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Cable and Satellite Television Network Tiering and a la Carte Options for Consumers: Issues for Congress

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Summary

Multi-channel (cable and satellite) television is the single largest component of the entertainment sector, generating $48.6 billion in residential subscription revenues and an additional $15.0 billion in advertising revenues in 2002. It is a major source of news and informational programming and diverse entertainment programming, including niche programming. Some consumer advocates complain, however, that, as a result of the industry-wide practice of offering almost all advertiser-supported cable networks in a single tier only, consumers are forced to purchase networks they are not interested in receiving in order to obtain the networks they want. For example, in order for consumers to obtain desired children's networks, such as Nickelodeon or Discovery Kids, they must purchase the expanded basic service tier that includes networks whose programming some consider not of interest or objectionable. These advocates claim consumers would be better off if they had the option to purchase just the individual cable networks they want (this is frequently referred to as "a la carte" purchasing) or, at the least, to purchase smaller tiers that include fewer of the cable networks they do not want.

The large cable programmers, who provide most of the popular cable (and broadcast) television programming, respond that a single large expanded basic service tier represents the most efficient way to offer programming and that allowing customers to obtain networks on an a la carte basis or in small tiers would raise costs – and hence prices to consumers – and also reduce the diversity of programs offered, so that consumer welfare would suffer in the long run. They claim a single large tier reduces the risks associated with introducing new cable networks and helps support niche networks.

Several proposals have been made to Congress that are, in effect, variations on the theme that subscribers should have greater decision-making power over the cable networks they receive. The various proposals would: prohibit programmers from requiring cable and satellite operators to carry their less popular networks in order to attain access to their popular networks, and – more specifically – prohibit programmers that own broadcast stations from tying the retransmission consent they give cable and satellite operators to carry their broadcast programming to the carriage of the programmers' cable networks; prohibit programmers from requiring cable and satellite operators to offer the programmers' networks in the expanded basic service tier only; require cable and satellite operators to offer subscribers the options of purchasing smaller program tiers or purchasing networks a la carte; and require sports programmers and cable and satellite operators to offer expensive sports programming on a separate tier. In response to requests from key members of the House and Senate Commerce committees, the Federal Communications Commission has opened a docket seeking factual information on the potential merits and drawbacks of making networks available to subscribers on an a la carte or themed-tier basis. In this report, the pros and cons of offering subscribers only a single large expanded basic service tier and also of the various proposals to provide consumers more options are presented. This report will be updated as events warrant.

Contents

List of Tables

Cable and Satellite Television Network Tiering and a la Carte Options for Consumers: Issues for Congress

The Issues Before Congress

Multi-channel (cable and satellite) television is the single largest component of the entertainment sector, generating $48.6 billion in residential subscription revenues and an additional $15.0 billion in advertising revenues in 2002.[1] By comparison cable and satellite subscription and advertising revenues totaled only $18.4 billion in 1990.[2] Approximately 85% of households with televisions subscribe to multi-channel service.[3] Besides commanding a significant portion of Americans' discretionary spending, multi-channel television is a major source of news and informational programming and diverse entertainment programming, including niche programming. The question of how best to make cable and satellite video networks available to consumers therefore has been the subject of serious debate in Congress.[4] The purpose of this report is to discuss the pros and cons of the current industry practice of making the bulk of multi-channel programming available to consumers in a single large package only and of various proposals to give consumers additional purchasing options. These options include purchasing smaller packages or

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[1]Kagan World Media, *Broadband Cable Financial Databook 2003*, tables entitled "Kagan's 10-Year Cable TV Industry Projections" (pp. 11-13) and "Total Cable TV Advertising Billings (1980-2013)" (p. 19), and Kagan World Media, "DBS Report," June 27, 2003, table entitled "DBS Industry Projections 2002-2013" (p. 9). These totals do not include $1.3 billion in cable installation charges to subscribers and an unquantified level of satellite installation charges to subscribers in 2002. In these tables, Kagan projects a 5.4% increase in cable subscription revenues, a 13.6% increase in satellite subscription revenues, and a 11.0% increase in advertising revenues in 2003.

[2]See CRS Report RL32027, *Market Structure of the Video Programming Industry and Emerging Public Policy Issues*, Table 4, p. 19.

[3]According to the Federal Communications Commission's *Tenth Annual Report on Competition in Video Markets*, released on January 28, 2004 (at pp. 4-5, paragraph 7), as of June 2003, 85.25% of all television households subscribed to a multi-channel video service, but that might overstate the total as a small number of households subscribes to multiple services (for example, cable and satellite service). Since June 2003, satellite subscriptions have risen significantly, and many of those new subscribers had not been cable subscribers.

[4]See, for example, the statements, pre-filed testimonies, and transcripts of the Senate Committee on Commerce, Science and Transportation Hearing on Escalating Cable Rates: Causes and Solutions, March 25, 2004, and the Senate Judiciary Subcommittee on Antitrust, Competition Policy, and Consumer Rights Hearing on the News Corporation/DIRECTV Deal: Marriage of Content and Global Distribution, June 18, 2003.

purchasing on a network-by-network basis (frequently referred to as "a la carte" purchasing).

Currently, virtually all cable system operators make cable networks available to customers only in a limited number of packages (or tiers):

- The **basic service** tier, typically consisting of a package of local stations (local broadcast stations and public, educational, and governmental (PEG) access programming)[5] plus a few advertiser-supported cable networks.[6]

- The cable programming service tier, referred to in the industry as the **expanded basic service** tier, consisting on average of 36 advertiser-supported cable networks.[7] This tier typically includes many of the most popular cable networks, ranging from Nickelodeon and the Discovery Channel to MTV. Cable operators require subscribers to purchase the basic service tier in order to purchase the enhanced service tier. Since approximately 90% of subscribers purchase the expanded basic service tier, most customers have this enhanced basic service tier in mind when they talk of "basic service."

- Various **premium** tiers, typically consisting of a small package of "premium" program networks (such as HBO and Showtime), usually offered without commercial advertising.[8]

- **Pay-per-view** channels with programming (first-run movies, live concerts, boxing matches, sexually-explicit programming) that subscribers pay for on a program-by-program basis.

The direct broadcast satellite (DBS) distributors of multi-channel television also offer the bulk of advertiser-supported networks on a single tier, analogous to cable's expanded basic service tier, with additional premium tiers and pay-per-channel programming available.[9]

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[5]Local cable systems are required to have a basic offering that includes the local broadcast channels and , if available, PEG channels. See "Consumer Options for Selecting Cable Channels and the Tier Buy-Through Prohibition," Federal Communications Commission Fact Sheet, February 2003, at p. 1.

[6]The Government Accounting Office found that on average the basic service tier includes 25 networks. See *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, General Accounting Office Report to the Chairman of the Senate Committee on Commerce, Science and Transportation (GAO Report), October 2003, at p. 5.

[7]GAO Report at p. 5.

[8]Although premium networks typically do not include commercial advertising, they do typically include a significant amount of promotions for other programs on that network.

[9]Satellite television providers and cable operators distribute the same program networks, which are generically referred to as cable networks. In most situations, the market analysis and public policy issues surrounding consumer options for cable networks are the same

(continued...)

Some consumer advocates complain that, as a result of the industry-wide practice of offering almost all advertiser-supported cable networks in a single package only, consumers are forced to purchase networks they are not interested in receiving in order to obtain the networks they want. As shown in Table 1, even those subscribers who receive more than 120 cable networks view, on average, fewer than 20 networks in a week. (Some subscribers, however, may watch a larger number of networks over a longer period of time – either as a result of casually surfing across networks or because some networks they watch on occasion did not happen to have programming of interest to them in that particular week – and may value access to those additional networks.) Consumer advocates claim consumers would be better off if they had the option to purchase just the individual cable networks they want (a la carte purchasing) or, at the least, to purchase smaller tiers that include fewer of the cable networks they do not want.[10]

The large program providers, who provide most of the popular television programming, respond that a single large expanded basic service tier represents the most efficient way to offer programming and that allowing customers to obtain networks on an a la carte basis or in small tiers would raise costs – and hence prices to consumers – and also reduce the diversity of programs offered, so that consumer welfare would suffer in the long run.[11] They claim a single large tier reduces the risks associated with introducing new cable networks and helps support niche networks. (The economics underlying the cable programmers' business model, and its reliance on a single large expanded basic service tier, is discussed in detail in the next two sections.)

Some cable system operators have taken a middle road position, arguing that in most – but not all – cases requiring consumers to take a single large expanded basic service tier is more efficient than giving consumers the option of purchasing networks a la carte or in smaller tiers, but that the decision on how to offer networks to customers should reside entirely with the cable system operators. They assert that cable operators should neither be required to offer networks a la carte or in small tiers **nor** be restricted by the government or programmers from offering networks a la carte or in small tiers.[12]

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[9](...continued)
whether the multi-channel distributor is a cable system or a satellite system. For simplicity of exposition, when this report refers to cable, it also implicitly includes satellite. In those situations where analysis differs for cable and satellite, the report explicitly identifies those differences.

[10]See, for example, the Testimony of Gene Kimmelman, on behalf of Consumers Union and Consumer Federation of America, before the Senate Committee on Commerce, Science and Transportation (Kimmelman Testimony), March 25, 2004, at pp. 3-4.

[11]See, for example, the Testimony of George Bodenheim, president, ESPN, Inc. and ABC Sports, before the Senate Committee on Commerce, Science and Transportation, March 25, 2004, at p. 1.

[12]See, for example, William P. Rogerson, "Cable Program Tiering: A Decision Best and Properly Made by Cable System Operators, Not Government Regulators," November 10, 2003, at pp. 5-7. This study was prepared and funded by Cox Communications Inc. and (continued...)

Table 1. Cable Channels Receivable vs. Viewed

Number of Channels Receivable	Average Number of Channels Receivable	Average Number of Channels Viewed
11-20	15.4	5.5
21-30	24.7	6.8
31-40	35.4	10.2
41-50	45.7	12.6
51-60	55.9	15.2
61-70	66.4	15.3
71-80	75.9	15.4
81-90	84.5	15.5
91-100	95.1	16.6
101-110	105.2	18.4
111-120	115.9	16.5
121+	183.2	19.2

Source: Nielsen Media Research, National People Meter Sample, August 25-31, 2003, presented by the Television Bureau at [http://www.tvb.org/rcentral/mediatrendstrack/tvbasics/10_Channels-RecVsViewed.asp], viewed on 4/22/2004.

The issue of cable program tiering has come up in several policy debates currently before Congress.

In the debate on indecent programming, some consumer advocates have complained that in order for consumers to obtain desired children's networks, such as Nickelodeon and Discovery Kids, they must purchase the expanded basic service tier that includes networks whose programming they consider objectionable.[13] Most cable operators have recently agreed to provide all customers, upon request and at no additional charge, the equipment needed to block objectionable programming.[14] But

[12](...continued)
attached to the Testimony of James O. Robbins, president and chief executive officer, Cox Communications, Inc., before the Senate Committee on Commerce, Science and Transportation, March 25, 2004.

[13]See, for example, the letter dated March 4, 2004, from L. Brent Bozell, III, founder and president, Parents Television Council, to Sen. John McCain (Bozell letter).

[14]"NCTA's Sachs Tells Families 'Cable Puts You in Control' in Speech to Cable Public Affairs Conference," National Cable & Telecommunications Association (NCTA) press (continued...)

some consumer advocates claim consumers still are forced to bear inappropriate costs and inconveniences. They assert that cable operators build into the price they charge for the expanded basis service tier the licensing fees for all the networks on the tier, including the fees for those networks some consumers do not want to receive. These consumer advocates also claim subscribers are inconvenienced by the need to program the equipment to block the unwanted programming. Some have proposed that cable operators allow customers to purchase networks on an a la carte basis or, at the least, offer a smaller (or different) expanded basic service package that excludes the objectionable networks.[15]

In the debate on cable prices and media ownership concentration, cable operators have argued that one of the major contributors to rising cable prices is the sharp increase in license fees that programmers charge cable operators, especially for sports networks.[16] The General Accounting Office (GAO) found that the average license fees cable operators paid to purchase programming increased by 34% between 1999 and 2002 – an average of 26% for 72 non-sports networks and 59% for seven national sports networks.[17] James Robbins, chief executive of Cox Cable, reportedly stated at a Goldman Sachs investors conference in October 2003 that ESPN sought a 20% annual increase in its fees from Cox, while Fox Sports proposed a 35% increase for 2004.[18] He stated that Cox pays ESPN $2.61 a month for each subscriber, more than it pays for the seven top-rated advertising-supported networks combined, and that ESPN accounted for 4% of Cox customers' viewing, but 18% of Cox's programming costs.[19] These major sports programmers contractually require that their sports networks – which are viewed as "must have" programming by most cable and satellite operators – be included by operators in their expanded basic

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[14](...continued)
release, March 23, 2004. According to the press release, this commitment was made by the 10 largest NCTA member companies and many smaller cable companies that, in all, serve about 85% of cable subscribers in the United States.

[15]See, for example, the Bozell letter or the Kimmelman Testimony.

[16]See, for example, the Testimony of Charles F. Dolan, chairman of Cablevision Systems Corporation, before the Senate Committee on Commerce, Science and Transportation, May 6, 2003, at pp. 4-5; the Testimony of James O. Robbins, president and chief executive officer, Cox Communications, Inc., before the Senate Committee on Commerce, Science and Transportation, May 6, 2003, at p. 1 (Robbins Testimony of May 6, 2003); and the Testimony of James M. Gleason, president and chief operating officer, CableDirect, and chairman, American Cable Association, before the Senate Committee on Commerce, Science and Transportation (Gleason Testimony), May 6, 2003, at pp. 7-8.

[17]GAO Report at p. 22.

[18]David D. Kirkpatrick and Geraldine Fabrikant, "Sports Fan Is the Prize, or the Victim, in Cable Fight," *New York Times*, October 6, 2003, at pp. C1 and C4.

[19]ESPN generates significantly more advertising revenues for cable operators than do most other cable networks, however, which partially compensates for the higher cost. ESPN claims that "local ad sales revenue offsets a significant portion of the wholesale cost. As a result, the net wholesale cost for ESPN is about $1.00 a sub[scriber] per month." ("ESPN Reaffirms Value to Cable," ESPN Press Release dated May 6, 2003, provided to the Senate Committee on Commerce, Science and Transportation for its hearing on May 6, 2003.)

service tier, not sold to consumers as a separate, premium tier.[20] Some consumer advocates and some cable operators argue that although sports fans have a very strong demand for sports programming, only a small minority of expanded basic cable customers watch sports programming, and therefore most consumers would benefit if the program were provided to customers as a separate programming tier.[21]

At least one major cable operator appears to want the discretion to offer sports networks on a separate, premium tier, but does not currently seek to offer such a tier.

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[20]This contractual requirement was upheld recently by an arbitration panel in a specific dispute involving Cablevision and the YES Network, which is owned by the New York Yankees and offers Yankee and New Jersey Nets games. That dispute has been perhaps the most visible contractual dispute between a cable operator and a sports programmer about the rights of the cable operator to place a sports network on a separate premium tier instead of including it in the expanded basic service tier. In 2002, Cablevision had refused to carry YES, claiming that the monthly subscription fee of $2 per month per subscriber was too high and that its 2.9 million New York and New Jersey area customers should be allowed to choose if they wanted the network by providing the network as a separate, premium tier. Yankees games were blacked out, and approximately 45,000 Cablevision subscribers turned to DirecTV, which continued to carry the YES network as part of its expanded basic service offering. In 2003, just before the opening of the baseball season, in negotiations that included the Mayor of New York City and the Governor of New Jersey, YES and Cablevision agreed to a temporary solution by which Cablevision would offer YES for a year as a premium channel, charging customers $1.95 per month for YES or $4.95 a month for a premium package that also included MSG Network and Fox Sports Net New York, which between them televise the games of five professional sports teams – the Mets, Knicks, Rangers, Islanders, and Devils. (YES also allowed Time Warner Cable to offer the YES network as a premium channel. Cablevision and Time Warner reduced their rates for expanded basic service by between $0.50 and $1.00 when the YES channel was put on a separate tier.) Cablevision and YES agreed to submit to binding arbitration to determine whether Cablevision could continue to offer YES to its subscribers as a separate premium tier outside the extended basic service tier. About 1.5 million Cablevision customers chose to subscribe to YES. Thus, YES lost almost half the license fee revenues it had been receiving from Cablevision for its cable subscribers. On March 24, 2004, the three-man arbitration panel voted unanimously that the games should be shifted to the widest possible audience – expanded basic cable service – for six years. Although the exact terms of the arbitration decision were kept confidential, various news sources reported that the arbitrators set the per subscriber license fee at $1.83 per month, lower than the $2.28 sought by YES. But it appears that Cablevision had to pay the license fee retroactive to the start of the 2003 baseball season, which would have allowed YES to recoup the previously lost license fee revenues. (See "News in the Yes Network, Cablevision Battle," at [http://abclocal.go.com/wabc/news/print_WABC_03244_cablevisionyanks.html], viewed on 3/31/2004, "YES 1, Cablevision 0," at [http://www.reuters.com /newsArticle.jhtml?type=televisionNews&storyID=4649545&section=news.html], viewed on 4/13/2004, and the GAO Report, at p. 38.)

[21]For example, in his testimony before the Senate Commerce Committee on May 6, 2003, Cox Communications president James Robbins claimed that "Our research shows that less than 20% of our customers are avid TV sports viewers. But sports programming is disproportionately driving up cable prices for everyone." (at p. 2.) In contrast, ESPN, in a press release dated May 6, 2003 that it provided for the same hearing, claimed that "86% of Americans ... consider themselves sports fans." (at p. 3.) The ESPN press release does not address how many of those sports fans actually watch sports programming.

Cox Communications president James Robbins, stated in his May 6, 2003 testimony before the Senate Commerce Committee:

> Tiering presents an intriguing solution to restore an acceptable price value proposition for the most expensive networks – perhaps those that charge Cox a wholesale prices of more than $1 per subscriber. If operators had the flexibility to sell these networks – sports channels or others – on a separate tier, consumers would gain an opportunity to manage their cable expenditures by choosing whether or not to buy certain programming. Likewise, programmers would be motivated to keep their prices reasonable to remain on expanded basic cable line-ups.[22]

In response to a question from Senator McCain in the March 25, 2004 Senate Commerce Committee hearing, however, Mr. Robbins stated that he had successfully completed negotiations with ESPN for a license fee increase that was significantly less than 20% and, as a result, he no longer wants to offer ESPN to customers as part of a separate, premium sports tier.

In the debate on cable prices and media ownership concentration, small cable operators sought congressional action

> to ensure that the programming conglomerates cannot force consumers and cable businesses to take bundled services or require that these services be carried on the lowest levels of service.... Congress should amend telecommunications laws to provide that no programming provider can require that its services be carried only on the basic or expanded basic level of service. Rather, to give consumers choice and to 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, or even a la carte.[23]

The small cable operators also proposed that Congress amend the retransmission consent laws to prohibit broadcasters that also own cable networks from requiring cable operators to carry those cable networks on their systems in order to obtain retransmission consent for their broadcast signals.[24]

On the other hand, the program providers claim that their business model depends crucially on maintaining the large expanded basic service tier and that allowing (or requiring) cable operators to offer cable networks a la carte or on small tiers would threaten the financial viability of the industry, to the detriment of consumers.[25]

On May 18, 2004, House Commerce Committee chairman, Joe Barton, ranking member, John Dingell, Telecommunications Subcommittee chairman, Fred Upton, Telecommunications Subcommittee ranking member, Edward Markey, and

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[22]Robbins Testimony of May 6, 2003 at p. 2.

[23]Gleason Testimony at p. 7.

[24]Ibid at p. 13.

[25]See GAO Report at p. 34.

Representative Nathan Deal sent a detailed letter to Federal Communications Commission (FCC) chairman Michael Powell asking the FCC to perform a study, within six months, that provides information needed to make an informed decision on the potential merits and drawbacks of proposals to allow cable and satellite operators to offer programming to their subscribers on an a la carte or themed-tier basis. They asked the FCC to determine the extent to which cable and satellite operators currently have the option of purchasing individual cable networks and of offering them to subscribers on an a la carte basis; to study the likely impact of a la carte and themed-tier offerings on retail rates; to investigate the likely impact of a la carte and themed-tier offerings on advertising revenues; to investigate the impact of the current retransmission consent process on consumers' ability to select their own programming; to investigate the likely impact of a la carte or themed-tier offerings on the diversity of programming; to study the unique characteristics of rural and smaller markets; to estimate how many households would have to invest in set-top boxes in order to receive a la carte or themed-tier offerings; and to study what legal issues might arise if Congress decided to mandate a la carte purchasing.[26]

On May 19, 2004, Senate Commerce Committee chairman John McCain sent a letter to FCC chairman Michael Powell urging the FCC "to use any existing authority you have to promote, or to create incentives to promote, an a la carte pricing option, in conjunction with whatever tiers cable and satellite companies already offer."[27]

Responding explicitly to these letters, on May 25, 2004, the FCC initiated a docket seeking comment on "factual questions regarding the provision of a la carte and themed-tier services on cable television and direct broadcast satellite systems."[28] The Commission sought factual information relating to all of the questions in the letter from the members of the House Commerce Committee.

The Current Cable Programmer Business Model

The current cable programmer business model is designed to maximize short term and long term industry profits. To the fullest extent possible, it takes advantage of economies of scale and scope as well as some elements of market power and some market distortions. In so doing, it is in many ways very efficient but according to critics does not fully serve consumer welfare. This business model has not developed independently of the market structure. The industry is characterized by a small number of large programmers that provide the bulk of popular cable (and broadcast)

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[26] Letter dated May 18, 2004, from Reps. Barton, Dingell, Upton, Markey, and Deal to FCC Chairman Michael Powell.

[27] Letter dated May 19, 2004, from Senator John McCain to FCC Chairman Michael Powell.

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

networks[29] – and that are starting to integrate forward into distribution[30] – as well as a small number of cable and satellite providers that serve the vast majority of cable and satellite television subscribers.[31] Although independent programmers' and cable systems' interests often coincide with those of the large programmers and system operators, the industry business model presented by corporate executives and Wall Street analysts at congressional hearings is the one developed by, and tailored to the interests of, the large programmers (and, to a lesser extent, large distributors). For example, employing a single large tier that allows efficient cross-promotion of cable networks on affiliated networks is most efficient for large programmers with multiple cable networks.

Most relevant for the public policy issue of consumer options for selecting cable networks, the current cable programmer business model is based on the vast majority of subscribers purchasing the large expanded basic service tier of advertising-supported cable networks (in addition to the basic service tier) and a smaller group of subscribers purchasing additional programming on premium tiers and/or on a "pay-per-view"basis.[32] The business model employs the following strategies:

- By carefully assigning cable networks to basic or premier tiers and using two primary programming revenue sources – direct payments for programming (in the form of per subscriber license fees and per use charges assessed on cable system operators) and advertising fees[33] – programmers simultaneously benefit

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[29]According to Kagan World Media data presented in CRS Report RL32027, *Market Structure of the Video Programming Industry and Emerging Public Policy Issues*, at p. 21, six major media companies (which include the companies that own the four major broadcast networks) are full or partial owners of 43 of the top 50 cable networks as measured by number of households reached; 30 of the top 34 as measured by average prime-time ratings; and 28 of the 30 cable networks with average license fees (paid by cable systems to cable networks) per subscriber per month of $0.14 or more.

[30]For example, News Corp., which owns the Fox broadcast and cable networks, has acquired a controlling interest in DirecTV.

[31]According to National Cable & Telecommunications Association data presented in CRS Report RL32027, *Market Structure of the Video Programming Industry and Emerging Public Policy Issues*, at pp. 20-21, the ten largest multi-system cable operators serve almost 60 million of the approximately 72 million households receiving basic cable service (83.3%), the five largest serve 71.2%, and the two largest serve 45.2%. In addition, the vast majority of satellite television customers is served by the two major DBS providers, DirecTV and Echostar.

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

[33]Cable programmers also increasingly receive revenues from product placement – the visible placement of a branded product in the programming itself. Product placement is especially prevalent on advertiser-free premium programming because it represents a way

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from the willingness to pay of those viewers with a general demand for cable programming, those viewers with a high intensity of demand for specific programs, those advertisers that seek large audiences, and those advertisers that seek targeted audiences. In 2003, programmers received $12.3 billion in gross advertising revenues and $12.1 billion in license fees from cable and satellite companies, an almost 50-50 split.[34] The revenue stream from subscribers insulates programmers somewhat from business cycle effects that reduce advertising revenues during recessions.

- By providing all but premier programming on a single large tier, the cable operators minimize their investments in scrambling and unscrambling equipment[35] and many consumers avoid investments in (or leasing of) unscrambling equipment (digital television sets with built-in unscrambling capability or addressable set-top converter boxes) that would be needed for subscribers to make a la carte channel selections or to choose among a number of small tiers and for cable operators to charge for these.[36] Although data are only fragmentary, it appears that somewhere in the vicinity of half of U.S. television households currently have the customer premises equipment needed to unscramble and be billed for individual networks or small tiers.[37] According

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[33](...continued)
for companies to show their product without the clutter associated with back-to-back commercials on advertiser-supported channels. Cable systems (though not programmers) also enjoy rapidly growing revenues from non-programming services such as high-speed Internet access and telephone services. (See Kagan World Media, *Broadband Cable Financial Databook 2003,* table entitled "Kagan's 10-Year Cable TV Industry Projections," at pp. 11-13.)

[34]Kagan World Media, "Cable Program Investor," April 19, 2004, at p. 1. Net advertising revenues in 2003 were $10.5 billion. Cable programmers also received $0.8 billion in other revenues.

[35]If networks were offered on an a la carte basis, or in small tiers, cable operators would need to scramble all of the networks they transmit to ensure that subscribers were unable to view those networks they were not paying to receive. Those subscribers choosing a la carte or small tier options would need premises equipment capable of unscrambling the scrambled signals they were paying to receive. See GAO Report at pp. 32-33.

[36]GAO Report at pp. 32-33.

[37]To estimate this total, a number of disparate households must be added together. According to Kagan World Media's *State of HDTV 2003,* in 2003 there were 1.7 million households with advanced analog cable set-top boxes. The same source estimated that the cumulative number of digital cable set-top boxes in 2003 was 37.5 million, but with an estimated 1.42 boxes per household, the total number of households with digital boxes was 26.4 million. In addition, the National Cable & Telecommunications Association website reports (at [http://www.ncta.com/Docs/PageContent.cfm?pageID=86], viewed on 5/4/2004) there were 24.9 million subscribers to non-cable multichannel video program distributors in December 2003; the vast majority of these get digital satellite service with the capability for ordering and billing for individual networks or small tiers. In addition to these approximately 53 million households there are an unidentified number of households that have purchased digital television sets with that capability (though many of those households also have non-digital television sets that could not receive and be billed for individual
(continued...)

to the GAO Report, the average leasing charge is approximately $4.39 per box per month. Since each television set requires a separate box, a two-television household might have to pay $8.78 in leasing charges each month.[38] This market effect from a single tier that does not require customer premises equipment with unscrambling capability will become less important as digital penetration increases since digital technology provides the ability to select and bill for individual channels or multiple tiers.[39]

- By requiring cable and satellite operators to offer all but premier programming on a single large tier, cable programmers in effect create a composite product, "basic cable programming," that subscribers must take or leave. Since today consumer demand for cable programming as a whole appears to be relatively "price inelastic" (insensitive to price increases), programmers can increase the per subscriber fee for their most highly demanded cable networks and cable systems can pass through these increases in tier rate increases. It appears that demand for basic cable programming, as a single package, is less price-sensitive than demand for individual networks, and therefore price increases can be more readily sustained with a single expanded basic service package than with a la carte offerings or small tiers.

- With most advertiser-supported cable networks on a single large tier, subscribers have the widest possible choice of cable networks to surf among, and "casual" viewing is maximized. At any particular time, viewers who have purchased networks a la carte or in small tiers may not have any programming they choose to view on the channels they have paid for and therefore may turn off the television altogether, but if they had access to the full panoply of the basic enhanced service package they might find programming to watch when surfing all channels. The larger the audience, the more attractive cable programming is to advertisers, and thus the greater the advertising revenues to cable programmers. In a competitive market this would be expected to lead to lower charge to subscribers.[40]

- With most advertiser-supported cable networks on a single tier, it is less risky to introduce a new advertiser-supported cable network. By being part of a large package, a new cable network does not sink or swim based on its

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[37](...continued)
networks or small tiers).

[38]According to a National Cable & Telecommunications Association policy paper entitled "The Pitfalls of a la Carte: Fewer Choice, Less Diversity, Higher Prices," (May 2004, at p. 12), the average home has 2.5 television sets.

[39]GAO Report at p. 33.

[40]The cable advertising market has several anomalies. The disparity between the price per thousand viewers that advertisers pay broadcast television and the price per thousand viewers they pay cable has widened over time. As a result, even though advertiser-supported cable now commands a total audience that exceeds that of broadcast television, cable advertising revenues continue to significantly lag broadcast advertising revenues. Also, cable advertisers apparently continue to value the *potential* cable audience size as well as the *actual* audience size.

immediate audience reception. Rather, the system operator can allow the new cable network to acquire an audience through a combination of cross-marketing (promoting the new network on existing networks) and subscriber channel-surfing. By contrast, under a la carte, viewers must make the up-front decision to pay for a new cable network, perhaps without having had the opportunity to see any of its programming in advance. Similarly, with a large tier, large cable programmers can efficiently market new networks by advertising the new networks on their existing networks.[41] This marketing strategy is less effective if, as in an a la carte environment, many of the viewers receiving the marketing messages on the existing networks are not subscribed to the new network – and therefore cannot easily check out that network in response to the marketing message.

- Placing most advertiser-supported cable networks on a single large tier facilitates the competitive strategy of large programmers to proliferate new networks, which may act as an impediment to entry by independent networks.[42] The larger the tier, the more efficient it is for large programmers to cross-promote their networks and to exploit brand identification (FOX, ESPN, Discovery, MTV, etc.). Large programmers can take advantage of the market power they enjoy from owning popular networks (see the discussion in the next section) to pressure cable and satellite system operators to carry their new networks. Distributors may be faced with the choice of replacing independent networks with these new networks or expanding their system capacity to be able to carry more networks.[43] Cable and satellite operators

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[41]The efficiencies from marketing new cable networks on existing networks have provided a strong incentive for industry consolidation – both horizontally, as programmers seek to exploit scale economies by offering multiple cable networks, and vertically, as distributors integrate backward into partial ownership of programming that they can cross-promote on their other channels.

[42]Network proliferation represents a type of brand proliferation, which has been the subject of intense analysis in the economics literature, beginning with a seminal article by Richard Schmalensee, "Entry deterrence in the ready-to-eat cereal industry," *Bell Journal of Economics*, 9 (Autumn), pp. 305-327. The general argument is that by proliferating slightly differentiated products dominant firms can crowd "product space" in a fashion that raises rivals' costs, reduces their expected revenues, and deters entry.

[43]The cable industry has argued that cable rates, properly measured, have not actually increased for consumers. The industry claims that the number of networks that subscribers receive when they subscribe to expanded basic service has increased at about the same rate as the price for expanded basic service and, as a result, the price per network has remained relatively constant (and actually has fallen in terms of price per minute of viewing time). See, for example, Jeffrey A. Eisenach and Douglas A. Truehart, *Rising Cable TV Rates: Are Programming Costs the Villain?*, October 23, 2003, a study supported by ESPN, Inc. Conversely, to the extent the market is operating efficiently so that the most highly demanded programming will tend to be offered first and additional, lesser valued channels of programming will tend to be offered only as additional capacity is made available, the *marginal* utility (or value) to consumers of an additional channel will tend to fall as additional channels are made available. Thus a constant price per channel does not demonstrate that the market is serving customers well. Moreover, some subscribers have

(continued...)

may have some incentive to resist making the additional investment needed to do the latter, but that incentive is muted by the fact that customer demand for enhanced basic service is relatively inelastic and cable and satellite operators therefore can raise rates to recover the additional costs. This programmer strategy also may create incentives for independent networks to sell cable and satellite operators an equity interest in their networks in order to maintain their distribution channels.

Market Imperfections

The multi-channel television market can never resemble the perfect competition model beloved by economists. Although subscription television clearly is valued by consumers and has substantially increased consumer choice, the market exhibits elements of market power and some market distortions that, if exploited, can harm consumers. In the current market structure, there are few market incentives to constrain costs and hence prices.

- Popular programming will always engender market power because it is highly demanded and, by definition, has no perfect substitute. Talent – athletes, actors, directors, writers, program producers – can command high salaries precisely because consumers want to see the programming that only these talents can produce. While talent should be rewarded, consumers do not benefit when talent (and the team owners, programmers, and distributors that package the talent for consumers) is rewarded more than is necessary for it to continue to generate popular programming.[44] The large programming companies and program distributors have the incentive to share in the rewards to talent and may not have the incentive to contain the size of those rewards if they are able to share in them.[45] As discussed below, the current business

[43](...continued)
claimed that additional channels just make it more difficult for them to find the channels they prefer; for them, additional channels have a negative utility or value.

[44]For example, 42 major league baseball players reportedly have 2004 salaries that exceed $10 million. (See "Major league baseball: 2004 salaries," *USA Today*, April 9, 2004, at p. 10C.) Team owners are able to offer such large salaries (despite the league's salary cap and attendant penalties for exceeding the cap) in large part because of the very high payments they receive from broadcast and cable programmers for the rights to televise their games. It is likely that such players would continue to play baseball, and perform at an equally high level, if their salaries were lower. These players are competitors who seek to star in their sport and are unlikely to have alternative job prospects that would compensate them at a comparable level.

[45]One way for programmers and distributors to share in the rewards is to own and control more of the programming, which may partially explain the pattern toward greater vertical integration backward into program production. As discussed in CRS Report RL32026, *Market Dynamics and Public Policy Issues in the Video Programming Industry*, at p. 11, in order to have the market leverage needed to attain cable and satellite carriage, independent content providers increasingly must give a substantial equity interest in their cable networks (continued...)

model fosters their ability not just to share in, but also to leverage, these rewards, and thus is not likely to constrain rates to consumers.

- The large cable programmers – especially those that own broadcast network television stations – are able to exercise market power, as demonstrated by their ability to require cable and satellite operators to purchase and carry their less highly demanded networks in order to purchase and carry their popular networks and by setting the terms on which the distributors may make the networks available to consumers. Sometimes the primary source of the market power is not ownership of popular cable programming, but rather the programming on the broadcast stations owned by these large programmers. Cable and satellite operators must obtain retransmission consent to carry these broadcast programs.[46] That consent often is provided only if the cable and satellite operators also carry all or most of the programmer's cable networks. The GAO found that cable networks owned by a broadcaster were 46% more likely to be carried by cable operators than networks not owned by a broadcaster or cable operator.[47] This can limit consumer access to independent programming and result in consumers paying for less preferred programming.

- The GAO Report found that cable operators face price-constraining competition only in the 2% of markets where there are wireline overbuilders that offer consumers a wireline alternative to cable.[48] Although most households have access to satellite service, to date satellite competition has

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[45](...continued)
either to a "mega-programmer" (such as Viacom, Discovery Networks, FOX, or Disney) or to a major cable distributor (such as Comcast or Time Warner). This has allowed the programmers and distributors to integrate backward. At the same time, in some instances the owners of the talent, such as professional athletic teams, are increasingly vertically integrating forward into the creation of sports networks, to allow them to hold on to as much of the rewards as possible. For example, the New York Yankees have created the YES network and the National Football League has created its own network. But, as discussed in CRS Report RL32026, at pp. 9-15, vertical integration also allows programmers to exploit economies of scope and reduce risk, and these efficiencies can benefit subscribers.

[46]The Cable Television Consumer Protection and Competition Act of 1992 (P.L. 102-385) established new standards for television broadcast station signal carriage on cable systems. Under these rules, each local commercial television broadcast station was given the option of selecting mandatory carriage ('must-carry") or retransmission request ("may-carry") for each cable system serving the same market as the commercial television station. Under "must-carry", the cable system must carry the broadcaster's signal, but the cable system does not have to pay for the programming. Under retransmission consent, the cable system is not permitted to carry the broadcaster's signal without the station's consent – and at a rate of compensation (typically in the form of money, advertising time, or additional channel access) determined by private negotiations.

[47]GAO Report at p. 30.

[48]GAO Report at pp. 9-11.

proven insufficient to constrain prices.[49] The lack of competition among distributors reduces their incentive to resist programming price increases because the distributors are not heavily penalized when they pass through those increases to subscribers (and perhaps advertisers).

- In most markets, consumers directly demonstrate how much they value a product or service through their willingness to pay for it – withdrawing from the market as prices increase beyond their willingness to pay. Cable programmers' two primary revenue sources at best indirectly measure how consumers value the programming. Advertising revenues measure advertisers' valuations of the audience, not subscribers' valuations of the programming. Intensity of consumer demand is at best indirectly measured. Per subscriber license fees more closely measure consumer valuations, but still only indirectly. Cable and satellite operators pay fees for each subscriber, whether or not the subscriber watches the network. Although the fee is assessed on a per subscriber basis, the level of the fee negotiated for each network will indirectly reflect the number of subscribers who actually view the network and the intensity of demand (intensely demanded networks should command higher license fees from distributors since subscribers with high demand intensity might switch to a competing distributor if the network were no longer carried). At the retail level, consumers are allowed to exercise their willingness to pay for cable programming as a whole, in the form of a single large expanded basic service tier, but not their willingness to pay for individual networks or small tiers.

- The advertising market does not appear to value audience efficiently. The gap between the cost per thousand viewers (CPM) for prime-time advertising on broadcast television and advertising on general cable networks has grown to 61% in 2003-2004 – $24.47 for broadcast vs. $9.63 for cable.[50] One might expect some differential because there will be higher transaction costs associated with advertising on many different cable networks, each with a small audience, versus advertising on a few broadcast networks with large audiences. But this differential far exceeds those costs. Cable "eyeballs" continue to be less valued by advertisers than broadcast "eyeballs".

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[49] Ibid at pp. 9-11. Cable television is somewhat insulated from price competition from satellite television in part because cable operators are able to offer packages of cable, telephone, and high-speed Internet access services that satellite operators cannot offer. For a discussion of the competitive impact of bundling services, see CRS Report RL32232, *Bundling Residential Telephone, Internet, and Video Services: Issues for Congress*.

[50] John M. Higgins, "The Great Divide: Why is the CPM gap widening if cable keeps grabbing viewers from broadcast?", *Broadcasting & Cable,* March 29, 2004, at p. 1.

Proposals to Give Subscribers More Purchasing Options for Cable Networks

Consumers are well-served by the multi-channel television industry when they receive the programming they want at reasonable prices that provide sufficient incentive for the on-going production of responsive programming.

Multi-channel operators now have a larger total viewing audience than broadcasters[51] in part because of technological advantages: cable and satellite technologies can offer more channels, can provide better signal quality, and can charge consumers directly for programming, which allow them to respond to consumer tastes while maintaining two primary revenue streams. These technological advantages provide the multi-channel television industry with the potential for serving consumers well. Of course, how well any individual household is served by the industry will depend in part on that household's tastes and needs – for example, its preference for niche vs. popular programming, its preference for a very limited number of networks vs. a wide variety of networks, etc.

Some aspects of the current cable programmer business model appear to benefit most consumers and foster certain U.S. media policy objectives. In particular, new and diverse programming may be fostered by limiting subscribers to a single large expanded basic service tier. If some threshold level of the cable audience moved to a la carte purchasing or chose small, narrowly focused tiers, it could be more difficult for a new cable network to build an audience, even if it were on the expanded tier.[52] As explained earlier, limiting all subscribers to a single tier can ease roll-out of a new cable network by maximizing the casual viewing audience that surfs across networks and by facilitating programmers' efforts to promote the new network on existing networks. Similarly, existing cable networks that serve niche audiences might be less likely to survive if consumers could purchase networks a la carte or in smaller tiers, which would decrease the number of expanded basic service subscribers. Niche networks that have relied on casual viewers but do not have a large enough base of viewers who would purchase on an a la carte basis might lose too many casual viewers to remain viable. Several niche cable networks have voiced concern that a move to a la carte purchasing could harm them.[53] Nearly 40 members of the

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[51]"Final 2002/2003 Full Season Viewership Results: Ad-Supported Cable Captures Almost a 50 Primetime Share: Surpasses the Seven Broadcast Networks Combined by Nearly 5 Share Points," Cable Television Advertising Board Press Release, 9/24/2003, at [http://www.cabletvadbureau.com/03PressReleases], release number 030917.htm, viewed on 4/29/2004.

[52]Unfortunately, that threshold level is not readily identifiable.

[53]See, for example, Letter dated March 8, 2004 from Judith McHale, president and chief operating officer, Discovery Communications, Inc. to members of the Senate Committee on Commerce, Science, and Transportation. Discovery Communications has four shareholders: Liberty Media Corp. (49.0%), Cox Communications, Inc. (24.5%), Advance/Newhouse (24.5%), and Discovery founder John Hendricks (2%). (See the Discovery Communications website, [http://corporate.discovery.com/] (then hit "shareholders") and Kagan World Media, *Economics of Basic Cable Networks 2003*, at p. 59.)

Congressional Black Caucus have expressed concern that a la carte purchasing could result in a loss of diversity in programming and that new cable networks, such as TV One, which serves the African-American community, and ESPN Deportes, a Spanish-language sports network, might never have been launched in an a la carte environment.[54]

It is not clear, however, how many subscribers would shift to a la carte purchasing or to smaller tiers if those options were made available. A substantial portion of cable and satellite households is accustomed to a wide choice of networks and likely have a number of household members with different programming tastes. For these households, the more limited choices available under an a la carte or small tier option might not be attractive. Moreover, to select the a la carte or small tier options, subscribers would have to have the technology in place to unscramble cable signals, just as subscribers must do today to receive premium channels. Current recipients of premium channels and all subscribers with digital televisions have the equipment needed to unscramble the signals. But a large proportion of analog subscribers would have to lease set-top boxes, which currently are available from cable operators at an average price of $4.39 per television set per month, thus reducing the potential price savings from choosing more limited tiers.

In addition, cable programmers might raise per subscriber license fees to make up for the lower advertising revenues generated when a la carte and multiple small tiers are available. To the extent they raise those license fees and cable operators pass through those fee increases in their rates, the sum of prices for individual programs or small tiers might be higher for many subscribers than the price for a single large tier. Also, cable operators might have the incentive to minimize the "cannibalization" of the expanded basic service tier by setting a la carte and small tier prices in a way that made those options attractive only to a very small portion of households with very narrow viewing tastes.[55] Thus the "threat" to the cable programmer business model from allowing a la carte or multiple tier purchasing options might not be substantial.

It is possible that by offering those options, the needs of what proves to be a small minority of households with very narrow viewing tastes could be met without undermining the viability of an expanded basic service tier that supports diverse and new networks. Still, it appears that allowing or mandating a la carte or small tier purchasing options might retard the introduction of new cable networks and endanger niche program networks.

The current cable programmer business model may simultaneously benefit consumers by exploiting efficiencies (which could lead to lower cable rates) and

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[54]"NCTA Faults Lawmakers' Request to FCC to Study 'A La Carte' Cable Programming," *Daily Report for Executives, Regulation & Law*, BNA, Inc., No. 97, May 20, 2004, at p. A-12.

[55]As a simplistic example, if the per network a la carte price were $10.00 per month and the price for an 60-channel enhanced basic service package were $45.00, then only those customers with very narrow video tastes that are satisfied by four networks would select the a la carte option.

disadvantage consumers by fostering programmers' ability to leverage their market power (which could lead to higher cable rates). Several proposals have been made to Congress that are, in effect, variations on the theme that subscribers should have greater decision-making power over the cable networks they receive. Several focus at the programmer level, several at the distributor (cable or satellite operator) level. The various proposals would:

- prohibit programmers from requiring cable and satellite operators to carry their less popular networks in order to attain access to their popular networks, and – more specifically – prohibit programmers that own broadcast stations from tying the retransmission consent they give cable and satellite operators to carry their broadcast programming to the carriage of the programmers' cable networks.[56]

- prohibit programmers from requiring cable and satellite operators to offer the programmers' networks in the expanded basic service tier only.[57]

- require cable and satellite operators to offer subscribers the options of purchasing smaller program tiers or purchasing networks a la carte.[58]

- require sports programmers and cable and satellite operators to offer expensive sports programming on a separate tier.[59]

Proposal: Prohibit Tying Carriage of Popular Programming to Carriage of less Popular Programming

Some cable operators have alleged that integrated programmers with local broadcast stations and cable networks tie retransmission consent for the broadcast signal to carriage of an entire suite of cable networks.[60] They have further alleged that these tie-ins sometimes extend beyond carriage on the local cable system and that these tie-ins may require multi-system operators to carry the suite of cable networks on all their cable systems and/or for time periods that extend far beyond the

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[56]See, for example, Gleason Testimony at p. 13.

[57]See, for example, Gleason Testimony at p. 7. Also, during mark-up of the Committee Print of the Satellite Home Viewer Extension and Reauthorization Act of 2004 in the House Subcommittee on Telecommunications and the Internet, on April 28, 2004, Rep. Deal introduced, and then withdrew, an amendment that would have required the Federal Communications Commission to prescribe rules to prohibit any multi-channel video programming distributor (MVPD) from entering into a contract with any video programming producer that would preclude the MVPD from voluntarily offering a la carte or special tier programming to the MVPD's subscribers.

[58]See, for example, Kimmelman Testimony at pp. 3-4.

[59]See, for example, Robbins Testimony of May 6, 2003 at p. 2.

[60]See American Cable Association *Petition for Inquiry into Retransmission Consent Practices,* filed with the Federal Communications Commission on October 1, 2002.

period covered by the retransmission consent.[61] Such tie-ins can result in cable system operators providing programming their customers do not prefer or passing through high programming charges to customers.

The proposal to prohibit programmers from requiring distributors to carry less popular programming in order to gain access to more popular programming would give cable and satellite operators greater discretion in choosing cable networks that meet their customers' tastes. This would tend to benefit customers. In addition, it would be beneficial to independent cable networks and to small cable systems that have the capacity to carry only a relatively few networks.

Some programmers that own broadcast stations claim that, in some cases, it was cable operators not programmers who initially proposed that their compensation for retransmission consent take the form of carrying the programmers' cable networks (as well as the broadcast signal) at a low charge or no charge, rather than paying a high price for the retransmission rights to the broadcast signal. At the time, the cable operators had available capacity on their systems but not much cash to pay for programming. Now the situation is reversed: the cable operators have limited available capacity for additional cable networks and many would prefer to pay higher prices for the broadcast programming and free up scarce capacity on their systems.

A prohibition on tie-ins potentially could have a number of other market implications that could benefit but also could harm consumers. It would strengthen the negotiating position of distributors and independent networks relative to the large programmers that own multiple cable networks and broadcast networks. In the case of tying retransmission consent for popular broadcast programming to the carriage of less popular cable networks, a prohibition would set limits on the impact of current law, which is intended to strengthen the negotiating position of broadcasters relative to cable and satellite operators. The current law states:

> no cable system or other multichannel video programming distributor shall retransmit the signal of a broadcasting station, or any part thereof, except–
>
> (A) with the express authority of the originating station.[62]

It does not authorize the Federal Communications Commission to regulate the terms and conditions of the retransmission consent agreements, beyond imposing a good faith negotiations standard and a prohibition on providing any distributor exclusive retransmission consent.

Under a prohibition, the large programmers might, in the short run, be able to generate just as much revenue simply by raising the prices for their popular programming (rather than obtaining revenues indirectly – and perhaps with a lag – from the new networks). But several strategies at the heart of the current cable programmers business model would be constrained. If distributors chose not to carry the large programmers' less popular networks, the programmers' efficiencies from cross-marketing and branding would be diminished. In turn, this could lead them to

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[61]Ibid.

[62]47 U.S.C. § 325(b)(1).

raise per subscriber license fees. Also the strategy of proliferating networks could be curtailed, which could make it easier for new independent networks to enter the market.

Proposal: Prohibit Programmers from Requiring Their Networks to Be Placed on the Expanded Basic Service Tier

The proposal to prohibit programmers from requiring cable and satellite operators to offer the programmers' cable networks only on the expanded basic service tier would place the decision for cable network tiering entirely in the hands of the cable and satellite operators. In most situations, distributors share the large programmers' preference for a single large expanded basic service tier, and thus the impact of the prohibition on consumers might be limited. But there may be situations in which programmer and distributor interests diverge and, more generically, the prohibition would create an opportunity for distributors to experiment with their cable tiers.

For example, while cable programmers receive about half their revenues from advertising and half from per subscriber fees assessed on cable and satellite operators, those operators get almost 90% of their revenues from subscribers and only a little more than 10% from advertisers.[63] An optimal tiering strategy for programmers therefore may not be optimal for distributors. Moreover, cable and satellite operators do not have a retail layer to insulate them from consumers, and therefore may be more responsive to consumer complaints about the placement of specific networks on tiers.

Cable operators may choose to experiment with cable tiers – and even with a la carte pricing – if they perceive that these additional offerings might increase their profits. When the per subscriber license fee for a cable network does not appear to be in equilibrium with subscriber viewing patterns,[64] then the operator will have the incentive to either decrease payments to the programmer or increase revenues from end users or both. By placing a high-cost network on a separate tier, the operator might be able to reduce payments to the programmer by only paying for those subscribers who actually desire that network while maintaining (or at least not decreasing by as much) the revenues received from subscribers. If the operator were able to take a high-cost cable network off its expanded basic service tier, place it on a separate tier, and then re-price the expanded basic service tier in a way that did not lower revenues from that tier by as much as it gained revenues from the new separate tier, it would benefit from having the discretion to place cable networks on tiers as it saw fit. As discussed earlier, GAO found that satellite operators do not provide sufficiently strong competitive constraints on cable operators to constrain prices, and

[63] Kagan World Media, *Broadband Cable Financial Databook 2003*, tables entitled "Kagan's 10-Year Cable TV Industry Projections" (pp. 11-13) and "Total Cable TV Advertising Billings (1980-2013)" (p. 19), and Kagan World Media, "DBS Report," June 27, 2003, table entitled "DBS Industry Projections 2002-2013" (p. 9).

[64] For example, Cox Cable alleges that ESPN represents 18% of Cox's total programming costs but only 4% of Cox's viewing audience. ESPN responds that Cox fails to take into account additional local advertising revenues Cox receives by carrying the ESPN networks.

therefore the shift of control over the placement of networks on tiers from programmers to distributors might not reduce rates to consumers so much as redistribute the profits from programmers to distributors.

Cable and satellite operators may be more willing than programmers to take particular cable networks off the expanded basic service tier and place them on premium tiers because they only indirectly benefit from the strategies of cross-promotion of networks and network proliferation that directly benefit programmers, which depend heavily on a single large expanded basic service tier.

Proposal: Require Distributors to Offer Networks a La Carte and in Small Tiers

The pros and cons of limiting consumers to a single large expanded basic service tier vs. giving them the option of purchasing cable networks a la carte or in small tiers have been discussed at length earlier in this report. When cable system operators require subscribers to purchase a single large expanded basic service tier, without an option for the purchase of individual cable networks or small tiers, some purchasers will be forced to buy more programming than they want, and perhaps at an outlay that is greater than they would make if allowed to purchase individual networks. Thus, some purchasers are worse off when forced to purchase large tiers than they would be if they could purchase individual channels.

An a la carte rule might constrain the large rewards that athletes, performers, and producers earn – and that raise the costs (and prices) of such programming – if substantial numbers of subscribers with low intensities of demand for the sports or entertainment programming chose a la carte or small tier options that did not include the high-cost programming. Certain sports and entertainment programming is highly valued by a small portion of cable subscribers. However, currently such programming is funded by imposing higher rates on all subscribers to expanded basic service. If that programming had to be supported only by subscribers with high intensity of demand, either those subscribers would have to pay more, or the talent producing that programming would have to accept lower compensation.

But an a la carte requirement also could have disadvantages for some consumers. Large service tiers make it less risky for a cable or satellite system to introduce a new cable network. With a large tier, the new cable network does not succeed or fail based on its immediate audience reception. Rather, the system owner can allow the new cable network to acquire an audience by having viewers accidentally tune in to the network. By contrast, under a la carte, viewers must make the up-front decision to pay for a new cable network, perhaps without having had the opportunity to see any of its programming in advance.

Similarly, with a packaged offering, the local cable system operator can efficiently market new networks by advertising the new networks on its existing networks. This marketing strategy is less efficient if, as in an a la carte environment, many of the viewers receiving the marketing messages on the existing networks are not subscribed to the new network and therefore cannot easily check out that network in response to the marketing message.

Also, the availability of a large package of networks is expected to increase overall audience size because at any particular time viewers who pay a la carte may not have any programming they choose to view on the channels they have paid for (and therefore might turn off the television altogether). But if they had access to the basic enhanced service package, they might find programming they enjoy when surfing all the channels offered in the package. The larger the cable audience, the more attractive cable is to advertisers, and higher advertising revenues might allow programmers to decrease per subscriber license fees, which, in turn, could result in lower rates for the expanded basic service tier.

In addition, offering a la carte and small tier options in addition to a large expanded basic service option would, according to the major industry association, significantly increase cable operators' customer services expenses, as more customer service representatives would be needed to explain the options as well as process the more complex orders.[65]

As a result of these factors, it is possible that the sum of the individual prices for each network that a typical household subscribes to in an a la carte environment could be higher than the single price for the expanded basic service tier. At the same time, the choices available to consumers could be reduced both because they would only have available to them the networks they paid for and because there are likely to be fewer new networks due to the higher risk associated with a network launch when many subscribers make a la carte network purchases.

The extent to which these effects of an a la carte requirement would actually occur would depend on the proportion of subscribers who chose the a la carte option vs. the enhanced basic service package. If the a la carte option were chosen only by a very small portion of subscribers with narrow video tastes that can be met by a limited number of networks, it may create a very weak disincentive for new network launches.[66] But if the a la carte option were widely selected, the disincentive could be substantial.

The pros and cons of an a la carte (or small tier) option will be affected by the rate of consumer transition to digital equipment. From one perspective, the benefits of a la carte purchasing are reduced for the majority of customers who do not currently have customer premises equipment (in the form of a digital television set, an advanced analog set-top box, or a digital set-top box of the sort that comes with digital cable or satellite service). They would have to lease such boxes (current rates are about $4.39 per month per television set) to be able to select and be billed for individual networks or small tiers. Yet to the extent that the lack of customer premises equipment reduces the number of households that might forsake the expanded basic service tier for a la carte purchasing or small tiers, the threat to the viability of the expanded basic service tier and cable programmers' business model

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[65]"The Pitfalls of A La Carte: Fewer Choices, Less Diversity, Higher Prices," National Cable & Telecommunications Association Policy Paper, May 2003, at pp. 15-17.

[66]But some of the signal scrambling/unscrambling, billing, and customer service costs associated with a la carte purchasing are fixed and must be borne even if only a small number of subscribers choose the a la carte option.

is reduced. Cable executives generally agree that, as digital penetration of the household grows, the current business model will evolve into a video on demand model.[67]

There is potentially an additional issue relating to small tiers. Even if cable and satellite operators were to offer one or more small tiers, those tiers could not meet the needs of each and every household equally well. Businesses every day must determine the best way to meet the needs of their customers. But if there were a requirement that cable and satellite operators offer small tiers, could they also be subject to regulatory (as opposed to market) challenge about the choice of networks placed on those tiers? It would likely be extremely difficult for a regulatory body to determine what constitutes an "acceptable" line-up of networks on a small tier or an "acceptable" suite of small tiers.

Proposal: Place High Cost Sports Networks on a Separate Cable Tier

Major sports networks are unique in a number of ways. First, the per subscriber license fees to cable and satellite operators for major sports networks are far higher than those for almost any other networks. In 2001, when the average license fee per subscriber per month was $0.13 for national cable networks, the license fee for ESPN was $1.53 and for FOX Sports was $0.70.[68] By the end of 2003, the license fees for ESPN and FOX both exceeded $2.00 per subscriber per month.[69] Regional sports networks, such as the YES Network owned by the New York Yankees, also have relatively high per subscriber license fees. GAO found that license fees for sports networks have been growing at more than twice the rate of non-sports networks.[70]

Second, with the exception of the Super Bowl, World Series, and some Olympic events, only a minority of television viewers regularly view sports programming, and many households never watch such programming. Thus, under the current system of sports programming being offered on the expanded basic service tier, with a per subscriber fee imposed based on total subscribership rather than on actual viewers, sports networks represent a far higher portion of cable operator programming costs than they do cable operator viewers. James Robbins, chief executive of Cox Cable, reportedly stated at a Goldman Sachs investors conference that ESPN accounted for 4% of Cox subscribers' viewing, but 18% of Cox programming costs.[71]

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[67]See footnote 32 above.

[68]Kagan World Media, *Economics of Basic Cable Networks 2003*, September 2002, table entitled "Average License Fee per Subscriber per Month by Network," at pp. 53-54.

[69]Peter Grant, "Cox to Blame Cable Sports for Rate Surge," *Wall Street Journal*, October 6, 2003, at p. B1.

[70]GAO Report at p. 22.

[71]David D. Kirkpatrick and Geraldine Fabrikant, "Sports Fan Is the Prize, or the Victim, in Cable Fight," *New York Times*, October 6, 2003, at pp. C1 and C4. This claim appears to be consistent with other available data. According to Nielsen data analyzed by TN Data, in 2000 (the latest year for which data were available), the average U.S. television household

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Third, for the minority of television viewers who are sports fans, their demand for sports programming is intense and they are more likely than the viewers of other programming to subscribe to a premium sports channel if that were the only source of the desired sports programming. For example, when Cablevision took the YES Channel off its expanded basic service tier and made it available to subscribers in two options – on its own for $1.95 per month or as part of a new premium sports tier at $4.95 per month – about half its subscribers elected to receive the YES Channel through one or the other of those options.[72]

Fourth, although programming of major sports is viewed by cable and satellite operators as "must have" programming, the sports programmers report financial losses from winning the rights to these major sports. For example, News Corp. reported on February 12, 2002 that it took a $909 million operating charge in the second quarter because of its three major professional sports television contracts.[73] According to Steve Sternberg, senior vice president and broadcast research director at TN Media:[74]

> There's a cachet to having sports, especially major sports. They're like a loss leader. Sports promote the networks' primetime lineups and sports are one of the things that drive people to their internet sites.

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[71](...continued)
watched 213.5 hours of nationally televised sports programming including the Olympics, 200.4 hours excluding the Olympics. (See Kevin Downey, "Sports TV get pricier and pricier. Here's why."available at [http://www.medialifemagazine.com/] news2001/ apr01/ apr09/4_thurs/news1thursday.html, viewed on 5/12/2004.) Of the 200.4 viewed hours, 103.6 were on broadcast networks, 74.7 on expanded basic cable networks, and 22.1 on broadcast syndication. (There was additional viewing of regional cable networks.) Assuming half the Olympics viewing was on cable networks, the average U.S. household watched about 80 hours of sports programming on expanded basic cable networks in 2000. According to a recent Nielsen Media Research report entitled "Average Daily Viewing 1949-2003," in the broadcast year September 2000-August 2001, U.S. television households spent on average 7 hours, 47 minutes per day watching television; this increased to 8 hours, 12 minutes in September 2002-August 2003. As discussed earlier, a little more than half that viewing was of cable networks. On average U.S. households watch a little less than 4 hours of expanded basic television per day – or about 1,420 hours per year. Thus, about 5.6% of household cable viewing is of national sports networks (80 ÷ 1420). Given the very high per subscriber charges for ESPN and FOX Sports networks, it certainly is likely that the proportion of programming costs associated with those national sports networks exceeds the proportion of cable and satellite viewer time spent watching national sports networks approximately as claimed by Mr. Robbins.

[72]See footnote 20 above.

[73]Peter S. Battin Media, "Television Sports Rights 2003," October 23, 2003, available on [http://www.gouldmedia.com/nv_rpt_tsr03.php], viewed on 5/12/2004.

[74]Kevin Downey, "Sports TV get pricier and pricier. Here's why." available at [http://www.medialifemagazine.com/news2001/apr01/apr09/4_thurs/news1thursday.html, viewed] on 5/12/2004. Broadcast and cable networks maintain Internet sites to provide additional information to viewers with high intensity of demand for their programming, to provide an additional marketing tool for their programming, and to gain additional advertising revenues. These Internet sites are potential profit centers.

Sports programmers apparently have made the strategic business decision to get into a competitive bidding environment to attain the rights to popular sports events even with the knowledge that, if they win the bid, they would be unlikely to recoup those costs directly from the sports programming shown. Rather, sports programmers may expect to benefit indirectly by exploiting the sports events to market their other programming to the highly desirable teenage and young adult male audience – both by cross-marketing their other programs and by "branding" their networks. Those programmers, of course, seek to recover as much of the costs as possible from program distributors – through the very high per subscriber fee imposed on cable operators and, for those sports programmers that own broadcast networks, through attempts to get their local stations affiliates to share the cost burden.[75]

Given these unique characteristics, the consumer benefits from a la carte purchasing may be greater for major sports networks than for other cable networks, and the consumer disadvantages may be less. Since the costs of major sports programming are disproportionately large relative to the audience they attract, when major sports networks are included on the expanded basic service tier those subscribers who are not sports fans are forced to bear a substantial burden. If major sports programming represents almost 20% of programming costs and half the subscribers do not watch that programming, then those non-fans are bearing almost 10% of total programming costs to fund programming they do not want.[76] Placing major sports programming on a separate tier would benefit these non-sports fans. At the same time, given the intensity of demand that sports fans have for major sports programming, it is likely that a substantial portion of sports fans would be willing to purchase that programming separately. As indicated earlier, half of Cablevision's subscribers paid separately to receive the YES Channel. Thus, it appears unlikely that the cable programmer business model, based on a single large expanded basic cable tier, would be threatened by placing major sports networks on a premium tier. In the March 25, 2004 Senate Commerce Committee hearing, James Robbins of Cox Communications stated that he opposed any requirement that cable operators be required to offer networks on an a la carte basis, but that Cox would consider offering a separate sports tier.[77] In that hearing, Mark Goldstein, director of physical infrastructure issues at GAO, indicated that sports programming represents the best choice of programming for a separate tier.[78]

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[75]See, for example, John Eggerton, "CBS, Affils Deal on NCAA," *Broadcasting & Cable*, December 8, 2003, at p. 10..

[76]Although an imperfect analogy, automobile purchasers typically can choose between a standard package of features and one or more premium packages. It is unlikely that a high-cost feature that is sought by only half of all customers would be included in the standard package.

[77]Senate Committee on Commerce, Science and Transportation Hearing on Escalating Cable Rates: Causes and Solutions, March 25, 2004.

[78]Ibid.