

# **GEORGE MASON UNIVERSITY SCHOOL OF LAW**

## **SHEDDING TIERS FOR A LA CARTE? AN ECONOMIC ANALYSIS OF CABLE TV PRICING**

**Thomas W. Hazlett**

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# Shedding Tiers for a la Carte?

## An Economic Analysis of Cable TV Pricing

Thomas W. Hazlett<sup>1</sup>  
March 2, 2006

A new regulatory debate has sprung up around the pricing of TV networks on cable and satellite systems. Many argue that bundling networks on tiers, rather than selling channels individually, is anti-consumer and forces families to purchase programming they don't value and often find offensive. The Federal Communications Commission, after issuing sharply conflicting reports on the subject, is considering measures to enforce a la carte pricing. This paper explains the economics of multi-channel video distribution, showing that network cost conditions dictate reliance on bundling. Consumers do, in fact, purchase programs they find valuable, with operators effectively throwing in additional content for free. This outcome is dictated not by market power, as competitive entrants bundle just as aggressively as do incumbents, but by the underlying economic conditions: cable TV networks are distributed to additional households at zero marginal cost. Restricting the basic tier from, say, 60 channels to just those, say, 20 channels a given subscriber prefers is actually more expensive than providing the large tier to all. The upshot is that the goal of reduced retail prices under a la carte is a chimera.

Key words: economic regulation, cable television, bundling, rate controls

JEL Categories: D23, D85, L14, L82

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## I. INTRODUCTION

### A. A New Regulatory Debate

The government regulation controversy is perhaps the longest running show on cable television. In the 1960s, federal regulators enacted rules blocking cable TV operations in major markets, protecting broadcast TV stations from upstart competitors.<sup>2</sup> When such rules were swept away in the “deregulation wave” of the mid-to-late 1970s, a cable “gold rush” ensued in which the country was wired for multi-channel video service. The policy momentum for cable operators was topped off by rate deregulation in the 1984 Cable Act, which pre-empted municipal franchise authorities. Yet, complaints were soon heard about monopoly power and rising rates, and the political winds shifted. Numerous hearings were held in Congress starting in 1989, and rate re-regulation was enacted in the 1992 Cable Act. The controls proved unworkable, however, as operators re-tiered offerings, shifted charges, and lowered service quality. Rate regulation was first relaxed by the Federal Communications Commission (FCC) in late 1994, and then formally eliminated, again, pursuant to the 1996 Telecommunications Act.

Yet controversy over rate regulation rages anew. This time, headlines trumpet consumer frustration over bundled basic cable tiers. Many, including Sen. John McCain (R-AZ), criticize cable operators for restricting customers’ choices, offering all-you-can-eat buffets instead of a la carte menus. Cable subscribers are typically given a take-it-or-leave-it purchase decision for an “expanded basic tier.”<sup>3</sup> This allows households to buy a large package of basic cable channels – such as USA, WTBS, ESPN, Lifetime, TNN, CNN, Fox News, and MTV – but not to customize their order.<sup>4</sup>

It appears that, were consumers to select their own mix of channels, they would improve their position because they wouldn’t be forced to pay for TV shows they have little or no interest in viewing. *If shoppers can choose between apples and oranges at the grocery store, rather than a big bag of both, why shouldn’t they be allowed to pick their own cable networks?*

It is a good question. Instead of providing households a basic tier, with, say, 50 cable networks for \$50 a month, why don’t operators allow subscribers to check-off their choices, from among the 50 (or 100) individual networks, charging \$1 or \$2 each? The fact that they do not suggests an anti-consumer bias, prompting calls for stricter federal rules.

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<sup>2</sup> Stanley Besen and Robert Crandall, *The Deregulation of Cable Television*, 44 LAW AND CONTEMPORARY PROBLEMS (1981): 78.

<sup>3</sup> By law, cable TV systems must offer a bundle of video networks as a “basic tier,” this package including local TV stations. This tier is a bare bones offering often called “limited basic.” The controversy over bundling of cable networks relates to tiers above this, generically called “expanded basic.” These larger tiers do not include premium channels, typically sold a la carte, or pay-per-view.

<sup>4</sup> Premium channels are offered on an individual basis, but after the basic channels are purchased as a bundle.

The logic appears so obvious that a formidable political coalition has formed to support regulation mandating that cable operators promote just this outcome. Groups such as Consumers' Union and the Consumer Federation of America allege that monopoly power has resulted in current cable industry pricing policies, and that only government controls can remedy the harm.<sup>5</sup> "Religious Right" organizations such as the Parents' Television Council simultaneously demand a la carte pricing mandates, motivated by a desire to enhance parental control over programming.<sup>6</sup> These groups see network bundling in the basic cable package as forcing parents to subsidize programs that their kids should not be allowed to watch and that they find offensive.

The FCC is being petitioned to enact rules mandating that cable operators offer channels a la carte. Interestingly, the Commission has recently switched sides in the controversy. In Nov. 2004, an agency report that found that a la carte rules would harm consumers, and FCC Chairman Michael Powell stepped down in early 2005 without taking regulatory action. In Nov. 2005, however, Powell's successor, Kevin Martin, condemned the FCC report for containing "problematic assumptions and presented incorrect and, at times, biased analysis,"<sup>7</sup> promising that a new agency study would demonstrate how a la carte rules could increase consumer welfare. Martin was lauded by pro-regulation groups.<sup>8</sup>

When the new study was released on Feb. 9, 2006, it argued that consumers could obtain 20 channels of their favorite programming (including six broadcast TV stations) at cost savings of between 3% and 13% under various scenarios.<sup>9</sup> Political leaders hailed the findings as a rationale for mandating a la carte.<sup>10</sup> The Parents Television Council, lobbying for a la carte rules, stated the case thusly:

We applaud the FCC and chairman Martin for bringing the truth to an issue where only lies and deceit had gone before. Cable choice will help,

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<sup>5</sup> Mark Cooper, *Time to Give Consumers Real Cable Choices* (July 2004), paper submitted by the Consumers Union and Consumer Federation of America to the Federal Communications Commission, *In the Matter of 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 (July 15, 2004) ["Cooper 2004"].

<sup>6</sup> Parents Television Council, *PTC Promotes Benefits of A La Carte Cable Television Programming; Senator John McCain and Diverse Group of Public Policy Organizations Join the PTC in Demanding Cable Choice for American Families*, Press Release (May 5, 2004); <http://www.parentstv.org/ptc/publications/release/2004/0505.asp>.

<sup>7</sup> Ted Hearn, *Martin: New FCC Study Favors a la Carte*, MULTICHANNEL NEWS (Nov. 29, 2005), <http://www.multichannel.com/article/CA6287703.html?display=Search+Results&text=Powell>. See also, Arshad Mohammed, *Cable By the Channel Favored, FCC Chairman Aims to Limit Indecency*, WASHINGTON POST (Nov. 30, 2005), p. D1, <http://www.washingtonpost.com/wp-dyn/content/article/2005/11/29/AR2005112901354.html>.

<sup>8</sup> Paul Davidson and Laura Petrecca, *A la carte Cable Could Be a Tough Sell*, USA TODAY (Nov. 29, 2005), p. 3B, [http://www.usatoday.com/printedition/money/20051130/fcc\\_consumers30.art.htm](http://www.usatoday.com/printedition/money/20051130/fcc_consumers30.art.htm).

<sup>9</sup> See discussion in Section V, below.

<sup>10</sup> "If a la carte is not more expensive for consumers, I will support an effort to take such an approach, subject to discussions with providers on the downside of such a process," Senate Commerce Committee Chairman Ted Stevens (R-Alaska) said in a prepared statement." Ted Hearn, *FCC Study Boosts A La Carte Pricing*, MULTICHANNEL NEWS (Feb. 9, 2006), <http://www.multichannel.com/article/CA6305989.html>.

not hurt, consumers. Consumers -- and especially families -- must be afforded the ability to pick and choose and pay for only those networks they want in their homes.<sup>11</sup>

Hence, the underlying economics of cable TV pricing are central to a raging policy controversy. In fact, the economics of channel bundling are both interesting and informative, and when combined with institutional factors, produce a policy conclusion: a la carte pricing rules will not be likely to improve consumer choice, increase efficiency, or lessen market power in the video marketplace.

## **B. The Economics of A La Carte Pricing**

This paper offers an economic analysis of a la carte pricing in cable. While the common interpretation is that consumers benefit when they get to choose one channel at a time, unbundling basic cable networks saves neither the cable operator nor the cable network a penny. In fact, costs for both operators and subscribers *increase* when basic cable tiers are customized. This is distinct from the corner grocery store, and renders an oft-repeated comparison highly misleading.

A household subscribes to basic cable if and only if the value of they place on the programming they *desire* to watch exceeds the retail price. That is true even though no customer watches every channel, but their own customized sub-set of programs. Effectively, the consumer subscribes to realize their individual preferences, and the cable company tosses in the additional channels for free. The practice is highly efficient. It dramatically reduces transaction costs and it prices marginal viewing choices at zero – exactly their marginal cost.

This is the socially efficient result, and it offers a creative market solution to an age-old theoretical problem in welfare economics. Social losses result when public goods – those that require investments to create but then require no additional costs for marginal units to be consumed – carry positive (per unit) prices. This squanders benefits that could be obtained were investments by producers to be recouped in a manner that did not restrict product availability. Subsidizing investments in public goods to compensate producers and then imposing price controls (at price = \$0.00 per unit) to distribute services to the widest possible audience, the government does not know which projects are worth their costs.

Bundling basic cable programs on an “expanded basic tier” offers a solution to this dilemma. Costs of the network provider (the cable operator) are largely recouped through a fixed monthly fee to access a large block of programming. Consumers then select the programs they wish to watch. If they do not obtain sufficient value from those programs, then they choose not to subscribe. Importantly, were a la carte pricing to be imposed, and (say) attach a \$1 fee for an additional network, it would deprive any access to customers who value the additional network at \$0.95. This constitutes a dead-weight loss to society, as no costs are saved by depriving the customer of access to the program

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<sup>11</sup> Prepared statement of L. Brent Bozell, Parents Television Council, as reported in Hearn, *ibid*.

channel, which is a classic example of a non-rivalrous good.<sup>12</sup> These losses are eliminated by large basic tiers which allow consumers to select programs, using the remote control and a wide array of blocking devices to eliminate channels deemed to be of zero (or negative) value.

The program bundling practices in the cable TV industry are far from unique. Not only is bundling ubiquitous throughout the economy, creating substantial efficiencies in production and distribution of goods and services, but bundling is pronounced in network industries like cable TV. This is why new entrants into the multi-channel video program distribution (MVPD) space, such as satellite TV and broadband service providers (BSPs), typically elect to offer even larger bundles to compete with cable incumbents. This strongly suggests that efficiency, not market power, drives the practice.

Policy proposals to require “a la carte pricing” actually cover a broad range of possibilities, from mandatory per-channel sales options (complete unbundling) to the offering of additional, “theme tiers” (which, e.g., would give families options that exclude programming inappropriate for children). Yet, with each approach, a practical reality dominates: Such rules are entirely irrelevant in the absence of rate regulation. That is because a mandate to price channels (or additional, smaller tiers) individually is thwarted by video providers by simply pricing the new content such that customers universally opt for the “extended basic” package. Forcing cable operators to price each channel separately, but failing to cap that price, renders the constraint non-binding.

But cable TV price regulation is a question that has been “asked and answered” – definitively. In multiple episodes of regulation and deregulation, both nationally and within state level regimes, rate regulation on cable TV systems is a demonstrated failure. The complexities of the video marketplace rendered price regulation unworkable; when rates were capped by authorities, cable operators and cable networks responded to these constraints by altering the nature, packaging, and quality of video programming services. Ultimately, video service quality is beyond the control of regulators both because service is exceedingly difficult to monitor, and because content quality is determined by private firms exercising their First Amendment rights.<sup>13</sup> No party today makes a serious attempt to resuscitate this regulatory corpse. Yet, without this enforcement structure, a la carte pricing rules constitute an inchoate policy idea.<sup>14</sup>

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<sup>12</sup> “Nonrival goods may be consumed by multiple people without diminishing the utility available to each user.” Wikipedia, <http://en.wikipedia.org/wiki/Non-rivalrous> (visited Feb. 23, 2006).

<sup>13</sup> See Hazlett & Spitzer (1997) for a book length treatment of multiple rate regulation episodes.

<sup>14</sup> The incompleteness of the a la carte policy solution does not render reform irrelevant. The path lies in the direction of policies that increase competitive pressure among service providers. This has been observed both with respect to satellite TV entry into MVPD markets, and with the introduction of head-to-head cable TV rivalry in specific markets. Either has been shown to lower retail rates. See William M. Emmons and Robin Prager, *The Effects of Market Structure and Ownership on Prices and Service Offerings in the U.S. Cable Television Industry*, 28 RAND J ECON 732 (1997); General Accounting Office, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, GAO-04-8 (Oct. 2003); David Reiffen, Michael Ward and John Wiegand, *Duplication of Public Goods: Some Evidence on the Potential Efficiencies from the Proposed Echostar/DirectTV Merger*, Univ. of Texas at Arlington Dept. of Economics Working Paper 03-006 (April 2004); Austin Goolsbee and Amil Petrin, *The Consumer Gains*

Still, a la carte pricing remains politically popular, and offers what equity analysts call “headline risk” for sector investors. Some measures may be enacted, introducing regulatory uncertainty even as pro-consumer outcomes fail to result.<sup>15</sup> Cable operators have announced plans to introduced “family tiers” in response to the controversy.<sup>16</sup> These packages will attract virtually no unique audiences; subscribers will add other tiers, ending up with similar services and comparable rates. For instance, Time Warner’s “Family Choice” service consists of 15 channels: “Boomerang, Discovery Kids, Disney Channel, Toon Disney and Nick Games & Sports... The Science Channel, DIY Network, Fit TV, Food Network, Home & Garden Television, La Familia, The Weather Channel, C-SPAN-2, C-SPAN 3 and Headline News.”<sup>17</sup> To get this tier costs \$32.98 per month (which includes limited basic cable and a digital set top box, necessary tie-ins).

The trick is that this package would satiate video network demand only in a household headed by an 8-year old. Adult subscribers, which number at least one per household, demand cable to (at a minimum) access such programming as ESPN, CNN, Fox News, Lifetime, USA, Discovery, WTBS, TNT, TMC, Oxygen, Comedy Central, CourtTV, A&E, TNN, MTV, and so on.<sup>18</sup> Purchasing additional tiers to gain back the news, entertainment, and sports channels quickly elevates the monthly bill up to the level extracted via “expanded basic” alone.<sup>19</sup> It is also ironic that the cable operator is forced to include the full complement of local broadcast TV signals on any package sold to subscribers, and these channels are now judged to offer some of the most offensive

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*From Direct Broadcast Satellites and the Competition with Cable TV*, 72 *ECONOMETRICA* 351 (2004); Hazlett (2005).

<sup>15</sup> This mirrors the experience in 1991-94, when cable TV shares (and bonds) were adversely impacted by re-regulation, even as the episode resulted in decreased subscriber growth, a perverse outcome for price controls designed to increase output. See Hazlett & Spitzer (1997, 163-69).

<sup>16</sup> “National Cable & Telecommunications Association president Kyle McSlarrow told a Senate committee Monday that Comcast Corp., Time Warner and other MSOs [multiple system operators] serving about 50% of all cable subscribers will offer a Family Choice tier, probably in the first quarter of next year, as their response to concerns about indecent content across the cable dial.” R. Thomas Umstead, *Time Warner Spells Out Family Tier*, MULTICHANNEL NEWS (Dec. 15, 2005).

<sup>17</sup> Ibid.

<sup>18</sup> It should also be noted that the “Family Choice” tier pointedly does not include some of the most popular and valuable children’s programming, including Nickelodean, Animal Planet, and PBS Kids.

<sup>19</sup> The mean cable subscriber bill, in 2003, was \$45.32 FCC, *In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992, Report on Cable Industry Prices*, MM Docket No. 92-266 (Rel. Feb. 4, 2005), par. 7. While these are the most recent FCC data on cable bills, the data can be updated by simply assuming annual increases of 5.4% (the rate of increase in 2003). This implies that the mean 2006 cable bill equals \$53.07, for which the customer receives access to 79.3 channels on expanded basic cable. (Since the package size – counted as number of channels -- was increasing at 4.1 percent in 2003, the 70.3 channels received via expanded basis in 2003 is projected to grow to 79.3 in 2006.) According to the FCC, the typical U.S. household can receive about 13 over the air broadcast TV signals, which are included on the limited basic tier. The “family tier” offered in this instance, then, results in an average bundle about 28 channels, and costs about \$33 monthly, or \$1.18 per channel. The typical subscriber, who receives expanded basic plus additional services (including premium channels), now accesses something more than 79 channels for about \$53 a month, or \$0.67. It is true that there are a good many channels in the expanded basic tier that are not important to this typical subscriber (with these unimportant channels changing from house to house), but it is equally true that the channels that are most important to the typical household’s adult viewers are entirely outside the “family tier.” This will drive the overwhelming majority of customers to existing market offerings.



Nonetheless, there exists robust support within the communications regulatory framework to regulate cable TV. This is observed in the historical pattern by which various rate regulation schemes have been tried, eliminated, and then tried again. The process affords policy makers the opportunity to gain valuable publicity, staking our high-profile positions as opponents of the cable industry standing up for consumer rights. Framing hearings, proposed legislation, or advancing FCC regulation to “hold cable’s feet to the fire”<sup>20</sup> identifies policy makers as advocates for the public interest.

Two beneficial outcomes result for regulators. First, concessions can be extracted for entirely unrelated purposes. Current reports suggest that FCC Chairman Kevin Martin is pursuing an “indecent agenda,” with the thought that he may return to North Carolina to run for a Senate seat.<sup>21</sup> Regulatory threats can be made by legislators who seek to gain support for other legislation, campaign contributions, or illegal bribes.<sup>22</sup> Cable executives lobbying regulators believe that cooperating on the FCC’s a la carte initiative by offering family-friendly programming tiers constitutes payment for Commission approval of a pending merger (Comcast and Time Warner acquiring Adelphia) and for slowing competition from telephone companies.<sup>23</sup>

Second, the failure of proposed remedies will not prove a liability to policy makers. Neither the statutory abandonment of cable rate regulation in the 1984 Cable Act or the 1996 Telecommunications brought any political cost to previous opponents. Similarly, the enactment of rate re-regulation in 1992 did not incur damage to previous champions of deregulation (sponsors of the 1984 Cable Act, e.g.).<sup>24</sup> In fact, policy failures general yield additional opportunities for favorable publicity, as long-time champions will again issue pronouncements as to the severity of the problem, this time warning that sterner measures are needed to “hold cable’s feet to the fire.”

While the politics are fascinating, so are the economics of a la carte. Throughout the video marketplace, indeed throughout network industries generally, product bundling is a key marketing strategy. With the rise of the “network economy,” understanding the

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<sup>20</sup> This is an oft-heard phrase in regulatory discussions and newspaper reports. See, e.g., Comments of the National Cable and Telecommunications Assoc., *In the Matter of Implementation of Section 304 of the Telecommunications Act of 1996*, Federal Communications Commission, CS Docket No. 97-80 (Feb. 19, 2004), 14.

<sup>21</sup> “The scuttlebutt inside the Beltway is that Kevin Martin has political aspirations beyond being chairman of the FCC. Now when he campaigns for Senate in North Carolina (as he’s expected to), he can say that he held cable’s feet to the fire and made it take real steps toward solving the indecency issue.” John P. Ourand, *Executive Editor’s Letter: A Decent 2006*, CABLE WORLD (Jan. 9, 2006).

<sup>22</sup> Fred McChesney, Money for Nothing: Politicians, Rent Extraction, and Political Extortion (Harvard, 1997).

<sup>23</sup> FCC Chairman “Martin has made clear in closed-door meetings that he would like Time Warner and Comcast to help advance his anti-indecency agenda. The companies are seeking to acquire Adelphia Communications Corp. for \$17.6 billion... Cable operators are not eager to pick a fight with the FCC. Although the agency lacks the authority to make new rules, it does have the power to rein in the industry on several fronts. For example, it will determine the speed at which phone carriers can enter the pay-TV business.” Sallie Hofmeister, *Cable TV Pressured to Clean Up Offerings*, L.A. TIMES (Dec. 9, 2005).

<sup>24</sup> Enactment of the 1992 Cable Act came dramatically, in an Oct. 5 over-ride of a veto by Pres. George H.W. Bush. This was the only veto, of 44 in the first Bush Administration, to be reversed by Congress. *Presidential Vetoes, 1989-2000*, Senate Publication 107-10 (Oct. 2001), ix.

role of multi-product packaging offers essentials insights. This understanding, in turn, can better inform both future policy debates in far-flung product markets, and the current policy debate raging over a la carte pricing in cable television.

## **II. THE BASICS OF BUNDLING**

### **A. Grocery Stores v. Amusement Parks**

The marketplace yields consumers a limited number of supplier-selected options. Customized products, when available, generally incur premium prices; “boutiques” cater to such preferences, charging higher prices relative to mass market goods. Packaging is one of the competitive margins on which firms attempt to attract customers. The benefits of a greater number of specially tailored choices are often offset by cost efficiencies derived from uniformity. A new car dealer offers buyers some options but not others: a Ford “bundle” is limited – don’t bother asking for a Chevy engine in your new Mustang. And buyers typically face lower prices when they choose among the few items in inventory (cars on the lot) rather than ordering their personal favorites from the factory.

In video, some critique the market as insufficiently responsive to consumer preferences. In a paper filed with the Federal Communications Commission, Mark Cooper argues the following:

In fact, cable operators give consumers almost no choice. If I really need two pounds of tomatoes for my spaghetti sauce, I have to take all five pounds and most of the other fruits and vegetables, even though the rest are of little value to me. My next door neighbor, who really needs two pounds of apples for her pie, is forced to buy five pounds of apples and the tomatoes and all the other fruits and vegetables, too. We both end up paying a higher price and, given the nature of the commodity, we cannot recapture the surplus through trade.<sup>25</sup>

This approach ignores two basic facts. First, the grocery store itself stocks a limited number of items and “forces” its shoppers to choose from the supplier-determined selection. Indeed, some very popular stores selling groceries – for example, Costco – markedly depart from the selections provided elsewhere. A Costco customer who desires just “two pounds of tomatoes” would be likely to “have to take all five pounds” – or more.<sup>26</sup> Given efficiencies in selling larger quantities (and stocking fewer distinct packages), some shoppers happily capture this discount-for-volume trade-off. Second,

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<sup>25</sup> Cooper 2004, pp. 39-40 (footnotes omitted).

<sup>26</sup> A facile response would note that, with groceries, the competitive retail market still yields many different package choices even if a given supplier offers only a select few. That is true and fully supports the conclusion offered: suppliers restrict the packaging choices they offer customers even under highly competitive conditions. The extensive use of expanded basic tiers by entrants in MVPD markets, discussed below, will also make this point. The market structure issue (retail grocery competition vs. MVPD rivalry) is shown to be distinct from the product packaging question involved in the a la carte controversy.

the cost structure of retailing groceries is distinct from that of delivering video programs via cable or satellite TV systems. In the case of the former, total costs are largely accounted for by the costs of goods sold. In the latter, network infrastructure costs (both for distribution plant and programming) are largely invariant to the number of units sold.

This latter factor fundamentally alters pricing decisions, as seen in a better analogy to cable television (than grocery stores): theme parks. A visitor to Disney World pays a fixed fee to enter the entertainment park, and does not receive a rebate should she simply ride *It's a Small World After All* before exiting. The die-hards who show up at dawn and experience every ride, exhibit, and show they can take in before closing pay exactly the same fee as selective tourists who partake of only their favorite attraction. The theme park has a cost structure more resembling that of the “video entertainment park” delivered by cable and satellite operators, who similarly charge customers a fixed entry fee for admission to a wide variety of attractions.

This is an apt example in light of Dr. Cooper’s argument: “The GAO reports that the typical household watches only 17 channels. People are being forced to buy a lot of programs they don’t watch to get the ones they want.”<sup>27</sup> Surely, the typical Disney World patron visits only a limited subset of the park’s total attractions on a given visit, even as they are charged a flat fee permitting access to every attraction. Yet, this pricing structure has proven efficient relative to alternatives, including the original Disneyland pricing scheme that featured both a fixed entry fee and special tickets (sold in bundles with admission fees) for particular rides.<sup>28</sup>

The sharp distinction in cost structures between grocery retailing and multi-channel video programming distribution masks a more fundamental pricing reality. Grocery store customers could also be viewed as being charged for services they do not consume, as when the 3 P.M. shopper is charged the same price as the 3 A.M. shopper in a 24-hour supermarket. This results in the low-cost (business hour) customer effectively assisting the high-cost (graveyard shift) shopper by paying the cost of conveniences they do not consume. Twenty-four hour grocery stores operate this way because, given that they are open during the day, they can profitably serve night customers – even if they would not serve those customers on a stand alone basis (i.e., by being open *only* at night).

This tends to go unnoticed because the common costs being apportioned are relatively small. The issue becomes more visible in the cable television business where a far higher percentage of total expenses do not vary with sales. This fact is of key significance in devising efficient pricing rules. Cable and satellite systems must first build distribution networks to carry video signals to subscribers, and a large part of the subscriber’s monthly bill compensates for these investments. Infrastructure costs, conversely, are only a small fraction of the cost of groceries sold.

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<sup>27</sup> Cooper 2004, p. 39.

<sup>28</sup> Walter Oi, *A Disneyland Dilemma: Two-Part Tariffs for a Mickey Mouse Monopoly*, 85 QUARTERLY JOURNAL OF ECONOMICS (Feb. 1971), 77-96.

If Subscriber A were to order just one channel, while Subscriber B orders 100, the cost of delivering service to the rival customers would be still about the same. No material savings are realized when the first subscriber decides to receive just one channel and to forego the other 99. Indeed, to the extent that the cable operator has to customize A's service by eliminating programs on a package popular with B and other subscribers, A imposes *greater* costs.

Issues of monopoly power commonly enter this discussion, as it is claimed that cable operators would have to offer greater choice in creating service tiers were there more competitors. But additional rivals have already entered this product space, and they reliably offer a choice of tiers, not individual channels, much as do incumbent cable operators.

<b>TABLE 1. BASIC TIERS OFFERED BY MVPD ENTRANTS</b>					
<i>MVPD Operator</i>	<i>Delivery System</i>	<i>No. of Cable Channels on Basic Tier</i>	<i>Price of Basic Tier</i>	<i>Minimum Contract Period</i>	<i>A La Carte Option for Basic Tier?</i>
[1] DirecTV <sup>[A]</sup>	Satellite	91	\$41.99	One Year	No
[2] EchoStar <sup>[A]</sup>	Satellite	72	\$31.99	Month	No
[3] RCN (WDC)	Overbuild	90	\$43.00	Month	No
[4] USDTV <sup>[A]</sup>	Wireless	26	\$19.95	Month	No

<sup>[A]</sup> Does not include local broadcast channels. [1] See <http://www.directv.com> (visited January 11, 2006). DirecTV states that there are over 155 channels on the basic tier, listing just 146 (of which 49 are XM music channels). [2] See <http://www.dishnetwork.com> (visited Jan. 11, 2006). DISH Network lists America's Top 60 as having 72 channels (none of which are music channels). [3] RCN customers are served by Starpower in Washington, DC. See <http://www.starpower.net>. [4] See [http://66.239.34.145/LV\\_OFF.php](http://66.239.34.145/LV_OFF.php) (visited Jan. 11, 2006)

Four such entrants are noted in Table 1. With both satellite TV providers, the nation's largest "overbuilder" (a head-to-head wireline cable competitor) and a new entrant leasing digital TV channel bandwidth to deliver basic cable networks to subscribers, basic service is sold via bundles. With some satellite services, moreover, *one year contracts* may be necessary in order for customers to obtain advertised service rates (bundling an entire year of programming).<sup>29</sup> This is often tied to the satellite TV operator's investment in the customer's receiving equipment, an upfront cost invariant to the amount of viewing time it provides thereafter.

When substantial costs are *fixed*, cost savings from fewer subscribers are trivial or non-existent. Here it is highly efficient for suppliers to encourage additional use through sharp volume discounts. In cable television, this results in perhaps one or two "expanded

<sup>29</sup> One year contracts are required, as noted in Table 1, for DirecTV's basic package. EchoStar offers a "no commitments" service agreement, but extends a \$49.99 rebate to with an 18-month contract. This effectively charges extra for the unbundled (month to month) service.

basic” tiers as the standard entry-level purchase.<sup>30</sup> This standard marketing structure exists irrespective of market power, observed both where incumbent cable operators realize considerable monopoly rents and where entrants possess none.<sup>31</sup>

Tier pricing in MVPD markets can be broken down into two components: (1) a charge to obtain access to the network; (2) additional charges for programming. With the expanded basic tier selected by the overwhelming majority of consumers, a flat monthly fee gains access to the network *and* to dozens of basic cable networks. In addition, premium services are then purchased, such as pay-per-view or pay channels such as HBO and Showtime.<sup>32</sup> Rather than being charged extra for cable networks that they do not want, subscribers are charged a monthly connection fee that comes with lots of zero-priced (after the subscription fee) programming. They then select what they desire to watch: their remote control customizes their viewing choices.

This is the theme park model. A basic admission price is exacted; those paying this entry fee then determine what attractions they wish to enjoy. Ancillary services (serving heterogeneous demanders) are also available for purchase. No rebates are given to those who eschew particular amenities, or desire to purchase a smaller “tier” of services than is offered by the operator.

Customer segmenting to reduce negative externalities is an issue. A family consuming Disney World’s amenities would find its utility decreased were Adults-Only revues to be located, with graphic billboard adverts, adjacent to the *Dumbo* ride, or were *Pirates of the Caribbean* to be slightly (or significantly) more bawdy.<sup>33</sup> As a theme park owner, Disney has strong economic incentives to boost demand by controlling both the quality of individual attractions (aligning content with demand) and costly spillovers, notably those that lower other patrons’ enjoyment. In practice, park owners take substantial measures to homogenize Disney World as a “family friendly” environment. Theme parks catering to adult tastes (e.g., Treasure Island) are physically removed, providing buffers demanded by consumers.

Cable and satellite TV operators have similar incentives and additional options. Given their electronic “amusement park” service, MVPD suppliers supply large bundles and cede viewing choices to subscribers. Consumers tailor their viewing experiences by multiple technologies. In a home without children, a simple channel selector is a

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<sup>30</sup> Note that all cable TV systems must offer a limited “basic tier” as the entry-level purchase due to regulatory mandates. These force the customer to purchase an initial bundle of video channels, including all over-the-air broadcast TV stations in the local market, in order to access any other programming.

<sup>31</sup> RCN, e.g., declared bankruptcy in 2004. Having “restructured” its debt, it continues to operate, but cannot be said to enjoy monopoly pricing power given its evident lack of supra-competitive returns.

<sup>32</sup> Additional (non-video) services are also offered by cable and satellite operators, including high-speed Internet access and (with cable systems) voice telephony. It is noteworthy that these services are offered in large bundles – broadband is priced at a flat fee for unlimited monthly use, e.g. These ancillary services are also bundled with video subscription service via highly discounted pricing for the “triple play” of voice, video, and data service. Indeed, the bundle may grow to include mobile phone service – a “quadruple play.” Michael Grebb, *Cable Wants to Cut the Cord*, WIRED (July 7, 2005).

<sup>33</sup> It is undoubtedly the case, given heterogeneous preferences, that some families believe that the current *Pirates of the Caribbean* is excessively lascivious.

sufficient control mechanism. With children, rules limited kids' viewing to prescribed channels is a crude but common method of limiting exposure to inappropriate content. A more precise and reliable solution is imposed by programming the cable or satellite set-top box, blocking certain channels. Alternatively, it is possible to employ a filter such as the V-chip.<sup>34</sup> Also, cable TV operators offer to remove certain channels upon request of the subscriber,<sup>35</sup> while satellite television providers have used their relatively easy to use blocking methods as a competitive tool since launching service in the mid-1990s.<sup>36</sup>

## B. Paying for Overhead

Shopping at a grocery store, a customer underwrites the fixed cost of operations (store rent, electric costs, personnel) implicitly in prices charged for individual items. Overhead costs (incurred for the benefit of all shoppers) are paid via charges tucked into product prices. This means that the customer buying \$100 of groceries generally pays a lot more of the electricity bill than does the customer buying just \$25. Because the common costs are a relatively small part of the total costs of the grocery store, however, the differences are not large. The \$100 shopper costs the grocery store nearly \$100 in the cost of goods sold, and the \$25 shopper costs the store only about one-quarter as much. Even so, stores try to reward \$100 shoppers through loyalty clubs and volume discounts.

The situation is markedly different when large upfront investments in infrastructure, such as are required to create an MVPD system, constitute the major expense in delivering service. This makes it efficient to price the supply of services

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<sup>34</sup> All TV sets 13 inches and larger sold in the United States (since Jan. 1, 2000) contain a V-chip, as per a provision in the 1996 Telecommunications Act. This is a filter that works with a rating system, allowing parents to set the level of protection desired (the TV set will not display programs with ratings that exceed the level set). *How to Prevent Viewing Objectionable Television Programs*, FCC website; <http://www.fcc.gov/cgb/consumerfacts/objectionabletv.html> (visited Jan. 11, 2006).

<sup>35</sup> *Control Your TV*, website provided by the National Cable & Telecommunications Assoc.; <http://www.controlyourtv.org/faq.php#q8> (visited Jan. 11, 2006). See also the website provided by About.com, *Parental Control Technology*, <http://kidstvmovies.about.com/od/parentalcontroltools/a/parentcontrol.htm> (visited Jan. 11, 2006).

<sup>36</sup> DirecTV, the largest satellite TV operator, features the following information on its web site:

“DIRECTV offers access to over 225 channels of programming entertainment. If you are a parent, you may want to limit the channels that your children are watching. Let's face it, you can't always watch what your children are doing. Maybe you want to order HBO programming, but you don't want your children watching it - or - maybe you have young children in the house and you don't want them to watch programs you deem unsuitable for their age. DIRECTV has a perfect solution!

“The Locks & Limits feature built into your equipment allows you to restrict unsupervised television viewing however you want to. You can block specific movies based on their MPAA rating, lock out entire channels, set limited viewing hours, or even establish spending limits on pay per view programming. This is a great feature for parents who wish to limit the programming that their children watch on DIRECTV, but don't want to limit their programming options, when they pick their programming packages.

“With the Locks & Limits feature, you can protect your children from flipping to channels that are inappropriate for their age group. There is no limit to the amount of channels that you can lock out from your children's view, and when it's time to watch what you want to watch, you can easily access the programming you like by entering your personal identification (PIN) number (see your owner's manual for details).” DirecTV web site, [http://www.expertsatellite.com/exp\\_page.php?pg=faqs.php](http://www.expertsatellite.com/exp_page.php?pg=faqs.php) (visited Jan. 11, 2006).

differently than in the case of the grocery store, where customers are charged, more or less, for what they consume. In fact, it is commonly said that the cable operator's customers are "subscribers," whereas the grocery store's customers are "shoppers." To support a network, companies establish ongoing relationships with consumers – selling not spot services, but *subscriptions*.<sup>37</sup>

A la carte pricing involves purchases of very small increments – implicitly, one network for one month. It is revealing that in the public debate the a la carte unit is assumed to be a monthly subscription to a single program network, or a small group of channels lumped together thematically.<sup>38</sup> But unbundling could also be applied to the purchase of program networks for shorter intervals (a day, an hour, a minute), or to the purchase of individual programs. Pay-per-view has long been offered by MVPD operators, at relatively high per-hour prices, but forms a very small part of the market, whether measured by revenues or (even less) by viewing time. Consumers much prefer the larger bundles.

It is well understood that there are important economies of scale in creating and supplying cable networks, and that restricting sales to too-small increments would destroy those economies, undermining consumers' interests in promoting valuable programming. Without artificial constraints applied by regulators, that logic drives creation of the bundle of channels sold on expanded basic cable.

In some situations, it appears controversial *not* to offer all-you-eat buffet pricing. This is the case with cable modem service, where broadband connections are priced such that subscribers pay the same monthly fee no matter how much content they download from the Internet. Interestingly, this form of bundling has been widely popular, crowding out earlier pricing plans (like used originally with AOL's dial-up access) that charged users according to how many online hours they used. Both consumer preferences and supply-side efficiencies are important to consider in evaluating pricing strategies.

### III. THE CASE FOR A LA CARTE

Proponents of a la carte pricing make two distinct cases for rules requiring cable operators to make individual channels available to consumers. Allowing consumers to pick and choose

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<sup>37</sup> Of course, magazines and newspapers also distribute their product via subscriptions, for similar economic reasons: the cost of selling that service to one given customer is small relative to the cost of serving customers generally. Note also that newspapers and magazines bundle content in a way similar to cable operators' bundling of channels. Readers rarely 'consume' all content, electing to read only that subset of articles of interest to them. This is true of the NY TIMES' customer who buys the paper to read William Safire's column, but is outraged by Paul Krugman's. Or vice versa.

<sup>38</sup> This relates to the 'a la carte light' policy suggestion that cable operators offer, if not individual channels for sale, then a larger number of tiers on which cable networks are clustered according to genre – news, family, sports, etc. The analysis of a la carte extends seamlessly to this alternative to expanded basic tier bundling.

- will reduce consumer cable bills (the *economic* justification).
- will end the flow of unwanted programming, with offensive content, into subscribers' homes (the *social* justification).

These rationales are theoretically independent of one another. The elimination of unwanted programming may provide a valuable service, such that cable subscribers would be willing to pay *more* for service with *fewer* (unwanted) channels. Yet, in practice, the arguments tend to converge. Those who espouse the social justification for a la carte also argue that prices for reduced bundles should be lower.

### **A. The Economic Rationale**

The reasoning that leads from a la carte pricing to lower cable bills stems from a belief that consumers are charged for basic tier channels that they rarely, if ever, watch. As summarized by Senator John McCain (R-AZ), chairman of the Senate Commerce Committee:

*À la carte* pricing would enable consumers to pay for only those channels they want to watch. It would undoubtedly benefit those consumers who watch only three or four cable channels or who may be on a limited budget. It may also have the effect of disciplining cable rates overall.<sup>39</sup>

This reasoning connects to the claim that a la carte pricing would allow consumers to reveal what programming is most popular. The current bundling practice is used by cable operators, according to regulatory advocates, to favor their preferred programming (which they enjoy financial interests in) over what customers demand:

The [cable] companies never offer channels on an a la carte basis to determine if consumer demand exists. Consumers are forced to pay for the added, low value channels because they do not want to give up the whole bundle. Since there is little competition and the competitors offer bundles too, there is no real alternative. Cable industry claims that its prices should be evaluated on a per channel basis must be rejected by policymakers for the simple reason that they do not allow consumers to buy its services that way.<sup>40</sup>

### **B. The Social Rationale**

Some proponents of a la carte pricing argue that families should not be forced to support programming they find objectionable. It is not sufficient that these households do not watch, or may block, the channel. As put forth by L. Brent Bozell, III of the Parents Television Council:

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<sup>39</sup> Letter to The Honorable Michael Powell (Chairman, Federal Communications Commission) from Senator John McCain (May 19, 2004).

<sup>40</sup> Cooper 2004, p. 40.



The cable industry argues that parents have the option of blocking channels they don't want. But what kind of a choice is that, when they still have to pay for those channels? There is something terribly and fundamentally wrong with requiring consumers to pay for a product they don't want, and may even find offensive, in order to get something they do want. It's like a grocery store telling you that in order to buy a gallon of milk; you also have to buy a six-pack of beer and a carton of cigarettes. But that is exactly what the cable industry has been forcing cable subscribers to do for years.<sup>41</sup>

This perspective suggests that an alternative cable menu, one offering subscribers the opportunity to create their own customized tiers, would allow individuals to determine what kinds of programming their purchases support. This new marketing approach would then quarantine the video viewing purchases made by Household A, interested in only watching the Family Channel, PBS Kids, Fox News and Animal Planet, from those of Household B, which is interested in MTV, Speedway, E! and Bravo. Consumers would succeed in customizing their viewing fare such that the channels coming into their home were, all things considered, more valuable to them.

This brings the social perspective into conformity with the economic rationale. The confluence is affirmed when proponents of the social view extend the argument (as seen in the passage above) to suggest that consumer charges would then be lower for channel bundles of reduced size.

### C. Economic Analysis

The actual economics are quite different from how they are portrayed in the popular argument for regulation. Customers pay a standard fee for access to a given package of channels, but because each places a distinct value on the services within the package, each pays a different price for the component parts. This is an effective way to share the costs of the fixed infrastructure necessary to create and distribute cable programs. Household A – with family-oriented viewers – subscribes to get access to its favorite channels, while Household B pays to gain access to its racier choices. *Neither pays for the other's selection, but for the network infrastructure from which they jointly gain advantage.* Two implications emerge:

- No cost savings would be realized if either A or B were to receive a smaller package of channels, as the marginal cost of video transmissions equals zero;
- Neither A nor B would benefit from being served by a separate network, as they each benefit by sharing overhead costs with other users – including those with dramatically different tastes and preferences.

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<sup>41</sup> Statement of L. Brent Bozell, III, Founder and President of the Parents Television Council on Cable Choice, May 5, 2004. See <http://www.parentstv.org/ptc/publications/email/plain.asp>, (visited July 20, 2004).

When all subscribers *pay one price* to receive a standard package of channels, they will nonetheless *watch a different mix* of shows. Some households may desire to block certain networks – less may indeed be more, particularly where children are concerned. That customization provides incremental value because just those who desire to block, do so, and because the costs of eliminating specific networks in targeted households is not large. This allows an important economic efficiency: support payments for network infrastructure capable of serving diverse sources of demand.

While it appears that subscribers are being charged for programs they *do not* demand, the fact is that they only pay the subscription fee if the value of the programs they *do* demand exceeds the fee. In reality, they only pay for the tier programs they desire to receive, and the cable operator throws the additional channels in for free. Some may not be wanted, and will not be watched. If inconvenience or irritation are involved in avoiding such programming, these costs are internalized by profit-maximizing MVPD suppliers, which seek to make their services desirable to potential subscribers. But these costs will be weighed against the benefits to consumers of including extra channels. Consumers generally prefer more options, while basic cable networks, which can more effectively compete for audience share once subscribers once they are included in the basic tier of programming, lower license fees in exchange.

While both the economic and social arguments for regulation suggest that knocking unwatched channels off the basic tier will result in cost savings, the premise is false. Video program networks are public goods, and limiting access by infrequent viewers, or even never-time viewers, does not conserve scarce resources.

In fact, constraining the size of the expanded basic tier imposes costs on both subscribers and program networks. Asking households to select exactly those channels they will watch later in the month (or year) is a demanding, time-consuming request. It is expensive, requiring company staff personnel and, in most cases, digital set-top boxes. And because nothing is saved by eliminating a program network from a given cable TV connection, the dividend promised by a la carte fails to materialize.<sup>42</sup>

While customers see one price for a standard package, economists identify this situation as involving price discrimination because consumers effectively pay *different* prices for the *same* channel. The practice is common. A well known, and more visible, example involves airline tickets. The airlines know that business travelers are typically willing to pay more for a given seat than a vacation traveler. By charging higher prices for trips that do not include a Saturday night stay-over or are made without a 21-day advance purchase, the business traveler (placing large value on flexibility) is charged a high price, while the tourist (willing to change plans to travel when fares are cheap) is

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<sup>42</sup> While cable operators routinely pay cable network license fees on a per-subscriber basis, this does not change that argument that zero economic savings are associated with reduced network coverage. First, license fees are transfers between businesses; historical program costs are invariant to the incremental consumer's decision. Second, these payments can and would be restructured were wide coverage on basic tiers removed. This is seen in the case of premium channels, which carry far higher per-subscriber license fees. It is also seen in a la carte price schedules offered in the C-Band satellite TV market and, for a small number of services, the DBS market. See discussion below.

charged much less. Price discrimination also exists in hotels, movie theaters, and restaurants, all examples where an inventory (rooms, seats, or tables) is worthless if not utilized. This parallels the situation in multi-channel video programming, where marginal channels have no value withheld from basic cable subscribers.

When customers with distinct tastes purchase a basic tier of cable programming, they do so for different reasons. The cable operator gains little by sorting out which channels they have expressed a desire for; viewers are quite capable of manipulating their own remote controls, and most do not desire to limit their options. Moreover, the transactions that take place allow rival consumers to pay for the programming they value – whether it be 17 channels<sup>43</sup> or 91<sup>44</sup> – and to pay a lower price for what they want because other households are helping to support the fixed costs common to all services.

This contribution to infrastructure funding yields investors the incentive to create both physical distribution networks and programming, and is particularly crucial to inducing competitive entry. This is seen in the manner in which the new entrants typically offer very broad, diverse bundles (Table 1), and in the allegation that actions limiting the ability of entrants to assemble such large basic tiers (say, when exclusivity agreements with incumbents limit access to particular programs) undermine market rivalry.<sup>45</sup>

The economic explanation of basic cable tiers, then, undercuts the charge that customers who do not wish to receive a channel are subsidizing that channel by receiving it in their basic subscription. A household exclusively populated by sports fans rightly views its cable bill as the price of admission to televised sports events, while a household composed only of classic movie buffs correctly views its subscription as a ticket to old motion pictures. They pay for what they demand, and either payment is less than what it might otherwise be if less efficient marketing mechanisms were used to enlist subscribers and to finance common costs.

A simple numerical example illustrates. Suppose the market consists of four viewers, Tom, Dick, Harry and Moe, and two cable networks, ESPN and Discovery. Costs do not depend on the number of subscribers, as network infrastructure and cable programming costs are sunk. Each individual's willingness to pay, summarized in Table 2, reflects the following.

- Tom and Dick like ESPN more than Discovery
- Harry and Moe prefer Discovery to ESPN
- Tom and Harry are willing to pay more for TV service than Dick and Moe

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<sup>43</sup> “The GAO reports that the typical household watches only 17 channels” (Cooper 2004, p. 39).

<sup>44</sup> See Table 1.

<sup>45</sup> “Bundling is critical to entry into the emerging digital multimedia market” (Cooper 2004, p. 32; footnote omitted).

<b>TABLE 2. CONSUMER DEMAND FOR CABLE NETWORKS</b>			
	ESPN (\$)	Discovery (\$)	Total Willingness to Pay (\$)
Tom	6	2	8
Dick	4	1	5
Harry	2	6	8
Moe	1	4	5
Total Value	13	13	26

Suppose the cable company charges a single price for each channel – a la carte. The firm then maximizes its revenue by charging each subscriber \$4 per channel. At this price, two customers subscribe to ESPN (Tom and Dick), while two subscribe to Discovery (Harry and Moe). Total revenue equals \$16 ( $4 \times \$4$ ). The value created is represented by consumers’ surplus, the difference between what a consumer is willing to pay and what it does pay (price). Here, Tom gains \$2, as he is willing to pay \$6 for ESPN, which he buys for \$4. The same holds for Harry with respect to Discovery. The other channel purchases produce no value above their cost to consumers. In aggregate, consumer surplus is \$4. (Note that total consumer value equals \$20, while total revenue equals \$16.) Charging a different price for either channel does not increase the cable operator’s revenue.<sup>46</sup>

Now suppose that the cable company abandons a la carte, bundling both networks on a tier priced at \$5. All four consumers subscribe, because each potential customer values the bundle at \$5 or more. In aggregate, consumers now pay \$20, and receive \$26 worth of viewing. Consumers as a whole realize a surplus of \$6 ( $=\$26 - \$20$ ), or \$2 more than under a la carte. This gain comes from the efficiency of allowing all programs to go to all customers, the “expanded basic” approach. When this obtains, content is distributed even to marginal demanders with modest desires. This is precisely the efficient result, of course, because it cost nothing to allow additional viewers to enjoy existing video programs.

The result of bundling in MVPD markets, then, is that consumers gain (through increased viewing choices) while program producers gain (through an increase in revenues). Ultimately, the payments made to programmers also create new value for customers, as competition to produce popular video content intensifies. Moreover, transaction costs are dramatically reduced under basic cable bundling, as discussed below.

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<sup>46</sup> Charging *different* prices for the *same* channel could increase profits, posting a high price to high-demand customers, lower prices to others. The cable operator, however, does not know how who to charge extra, and does anticipate being able to rely on high-demand customers to volunteer their identity.

#### IV. COSTS AND BENEFITS OF BASIC TIERS

The marketing of bundles solves a potentially difficult economic problem: how to achieve efficient distribution of services that entail substantial costs to create, but virtually no additional costs to share. This has historically been referenced, in fact, as the “marginal cost controversy.”<sup>47</sup>

##### A. The “Marginal Cost Controversy”

Economist Harold Hotelling long ago pointed out that the provision of public goods (such as TV programming, which was an example later used explicitly<sup>48</sup>) entails a fundamental economic problem.<sup>49</sup> The cost of providing a public good to an additional consumer is effectively zero. To deny that additional customer the enjoyment of that good or service, then, is inefficient: greater social value could be generated (as measured by consumers) at no extra cost. This is an extension of a basic postulate that any price above marginal cost creates economic waste by restricting access to goods even when consumers are willing and able to pay the incremental costs of their consumption.

The problem that arises is that pricing a public good at its marginal cost, while efficient once the good is created, will not compensate the supplier for creating the product in the first place. To create a cable TV distribution grid is expensive, as is the creation of cable TV programming. If private investors are to provide valuable public goods, like cable TV systems and cable TV programming, then prices (above zero) must be charged.

Hotelling suggested that markets would fail to efficiently provide the valuable services demanded by consumers, and that government subsidies and/or regulations would be necessary. Without such policies, markets would under-provide the services customers demanded. Ronald Coase responded that markets could provide such services efficiently – relative to government provision, subsidy, or regulation – via pricing strategies that would both allow firms to recover their investments and permit consumers to efficiently utilize the public goods produced.

The key innovation was multi-part pricing. If the fixed costs incurred by suppliers could be compensated with, say, subscriber fees that gave each paying customer access to the public good – in this case, a cable TV network – then additional services could be priced at their (low) incremental costs. This approach retains the efficiencies of competitive markets, wherein new networks (for distribution or content) are constructed by investors who risk capital based upon their assessment of long run consumer demand.

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<sup>47</sup> R. H. Coase, *The Marginal Cost Controversy*, No. 51 *ECONOMICA* (August 1946), reprinted in R. H. Coase, *The Firm, The Market and The Law* (Univ. of Chicago Press, 1990), pp. 75-93.

<sup>48</sup> Paul Samuelson, *Public Goods and Subscription TV: Correction of the Record*, 7 *JOURNAL OF LAW AND ECONOMICS* (1964), pp. 81-84.

<sup>49</sup> Harold Hotelling, *The General Welfare in Relation to the Problems of Taxation and of Railway and Utility Rates*, 6 *ECONOMETRICA* (July 1938), pp. 242-69.

The alternative, relying on government to value competing investments, is likely less efficient.

The adaptation of MVPD markets to multi-part pricing is straightforward. Subscribers pay an entry-level fee in the form of the expanded basic tier subscription. This supports the outlay of fixed costs that create the underlying distribution network. They also support the fixed costs of an array of programming choices, choices which give value to the underlying distribution grid.<sup>50</sup> These investments are largely invariant to the number of customers who purchase service. Once a subscriber has purchased access, a large bundle of services are supplied to the customer at marginal cost -- zero. In this way, a two-part tariff collapses to a standard monthly subscription fee.

The solution to the “marginal cost controversy” enables cable and satellite firms to provide service, recover their costs, and capture market efficiencies. The subscriber pays a monthly fee if and only if the value of the service package exceeds the basic tier price. For the U.S. market today, MVPD subscribers constitute about 88% of total TV households,<sup>51</sup> suggesting that relatively few customers are deterred by this entry fee.

When consumers enjoy public goods, they enjoy the benefits of *joint production*. This means that people are able to efficiently obtain goods or services when costs are shared between many users. As millions of households subscribe to MVPD services, and view programs created for cable TV networks, the economic burden of creating these choices is spread across millions of audience members. Given the diverse tastes and viewing habits of the population, this sharing is undertaken for different reasons. And the reasons may even conflict, as when one viewer objects to the content viewed by another. But each cooperates because it advances *their* interests, bringing them programming that they value, and which would otherwise (without such cooperation) cost them more.

Market forces based on bundling have improved networks and upgraded service. DBS operators have, since their mid-1990s entry, offered a large number of channels in their competitive basic tier. Cable operators responded with huge capital improvements to provide additional services (including digital program tiers and high-speed internet access). The largest U.S. cable operator, Comcast, has alone spent \$40 billion over the last eight years upgrading its systems, reportedly to better compete with satellite television services.<sup>52</sup> Nasty, intensely competitive inter-modal ad campaigns have emerged.<sup>53</sup>

The burgeoning of platform-based competition has encouraged a vast assortment of innovative programming. Since the emergence of DBS the number of networks has tripled, with Fox News, Boomerang, PBS Kids, ESPN News, ESPN Classic, Spike,

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<sup>50</sup> Note the complementary values of conduit and content. Either is worth considerably less without the other.

<sup>51</sup> *FCC Tenth Annual Report*, App. B, Table B-1.

<sup>52</sup> Derek Caney, *Facing Competition, Comcast Fights Back*, REUTERS (June 30, 2004); Lehman Brothers, *Cable Television Industry Technology & Capital Expenditures* (July 29, 2002), p. 5.

<sup>53</sup> Nat Ives, *Cable And Satellite Companies Take Their Battle For Television Viewers Into The Mud*, NEW YORK TIMES (Nov. 24, 2003), p. C9.

Oxygen, We, Logo, and Biography added to MVPD line-ups. Discovery, which began as a single network, has blossomed into 14 domestic U.S. networks, including Discovery Health, Discovery Times, and Discovery Kids.<sup>54</sup> Individual consumers are not likely to watch each of these, but the expanded choice affords valuable options.

## B. Competitive Entrants Bundle

DirecTV and Echostar, recent entrants into the MVPD market, illustrate the efficiencies involved in multi-channel video distribution. Here, entrants into the market – and firms having little or no financial interest in program networks<sup>55</sup> – offer very large basic tiers. DirecTV's smallest package consists of over 90 video channels.<sup>56</sup> Echostar's consists of 72 channels.<sup>57</sup> Cable operators offer, on average, 62.7 channels in their basic tier.<sup>58</sup> Given that over 22 million households have been attracted to the new, larger channel packages, the evidence is that many customers attach value to the additional channels. It also suggests that the market power of cable companies is not driving the all-you-can-eat menu. Rather, competitive market forces are expanding the size of the tier.

Similar observations emerge from the market for audio programming. Two companies, XM Satellite Radio Holdings and Sirius Satellite Radio, have recently begun to transmit radio programming by satellite. XM and Sirius face a difficult challenge in charging subscription fees for radio broadcasts. Further, each has incurred substantial sunk costs. Neither, however, offers radio channels on an a la carte basis. (They do offer premium services after the purchase of the basic service.) Both XM and Sirius offer more than one hundred channels in their entry-level package.<sup>59</sup> XM offers 160 channels while Sirius offer over 120 channels.

Competitive pressures to offer programming in packages is also faced by those that provide music over the internet. RCN Corporation, an “overbuilder” (which has emerged from A 2004 bankruptcy) provides phone, cable and high speed internet services in direct competition with cable and phone operators. RCN offers subscribers a premium service called Interaction Music.<sup>60</sup> For \$7.95 per month, customers have unlimited

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<sup>54</sup> Discovery Networks website, <http://corporate.discovery.com/> (visited Feb. 23, 2006).

<sup>55</sup> A substantial interest in DirecTV has recently been sold to the News Corporation, which owns Fox Television and other programming networks. Yet DirecTV launched and grew rapidly from 1994-2003, prior to this integration. The ownership change appears to have virtually no impact on the question of how DirecTV bundles basic services. And the practices of (non-integrated) EchoStar are similar.

<sup>56</sup> See Table 1.

<sup>57</sup> See Table 1.

<sup>58</sup> Federal Communications Commission, *Report on Cable Industry Prices, In the Matter of Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment* (July 8, 2003), Par. 4.

<sup>59</sup> See [http://www.xmradio.com/service\\_subscription/service\\_subscription.jsp](http://www.xmradio.com/service_subscription/service_subscription.jsp) (visited Feb. 21, 2006) and <http://www.sirius.com/> (visited Feb. 21, 2006).

<sup>60</sup> RCN Corporation press release, “RCN Launches New Fully Integrated RCN Interaction Music Subscription Tier,” July 6, 2004 (see <http://www.rcninteraction.com/music/signup.jsp> (visited Feb. 21, 2006)).

access, including the ability to stream, download and copy, any of the more than 1.2 million songs available through MusicNet and Synacor.

Efficiencies associated with bundling are evident in other sectors, as well. Like cable networks, newspaper and magazine producers face high fixed costs and low marginal costs. The standard sale, then, bundles a large amount of product for a fixed fee, and large discounts are given to subscribers – those who buy a large number of such basic bundles. Subscribers to the *New York Times* are not given a choice between the columns of Paul Krugman (a noted liberal commentator) or David Brooks (a conservative), or allowed to buy just the Times’ international news while omitting business and sports. All subscribers receive the same content, and then make their own choices about what stories, columns, or sections to read.<sup>61</sup>

It is stunning that newspapers are sometimes offered as analogies for an unbundled business model. Writing in *National Review*, one advocate of a la carte pricing for cable TV systems writes:

[C]able consumers face an all-or-nothing choice. This would be analogous to requiring consumers to purchase the Sunday edition of the *Washington Post* with a *Penthouse* magazine insert...

If cable operators unbundled their programming, parents could buy the Discovery Channel, Nickelodeon, and other family-friendly fare without being forced to pay for objectionable material...

[O]perators could offer a “block and reimburse” option to consumers. Currently, cable providers have the technological capability to block individual channels, and many already provide this service to consumers. It’s only fair that consumers be reimbursed the per-channel fee of the channels they choose to block.<sup>62</sup>

But the *Washington Post* Sunday edition comes with a *Washington Post Magazine*, and consumers that would prefer a *New York Times Magazine* or *Parade* or, for that matter, *Penthouse*, are not given “block and reimburse” options. They then decide to either buy the *Post* – all its sections and features – and, if so, which parts of the paper to enjoy. If the expected value of the parts they plan to enjoy exceed the price, they will rationally elect to purchase. Customers with distinct preferences will end up purchasing the bundle, gaining utility from different features. The model precisely tracks that employed by cable TV systems.<sup>63</sup>

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<sup>61</sup> Increasingly, newspapers attempt to charge for individual articles in the online archives. This mirrors cable TV system pricing patterns for premium channels or pay per view.

<sup>62</sup> Cesar V. Conda, *Cable, à la Carte?* NATIONAL REVIEW ONLINE (Jan. 12, 2006).

<sup>63</sup> Other examples of bundled subscription prices (and heterogeneous consumer valuations) are found in health clubs, ski resorts, and theme parks, all of which are characterized by large sunk costs and low marginal costs.



### C. Cost Savings from Bundling Basic Cable TV Networks

Both consumers and cable system operators reduce their transaction costs when networks are sold as a bundle. Consumers do not have to make complex decisions over future viewing choices when they sign up for cable service. Instead of evaluating each channel before subscribing to it, a consumer can browse the expanded basic package at their leisure. A broad bundle of channels also eliminates the need to reconfigure selections as tastes or program networks change. In lieu of placing orders, subscribers merely use their remote control.

The cable system operator also enjoys transactional savings in order processing, a task that is greatly complicated when the number of distinct packages delivered increases from a limited number of standard tiers to all possible channel combinations. The MVPD will have to track these idiosyncratic menus in its operations and billing systems, incurring increased expense.

Implementing an a la carte pricing mandate could create significant new infrastructure and operating costs for cable TV operators.<sup>64</sup> The devices needed to control a la carte channel access at each cable customer's home are not ubiquitously deployed, nor are the billing or customer support systems. Deploying these capabilities will create additional costs, both for operators and their customers.

Customizing cable packages sent by cable systems can generally be done in one of two ways. For channels that are broadcast through the cable system in analog format, traps block individual channels. Traps are relatively expensive to install because they must be placed on the cable conduit near the customer's home by a cable company employee. Current trap technology implies that the quality of untrapped channels could be degraded when more than a few channels are blocked.

The more sophisticated way to customize basic cable program packages is by use of addressable digital set-top boxes, the equipment now commonly used to supply mini-tiers, such as sports packages, and pay-per-view. This requires programming to be digitally formatted. To implement a la carte pricing, cable operators could either convert their systems to all-digital formats (abandoning analog), or duplicate analog programming on digital channels.

Today, about 38% of cable households have at least one addressable digital set-top-box.<sup>65</sup> Converting a cable system to all-digital would require all subscribers to have a digital set-top box, regardless of their programming choices. In 2006, Comcast rents customers digital boxes for \$2.75-\$3.50 per month depending upon your location.<sup>66</sup> Such a fee would be incurred for each TV. That includes boxes for all sets in the approximately sixty percent of U.S. cable households that do not yet subscribe to digital

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<sup>64</sup> Other suppliers, such as DBS, have network infrastructure that may better accommodate a la carte.

<sup>65</sup> This assumes that each digital cable subscriber has a digital box, and that each non-digital cable subscriber does not. Website of the National Cable & Telecommunications Assoc., <http://www.ncta.com/Docs/PageContent.cfm?pageID=86> (visited Feb. 23, 2006).

<sup>66</sup> Comcast website, [www.Comcast.com](http://www.Comcast.com) (visited Feb. 22, 2006).

cable, as well as for cable-connected sets in digital cable households that still receive analog feeds. This involves substantial costs. Given that satellite systems already using all-digital formats choose not to offer a la carte, however, suggests that the benefits would be insubstantial.

In truth, such transaction costs pale beside those that would be imposed on cable TV networks themselves. A la carte regulation would severely tax both existing and new cable program networks, because it would undermine fundamental marketing efficiencies – subtle and unseen in the public debate – that make it possible for cable TV to effectively compete in the entertainment marketplace. This accounts for universal condemnation of a la carte rules by cable TV programmers, which itself constitutes key evidence. If a la carte pricing dissipated monopoly power exercised by system operators and empowered consumers, it would predictably increase demand for cable TV programs. Instead, programmers see a la carte as a threat to their very businesses, as seen in the following sub-section.

#### **D. Cable TV Networks Vigorously Resist A La Carte**

Consumers Union and the Consumer Federation of America characterize present marketplace opportunities for innovative new networks as grim, largely due to bundling practices, and illustrate with the following:

Stephen Cunningham, CEO and president of start-up channel JokeVision, summed up his network's fate with a morbid sense of humor: "Have you heard the one about the cable programmer who paid no attention to a Comcast suggestion? He's not around any more."<sup>67</sup>

The CU/CFA Comment takes this comical dark side to underscore the argument that MVPD operators bundle networks to both force additional channels on victimized consumers, and to deny channel space to independent programmers. Instead of allowing new competition, operators simply fill slots with less worthwhile programming in which they maintain a financial interest. The CFA's Mark Cooper writes:

Because the current system is so discriminatory against independent programming, we believe that a la carte could expand the opportunity for independent programming.<sup>68</sup>

The argument is extended to niche programming and, particularly, to content targeted for underserved socio-economic groups: "Now if we had a la carte, more African-American themed and owned channels could be created and offered to consumers of color."<sup>69</sup>

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<sup>67</sup> Consumers Union and Consumer Federation of America, Comment submitted to the Federal Communications Commission, *In the Matter of 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 (July 15, 2004), p. 5.

<sup>68</sup> Cooper 2004, p. 8 (original text in boldface).

<sup>69</sup> Consumers Union and Consumer Federation of America to the Federal Communications Commission, *In the Matter of Comment Requested on A La Carte and Themed Tier Programming and Pricing Options for*

This assertion is rejected by evidence in the record. Program networks virtually unanimously oppose a la carte, as seen in Comments filed with the FCC. This opposition encompasses established networks, such as Discovery, fledgling networks, such as Bloomberg News, and start-ups, such as Altitude Sports & Entertainment. It applies to programmers affiliated with cable companies, such as Turner Broadcasting, to networks owned by companies with TV broadcasting interests, such as Viacom, to independent networks, such as the Weather Channel, and to non-profit networks, such as C-SPAN.

And as for the specific assertion that “more African-American themed and owned channels could be created and offered to consumers of color” under a la carte, the MBC Gospel network writes: “The end result of such government intervention would be the death of independent programmers and fewer programming choices for consumers, particularly African-American viewers who already receive disproportionately few services.”<sup>70</sup> TV One, a recently initiated African-American program venture, adds that a la carte requirements “would shrink the audience base for newly launched networks and networks intended for minority tastes, seriously eroding the advertising base needed to sustain programming efforts.”<sup>71</sup> According to *actual* African-American program networks trying to get established in the video marketplace, a la carte would impose substantial barriers to entry.

The overwhelming opposition of programmers is based on a crucial economic consideration: *each cable network needs to get its programs to where viewers can see them, and imposing a la carte will make that harder.* Providing customers with a large bundle of channels for a standard monthly fee has delivered exceedingly important efficiencies, and forcing customers to order one network at a time would eliminate those advantages.

Consider the simple calculus of a new basic cable network. Launching a venture typically requires upfront investment of about \$85 million to \$150 million.<sup>72</sup> These capital outlays create programs, mold them into a branded product, and arrange delivery to viewers. Of course, the start-up entrepreneur studies existing networks, observes viewing preferences, and conducts extensive market research in creating this additional option. But the key link connecting this creative opportunity with market success is

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*Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), pp. 5-6.

<sup>70</sup> Comments of MBC Network, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry 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 (July 15, 2004), p. 9.

<sup>71</sup> Supplemental Comments of TV One, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry 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 (July 15, 2004), p. 2.

<sup>72</sup> Declaration of Larry D. Gerbrandt, Attachment to the Supplemental Comments of TV One, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry 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 (July 15, 2004), p. 4.

*information flow.* Consumers are not aware of this new viewing choice, and will not gain utility from its presence until they are made aware of the value it delivers.

Gaining carriage on a popular basic tier is the economical way to bridge that informational gap. By successfully marketing to a finite number of cable and satellite operators, the start-up launches its product to a potential audience of millions. Having accessed the viewer's TV set-top box, the new network can easily be sampled by potential customers who may previously possess little or no information about this new viewing option. This constitutes a low cost method of delivering both the product, and valuable information about the product, to millions of households.<sup>73</sup>

*Extremely low cost,* in fact, relative to the relevant alternative: *a full-blown national marketing campaign to enlist the active support of 110 million households.* This is the practical implication of a la carte, where government rules would require that each customer individually evaluate each network ex ante (i.e., prior to seeing it in their local cable system), and then make an affirmative decision to order it.<sup>74</sup> For a niche network that hopes to reach ½ million homes each day with specialty programs, the goal pursued by many start-ups, one national ad campaign designed to reach this universe could swamp the *entire* allotment of risk capital. Moreover, the vast majority of advertising expense will predictably be wasted, because viewers are currently dispersed across existing audiences – precisely the rationale for creating a new niche. And presenting an even higher barrier to success is the fact that each potential viewer has to process the information conveyed, evaluate it, and then act on it, calling up his/her cable or satellite operator and then ordering a channel they have never seen.

Cable and satellite operators aggregate content. Consumers benefit by using a purchasing agent to assemble and deliver a diverse program menu. Operators are compensated by how well they meet subscribers' expectations, and seek to provide popular choices. To select among potential program channels, they employ complex

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<sup>73</sup> In a Comment in this proceeding, A&E Television Networks (AETN) writes: "Current research demonstrates the importance of such sampling. It shows that consumers have difficulty recalling even the best-known multichannel programmers without a reminder of their availability. Among subscribers to cable systems that carry A&E and the History Channel® [owned by AETN], fewer than one in five, on average, are able to name either channel through unaided recall as a network available to them. This is the case even though the History Channel® had the fourth-highest unaided recall score among major networks, and A&E was not far behind. With aided awareness of the channels, however, nearly nine out of ten recognize A&E and the History Channel® as available programming choices. This is a strong indicator that viewers 'surfing' bundled channels and finding an AETN network are likely to recognize it and, if interested in the programming they encounter, tune in, whereas it is unlikely that viewers lacking access to an AETN will think to seek it out, even if AETN were to substantially increase its marketing budget." Comments of A&E Television Networks, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry 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 (July 15, 2004), p. 12 (footnotes omitted).

<sup>74</sup> This also applies to 'a la carte light' mandates, forcing MVPD systems to offer smaller tiers than the current expanded basic, because it would block the low cost transactions path connecting excluded program networks and viewers. A similar outcome would ensue from 'voluntary a la carte,' which would involuntarily limit contracts between program networks and MVPD operators, potentially forcing networks into far more costly (and less effective) marketing efforts in order to gain access to TV households.

metrics, evaluating customer value by investing heavily in survey information, viewer ratings, and economic analysis of subscription differentials. The joke cited as representative of the industry dynamic is, in fact, deeply revealing: It *ought* to be difficult for a new service provider to ignore what a large customer (i.e., Comcast) thinks. Indeed, cable and satellite operators have strong views about what programming will best generate subscribers, and their ability to convey this information to the market, transacting with those new and existing networks that meet customers' needs, is exactly the efficiency *destroyed* by a la carte.

This explanation is not mere theorizing; it can be seen as the explicit arguments against a la carte rules filed by program networks in this FCC proceeding. Programmers fear the cost of national mass marketing campaigns required by a la carte, preferring the present system as the more efficient alternative. This is true even for independent program owners (i.e., not vertically integrated with cable TV or other interests) such as the Weather Channel. It is based, as the comments make clear, on the economic waste that would accompany a la carte. As Bloomberg (a network delivered to about one-third of MVPD households) writes:

Such requirements would... impose high marketing and other costs on BTV as it tried to compete with dozens, if not hundreds, of other programming services vying for new subscribers. It would be difficult for BTV to survive in such an environment... The net effect of mandatory a la carte or themed tiering would then be to drive BTV and similarly situated programmers out-of-business, thereby harming program diversity and consumers.<sup>75</sup>

Virtually every other program network filing Comments regarding a la carte with the FCC makes the same point, and opposes a la carte (see Appendix for a summary). Pointedly, these networks include Oxygen Media (launched in March 2000, now reaching about 65 million households with programming aimed at female audiences), Univision (Spanish language programming), the International Channel (offering programs in 16 languages), and C-SPAN (a non-profit public affairs channel that does not sell advertising).

The testimony of program networks is crucial in two key respects. First, it directly reveals what's good for programmers. In a contest between bundling and a new regime requiring a la carte, cable program networks leave no doubt which would leave them better off. According to these parties -- industry experts who are reliably expressing a self-interested policy preference -- a far more diverse and valuable array of programming is available with bundling. Second, this programmer-based argument is compelling evidence that *consumers* are better off with bundling. That is not only because consumers value program choice and diversity, but because the program

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<sup>75</sup> Comments of Bloomberg Television, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry 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 (July 15, 2004), p. 3.

networks' conclusion strongly indicates that a la carte will not realistically achieve promised benefits.

Consider the argument put forth: *Cable operators now force households to subscribe to programs they do not want, and a la carte will improve the ability of households to access just the shows they truly desire to watch.* If that were the case, a la carte rules would work as advertised, and many program networks would benefit – in particular those that produce the content that consumers *truly desire*. Those networks would then welcome rules unlocking consumer choice, directing additional demand in their direction. In fact, cable networks loudly reject this view, achieving overwhelming consensus. The clear implication is that a la carte will fail to deliver consumers the benefits promised.

#### **E. The Relatively Low Cost of Blocking**

Individual subscribers can remove unwanted programming from appearing on their home television screens. This responds to the concerns of families finding certain networks offensive. Customizing individual packages in this manner can be done at far lower cost, because the standard tiering arrangements stay in place, yielding scale economies. On a targeted basis, individual households are able to remove programming, gaining utility and incurring only modest costs. Billing systems are not affected, nor are ordering transactions or system operations.

Channel blocking is relatively simple when using a television set with a digital set-top box. This includes approximately 26.6 million DBS households<sup>76</sup> and about 27.6 million digital cable households.<sup>77</sup> Digital boxes typically have the ability to block channels by date and time and by TV and MPAA ratings. Advanced analog set-top boxes also have channel blocking capabilities and the cable industry has committed to providing one if a household requests one.<sup>78</sup>

### **V. PRICE EFFECTS OF A LA CARTE**

The impact of an a la carte mandate would vary with specific rules. Prominent advocates propose a mandate that 1) unbundles channels beyond the “broadcast tier” and 2) does not restrict cable operators from offering whatever package pricing options they choose (overruling carriage agreements with programmers that require networks to be

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<sup>76</sup> Leichtman Research Group, *Research Notes* (4Q 2005), p. 6.

<sup>77</sup> NCTA estimate as of Sept. 2005; <http://www.ncta.com/Docs/PageContent.cfm?pageID=86> (visited Feb. 23, 2006).

<sup>78</sup> This is how cable companies choose to fulfill the mandate of the Cable Act that any cable “subscriber can prohibit viewing of a particular cable service during the period selected by that subscriber.” See Section 624(d)(2) of the Cable Act, 47 U.S.C. § 542(d). The Telecommunications Act of 1996 also mandated television sets 13 inches and larger include V-Chip technology. All programming, other than sports or news, must be transmitted with a ratings code the television set can read. Users can then block programs above a set ratings level.

placed on the most popular tiers).<sup>79</sup> Both logic and experience suggest that implementing such a mixed regime (in that channels are offered in packages as well as a la carte) would result in per-channel rates some generous multiple of the mean channel price offered in tiers. One should not expect, for example, that each of the 60 channels in a \$40 tier would be priced at \$0.75 per month. Rather, individual channels would likely cost some generous multiple of this. Moreover, such prices would be set such that consumers would rarely if ever substitute for the standard tiers.

The essential logic is straightforward. If household demand for cable TV services is such that a cable operator maximizes profits by charging \$40 for a 60-channel tier, the same operator – when forced to price each channel alone, as in an a la carte mandate – will devise a price schedule to protect these revenues. The operator’s motivation is clear. Since no social costs are conserved by reducing distribution of signals, lost receipts go directly to the operator’s bottom line as lost profits. This means that the operator will price to avoid such outcomes. And given that customers are seen to be willing to spend as much as \$40 for the 60-channel tier, marketplace evidence implies that the operator will be successful. Households are willing to expend \$40 for the 60-channel package, and will reject alternatives that are individually priced (correctly, from the operator’s perspective) as inferior substitutes.

#### **A. Marketplace Experience**

Consider the experience of the Disney Channel, today one of basic cable’s most popular networks. The Disney Channel was launched in 1983 as a premium a la carte service.<sup>80</sup> In the mid-1990s, the Disney Channel began its migration to expanded basic.<sup>81</sup> Before the transition, subscribers paid an estimated \$10 to \$16 per month for the channel, much higher than the average channel price in most expanded basic tiers.<sup>82</sup> The incremental cost to customers with Disney in expanded basic was a small fraction of this rate.

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<sup>79</sup> Comments of Consumers Union and Consumer Federation of America, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry 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 (July 15, 2004), p. 7.

<sup>80</sup> Comments of the Walt Disney Company, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry 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 (July 15, 2004), p. 18.

<sup>81</sup> Comments of the Walt Disney Company, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry 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 (July 15, 2004), p. 19.

<sup>82</sup> Comments of the Walt Disney Company, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry 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 (July 15, 2004), p. 19.

<b>TABLE 3. C-BAND CABLE PROGRAM NETWORK A LA CARTE PRICES</b>					
<i>Channel</i>	<i>Package</i>	<i>1 Month</i>	<i>3 Month</i>	<i>6 Month</i>	<i>12 Month</i>
Arts & Entertainment	Combo	\$2.49	\$6.49	\$10.99	\$15.49
	Price	\$3.99	\$8.49	\$14.49	\$19.99
BET	Combo	\$1.99	\$5.49	\$10.99	\$14.49
	Price	\$4.49	\$8.99	\$14.49	\$19.99
Country Music Television	Combo	\$2.49	\$6.49	\$10.99	\$15.49
	Price	\$3.99	\$8.49	\$14.49	\$19.99
Cartoon Network Pack	Combo	\$2.49	\$6.49	\$10.99	\$15.49
	Price	\$3.99	\$8.49	\$14.49	\$19.99
CNBC	Combo	\$2.49	\$6.49	\$10.99	\$15.49
	Price	\$3.99	\$8.49	\$14.49	\$19.99
CNN	Combo	\$3.99	\$10.99	\$19.99	\$32.99
	Price	\$4.99	\$12.49	\$21.99	\$35.49
Denver Networks + FOX (KDVR-Denver)	Price	\$18.49	\$51.99	\$102.99	\$202.99
Denver Networks (KUSA, KMGH, KCNC, KWGN))	Combo	\$13.99	\$38.99	\$77.99	\$153.99
	Price	\$18.49	\$51.99	\$102.99	\$202.99
Discovery Network	Combo	\$2.49	\$6.49	\$10.99	\$15.49
	Price	\$3.99	\$8.49	\$14.49	\$19.99
Disney Channel	Combo	\$10.99	\$30.99	\$60.49	\$109.99
	Price	\$12.49	\$32.99	\$65.99	\$120.99
ESPN	Combo	\$5.49	\$15.49	\$27.49	\$54.99
	Price	\$6.99	\$18.99	\$32.99	\$65.99
FOX (KDVR, Denver)	Combo	\$5.49	\$14.99	\$29.99	\$59.99
	Price	\$6.99	\$19.99	\$38.99	\$76.99
FOX News	Combo	\$2.49	\$6.49	\$10.99	\$15.49
	Price	\$3.99	\$8.49	\$14.49	\$19.99

A la carte prices are also observed in C-Band programming transmitted to “big dish” satellite receivers.<sup>83</sup> The Superstar/Netlink Group (Superstar), the most popular provider of C-Band programming, offers channel-by-channel sales. However, a la carte prices are substantially higher than the average channel prices when networks are purchased in bundles. (It should also be noted that C-Band services are pure programming; subscribers independently purchase their own equipment.) Customers can choose to subscribe to just one channel at prices ranging from \$2.49 - \$12.49 per month. Choosing five or more a la carte channels qualifies a subscriber for discounted “combo” rates for each channel. See Table 3.<sup>84</sup>

<sup>83</sup> C-Band subscribers, using different frequencies and technology than DBS subscribers, rely on 4 to 8 foot satellite dishes for reception. Subscribership has sharply declined with the advent of “small dish” networks (e.g., DirecTV and Dish). By the end of 2002, just over half a million households subscribed to C-Band programming. *FCC Tenth Annual Report*, Pars. 73-74.

<sup>84</sup> See [http://www.superstar.com/alacarte\\_index.asp](http://www.superstar.com/alacarte_index.asp) (visited Feb. 22, 2006).



The Superstar/Netlink Group also offers several bundles of networks that offer subscribers further discounts. Both the Choice 15 and the SuperPak Basic are offered for (the same price of) \$28.99 per month, and include 15 and 27 basic cable channels, respectively. See Table 4.<sup>85</sup>

Large pricing differentials are also seen in the small number of channels that DBS operators (with all-digital, addressable systems) offer a la carte. DISH customer service representatives (contacted Feb. 23, 2006) detailed that, of their basic networks, only Bloomberg and the Outdoor Channel can be ordered a la carte. DirecTV personnel (also contacted Feb. 23, 2006) indicated that just the Outdoor Channel was available this way. (Both operators require basic tier subscriptions before selling the a la carte networks.) The retail a la carte prices, listed in Table 5, are about *four to six times* the mean price per month of a basic network purchased in the largest expanded basic tier.

<b>TABLE 4. C-BAND CABLE PROGRAM NETWORK PACKAGE OPTIONS</b>				
<i>Package</i>	<i>Channels</i>	<i>Monthly</i>	<i>Quarterly</i>	<i>Annually</i>
Choice 15	Choose 15 of 30 basic cable channels	\$28.99	\$80.99	\$318.99
Super Pack Basic	27 Basic Cable channels	\$28.99	\$80.99	\$318.99
Choice 15 with 2 movie networks	19	\$44.99	\$125.99	\$494.99
Choice 15 with 4 movie networks	23	\$57.99	\$161.99	\$637.99

<sup>85</sup> See [http://www.superstar.com/pkgpricing\\_index.asp](http://www.superstar.com/pkgpricing_index.asp) (February 22, 2006).

**TABLE 10. A La Carte Offerings on Echostar and DirecTV**

Echostar			
<i>Network</i>	<i>A La Carte Price (per month)</i>	<i>Price/Channel: America's Top 180</i>	<i>A La Carte Price Increase</i>
Bloomberg	\$1.50	\$0.29	517%
Outdoor Channel	\$1.50	\$0.29	517%
DirecTV			
<i>Network</i>	<i>A La Carte Price (per month)</i>	<i>Price/Channel: Total Choice Premier</i>	<i>A La Carte Price Increase</i>
Outdoor Channel	\$1.99	\$0.58	343%

Notes & Sources:

Dish Network a la carte offerings and prices obtained from call to customer service (Feb. 23, 2006). Dish Network charges \$49.99 for its America's Top 180 package. This package consists of 171 channels not including music channels. America's Top 180, unlike the America's Top 120 and Top 60 packages, includes the Bloomberg, Disney and Outdoor channels. See <http://www.dishnetwork.com> (visited Feb. 23, 2006). DirecTV a la carte offerings and prices obtained from call to customer service (Feb. 23, 2006). DirecTV charges \$93.99 for its "over 205 channel" Total Choice Premier (without local channels) package. Excluding music channels, this package consists of 168 channels. Total Choice Premier, unlike the Total Choice and Total Choice Plus packages, includes the Golf and Outdoor channels along with additional sports channels and the movie networks. See <http://www.directv.com> (visited Feb. 23, 2006).

When consumers have the option of purchasing a la carte off the menu, they overwhelmingly decide to forego such choices in favor of bulk purchases.<sup>86</sup> In fact, even those C-Band subscribers who have invested in receiving equipment are abandoning their a la carte choices, and 34-channel basic tier, to subscribe to the much larger packages offered by DBS operators.<sup>87</sup> Among C-band survivors, a la carte offerings have not proven popular, either. Turner Networks reports that of nearly 250,000 households that subscribed to CNN through C-Band provider Superstar in April 2004, only 798 subscribed on an a la carte basis that did not qualify them for a package discount. The same is true for 1,297 of the 195,000 Cartoon Network subscribers and 235 of the 187,000 Turner Classic Movie subscribers.<sup>88</sup>

Rogers Communications, Canada's largest cable operator, offers a similar experience. The company sells dozens of cable networks a la carte, but first requires a \$C24.00 monthly subscription to a basic package and leasing a digital set-top box for \$C8.95.<sup>89</sup> After those charges are incurred, channels can be purchased a la carte starting

<sup>86</sup> Bloomberg TV, for instance, reports just 7,000 a la carte subscribers on the DISH Network, while serving about 9 million basic subscribers. See Bloomberg FCC Comment, op cit., p. 8, and [http://www.dishnetwork.com/content/aboutus/company\\_profile/index.shtml](http://www.dishnetwork.com/content/aboutus/company_profile/index.shtml) (visited August 4, 2004).

<sup>87</sup> "The decline in subscribership is caused principally by HSD [home satellite dish] subscribers switching to DBS because of the smaller, less expensive and easier to use equipment, and the advent of local-into-local programming...." *FCC Tenth Annual Report*, Par. 74.

<sup>88</sup> These data were supplied to me by Turner Broadcasting executives.

<sup>89</sup> Ted Hearn, *A La Carte Lives, Up North*, MULTICHANNEL NEWS (June 14, 2004).

at \$C2.49 monthly.<sup>90</sup> Such a small number of people purchase channels individually that the company does not tabulate the total.<sup>91</sup>

## B. FCC Projections

In a fascinating game of regulatory ‘gotcha’ played as solitaire, the Federal Communications Commission has issued sharply conflicting reports projecting exactly how a la carte rules would change pricing for cable TV services. The first FCC report, issued in Nov. 2004,<sup>92</sup> predicted that a la carte pricing would generally increase the cost of cable service, using assumptions about the price of individual channels and the number of channels households would order supplied by a cable industry sponsored White Paper by management consultants Booz Allen. The second FCC report, issued in Feb. 2006,<sup>93</sup> uncovered numerical errors in the Booz Allen study. The second FCC report concludes that “The corrected calculations show that a subscriber could receive as many as 20 channels, including six broadcast signals, without seeing an increase in his or her monthly bill.”<sup>94</sup>

This recalculation provides entrée for the FCC to make a possible empirical case for a la carte as a pro-consumer regulatory policy, stating that “the current industry practice of bundling programming services *may* drive up retail prices... Some type of a la carte option *could* prove better than today’s bundling practices in fostering diverse programming responsive to consumer demand...A la carte *could* make it easier for programming networks valued by a minority of viewers to enter the marketplace.”<sup>95</sup> Indeed, estimating prices to be charged in the future, along with the number of channels to be purchased, *may* produce pro-consumer outcomes – by assumption. Yet, it violates the underlying economics for reasons stated above.

Were cable TV consumers willing to purchase “as many as 20 channels, including 6 broadcast signals” for prices approximating expanded basic tier rates, cable operators would undo such an outcome by (a) discouraging a la carte, which adds transactional inefficiencies, by re-pricing channels at prohibitively high rates; (b) encouraging the full panoply of expanded basic channels by pricing bundles at relatively favorable rates. The determinative facts are, first, that consumers already express demand for tiers that indicate the profit-maximizing outcome for cable operators and, second, without rate regulation authority – ended in the Telecommunications Act of 1996 (and phased out as of March 31, 1999) – the government is powerless to impose rules that deter cable TV operators from achieving this outcome. The non sequitur in mandating a la carte without

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<sup>90</sup> Ted Hearn, *A La Carte Lives, Up North*, MULTICHANNEL NEWS (June 14, 2004).

<sup>91</sup> Ted Hearn, *A La Carte Lives, Up North*, MULTICHANNEL NEWS (June 14, 2004).

<sup>92</sup> Federal Communications Commission, *Report on the Packaging and Sale of Video Programming Services to the Public*, Media Bureau (Nov. 19, 2004) [“First FCC Report”].

<sup>93</sup> Federal Communications Commission, *Further Report on the Packaging and Sale of Video Programming Services to the Public*, Media Bureau (Feb. 9, 2006) [“Second FCC Report”].

<sup>94</sup> Federal Communications Commission, *FCC Media Bureau Report Finds Substantial Consumer Benefits in A La Carte Model of Delivering Video Programming: Fact Sheet*, Media Bureau Press Release, (Feb. 9, 2006).

<sup>95</sup> *Ibid.* (emphasis added).

effective rate regulation in place haunts any policy discussion; for this reason, the failure of previous rate controls is discussed in more detail in the following section.

### C. Family Tiers as Quid Pro Quo

In an effort to achieve compromise with regulators, major cable TV operators are now offering “family tiers.” These are an attempt to answer conservative critics who argue that families with children want access to video services without viewing, or paying for, programming inappropriate for kids. Comcast, the nation’s largest operator, announced in Dec. 2005, that it will sell a package of 16 networks for about \$31.20 monthly, including limited basic (retransmitting off-air TV stations). The cable networks included on the Family Tier are: Disney, Toon Disney, PBS KIDS Sprout, Discovery Kids, Science (Discovery), Nickelodeon/Nick Too, Nickelodeon Games and Sports, TBN (Trinity Broadcasting), HGTV (Home and Garden), Food, Do-It-Yourself, CNN Headline News, The Weather Channel, National Geographic, C-SPAN and C-SPAN2.<sup>96</sup> Similarly, Time Warner announced its “Family Choice Tier,” a \$12 package (on top of limited basic), that requires a monthly rental of limited basic plus a digital set top box (for each TV receiving the tier). A pricing comparison supplied by Time Warner is displayed in Table 6.

The reality is that such packages, while offering a potential political solution, would be rarely used by actual consumers. Households subscribe to cable or satellite TV services to obtain a range of programming for adults and, where present, children. The family tiers are not designed to satisfy that consumer demand. Not only are some of the most popular children’s networks omitted – including Nickelodeon, PBS Kids, and Animal Planet – but virtually every adult-oriented network is excluded. Heads of households are extremely unlikely to spend \$33 per month for cable service, and *not* receive CNN, MSNBC, CNBC, Fox News, ESPN, Discovery, A&E, CourtTV, Lifetime, USA, History, TMC, TNT, TBS, or TNT. The option of getting access to all of these channels, and scores more, for \$41 – as shown in the Time Warner menu in Table 6 – is the alternative that will overwhelmingly dominate, rendering “family tiers” irrelevant.

Pro-regulation groups are alert to this outcome, and have attacked the “family tiers” as an insufficient substitute for price per channel menus.<sup>97</sup> The approach has been called “a product that is designed to fail.”<sup>98</sup> This is an accurate assessment, but it applies far more generally. A la carte would likewise be priced to so as to protect cable system revenues. Without effective rate regulation, the policy of a la carte is also “designed to fail.” And not only does federal law ban rate regulation, institutional constraints and

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<sup>96</sup> Reid Kanaley, *Comcast offers G-rated 'family-tier' package; The cable-TV giant sought to address criticism of sex and violence and to stave off a la carte pricing*, PHILADELPHIA INQUIRER (Dec. 23, 2005), <http://www.philly.com/mld/inquirer/business/13469884.htm>

<sup>97</sup> *Family-Friendly Tiers Are Not the Answer: CWA Calls on the U.S. Senate to Pass Indecency Legislation Now*, Testimony by Lanier Swann, Director of Government Relations, Concerned Women for America (Jan. 19, 2006), <http://www.cwfa.org/images/content/indecencytestimony011906.pdf>.

<sup>98</sup> According to “Dan Isett, director of corporate and government affairs for the Parents Television Council.” Kanaley (Dec. 23, 2005), *op cit*.

marketplace realities prevent adoption of a plausibly effective regime, as shown in Section VI.

TABLE 6. TIME WARNER'S BASIC TIER COMPARISON		
<b>Basic Tier</b>		
<b>Includes:</b> Local broadcast stations, public/educational and government access channels mandated by local cable franchise authorities and other select channels.		
<b>Price:</b> \$12	<b>Number of channels:</b> 15-20	<b>Price per channel:</b> 60 to 80 cents
<b>Family Choice Tier</b>		
<b>Includes:</b> Boomerang, C-SPAN 2, C-SPAN 3, CNN Headline News, The Science Channel, Discovery Kids, Disney Channel, DIY Network, FIT-TV, Food Network, HGTV, La Familia, Nick Games & Sports, The Weather Channel and Toon Disney		
<b>Price:</b> \$12.99	<b>Number of channels:</b> 15	<b>Price per channel:</b> 87 cents
	<b>Set-top box required:</b> Digital	<b>Added cost:</b> \$7.99
<b>Expanded Basic Tier</b>		
<b>Includes:</b> National and regional cable networks, superstations, local news channels.		
<b>Price:</b> \$41.00	<b>No. of channels:</b> 70 – 80	<b>Price per channel:</b> 51 – 58 cents

Source: Time Warner Cable.<sup>99</sup>

#### D. The Irony of Must Carry

"The vast majority of Americans are sick and tired of the sewage pouring out of their airwaves, or on cable programs they are being forced to underwrite," said L. Brent Bozell, president of the Parents Television Council. PTC-led efforts account for the majority of indecency complaints filed with the FCC in recent years.<sup>100</sup>

The campaign for a la carte regulation is driven by parental concerns over suggestive or raunchy programming inappropriate for kids. Many feel that they are being forced to pay for – and receive --inappropriate video fare largely due to current corporate practices of cable and satellite operators, and that simple changes in those practices, by government regulation if need be, will improve their options. Policy makers in Congress are entirely sympathetic, and several have pledged to push mandates for a la carte.

A central irony is that the greatest problem with unwanted indecency clearly appears to obtain with respect to broadcast TV content, and these programs are mandated for carriage on the most basic cable TV tier. That is to say, cable operators must carry

<sup>99</sup> As reported in R. Thomas Umstead, *Time Warner First In a Family Way*, MULTICHANNEL NEWS (Dec. 19, 2005), <http://www.multichannel.com/article/CA6292379.html?display=Top+Stories>.

<sup>100</sup> Brooks Boliek, *Martin Leads FCC With Firm Hand*, HOLLYWOOD REPORTER (Feb. 10, 2006), [http://www.hollywoodreporter.com/thr/article\\_display.jsp?vnu\\_content\\_id=1001994988](http://www.hollywoodreporter.com/thr/article_display.jsp?vnu_content_id=1001994988).

TV stations serving their locality, without charge.<sup>101</sup> Hence, inappropriate content appearing on broadcast television – “the sewage pouring out of their airwaves” – cannot be eliminated from “family tiers” or even cable a la carte offerings.

Thus, the driving force behind a la carte aims toward a cul-de-sac. Even if family tiers purchased or a la carte were implemented, households subscribing to cable or satellite<sup>102</sup> would not achieve a reasonable solution to the problem of indecent content. From Fox Television’s *Family Guy* to the now infamous Janet Jackson nano-nudity flap during halftime of Super Bowl XXXVIII, complaints about broadcast television content dominate those relating to cable TV networks.<sup>103</sup> This makes sense in that cable TV channels serve niche audiences, and it is the wide “broadcast” audience that is offended by unexpectedly crude programming.

This shows up in FCC complaint data. As of September 2005, the FCC had received 319 formal complaints about broadcast TV programs, as opposed to just 84 for cable TV shows.<sup>104</sup> This is a stark differential not only in absolute numbers, tilting nearly four-to-one in favor of broadcasting, but relatively. Cable TV programming now enlists a larger number of viewers, in aggregate, and offers a vastly larger quantity of programming. The opportunity for offense is vastly greater with increased supply, yet broadcasting’s relatively parsimonious programming hours dominate.

Hence, families subscribing to just those cable networks that they deem appropriate will yet be forced to use additional measures to block offensive content. These may include blocking devices filtering out programs our entire channels, or may consist of increasing in-person monitoring of the shows their children watch. But under the current must-carry regime, neither family tiers nor a la carte afford anything approaching parental “sewage” control.

## VI. CABLE RATE REGULATION

Rate regulation must enter the a la carte policy discussion, for the simple reason that MVPD operators would logically respond to an a la carte mandate by pricing individual channels with rates rendering the a la carte choice irrelevant. That is because, were a la carte pricing profit maximizing, operators would not have to be regulated to

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<sup>101</sup> Alternatively, stations can elect “retransmission consent,” negotiating fees for retransmission by cable operators. Network affiliates and larger independent stations typically adopt this course. But, should such negotiations fail, every station would have the opportunity for zero-priced cable carriage.

<sup>102</sup> Satellite “must carry” rules are different from those governing cable systems. Satellite subscribers need not receive TV broadcast stations; however, if their satellite operator offers them, the operator must offer them as a bundle – i.e., a la carte, or any tier less than the full set of all over-the-air signals, is illegal. See Ted Hearn, *4th Circuit Upholds DBS Must-Carry*, MULTICHANNEL NEWS (Dec. 10, 2001), <http://www.multichannel.com/article/CA185699.html?display=Top+Stories>.

<sup>103</sup> R. Thomas Umstead & Linda Haugsted, *Cracks in the Tier*, MULTICHANNEL NEWS (Jan. 30, 2006), p. 9.

<sup>104</sup> *Ibid.* The article does not define the period over which such FCC complaints have been accumulated.

pursue it. Given that it is evidently a sub-optimal pricing strategy for firms, firms would naturally react by deflecting its effects. Only by regulating cable rates generally could an a la carte mandate have the opportunity to constrain price menus. It is a fatal flaw of the FCC's Second Report that it fails to consider this crucial aspect of a la carte rules.

Not only is cable rate regulation illegal under the terms of the 1996 Telecommunications Act, they are not a viable option to implement. U.S. experience with rate regulation in the cable sector is extensive, and the lessons are clear: rate controls are counter-productive. By capping rates, the 1992 Cable Act, for example, led cable operators to reconfigure programming menus, reduce their demand for new and high-quality basic tier programming, and to alter marketing practices such that subscriber growth (and viewer ratings) suffered substantial declines from long-run trends.<sup>105</sup> This brutal evidence – showing that subscribers felt they were worse off even as rates declined, given the value of the services received – led policy makers to relax rate caps beginning in late 1994, and ultimately to the statutory deregulation of rates in the 1996 Telecommunications Act.<sup>106</sup>

While the federal and state regulators found that they could lower the nominal price of cable television subscriptions, and did so in the September 1992 to October 1994 period, they could not control the quality of the product. Once investors saw retail prices squeezed by regulators, capital fled and service improvements stopped. As reported in late 1994:

For weeks, senior [FCC] officials have struggled to reconcile two somewhat incompatible goals. They wanted to preserve the billion-dollar rate reductions they imposed earlier this year. But they also sought to encourage new programming services and investment in more sophisticated networks by cable operators.<sup>107</sup>

Regulators then decided to decisively raise cable rates, effectively eliminating rate regulation. As then FCC chairman Reed Hundt was to write: “What indeed was the point of the regulation if the beneficiaries were neither thankful nor economically better off?”<sup>108</sup> Even the Consumers Union and the Consumer Federation of America, both champions of cable re-regulation in 1992, today concede that price controls failed, offering a la carte regulation as an alternative:

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<sup>105</sup> Thomas W. Hazlett and Matthew L. Spitzer, Public Policy Toward Cable Television: The Economics of Rate Controls (MIT Press, 1997); Thomas W. Hazlett, *Prices and Outputs under Cable Reregulation*, 12 JOURNAL OF REGULATORY ECONOMICS 173-95 (September 1997).

<sup>106</sup> This experience mirrored that of a generation earlier, prior to federal pre-emption of local rate regulation in the Cable Act of 1984. See Thomas W. Hazlett, *The Demand to Regulate Franchise Monopoly: Evidence from CATV Rate Deregulation in California*, ECONOMIC INQUIRY 275 (April 1991); Thomas W. Hazlett, *Cable Television Rate Deregulation*, 3 INTERNATIONAL JOURNAL OF THE ECONOMICS OF BUSINESS 145 (1996).

<sup>107</sup> Edmund L. Andrews, *F.C.C. Approves New Rate Rises for Cable TV*, NY TIMES (November 11, 1994), p. D1.

<sup>108</sup> Reed Hundt, You Say You Want A Revolution? (1999), p 56.

We reject the claim that *a la carte* will fail to discipline cable behavior, like rate regulation did in the early 1990s. The 1992 Cable Act gave regulators a weak set of tools; *a la carte* rests on a much more powerful force, consumer sovereignty in the marketplace.<sup>109</sup>

Yet rate controls enacted in 1992 were far more powerful regulatory devices, allowing government to cap basic subscription fees and to regulate tiering.<sup>110</sup> The failure of those regulations to advance consumer interests imply that, not only are rate controls currently illegal under federal law, they are not a viable option for imposing *a la carte* under a new statute.

## VII. CONCLUSION

Cable and satellite TV systems face a challenge increasingly common in the Information Economy: How to efficiently price products that have high “first copy” costs, and are thereafter very cheap. Cable TV networks are costless to distribute to additional households once heavy investments have been sunk to create the necessary software (the content) and hardware (the cable TV system). They elect a widespread strategy: provide a high-volume product for a fixed, monthly fee. This approach has led to rapidly expanding choices in video programs.

A wide range of video service providers use similar bundling approaches. Satellite operators offer even larger tiers than do cable systems, and do so to offer a competitive alternative appealing to the widest segment of the consuming public. Consumers gain both through access to more programs, but also because transactions are far less costly. Information about what programs are available is simple to acquire; the channel surfing experience facilitated by the remote control allows for instant and continuous sampling. This, in turn, allows both new and old networks a path to attract new viewers, encouraging programmers to continually experiment with new ways to attract (fickle) viewers.

If *a la carte* were efficient, both incumbents and competitive entrants lacking market power would have strong incentives to offer such menus, sharing gains with subscribers. Instead, the marketplace converges on bundles. This outcome is particularly important to cable programmers, both popular, established networks and new, independent upstarts. These interests strongly argue that *a la carte* would hamper efforts to compete for viewers, making it far more expensive to market their programs to interested customers.

Experience in the U.S. C-Band market, DBS, and in the Canadian cable market, suggests that *a la carte* pricing results in higher prices and attracts few customers, even when subscribers can select between *a la carte* and bundled channels. Experience in

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<sup>109</sup> Cooper 2004, p. 8.

<sup>110</sup> For instance, Adelphia Cable was fined by the FCC for using an *a la carte* pricing scheme to escape rate regulation. Ted Hearn, *MSOs Were Once A La Carte Fans*, MULTICHANNEL NEWS (July 20, 2004).



other markets suggests that services are efficiently bundled under cost conditions similar to those prevailing in multi-channel video. Competitive entry by two satellite radio firms has been achieved by 100-channel bundles. Similar buffet style pricing occurs in theme parks, ski resorts, and in health clubs. And in the market for broadband Internet access, all-you-can-eat is popular with the consuming public; per-hour access fees have achieved little success in attracting customers. And a la carte rules cannot plausibly constrain cable operators' behavior without concomitant imposition of rate regulation. Not only are such controls currently ruled out via federal statute, they have proven unworkable through multiple episodes – precisely because operators react to controls by changing investments, marketing, and pricing, rendering the constraints impotent. Moreover, the video indecency that drives many to support regulation of cable pricing will not be confronted in any event: broadcast television, prompting by far the strongest outrage, is mandated to be included on all cable tiers, with or without a la carte pricing.

Nonetheless, the illusion remains that prices for bundles are unfair when users believe that they are paying to support channels they do not value. There is an important sense in which network users come together to support the joint costs of creating video services. But it is equally true that this support is actually garnered because different users pay for different uses of the network. Subscribers only pay for the basic tier when the value of the *service they receive* exceeds the *cost they pay*. This is the economic interpretation of bundling. It allows individual customers with diverse tastes to support efficient production of a wide range of services, and to realize their own value from that system.

Still, it appears to many that their subscription fee supports programming that they neither wish to watch or desire to support. That perspective is one-half illusion: in truth, subscribers are motivated to *pay for* only that programming *they value*. Operators simply throw in additional content for free, as it is far costlier for systems to customize packages when subscribers are capable of using remote controls. The sense in which the perception is true stems from the reality that heterogeneous consumers economize by sharing network costs with others. By establishing subscription fees entitling customers to access a wide variety of programs on the expanded basic tier, cable and satellite operators cater to diverse consumer tastes. Limiting this relatively efficient marketing arrangement will discourage productive investments, depriving customers, video distributors or content creators of the fruits of gains from trade.

## APPENDIX

**TABLE 7. POSITIONS TAKEN ON A LA CARTE REGULATION  
IN FCC COMMENTS FILED BY CABLE PROGRAM NETWORKS**

<i>Programmer</i>	<i>Networks Owned (2003 subscribers)</i>	<i>Earliest Launch Date</i>	<i>A La Carte: For/Against?</i>	<i>Comment</i>
A&E Television Network	A&E (87.7m) The History Channel (85.8m) The Biography Channel The History Channel en español The History Channel International	Feb-84	Against	"A la carte regulations would not lower prices for most consumers, would reduce consumer choice by driving some networks out of business, and would imperil much family programming that can exist only because it is part of a bundled package." p. vi
Altitude Sports & Entertainment et al	Altitude Sports and Entertainment Casino & Gaming Television (1.7m) Comcast Sportsnet Comcast Sportsnet Mid-Atlantic E! Entertainment Television (83.6m) G4TechTV(14.0m) The Golf Channel (58.4m) Inspiration Life Television The Inspiration Network (20.7m) Martial Arts Channel Outdoor Life Network (56.2m) SfTV(4.2m) The Tennis Channel (7.0m) Wisdom Television (7.9m)	N/A	Against	"Commenters do not believe that either the Congress or the Commission intend to eliminate the enormously valuable and diverse programming options created by niche networks, although such may be the effect of a governmentally imposed a la carte mandate." p. vi
Bloomberg Television	Bloomberg (30.5m)	Feb-94	Against	"Proponents of mandatory a la carte or themed tiering claim that such regulations will deliver more consumer choice and lower prices. In reality, such regulations would deliver neither." p. 1
Carolina Christian Broadcasting, Inc.	W65DS	Oct-72	Against	"This system would damage organizations like our own. We depend on a wide variety of audiences to help support our charity work...If an 'a la carte' system were put in place it would be more difficult to help our community. Our program audience would decline and it would cause our response rate to decrease. There are people that depend on us for assistance and spiritual guidance." p. 1

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IN FCC COMMENTS FILED BY CABLE PROGRAM NETWORKS**

<i>Programmer</i>	<i>Networks Owned (2003 subscribers)</i>	<i>Earliest Launch Date</i>	<i>A La Carte: For/Against?</i>	<i>Comment</i>
Christian Faith Broadcasting	WGGN-TV (Ohio)		Against	"We are a small broadcasting company and a la carte would make us even smaller - thus drying up our advertising revenue to a point where we would fail. Surely this is not the intention of a la carte proponents or the FCC...What more perfect example of the law of unintended consequences? An effort to restore more child-friendly programming should not result in the loss of Christian broadcasting." p. 1
Christian Television Network	Christian Television Network	N/A	Neither	"Let me emphasize that National Religious Broadcasters has not yet taken a position to support or oppose <i>A La Carte</i> outright....If an <i>A La Carte platform</i> will give other religious and minority networks greater access, then that's what we need." pp. 3-4
Courtroom Television Network	Court TV (79.0m)	Jul-91	Against	"Such rules [a la carte] also would undermine the way in which programming channels are marketed to subscribers, and thus drive up costs....New and niche programmers that grew up under cable's prevailing business model would be stillborn in such an environment." p. iv-v
Crown Media United States	Hallmark Channel (56.3m) Hallmark Movie Channel	Sep-88	Against	"The likely result of such regulation would be higher prices to consumers, lower quality programming, and a reduction in the diversity of programming available to viewers." p. 1
Discovery Communications	Discovery Channel (88.6m) TLC (87.0m) Animal Planet (84.7m) Discovery Health Channel (50.4m) Travel Channel (74.2m) BBC America (37.9m) Discovery Kids (34.2m) The Science Channel (34.2m) Discovery Times Channel (32.7m) Discovery Wings Channel (33.2m) Discovery Home Channel (32.7m) Discovery en Español (8.1m) FitTV (32.8m) Discovery HD Theater	Oct-80	Against	"Yet the <i>a la carte</i> proposals at issue in this proceeding would make Discovery's networks significantly more expensive for consumers and could result in some of them being forced off the air." p. iii
Eternal Word Television Network	EWTN	N/A	Against	" <i>A La Carte</i> would also dramatically reduce EWTN's ability to carry out its mission of service to the community." p. 3

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<i>Programmer</i>	<i>Networks Owned (2003 subscribers)</i>	<i>Earliest Launch Date</i>	<i>A La Carte: For/Against?</i>	<i>Comment</i>
Fox Cable Networks Group	FX (83.0m) Fox Sports Net (75.2m) 12 owned and operated regional sports networks Speed Channel (60.3m) National Geographic Channel (46.9m) Fox Movie Channel (27.6m) Fox Sports World Fox Sports en español Fuel Fox Reality Channel	Jun-94	Against	"If the government were to upset this model by imposing mandatory a la carte or themed tier services, consumers would quickly face the prospect of <i>less</i> choice and <i>more</i> cost." p. iv
GoodLife TV Network	GoodLife TV Network	May-86	Against	"While a la carte mandates would alter the business model upon which all cable program networks are based, independents like GoodLife would bear the brunt of the harm." p. 3
GSN	GSN (16.6m)	Dec-94	Against	"Viewers would pay more for fewer networks with scaled-back programming budgets. Media concentration would increase more rapidly and diversity would be lost." p. 10
International Cable Channels Partnership Ltd.	The International Channel (11.5m)	Jul-90	Against	"...a la carte carriage will jeopardize the viability of niche networks like the International Channel which already face significant challenges in expanding distribution and increasing advertising revenues in the current marketplace." p. 1
Lifetime Entertainment Services	Lifetime Television Network (87.5m) Lifetime Movie Network (41.5m) Lifetime Real Women (5.0m)	Feb-84	Against	"...any system of required a la carte or themed tier service offerings would have serious adverse consequences on the diversity, cost and quality of cable and satellite programming available to the American audience." p. 1
MBC Gospel Network	MBC Network (9.8m)	Fall 1999	Against	"The end result of such government intervention would be the death of independent programmers and fewer programming choices for consumers, particularly African-American viewers who already receive disproportionately few services." p. 9
NBC Universal, Inc.	USA (88.1m) CNBC (86.2m) MSNBC (81.3m) Bravo (75.0m) SciFi Channel (82.7m) Trio (22.7m)	Apr-80	Against	"...an <i>a la carte</i> mandate increases the likelihood that viewers, because of the transaction burdens inherent in an <i>a la carte</i> mandate, will lose, or never gain, access to programming they would prefer to watch." p. 4

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<i>Programmer</i>	<i>Networks Owned (2003 subscribers)</i>	<i>Earliest Launch Date</i>	<i>A La Carte: For/Against?</i>	<i>Comment</i>
Oxygen Media Corp	Oxygen (50.2m)	Mar-00	Against	"It would also decrease advertising and subscriber fee revenues while substantially increasing costs, making it far more difficult for existing programmers to survive and virtually impossible to create and launch new programming services." p. 1
Scripps Networks	HGTV (84.5m) Food Network (83.0m) Do-It-Yourself Network (26.0m) Fine Living Network (20.0m)	Dec-94	Against	"Furthermore, Scripps Networks could not commit capital to invest in new networks and services in the uncertain and turbulent environment that <i>a la carte</i> pricing would create." p. 4
Starz Encore Group	Starz! Starz! Theater Black Starz! Starz! Kids Starz! Cinema Starz! Family Encore Action Westerns Mystery Love Stories True Stories WAM! MOVIEplex	N/A	Against	"Rather than potentially stifling investment in new programming services by reducing distribution and advertising revenues and driving up costs for programmers and cable operators through a la carte carriage, the Commission should leave it to the marketplace to create and develop alternative services." p. 9
The America Channel	The America Channel	Early 2005	Neither	Against A La Carte as currently proposed.
The C-SPAN Networks	C-SPAN (88.1m) C-SPAN2 (73.2m) C-SPAN3	Mar-79	Against	"Now, the prospect of an a la carte pricing regulation promises to repeat that history by undermining the only business model in the television industry that allowed pure public affairs programming to pay for itself." p. 5
The Walt Disney Co.	ESPN (88.4m) The Disney Channel (83.4m) ABC Family (86.8m) Toon Disney (43.7m) SoapNet (35.8m)	Apr-77	Against	"...A La Carte or Tiered offering would drain advertising revenues from the system and decrease competition for advertising. A La Carte or Tiered offerings also would precipitate increased equipment, marketing and transaction costs." p. 2
The Weather Channel, Inc.	The Weather Channel (87.5m) Weatherscan	May-82	Against	"Broad Distribution of TWC is the Foundation for its Low Subscriber Fees." p. 2

**TABLE 7. POSITIONS TAKEN ON A LA CARTE REGULATION  
IN FCC COMMENTS FILED BY CABLE PROGRAM NETWORKS**

<i>Programmer</i>	<i>Networks Owned (2003 subscribers)</i>	<i>Earliest Launch Date</i>	<i>A La Carte: For/Against?</i>	<i>Comment</i>
Turner Broadcasting System	TBS (88.1m) TNT (88.2m) Cartoon Network (85.8m) Turner Classic Movies (67.2m) Turner South Boomerang CNN (88.2m) CNN Headline News (86.5m) CNN International CNN en español CNNfn (22.1m)	Dec-76	Against	“Based upon its nearly 30 years of experience, Turner strongly believes the imposition of any governmental requirements to lead to a la carte and themed tier programming and pricing options will adversely affect consumers and consumer prices, will reduce diversity of programming, and will inhibit development of new and original programming.” p. 1
TV One	TV One (8.0m)	Jan-04	Against	“An a la carte requirement would have a devastating effect on the continued viability of these services and would likely sound the death knell for many new service offerings.” p. 1
Univision Communications	Univision Network Telefuturo Network Galavisión (25.2m)	N/A	Against	“...a la carte carriage would undermine the three fundamental mandates of the Commission – localism, diversity and competition – while providing no countervailing public benefit.” p. i
Viacom	Nickelodeon/Nick at Nite (87.9m) MTV (86.7m) MTV2 (55.2m) VHI (86.3m) CMT (72.8m) Comedy Central (84.9m) Spike TV (87.2m) TV Land (82.1m) Noggin (37.7m) BET (78.0m) BET Jazz (9.9m) BET Gospel BET Hip-Hop MTV Español (7.4m) VHI Uno Showtime The Movie Channel Flix	Apr-79	Against	“These adverse economic effects ultimately would be borne to consumers, who would be faced with both a sharp increase in monthly fees and a reduction in the diversity and quality of program offerings.” p. 2

Networks Owned by each programmer from programmer websites and FCC filings in MB Docket No. 04-207 (July 15, 2004).  
Subscriber Data and Earliest Launch Date from Kagan Research, LLC, *Economics of Basic Cable Networks 2005*, 11th ed. (2004), pp. 30-32 and 95-453.  
A La Carte opinions from FCC filings in MB Docket No. 04-207 (July 15, 2004).