the migration of some threshold number of households to a la carte pricing could undermine the economic feasibility of large tiers.

Are Market Forces Likely to Affect the Program Networks' Current Tiered Business Model?

Most observers agree that technological change is likely to precipitate new market dynamics and that ultimately the tiered business model currently employed by the large programmers will give way to a video on demand approach that is akin to a la carte pricing.[35] But that change will not take place immediately and, indeed, there remain questions about how programmers will be able to construct a viable video on demand business plan. For example, how will the literally hundreds of thousands of programming options be marketed and priced? And what tools will consumers have to efficiently track down their choices among the huge available inventory? In the interim, the entry of competing distribution avenues – through telephone company broadband services or even Internet video streaming – may strengthen the negotiating position of programmers vis-a-vis distributors and may allow programmers to retain tiering for the foreseeable future.

Multiple tiers and a la carte pricing impose higher transactional costs – to restrict access to those networks the household chooses to purchase and to bill households for their selections – that deter demand. Those subscribers that already purchase digital service or pay-per-view service have set-top boxes that could readily accommodate these transactional tasks.[36] But more than half of all cable subscribers

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[34] As long as networks have been provided to consumers on a tiered basis, without individual prices, such data are not available.

[35] For example, during the question and answer portion of the March 25, 2004 Senate Commerce Committee hearing, Cox Communications president James Robbins stated that once digital cable has been fully deployed, the cable business plan will become a "video on demand" model with most programming provided on an a la carte basis. But, he stated that was a future business model that could not be implemented until the industry undertook an additional $30 billion in needed capital investment.

[36] Subscribers to digital cable (and satellite) typically have access to many more tiers than do analog subscribers, and increasingly have access to video on demand services, but operators generally charge monthly fees for these capabilities. For example, Echostar charges a $5.00 monthly service access fee to all accounts that do not subscribe to one of its basic programming packages and also charges a $5.00 transaction fee for removing programming or for changing from one like-priced package to another.

continue to receive analog cable service[37] and these customers would require set-top boxes (which rent for approximately $4.50 per television set) in a multiple-tier or a la carte environment.[38] Two-television households that would have to pay an additional $9.00 monthly for set-top boxes are unlikely to see savings from multiple-tier or a la carte pricing.

But the migration of households from analog to digital customer premises equipment is likely to be sped up with the statutorily mandated February 17, 2009 deadline for the conversion from analog to digital broadcast television.[39] In addition, there are a number of technological changes that are likely to foster multiple tiers and a la carte pricing from both a supply-side and a demand-side perspective. Most prominently, the development and deployment of Internet protocol television (IPTV) – already being deployed by some telephone companies and likely to be deployed in the future by both telephone companies and cable companies – will allow broadband providers to offer subscribers access to individual programs or blocks of programs on an on-demand basis through set-top boxes that call up a particular program rather than requiring the broadband provider to "broadcast" all the programming to the household.

Moreover, new technologies such as digital video recorders (DVRs, such as TiVo), which allow consumers to better control the timing and choice of their programming viewing, are creating a demand for programming more closely attuned to individual customer tastes, which tends to be consistent with an a la carte or video on demand approach. Also, recent deals between various programmers and Internet applications and equipment providers, which allow customers to download individual first-run programs for a fixed charge, is creating a demand for a la carte-like program access and pricing.

A key market development is the entry of both large and small telephone companies into the video market, sometimes using IPTV technology. These new entrants intend to compete with the cable companies for the triple play provision of voice, video, and data services. Given the first-into-market advantages of the cable and satellite video providers, the telephone companies may seek to compete by using a different business model, with multiple smaller tiers or a la carte options – and even video on demand – made possible by the new technologies they are deploying.

Unlike many of the large cable and satellite companies that are vertically integrated into program networks and even program production,[40] however, the

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[37] According to the FCC's 12th Annual Report to Congress on Video Competition, at para. 52 and Table 8, the five largest cable operators' digital subscriber counts equal 41% to 58% of their total basic cable subscribers.

[38] All satellite service is digital and thus can accommodate multiple tiers or a la carte pricing today.

[39] The mandate is in the Deficit Reduction Act of 2005 (P.L. 109-171).

[40] According to data in the *2005 TV Sourcebook* attached to the December 19, 2005 edition of *Broadcasting & Cable* and in Kagan World Media, *Economics of Basic Cable Networks* (continued...)

telephone companies have no ownership ties to cable networks or program production. They face the simultaneous tasks of building out networks and obtaining content that will attract viewers away from incumbent cable and satellite operators. Although they can expect to obtain programming from independent programmers that now have difficulty gaining access to cable tiers, those independent programmers do not have the "must have" programming – such as sports and popular entertainment programming – that consumers demand from their multi-channel video providers. In fact, on March 21, 2006, Verizon filed a formal access complaint with the FCC, seeking to secure access to the sports programming of Rainbow Media Holdings, a subsidiary of Cablevision Systems for Verizon's television customers in New York and New England.[41] Verizon alleges that Rainbow had refused to negotiate a carriage agreement with Verizon for Rainbow's regional sports networks. By adding a competitive distributor to the market, telephone company entry may, at least initially, improve the negotiating position of the large programmers (with their "must-have" programming) and reinforce their large tier business model.

Still, by providing independent content providers an alternative way to reach households, if the telephone companies can gain market share sufficient to generate the revenues needed to support themselves and the independent programmers, telephone company entry might quickly erode the large tier business model. Moreover, the large program providers, who rank piracy of their programs as a major business concern, might determine that successful a la carte or on-demand offerings by IPTV-based telephone companies could reduce piracy of their programs.

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[40] (...continued)
2003 (table entitled Cable Networks Owned, By Number Owned: May 2004), Time Warner has total or significant ownership interest in 13 large advertiser-supported cable networks and the largest premium network and also owns the largest film and television studios; DirecTV's parent, News Corp., has total or significant ownership interest in 7 large advertiser-supported cable networks and numerous regional sports networks, owns the Fox broadcast television network, and owns the fourth largest film and television studios; Disney has total or significant ownership interest in 16 large advertiser-supported cable networks and numerous regional sports networks, owns the ABC broadcast television network, and owns the second largest film and television studios; Comcast has total or significant ownership interest in five large advertising-supported cable networks and numerous regional sports networks; Cablevision has total or significant ownership in six large advertising-supported cable networks; Cox has a minority interest in 12 large advertising-supported cable networks.

[41] "Verizon Seeks FCC Intervention to Free Cablevision's Stranglehold on Sports Programming," Verizon News Release, available at [http://newscenter .verizon.com/proactive/newsroom/release.vtml?id=93328], viewed on March 29, 2006.