LET THE MARKET DECIDE
THE *À LA CARTE* OPTION IN THE CABLE MARKET

Today's cable market is far from competitive. American cable customers live in a world of the cable industry's making, a world of extremely limited choice and endlessly spiraling prices. With no meaningful government oversight and virtually no competition, cable providers have the power to decide what programming consumers can see by controlling both packaging and price (with the exception of broadcast channels, which must be carried). By placing their most popular channels in expensive tiers with other channels most people do not watch or worse, find offensive, the industry forces consumers to pay the equivalent of a cable tax by requiring them to buy bloated packages of channels in order to obtain access to the few channels they actually do watch. This tax represents the market inefficiency of a system in which the preferences of producers automatically trump those of consumers.

Cable television's upward pricing spiral reflects a major failure of market forces and public oversight since Congress launched cable deregulation in 1996.[1] In that time, cable rates have ballooned nearly three times faster than the rate of inflation. According to the Bureau of Labor Statistics, rates have shot up a staggering 56 percent since January 1996, while inflation increased by only 21 percent during the same time, even after having adjusted the price increases for additional channels (which may be of very low value to cable subscribers).[2] When the total cost of the cable bundle is considered (i.e. when price increases are not adjusted for the new channels forced into the bundle that few people watch), consumer cable prices have risen five times faster than the rate of inflation. Its clear that the hoped-for competition from deregulation has failed to materialize to temper prices.

Although not a panacea for current cable market efficiencies, allowing consumers to pick and choose networks *à la carte*, as well as offering them themed-tiered channels (such as family and sports tiers), would augment the current offerings and encourage <u>more</u> people to watch cable, not fewer. Such a policy would temper the market power of cable media giants, resulting in a more competitive cable market with lower prices and greater choice.

THE PROBLEMS WITH TODAY'S CABLE MARKET

Competition

In today's cable market, competition is virtually non-existent; 98 percent of Americans have only one cable provider. Of the two satellite television companies, one has extensive ties to the cable and broadcast industries. Satellite companies also buy programming from cable and broadcasting giants, further limiting the competition. Moreover, a recent Government Accountability Office report found that satellite does not provide enough competition to cable to

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[1] Public Law 104-104, The Telecommunications Act of 1996.

[2] Bureau of Labor Statistics, Consumer Price Index (March 2004). From 1996 until March 2004, CPI increased 20.6% while cable prices rose 56%, 2.7 times faster than inflation.

lower prices to their competitive levels.[3] Other market powerhouses include large broadcast companies that own over-the-air and cable TV channels. Their control of popular network programming and guaranteed rights to carriage on cable systems enables them to package their entire channel lineup and force these channels onto cable and satellite systems and ultimately the consumer. This lack of competition has led to staggering price increases.

Consumers naturally desire choice and value, but the market power of the cable industry results in anti-competitive, take-it-or-leave it packages. All cable customers must the basic package, which includes local broadcast channels that serve community needs and interests as well as public, educational, and government (PEG) channels, including C-SPAN and public access channels. This package is usually small, and its price regulated. Congress also requires that cable operators allow basic service subscribers to buy premium channels (such as HBO and Showtime and pay-per-view channels on an *à la carte* basis. Beyond this, however, the cable industry engages in aggressive anti-consumer bundling of channels. Those who wish to watch any channel in the expanded cable tier must buy all the channels in that tier. Expanded basic has grown steadily in size and cost over the years, but at questionable value. (The marginal value of an added shopping channel, for example, may be zero for most consumers, and may be negative for consumers who have to block it out, even though such a channel may lead to higher cable rates.)

Giving consumers the ability to choose cable channels through tiers (expanded basic and additional, themed tiers) and individually would greatly increase consumer choice and make the cable market more efficient, resulting in lower prices and greater choice.

Diversity

Like cable consumers, creators of new, independent, and diverse programming find themselves the victims of market power. The only way to ensure that their programming is aired is to negotiate secret contracts with huge cable companies and broadcast conglomerates or to give them equity ownership in the networks. This ensures that their programming is included in the expanded basic tier. The Government Accountability Office found that cable companies discriminate in favor of their own programming; they are much more likely to carry channels in which they have an ownership interest.[4] This reality leaves independent and small programmers with a simple take-it-or-leave-it proposition: They either must acquiesce to the cable operators' demands in order to be included on their lineup, or starve.[5]

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[3] In a footnote, the report notes: "In our October 2002 report (GAO-03-130) we did not find that DBS competition was associated with lower cable rates. Although the parameter estimate was negative – indicating that DBS competition was associated with lower cable rates – the estimate was not statistically significant. As part of our analysis for this report, we further examined and refined our competition measures to more accurately reflect the true nature of competition in the franchise areas that were included in our analysis. Although the parameter estimate remains negative and the estimate is now statistically significant, the magnitude of the estimate remains small." With true competition, we would expect to see an estimate of greater magnitude that was also statistically significant, indicating that satellite does not provide enough competition to lead to a competitive market. See GAO 04-8, *Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry,* October 2003.

[4] GAO-04-08, p. 1

[5] 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." (Andrea Figler "New Networks Face The VOD Taste Test,", *Cable World,* June 30, 2003.)

As start-up network consultant Cathy Rasenberger states, "[t]he majority of networks out there have no chance at all. That doesn't mean there isn't opportunity for some new networks. The eye of the needle has become a lot smaller, but if you've got a refined piece of thread you can still get through. You have to match up with the cable operators' objectives – and even if you do, you still may not have an opportunity."[6]

Six companies completely dominate the cable programming landscape of the basic and expanded basic tiers, accounting for three-quarters of the programming and writing budgets of the video industry. But these aren't just any six companies. Each of them is also a national network broadcaster, a cable or satellite operator, or has significant ties to both.

According to the Federal Communication Commission's (FCC) Tenth Annual Cable Report, of the top 20 cable channels measured by subscribers and top 15 cable channels measured by primetime viewership, only one, The Weather Channel, is not owned by a cable operator, a broadcast network or the cable industry. Of the 63 channels that reach more than half the cable viewers in the nation, only a half dozen are not owned by one of six dominant firms. Consider the dominance these companies have over the broadcast airwaves and cable/satellite viewers:[7]

- **Disney** owns ABC, ESPN, Lifetime, A&E, History Channel, and SoapNet.
- **Viacom** owns CBS, UPN, MTV, BET, Comedy Central, Nickelodeon, Showtime, Spike TV, CMT, and VH1, as well as local affiliates reaching almost 39 percent of the American television viewing audience.
- **Time Warner** owns the second largest cable company in the country, and owns the WB, CNN, Headline News, HBO, Court TV, TBS, TNT, and the Cartoon Network.
- **General Electric** owns NBC, Bravo, USA, Sci-Fi, Trio, CNBC, and MSNBC, as well as many local broadcast outlets.
- **NewsCorp** owns the FOX television network, local affiliates of both Fox and UPN reaching about 39 percent of the American TV viewing audience, national DBS satellite operator DirecTV and cable channels Fox News, FX, National Geographic and more than a dozen Fox Regional Sports networks.
- **Liberty Media**, the largest single shareholder of NewsCorp, owns a few cable systems and through previous merger transactions and enjoys guaranteed carriage for many of its networks such as the Hallmark Channel, Discovery, Animal Planet, QVC, Starz, and TLC on the largest cable operator in the country, Comcast.
- **Comcast**.,[8] with 23 million subscribers, not only is almost twice as large as the number two cable owner (Time Warner) but it also owns a significant stake in channels like TV One, E!, the Golf Channel, Outdoor Life Network, G4 (the successor to TechTV) and regional sports networks serving three of the nation's six largest metropolitan areas – Chicago, Baltimore-Washington, and Philadelphia.

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[6] Shirley Brady, "Attention New Networks! Here's everything you need to know about how to get a carriage deal with Comcast ... step by step from Amy Banse and Matt Bond," *Cable World*, June 21, 2004.

[7] Cooper, p. 36.

[8] Diane Mermigas, "Comcast Courting Bornstein," *TV Week*, November 18, 2002.

It is no wonder that network executives say these barriers are high when, according to one trade publication, "combined with industry consolidation, which has left a handful of powerful MSOs [i.e., cable companies] controlling the vast majority of cable subscribers, the current environment is arguably the worst ever to launch a new linear video service."[9]

Consider the dearth of programming offered to African-American consumers on expanded basic. Only one national cable channel (BET – owned by Viacom) targets African-Americans, and another (TV One) is largely only available to Comcast subscribers. Most other African-American themed channels are offered only on unnecessarily pricy digital tiers. Ironically, according to the Cable Television Advertising Bureau, "Urban black households are the most television-oriented as compared to all other groups. … Premium channel subscription in urban cable homes is greater among black and Hispanic subscribers as compared to white and Asian subscribers."[10] Adding themed tiered and *à la carte* options to the current system would result in more African-American themed and owned channels that target consumers of color. And with an *à la carte* option, then African-American consumers, like all consumers, could select and pay for the programming they wanted without having to pay unnecessarily for pricy expanded basic tiers and other bundles.

Taste and Programming

The immense public furor generated by January's Super Bowl halftime incident involving entertainer Janet Jackson illustrates the overwhelming desire of American consumers to have some control over the programming that comes into their homes. Technology such as the V-Chip allows consumers to block distasteful programming, but they still must pay for the programming they find offensive or indecent, which provides incentives to produce the offensive programming. Congress has dramatically increased fines for broadcasters of indecent content, but these fines are seen as a cost of doing business[11] and in any case do not apply for cable and satellite programmers.

Giving consumers the choice to select only those cable channels they want provides a different solution to the growing public concern about violent and indecent programming. Rather than putting the government in the untenable position of trying to control cable content for taste and decency, consumers could merely choose the programming they want, eliminating from their homes those channels which they find offensive. Such a system would allow the marketplace to decide what should be aired.

A Reasonable Proposal to Make the Market More Competitive

Consumers Union[12] (CU) and the Consumer Federation of America[13] (CFA) offer the following reasonable proposal to encourage the cable industry to move toward themed tiered-

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[9] *Multichannel News,* "New Nets Abundant at National Show; Fledgling Services Find Entry Into Digital-Cable Realm Difficult," R. Thomas Umstead, May 3, 2004.

[10] Cable TV Advertising Bureau: Multicultural Marketing Resource Center. "Psychographics and Cultural Insights," Urban Markets in the US, Horowitz Associates.

[11] As *Kansas City Star* television critic Aaron Barnhardt told a reporter from the *Marketplace Morning Report*, "In the time it will take for you to report this story, Viacom [which distributes *The Howard Stern* Show] will make enough profit to pay off all of its FCC fines and then some." (Marketplace Morning Report, July 1, 2004.)

[12] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education and counsel about goods, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for

programming and *à la carte* pricing on a voluntary basis. It is based on the notion that small cable operators do not offer their digital subscribers *à la carte* and themed tier offerings because of contractual arrangements with the large media broadcasters. These contracts determine the pricing of channels, lineup placement, bundling provisions and more.[14]

According to recent testimony of the American Cable Association, which represents the interests of small cable companies, "in dealing with the Big Five [Disney, Viacom, Fox, GE, and Time Warner], all ACA members continually face contractual restrictions that eliminate our flexibility to determine how local cable systems can package and distribute programming, instead placing programming cartels, headquartered thousands of miles away, in charge of what my community deems as 'decent' content, pricing and value."[15]

CU and CFA propose merely to prohibit these unfair contracts between cable companies and broadcasting giants that contain tying arrangements (requiring transmission of several of a broadcasting companies' networks in order to transmit a particularly popular one) or that require networks to be transmitted in a specific tier (such as expanded basic), which prevents cable companies from offering those channels* à la carte *or in themed tiers. This would free cable companies to voluntarily offer their customers themed tier programming (such as a sports or family packages) and individual channels *à la carte*,[16] in addition to the expanded basic and digital tiers already available. With the ability to make decisions based on customer preferences rather than the preferences of the broadcasting conglomerates, many cable companies would find it profitable to offer themed tiers and *à la carte* pricing to their digital customers, in addition to the current expanded basic lineup. Ultimately, the effects of this would reach consumers, who would benefit from lower cable rates and greater choice. If the voluntary system showed promise and led to lower cable rates and greater diversity, as we believe it will, then we would seek to ensure that all cable consumers would have an *à la carte* choice in addition to the cable choices they currently enjoy.

Our proposal would still retain the requirement that there be a basic tier of programming, including local broadcast channels that serve community needs and interests as well as public, educational and government (PEG) channels. Consumers would have to buy this basic tier to have access to *à la carte* offerings or other tiers. There is a clear public interest need in promoting local news and cultural awareness through this basic tier, which would remain the same as it is today. Beyond this, however, consumers should be given more choice.

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consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports,* with more than four million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

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

14 Dr. Mark Cooper, "Time To Give Consumers Reach Choices: Twenty Years Of Anti-Consumer Bundling And Anticompetitive Gatekeeping," Consumer Federation of America, pp. 1, 23.

15 Testimony of Ben W. Hooks, Jr. before the House Financial Services Committee, 14 July 2004. Available at: http://www.americancable.org/news/press/BHooks-Programming%20Written%20Testimony-071204-3.pdf.

16 CU and CFA estimate that the cost of offering channels *à la carte* would be $1-$3 per channel.

This analysis shows that the requirement to offer bundles and *a la carte* could have a number of salutary economic effects beyond the simple fairness of allowing consumers to pay for only the things they truly want to consume.

Because cable income from traditional video services has been growing much faster than cable costs (i.e., net income has grown), the requirement to make programs available on an *a la carte* basis can put downward pressures on prices. Cable operators could feel pressures to be more responsive to consumer needs. In all likelihood, they will still want to sell bundles, but they will have to be more careful not to overprice them, thereby driving consumers to *a la carte* purchases. This discipline would be created by attacking the core driver of anti-consumer bundling, the negative correlation between demand for different channels. The ability to cross subsidize from traditional video service to other services would be reduced.

Owners of the most expensive channels should feel pressures to control costs. Consumers' true preferences for individual channels would become apparent in a mixed bundled world. The threat to remove channels from bundles, or segregate expensive channels into theme tiers, should expose programmers more directly to consumer preferences.

Because the current system is so discriminatory against independent programming, we believe that *a la carte* could expand the opportunity for independent programming. Cable operators would come under pressure to remove their own shows from bundles, if the number of consumers who choose *a la carte* is significant but the shows they choose are not owned by cable operators. The ability of large national programmers to force large packages of channels into the expanded basic bundle could be put under pressure, if consumers show an *a la carte* preference for a small subset of its channels. Programmers who achieve a significant *a la carte* following could gain considerable leverage with advertisers, since they are delivering a dedicated and perhaps distinctive audience.

This CU/CFA proposal is intended to correct the most blatant market inefficiencies. Effective competition simply has not materialized under the current system, and limited government intervention is necessary to increase the market's competitiveness. We believe it is time for policymakers to release the stranglehold cable and broadcast giants have on the marketplace by encouraging *à la carte* and themed tiered options.

À la Carte Works: Ask Canadian Consumers

When those in the American cable industry try to raise feasibility arguments about the *à la carte* option, they need only look to their colleagues in Canada to realize their claims are baseless. Nearly all the major Canadian cable operators offer their bundled programming on an *à la carte* basis, and some cable operators, most notably Vidéotron, offer the kind of system that we envision for the United States.[17]

[17] Canada imposes a variety of content regulations that we believe are unnecessary and inappropriate for the U.S. market. We cite the Canadian example for the purpose of showing how *à la carte* can work and what prices it offers in a real-world example.

After subscribing to a basic cable services and buying or renting a digital converter box,[18] Canadian cable customers may select their programming through tiers or *à la carte*. Vidéotron customers, for example, first buy basic Canadian digital cable that includes roughly 20 TV channels. (The company offers those, along with 30 music channels and 14 broadcast radio stations, for $8.25.)[19] Vidéotron offers three general bundles, numerous themed bundles, and the option to purchase channels individually – 38 channels for $20 per month (the equivalent to the American expanded basic tier), 65 channels for $28 and 106 channels for $40, (the equivalent to various U.S. digital tiers). The cable operator also offers bundles of channels with programming focused on news, sports, documentaries, sitcoms, culture, lifestyle and music. It also lets consumers pick a bundle of programming in French or English. And if a consumer wants a channel that is not part of the bundle they've selected, then most channels will let Vidéotron sell it to their customers individually for $1 per month, a per-channel price that drops if a consumer orders 5, 10 or 20 other channels. Consumers can also select a bundle of 20 or 30 channels from Vidéotron 93-channel lineup, which Vidéotron calls *à la carte* and Canadian Cable Association President Mike Hennessey calls a "pick pack." A Vidéotron spokesman told the Orlando Sentinel, "We have noticed that some people prefer to pay for [just] what they want to look [at]."[20]

Consumers Want à la Carte

Recent nationwide surveys conducted by Consumers Union and the Concerned Women for America (CWA) demonstrate that consumers want increased choice and more control over their cable programming, and their cable bills. According to a CWA poll conducted by Wirthlin in April 2004,[21] more than two-thirds of cable customers would prefer to choose the channels in their cable packages, and fewer than a third are satisfied with the channel bundles they are currently offered. And approximately the same percentage of Latinos and African-Americans would prefer to choose their own channels. The poll found among non-cable subscribers, 66 percent would be more likely to subscribe to cable if they had control over their programming.

A CU national representative survey of cable subscribers in May 2004[22] resulted in similar findings. CU found that 66 percent of subscribers would prefer the option to pick only those cable channels they want to watch or have included in their service plan. Of those surveyed, 59 percent would pick fewer channels than they currently must buy in their cable package. And 29 percent would *still* choose fewer channels even if their cable bill didn't decline proportionally.

But it is not just consumers who would benefit from an *à la carte* option. Industry experts would as well. James Gleason, president and chief operating officer of CableDirect, a cable operator serving 20,000 customers in the Midwest said, "To give customers choice and allow the market to determine what gets on TV, programmers should be required to make their services available as part of a separate programming tier. One solution might be to offer the expensive programming in tiers

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[18] In U.S. dollars, Canadians pay approximately $45 to own the digital converter box and $9/month to rent one.

[19] All figures in U.S. currency. Conversions from CAD to USD obtained from http://finance.yahoo.com/currency, 07/01/2004.

[20] Orlando Sentinel, "À la carte Cable Could Redefine Pay-Per-View," Susan Strother Clarke, June 6, 2004.

[21] Wirthlin Worldwide, "National Quorum for Concerned Women for America," April 22, 2004.

[22] Consumers Union, "Cable TV Issues Survey," May 25, 2004.

or *à la carte*."[23] Charles Dolan, chairman of Cablevision, one of the largest cable operators with over four million homes in the northeast, told the Senate Commerce Committee: "Cablevision, as a policy, wants its customers to be able to pick and choose among its services, selecting what appeals to them, rejecting what does not, determining for themselves how much they will spend, just as they do every day in the supermarket or shopping mall."[24] He continued with an apt analogy: "To help the dairy industry, I ask, would the government insist that all customers be required to buy a dozen eggs and a quart of milk before they can purchase their bread?"

THE INDUSTRY'S MISREPRESENTATION OF *À LA CARTE* CHOICE

The consumer-friendly qualities of encouraging cable *à la carte* and themed tiers have sent cable operators into a panic over the possibility that Congress might act. In response, the large cable operators and dominant national programmers have hired a bevy of economists and accountants to paint a doomsday scenario for *à la carte* choice that bears no relationship to reality.

They have vastly overstated the costs and completely ignored the benefits of an environment in which consumers are allowed to choose to buy networks in bundles or individually. They fail to take into account the migration to digital technology that is already under way. A policy that promotes *a la carte* for digital subscribers would enhance consumer sovereignty and invigorate competition without raising consumer costs.

Network Economics and à la Carte Choice

The cable industry's analysis rests on a series of faulty assumptions related to subscribers. Their primary assumption is that *à la carte* will lead to a dramatic loss of advertising revenue owing to a decrease in subscribers. They maintain that a network must reach 50 million homes before becoming profitable (which contradicts their prior statements that this figure was 15 million, and that in order to do so marketing costs are shockingly high. It's hard to take the claims of the cable companies seriously when they choose their economic assumptions based on what suits their argument best.

The reality is much different. Given choice, consumers will sort themselves into three categories – devotees, grazers and captives**.** **Devotees** have high interest in watching a cable network and are most likely to pay a higher price to be able to do so. They are most likely to buy a channel *à la carte* . **Grazers**, who really value the bundle with its wide range of choices, are most likely to subscribe to these bundles. **Captives** are those who under the current system are forced to buy a network (or multiple networks) that they never watch in order to have access to other networks that they do watch. If they had the chance, captives would not buy certain networks. Those who currently watch a network would continue to do so, either by choosing shows *a la carte* (devotees) or by buying bundles (grazers). The captives, on the other hand, will no longer subscribe to a given network, but they will not decrease viewership, since they never watched the network to begin with. What advertisers, who pay primarily to reach viewers, lose in reach (the number of

[23] James Gleason, Testimony before Senate Commerce Committee, "Media Ownership (Video Markets)," May 6, 2003.

[24] Charles, Dolan, Testimony before Senate Commerce Committee, "Media Ownership (Video Markets)," May 6, 2003.

subscribers with access to a network) they make up for in effectiveness (the greater probability that someone is watching).

Cable Operator Economics

Many cable operators bemoan the cost of moving to *a la carte* in a digital system to policymakers, yet they have announced to programmers that they will completely convert within two or three years. A digital converter box is a prerequisite of moving to an *à la carte* system. However, many cable customers are already paying fees for digital converter boxes yet without an *à la carte* option, and according to the industry itself, other consumers will do so within three years. If everyone will be on a digital system within three years, why not given them the choice of *à la carte*? The industry's set-top box analysis is a $500 solution to a $50 problem. With almost half of all MVPD subscribers already being served by digital technology, the ramp up in customer care costs has already taken place.

Contrary to fact, the cable industry assumes that there is neither inefficiency, nor abuse of market power in the current prices paid by consumers. Yet most cable operators are monopolies, making high economic profits. The greater competition in a mixed bundling environment would squeeze excess profits and artificially-inflated costs out, leading to lower overall cable bills. (We estimate that the costs for *à la carte* programming would be in the range of $1 to $3 per month.) More importantly, the mixed bundling environment will better serve consumer and programmer needs.

Truly independent programmers will find a much less hostile environment.

Our proposal could actually lead to <u>increased</u> advertising revenues and <u>increased viewership</u>, since some consumers who are currently priced out by the massive bundle would be brought in. It would also lead to greater diversity, since small independent broadcasters would be able to make it without necessarily getting on a tier; people could choose them *à la carte*, whereas now those channels must make it onto the expanded basic or digital tiers to survive. In addition, cable operators could feel pressures to be more responsive to consumer needs in an *à la carte* environment.

Congress and the FCC have the ability to make the cable market more competitive. They should seize this opportunity. Rather than stifling innovation and competition, limited government intervention (by <u>encouraging</u>, rather than requiring, *à la carte* and themed tiers) would make cable programming <u>more competitive</u>. This would also provide a prudent First Amendment approach to dealing with offensive programming by giving consumers the option not to have that programming come into their homes. In short, by allowing the *à la carte* option, Congress and the FCC can correct market distortions with actions that lead to lower prices, greater choice, and greater innovation.