Exhibit A

Declaration of Robert D. Willig, Jonathan M. Orszag, and Jay Ezrielev
Regarding A La Carte Pricing

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter Of *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

DECLARATION OF ROBERT D. WILLIG, JONATHAN M. ORSZAG, AND JAY EZRIELEV REGARDING A LA CARTE PRICING

July 15, 2004

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I. Qualifications

A. Robert Willig

1. Robert Willig is Professor of Economics and Public Affairs at the Woodrow Wilson School and the Economics Department of Princeton University, a position he has held since 1978. Before that, he was Supervisor in the Economics Research Department of Bell Laboratories. His teaching and research have specialized in the fields of industrial organization, government-business relations, and welfare theory.

2. He served as Deputy Assistant Attorney General for Economics in the Antitrust Division of the Department of Justice ("DOJ") during the Administration of President George H.W. Bush (1989 to 1991). He also served on the Defense Science Board task force on the antitrust aspects of defense industry consolidation and on the Governor of New Jersey's task force on the market pricing of electricity. He is also the author of numerous articles, as well as the co-editor of *The Handbook of Industrial Organization*.

3. He has been active in both theoretical and applied analysis of issues affecting the Multichannel Video Programming Distributor ("MVPD") market. Since leaving Bell Laboratories, he has been a consultant to a number of major MVPDs and programming providers. He has testified before the U.S. Congress, the Federal Communications Commission, and the public utility commissions of about a dozen states regarding telecommunications issues. He has also been on government and privately supported missions involving telecommunications throughout South America, Canada, Europe, and Asia. On other matters, he has worked as a consultant with the Federal Trade Commission, the Organization for Economic Cooperation and Development, the Inter-American Development Bank, the World Bank, and various private clients. He also serves as a Director of Competition Policy Associates, Inc., ("COMPASS") an economic consulting firm based in Washington, D.C.

B. Jonathan Orszag

4. Jonathan Orszag is a Managing Director of COMPASS. His services have been retained by a variety of public-sector entities and private-sector firms ranging from small businesses to Fortune 500 companies. He has been a consultant to a number of major MVPDs and programming providers. He has testified before administrative agencies and Congress on a range of issues, including competition policy, industry structure, and fiscal policy. In 2004, he was named by the *Global Competition Review* as one of "the world's 40 brightest young antitrust lawyers and economists" in its "40 under 40" survey.

5. Previously, he served as the Assistant to the U.S. Secretary of Commerce and Director of the Office of Policy and Strategic Planning, as an Economic Policy Advisor on President Clinton's National Economic Council, and an economic aide to the Secretary of Labor. For his work at the White House, he was presented the Corporation

for Enterprise Development's 1999 leadership award for "forging innovative public policies to expand economic opportunity in America."

6. He has also served as an adjunct faculty member of the University of Southern California's School of Policy, Planning, and Development. Mr. Orszag received a M.Sc. from Oxford University, which he attended as a Marshall Scholar. He graduated *summa cum laude* in economics from Princeton University, was elected to Phi Beta Kappa, and was named a *USA Today* Academic All-American.

C. Jay Ezrielev

7. Jay Ezrielev is a senior economist at COMPASS, based in Washington, DC. He has consulted on a number of matters pertaining to the distribution of video programming, including work for major MVPDs and providers of telecommunications services. His work has entailed supporting litigation and regulatory review in the United States, the European Union, Australia, and New Zealand.

8. Prior to joining COMPASS, he was a senior economist at Competition Economics, Inc. He also has extensive experience working as an engineer and software developer at firms, such as Siemens and Goldman Sachs. He graduated with a degree in electrical engineering from Rutgers University, obtained a M.S. in electrical engineering from Rutgers, and a Ph.D. in economics from New York University.

II. Introduction and Summary

9. A decade ago, consumers had few choices for MVPD service. They usually had only one cable company to choose from – and that cable company often offered only 30 to 53 analog video channels.[1] By comparison, most consumers can now choose from at least three MVPD providers, who offer, on average, 70 analog video channels, 120 digital channels, and other advanced services that were not available in the early 1990s.[2]

10. While cable remains the most prevalent technology, the MVPD industry is far more competitive today than it was a decade ago.[3] As the Federal Communication Commission ("FCC") has found, such increased competition "provides consumers with choice, better services, higher quality, and greater technological innovation... the vast majority of Americans enjoy more choice, more programming and more services than any time in history."[4]

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[1] *See* Federal Communications Commission, *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Tenth Annual Report, (released January 28, 2004) at ¶ 18 ("Tenth Annual Report").
[2] Tenth Annual Report at ¶ 18.
[3] Tenth Annual Report at Appendix B, Table B-1.
[4] Tenth Annual Report at ¶ 4.

11. The improved competitive landscape in the MVPD industry is reflected in the fact that DBS firms continue to grow rapidly; MVPD providers are rolling out new advanced services, such as High-Definition Television ("HDTV") and Video-on-Demand ("VOD"); cable companies are introducing high-speed Internet access; and, in the past decade, more than 200 programming networks have been launched.[5]

12. Despite the improved competitive landscape and the fact that most consumers can now choose among dozens of combinations of cable programming packages, some policymakers have put forward proposals that are intended to create for consumers a new way to access cable programming networks from MVPD providers. Proponents of proposals to "unbundle" cable programming suggest that mandatory unbundling would (a) give consumers choices so that they do not have to pay for "unwanted" networks; (b) lower cable bills; and (c) address purported problems of indecent cable programming.[6] We have been asked to address the economics of such proposals.

13. Proposals to unbundle cable programming networks – which have many common elements with past public-utility style regulations – appear to be unwarranted.[7] As described above, market forces are driving the MVPD industry to become more, not less, competitive. It is key to recognize, from an economic perspective, that none of the preconditions exist that would suggest that this form of re-regulating the MVPD industry would be appropriate. Indeed, we are aware of no evidence to suggest that consumers as a group would be better off from the types of regulations necessary to unbundle cable programming. To the contrary, an economic analysis of proposals to mandate that MVPD providers sell cable programming à la carte suggests that such proposals will harm economic efficiency and will likely fail to achieve the goals delineated by their proponents.[8]

14. One form of mandatory unbundling would bar MVPD providers from selling bundles of cable programming and would force them to offer each network à la carte. (We call this proposal "pure" unbundling or "pure" à la carte.) Proposals to bar MVPD providers from offering bundles will harm many consumers who currently benefit from buying a bundle of programming networks. That is, in the name of providing choice to some consumers, policymakers run the risk of harming the vast majority of

[5] Tenth Annual Report at ¶ 17.

[6] Some proponents of proposals to unbundle cable programming note that the issue is that consumers are paying for *indecent* and unwanted programming. If the primary motivation for regulating the sale of video programming is indecent programming, proposals to unbundle such programming are an extremely blunt instrument. It would appear to us that there are far more efficient ways to address problems of indecent programming. For example, a number of MVPDs allow subscribers to "block" any programming channel through technology in the set-top boxes.

[7] *See, e.g.,* W. Kip Viscusi, John Vernon, and Joseph Harrington. *Economics of Regulation and Antitrust* (MIT Press: Cambridge, MA, 2000); and Alfred Kahn, *The Economics of Regulation: Principles and Institutions* (MIT Press: Cambridge, MA, 1988).

[8] We use the term "à la carte" to refer to the ability of consumers to pick and choose among individual cable networks, as opposed to choosing among groups (or "tiers") of networks.

consumers who value the benefits of receiving a diverse choice of bundled high-quality programming.

15. There would likely be additional, significant harms from "pure" unbundling proposals that will materialize over a longer-time period. Proposals to ban bundling of cable programming would fundamentally alter the economics of the programming industry in a way that could lessen the incentives for companies to launch new programming networks or to invest in high-quality content. Such a conclusion is supported by past business decisions of Discovery, a network with a record of investing in the kinds of high-quality content that consumers enjoy.[9]

16. Another form of mandatory unbundling would allow MVPD providers to continue to offer bundles of programming, but would require MVPD providers also to sell each cable network à la carte. (We call this proposal a "hybrid" approach to unbundling.) Under one approach being considered, MVPD providers would be encouraged to offer à la carte programming. Such a voluntary approach to unbundling would not likely benefit consumers, since MVPD providers would have essentially the same incentives to offer à la carte programming that they have today. As a result, it is unlikely that there would be a significant expansion in à la carte programming options.

17. To the extent that MVPD providers were to be required to offer à la carte programming – in addition to extant programming tiers – marketplace evidence suggests that few subscribers would likely choose to purchase networks à la carte in such a situation. As a result, MVPD providers would incur a variety of costs to comply with a hybrid unbundling regulation, but few consumers would receive any benefits. Since MVPD providers would pass at least some of the higher costs onto subscribers, most consumers would likely face *higher* cable prices as a result of hybrid unbundling – and only a small fraction of subscribers would choose their programming on an à la carte basis.

18. At first glance, the proposals to force unbundling of programming networks appear to provide consumers more choices. But a closer examination suggests that they would likely fail to achieve the desired results. Indeed, proposals to force MVPD providers to unbundle cable programming will likely harm economic efficiency and the public interest.

19. With regard to proposals to unbundle cable programming, a more appropriate means to achieve the ends desired by proponents of unbundling proposals is to encourage vigorous competition in the MVPD industry.[10] In a competitive market,

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[9] For fifteen straight years, Beta Research has ranked the Discovery Channel as the number one channel for program quality. *See* Beta Research, "Brand Identity of Basic Cable/Broadcast Networks," March 2004.

[10] *See, e.g.* General Accounting Office, "Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry," GAO-04-8, October 2003 at 9. The past research of two authors of this declaration found that the introduction of local-into-local service by the DBS firms resulted in significantly lower cable prices. *See* Letter from Gary Epstein and Pantelis Michalopoulos to Marlene Dortch, *Ex Parte Notice – Consolidated Application of EchoStar Communications Corporation, General Motors Corporation and Hughes Electronics Corporation for Authority to Transfer Control*, CS

MVPD providers will seek to provide consumers more choices at lower prices with appropriate safeguards to protect consumers from indecent programming. Moreover, competitive markets evolve in ways that are often difficult to predict. As MVPD providers roll-out VOD options, many industry observers believe that the MVPD industry is now on the cusp of a major evolution in the way its business is conducted. (VOD is a form of unbundling, since consumers could choose to purchase specific programming, instead of access to an entire network.)

20. Economic theory and the experience with past regulatory intervention in the MVPD industry suggest that policymakers would be well served to allow market participants to alter their business models in response to innovations, rather than mandating particular changes with regard to cable programming networks. Finally, if policymakers believe that such changes are not happening quickly enough, the focus should be on new efforts to enhance competition in the MVPD industry.

III. The Economics of Bundling

A. An Overview of The Economic Theory of Bundling

21. Bundling entails selling two or more goods in a single package. With "pure" bundling, the seller offers the goods *only* in a package. With "mixed" bundling, the seller offers the goods either bundled or unbundled and the price of the bundle is typically set below the sum of the prices of the unbundled components.[11]

22. Consumers experience bundles of goods or services in many different forms. For example, in a typical day, someone likely awakes to an alarm clock that was bundled with a radio; puts on shoes that were bundled with shoe laces; puts on a suit jacket that was bundled with suit pants; stops at a coffee shop that bundles coffee with a coffee cup; drives in a car that was bundled with many components, such as tires, windshield wipers, and service; works at a computer that was bundled with a monitor, software, a keyboard, and a mouse; eats lunch at a restaurant that offers a "value meal;" cooks dinner in a pot that was bundled with a lid; reads a magazine article that was bundled with other magazine articles; turns on a television that was bundled with a remote control; and watches a programming channel that is a bundle of television shows.

Docket No. 01-348 (dated September 23, 2002) at 9. The General Accounting Office found that the introduction of local service impelled cable companies to offer consumers more programming choices. *See* General Accounting Office, "Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry," GAO-04-8, October 2003 at 11. Such evidence suggests that consumers would either pay lower prices or get more programming choices if policies were put in place to better enable DBS firms to roll out local service in all areas of the country.

[11] *See, e.g.*, Hal Varian, "Price Discrimination," in Richard Schmalensee and Robert Willig, editors, *The Handbook of Industrial Organization* (Amsterdam: North-Holland, 1989).

23. In many cases, bundled goods are complements (*i.e.*, a pair of goods are complements when having one makes the other one more valuable), and in many other cases, bundled goods are substitutes (*i.e.*, two goods are substitutes if having the first good decreases the value of the second good). Left and right shoes are usually sold as a bundle of complements because most consumers would have little use for one shoe without the other shoe. Examples of substitute bundles include HMO memberships (which offer bundles of medical services) and gym memberships (which offer bundles of exercise equipment).

24. Consumers can benefit in many important ways from bundling of goods. Consumers can benefit from the convenience of bundling; for example, buying a car would be far more complicated if consumers needed to choose each component of the car. Consumers can benefit from the improved functionality that bundling produces; for example, car components likely work better together because they were bundled. Consumers can save money when buying a bundle; for example, a bundle of a sandwich, chips, and soda usually sells for a lower price than if each were purchased separately.

25. The FCC has recognized the economic benefits of bundling in competitive markets, noting that "[p]ackaged offerings are commonplace in a variety of industries in which customers can purchase a number of goods in a package at a lower price than the individual goods could be purchased separately."[12]

26. The FCC concluded that bundling can be an "efficient distribution mechanism" and an "efficient promotional mechanism" that can allow consumers to obtain goods and services "more economically than if it were prohibited."[13] We believe that the FCC's conclusion is well founded and supported by the economics literature.

27. While bundling is generally efficient, it can be used to further anticompetitive ends under certain circumstances. For example, bundling can harm competition through "anticompetitive tying."[14]

B. Why Do MVPD Providers Bundle Video Programming?

28. MVPD providers commonly distribute video programming as a bundle of channels. For example, subscribers typically pay a monthly fee for an expanded basic tier, which typically offers several dozen channels – such as CNN, ESPN, Discovery, MSNBC, and CNBC. The fact that consumers chose to purchase the expanded basic option suggests that the consumer values some, if not all, expanded basic tier channels enough to pay for the option.

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[12] *See Bundling of Cellular Customer Premises Equipment and Cellular Service*, CC Docket No. 91-34, 7 FCC Rcd. 4028, 4035 n. 35 (1992) ("Cellular Bundling Order").

[13] Cellular Bundling Order at 4030-4031. The Department of Justice has reached a similar conclusion. *See, e.g.*, U.S. Department of Justice, "Antitrust Division Submission for OECD Roundtable on Portfolio Effects in Conglomerate Mergers - Range Effects: The United States Perspective," October 12, 2001, available at http://www.usdoj.gov/atr/public/international/9550.htm.

[14] *See, e.g.*, *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2 (1984).

29. If consumers did not value the expanded basic option from one MVPD provider, he or she would have the option to purchase a different combination of channels from another MVPD provider (*e.g.,* DIRECTV or EchoStar, for example). Moreover, while consumers are often required to take the basic bundle, consumers have many choices about what *additional* programming to subscribe to.

30. For example, a subscriber to DIRECTV can spend an extra $3 per month to receive 15 extra channels (such as the Biography Channel, Discovery Wings, PBS Kids, The Science Channel, etc.). The same subscriber could also choose to add a package of local broadcast stations (for $3 per month), a package of 25 specialty and regional sports networks (for $12 per month), a package of seven HBO channels (for $12 per month), a package of 12 STARZ movie channels (for $12 month), a package of 3 Cinemax channels (for $12 per month), and a package of 9 movie channels from Showtime (for $12 per month). An individual could also buy all of these bundles together at a $15 per month discount. In addition, a subscriber could choose a package of HD programming, foreign-language channels, and various sports programming packages (such as NFL Sunday Ticket, MLB Extra Innings, etc.).

31. There are a number of reasons why network bundling by MVPDs improves social welfare.

32. First, bundling lowers distribution and marketing costs. If each channel were sold separately, MVPD and programming providers would need to engage in costly marketing campaigns to promote their products for purchase directly to consumers. À la carte network distribution would also entail additional expenditure on equipment, service support, and training (see below for a more detailed discussion of these costs). Moreover, the marketing and customer service operations for an MVPD provider would be significantly more complicated, especially since MVPDs now often offer hundreds of programming channels. Since at least part (if not all) of these additional costs of distribution and marketing would be passed onto consumers, consumer prices would accordingly rise.[15]

33. Second, if programs were only sold on an à la carte basis, subscribers would have to make an individual selection of each network they wanted to purchase. Making such individual selections may be inconvenient for a subscriber because learning about networks' program offerings and actually making the selections require some time and effort on the part of the subscriber. Because of the time and effort required in choosing networks, subscribers may forego picking some of the less popular networks

[15] In approving the AT&T-TCI merger, the FCC stated that "Post-merger, AT&T-TCI may well have lower costs in billing and servicing customers that subscribe to several of its products.... [B]y offering these products as a package at a price below that of the individual prices..., the merged firm would offer both lower costs and pass at least some of those cost savings on to consumers." *See e.g.,* TCI Order, Docket 98-178, (dated February 18, 1999) at ¶ 125. If the FCC believes that lower billing and servicing costs would be passed onto consumers, it would have to agree that higher costs of distribution and marketing would also be passed onto consumers in the form of higher prices.

that may nevertheless be of interest to the subscribers.[16] Furthermore, because of the difficulty in conveying to subscribers the type of content provided by a network, subscribers may select the wrong networks (*i.e.*, some subscribers may not choose networks they would actually enjoy viewing, but instead would select networks they do not watch). Such wrong choices would further contribute to the inefficiency of the à la carte selection process.

34. Third, bundling of video programming produces a more efficient system for pricing and distribution of programming. The incremental cost of distributing video content to another subscriber is usually zero.[17] Economic theory therefore suggests that allocative efficiency is achieved when the price for a single video channel is also zero. But charging a zero price is not feasible, since it would not likely allow programmers to recover their fixed costs (*i.e.,* the costs of producing the programming) and earn a competitive return on investment. Therefore, the à la carte price for a programming network must be greater than zero.[18] However, charging a non-zero price for each network would inevitably deter some viewers from purchasing the channel, even if they value watching it.

35. In such a case, there is an economic inefficiency created. Suppose a consumer values a channel at $1.00 per month. He or she would decide not to purchase it if the channel were priced at $2.00 per month. This is inefficient because $1.00 in potential benefits is lost.[19] Another way to explain this point is that allowing the subscriber access to the network would generate a benefit of $1.00 without incurring any additional distribution costs. As there would be similar losses in economic efficiency and welfare for many consumers and each network, the total inefficiency from selling unbundled programming can be quite significant. Under a bundled pricing regime, subscribers receive access to all the networks in the bundle. Thus, a subscriber would enjoy access to a network, even if he or she valued the network as little as $0.01 per month.[20]

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[16] If each programming channel were sold on an à la carte basis, each channel would, in effect, need to market itself to the viewer. Therefore, programmers would generally incur additional marketing expenses in an à la carte regime, as compared to a regime in which channels are sold through bundled offerings. This issue is discussed in more detail below.

[17] A key reason why the incremental cost of distributing video content to another subscriber is usually zero is that consumption of video programming is "non-rivalrous" – that is, the consumption of a programming network by one consumer does not diminish the ability of other consumers to also watch the programming network. Another reason why the incremental cost of distributing video content to an additional subscriber is essentially zero is that by the time subscribers receive video programming all the costs associated with providing the video content have already been incurred by the networks and MVPD providers.

[18] Furthermore, a zero à la carte price is essentially equivalent to bundling because under such a price the consumer would almost certainly choose the network, even if he or she intends to watch very little of it.

[19] The net lost benefit is the subscriber's valuation of the network minus the incremental cost of distribution. Therefore, since the incremental distribution cost is essentially zero, the foregone economic efficiency in this example is $1.00 per month.

[20] It would therefore be inaccurate to assert that consumers are "paying for unwanted programming" when they receive access to undesired programs bundled together with desired programming. The fact is that no additional resources are expended in distributing the undesired programs to a subscriber (see the example above), and not distributing such programming would not result in savings that could then be passed on to the subscriber. It is true that if consumers were purchasing bundles of goods with associated incremental

36. From an economic perspective, efficiency is therefore improved when the per-channel prices are as close to the efficient level (zero) as possible. But per-channel prices cannot be set too close to zero, since they must be set high enough for the programmer to recover their fixed costs plus a competitive return on investment. Bundling helps to achieve this outcome, thereby enhancing economic efficiency. This view does not appear to be controversial. The General Accounting Office ("GAO") wrote that "a panel of experts we commissioned agree that the bundling of cable programming, to at least some extent, results in economic efficiencies and thereby helps in minimizing cable rate increases."[21]

37. Another perspective on this same point can be found in the economics literature on public finance. There is wide-ranging and deep economic literature on the problems associated with financing a fixed expenditure, such as the production and distribution of video programming.[22] The literature shows that many socially desirable goods cannot be financed through user fees alone.[23] For example, the construction of a bridge typically cannot be funded using only bridge tolls.[24] In such cases, the literature shows that societal welfare is increased through per user rather than per use fees.[25] Similarly, economic theory suggests that it would be difficult (if not impossible) for many networks to fund the current level of investment in video programming content with the revenue generated in an à la carte regime. Bundling thus helps to ensure that there is diverse video programming, a stated goal of the FCC.[26] (See below for more discussion on this issue.)

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costs then excluding goods from the bundle would result in cost savings that could be passed back to the consumer. In such cases, purchasing bundles may entail paying for unwanted goods if desired goods were bundled with unwanted goods. But since such incremental costs are not present here, bundling is consistent with higher levels of economic efficiency.

[21] *See* General Accounting Office, "Telecommunications: Impact of Sports Programming Costs on Cable Television Rates," GAO-99-136, June 1999 at 16.

[22] For many goods, suppliers have no way of determining precisely (if at all) the demand elasticities of potential customers. By offering different bundles (*e.g.*, an expanded basic bundle, a premium bundle, etc.), the supplier can rely on customer self-selection to facilitate efficient recovery of fixed costs without detailed knowledge of individual consumers' demand elasticities. This point is shown in the example presented above, as well as in William Adams and Janet Yellen, "Commodity Bundling and the Burden of Monopoly," *Quarterly Journal of Economics* , Volume 90, No. 3 (August 1976), 475-498.

[23] *See, e.g.,* Harvey Rosen, *Public Finance.* (McGraw-Hill/Irwin: Boston, MA, 2002).

[24] There are several reasons why it may be the case that a socially desirable bridge cannot be funded with only tolls. First, tolls would distort the utilization of the bridge. Thus, if a bridge toll were set at $3, a person who values crossing the bridge at only $2 would not cross the bridge even though the person's value of crossing the bridge exceeds the social incremental cost of letting a car cross the bridge. Second, bridge tolls are normally uniform, that is, the toll is not dependent on the identity of the driver. Thus, a driver who values crossing the bridge at $20 would pay the same toll as the driver who values crossing the bridge at $5. This means that additional funding cannot be extracted from the individuals who value the bridge the most. There may also be some individuals who do not normally cross the bridge but value having the option of crossing the bridge. In addition, there are costs associated with toll collection. Such costs reduce the tolls' contribution to funding the bridge construction.

[25] That is, it is usually necessary to fund at least part of the bridge's construction through general tax revenue.

[26] *See, e.g.,* Federal Communications Commission, *Memorandum Opinion and Order*, MB Docket No. 03-124 (released January 14, 2004) at ¶ 260.

38. Finally, there is little support for the notion that bundling of video programming results in inefficient pricing of programming. Suppose that bundling were an inefficient mode of selling video programming and suppose that consumers would receive greater benefits when buying programming on an à la carte basis. If that were the case, MVPD providers could obtain higher revenues by switching to the à la carte model and subsequently raising prices.[27] In other words, if consumers received greater benefits when buying programming on an à la carte basis, MVPD providers would be able to increase revenues by switching to the à la carte model. However, bundling continues to be the predominant mode of video programming sales. Therefore, MVPD pricing behavior indicates that bundling is a more efficient mode of distributing video programming than selling programs on an à la carte basis.

39. Furthermore, incumbent cable companies face increased competition from other MVPD providers – such as EchoStar and DIRECTV – in selling their services to consumers. Such increased competition should induce MVPD providers to distribute cable network programming in an increasingly efficient manner. Therefore, the fact that MVPD providers continue to offer video programming primarily in bundled tiers further suggests that bundling is a more efficient method of selling programming than the à la carte model.

IV. An Economic Analysis of Mandatory Pure Unbundling

40. One proposal would bar MVPD providers from selling cable programming in tiers, thereby forcing MVPD providers to sell programming to consumers à la carte. Such mandatory pure unbundling would impose considerable costs on MVPD providers, programmers, and many consumers, while potentially creating some benefits for the fraction of consumers who value only a few channels and place little (or no) value on other channels. However, all those consumers who value more than a handful of channels will likely be worse off, if policymakers were to bar the ability of MVPDs to offer programming bundles. In addition, as described below, consumers would likely have fewer choices in the long run, since a pure approach to mandatory unbundling would likely lead to fewer programming channels and lower-quality content. Therefore, even the fraction of consumers who value only a few channels may be harmed by an à la carte regime because the program quality of the few channels they value may decline and/or some of those channels may not survive.

A. The Costs of A Pure Approach to Mandatory Unbundling

41. There would be a number of costs associated with facilitating the sale of video programming to consumers on an à la carte basis.

42. First, there would be a cost to consumers for new set-top boxes. It would be necessary in an à la carte regime for cable operators to scramble every network signal

[27] Consumers would be willing to pay such higher prices if they valued the option to select programs on an à la carte basis.

so that subscribers do not receive networks they were not paying for. Since many consumers do not have addressable converter boxes on every television set, consumers would need to install this new equipment.[28] According to 2002 data from the FCC, the average monthly rental cost was roughly $4.39 per box. And the National Cable & Telecommunications Association ("NCTA") notes that on average homes have 2.5 television sets. Thus, if a home has two to three TVs without addressable converter boxes, a proposal to mandate unbundling will cost the consumer between $8.78 per month and $13.17 per month.[29] (By comparison, the FCC estimates that the average monthly cable bill for programming alone was $36.47 in July 2002.[30]) A full assessment of the economic costs and benefits of proposals to unbundle cable programming would, therefore, need to account for the costs associated with new set-top boxes for many MVPD subscribers.[31]

43. Second, there would be a cost to MVPD providers for training and hiring customer service representatives. Since many MVPD providers now offer hundreds of programming channels, there are more than trillions of combinations for consumers to choose from. If an MVPD provider has 200 channels, the number of potential programming combinations that a consumer could choose in an à la carte regime would equal one with *sixty* zeros after it; by comparison, a trillion is a one with 12 zeros after it.[32] It is difficult to imagine how long it would take each call when a customer signs up for MVPD service, if the customer service representative needed to ask the customer whether he or she wanted to buy *each* programming network. In order to ensure that customers could choose among these combinations, MVPD providers would need to increase the number, and training, of customer service representatives. That is, if MVPD providers wanted to keep consumer wait times at current levels and each customer call increased in time (because of the increased number of programming choices), it should be clear that there would need to be more (and better trained) customer service representatives for each MVPD provider.

44. Third, there would be costs for MVPD providers to implement new billing systems. Since many MVPD providers do not currently have billing systems that would allow for the billing of à la carte services, MVPD providers would need to invest in new billing systems.

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[28] Subscribers to EchoStar and DIRECTV have addressable converter boxes, so there would be no additional set-top box costs for DBS subscribers.

[29] To the extent that an increase in demand for addressable converter boxes results in lower set-top box costs because of economies of scale, these figures may be overstated. But, to the extent that economies of scale were already exhausted, these figures would accurately reflect the costs to consumers of new set-top boxes.

[30] *See,* Federal Communications Commission, *Report on Cable Industry Prices*,, MM Docket 92-266 (released July 8, 2003) at Table 1.

[31] Two additional points are worth noting about set-top boxes: (1) at some point in the future when TVs have the functionality of new set-top boxes built into them or all households have digital set-top boxes, this cost will be mitigated; and (2) consumers would obtain some additional benefits from having addressable converter boxes.

[32] If an MVPD has 100 channels, the number of potential programming combinations would equal one with *thirty* zeros after it.

45. Fourth, there would be costs for MVPD providers and programmers to renegotiate extant programming contracts. Today, programming contracts between MVPD providers and programmers normally require bundled distribution by MVPD providers. Therefore, virtually every programming contract between MVPD providers and programmers would need to be renegotiated. For example, Discovery has roughly 1,000 programming contracts with MVPD providers. Renegotiating each and every one of these 1,000 contracts would impose costs on programmers and MVPD providers alike.

46. Fifth, there would be marketing costs for programmers in an à la carte regime that are not necessary in the existing tiered regime. Today, programmers generally market to consumers so that they "tune in" to particular programs. In an à la carte world, programmers would have to engage in such tune-in marketing, but at the same time significantly more general advertising and marketing that would be necessary to attract consumers to purchase a channel. Discovery executives note that Discovery's marketing budget is currently significantly below the reported marketing budget of HBO (which is offered à la carte) and significantly below the marketing budgets of major consumer product companies when adjusted for the level of revenue.[33] The extent to which marketing costs would increase is difficult to assess with precision, but Discovery business executives, for example, believe that it would be necessary to engage in significantly more marketing than it currently does. Such costs need to be considered in evaluating proposals to mandate pure unbundling of video programming.

B. Pricing Under Mandatory Pure Unbundling

47. Proponents of mandatory unbundling appear to believe that if the bundled price for 40 channels is $40 per month, the per-channel price in an à la carte world will be $1 per month. In fact, it is almost certainly the case that the à la carte average per-channel price would be much greater than the "implicit" average per-channel price of $1 in such a bundle.

48. Economic theory suggests that programmers will find à la carte distribution *less* profitable than distribution through programming tiers. If selling programming to consumers on an à la carte basis were the most economically viable strategy, one would expect rational programmers to sell programming in that manner. The fact that most video programming is sold through programming tiers suggests that such a distribution method is the best approach for programmers.

49. Indeed, market evidence suggests that those programmers who previously had an a la carte business model have tended to move away from it to a business model based on wide distribution (through programming tiers). Such a migration toward bundles suggests that being part of a bundle produces higher revenues. (Conversely, moving toward à la carte for these channels would lower revenues.) The GAO noted this migration, as did Bear Stearns, which concluded that "Every regional sports network

[33] According to Nielsen Media Research data, HBO spent more on marketing in 2003 than Discovery spent for its entire family of analog networks combined. *See* Reported 2003 Gross Media Spending for HBO Cable TV Channel, AdViews, Nielsen Media Research 2004.

(RSN) has changed from the pay to the basic model since there is more advertising revenue with broader distribution, with greater distribution more than offsetting the loss of the premium channel pricing."[34]

50. The experience of the YES Network supports the conclusion that profits are higher through widespread distribution than through an à la carte business model. In its dispute with Cablevision, the YES Network was offered the opportunity to be sold à la carte to consumers, to set its retail price independently of Cablevision, and to keep all revenue generated by the YES Network on Cablevision. The YES Network turned down this offer because it presumably believed that its revenues would be higher if it could obtain carriage on Cablevision's expanded basic tier.[35]

51. The impact of lower programmer profitability would have significant repercussions. One potential outcome is that programmers cut costs and reduce the quality of programming (see below for a further discussion of this impact). Another outcome is that the programmer reoptimizes its wholesale prices to account for the new market realities. Our review of the evidence suggests that programmers will likely do both. Increased wholesale prices will, in turn, be reflected in higher retail prices for consumers (on a per-channel basis).

52. The programming networks, which will seek to recover lost revenues and added costs associated with the à la carte regime (as discussed herein), would be inclined to set the à la carte prices at higher levels in part to reflect the fact that their remaining viewers, on average, value the programming more highly. This would further reduce the number of viewers for each network under the à la carte regime until the per-subscriber fee reached a new equilibrium.

53. Moreover, as the numbers of subscribers fall, networks would face declining advertising revenues. We understand that a key variable in national advertisers' purchasing decisions is the distribution of a particular cable network.[36] (Distribution is the number of households to which a network is made available.) Advertisers pay a premium for minutes on top tier cable networks, such as the Discovery Channel.[37] For example, Joe Abruzzese, the President of Advertising Sales, U.S. Networks, for Discovery, states that "If the Discovery Channel's distribution were to fall below 70 million households, it would no longer be considered to be as strong an alternative to broadcast for advertisers. Lower levels of distribution would have a substantial impact on Discovery's value for advertisers in two ways. First, the Tier 1 cost per thousand would no longer be warranted, and second, both the current and potential audience for programs on the Discovery Channel would decline, further diminishing the value to advertisers."[38]

[34] *See* Bear Stearns Equity Research Report, "A La Smart?" March 29, 2004.
[35] *See e.g.* Bill Bowman, "Yankee Network Official Blasts Cablevision Offer," *Courier News (Bridgewater, NJ)*, March 27, 2002.
[36] *See* Declaration of Joe Abruzzese at ¶ 5. Other key variables include audience levels and characteristics.
[37] *Ibid.*
[38] *Ibid* at ¶ 6.

54. The GAO estimates that in 2002 roughly half of programmer revenue was generated by advertising and half by affiliate fees.[39] Because in an à la carte distribution regime many networks will lose advertising revenue, these networks would need to rely on higher affiliate fees to offset the losses in advertising revenue. As the GAO noted based on its interviews of industry experts, "the cost burden of cable television would become less reliant on advertising revenues and much more reliant on *license fees* that would likely be passed on to consumers."[40] The CEOs of BET Holdings, Sì TV, TV One, and International Channel wrote that an à la carte regime would "instantly erode potential advertising support, forcing us to dramatically increase the per-subscriber fee we must charge."[41] Similarly, a group of women programming executives wrote that "license fees of cable program services would dramatically rise in order to cover the ad revenue shortfalls."[42]

55. The higher per-subscriber fees that would result in an à la carte regime are consistent with marketplace evidence. For example, Leo Hindrey, the former President of TCI, testified to Congress that "Our experience with moving the Disney Channel to a regulated tier demonstrates this point. The addition of Disney to the widely subscribed regulated tier added less than a dollar to the price of the tier. As an <u>à la carte</u> service, with a much smaller subscribership, Disney cost about $10."[43] The fundamental point is that there appears to be an inverse relationship between the scope of distribution and the per-subscriber fee.[44] The wider the distribution, in general, the lower the fee; the more narrow the distribution, the higher the fee. Since an à la carte regime will result in fewer subscribers viewing any particular channel, it should be expected that affiliate fees will rise for each programming channel.

C. Discovery Model of Pricing Under Mandatory Pure Unbundling

56. We have been asked to review a model developed by Discovery's Research Department. The model addresses a simple question: what would the per-subscriber fee need to be under an à la carte regime for the Discovery Channel to maintain its current level of economic returns? As described above, it is likely an impossible question to answer since economic theory suggests that Discovery would have less revenues and greater costs under an à la carte distribution business model than under its extant business model (which involves selling its programming through tiers).

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[39] *See* General Accounting Office, "Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry," GAO-04-8, October 2003 at 35.
[40] *Ibid.*
[41] *See* Letter to The Honorable Joe Barton and The Honorable John Dingell from Debra Lee, Jeff Valdez, Johnathan Rodgers, and Kent Rice, May 12, 2004 at 1, available at http://www.ncta.com/a_la_carte/a_la_carte_minorities_letter_5-04.pdf (downloaded on July 8, 2004).
[42] *See* "An Open Letter to Congress from Concerned Women Programming Executives Opposing A La Carte Pricing of Consumers' Television Channel Choices," May 5, 2004 at 1, http://www.ncta.com/a_la_carte/open_letter_from_women_execs.pdf (downloaded on July 8, 2004).
[43] *See* Testimony of Leo J. Hindery Jr., President Tele-Communications, Inc., Before the Senate Committee on Commerce, Science, and Transportation, July 28, 1998 at 17 (emphasis in original).
[44] *See e.g.* General Accounting Office, "Telecommunications: Impact of Sports Programming Costs on Cable Television Rates," GAO-99-136, June 1999 at 15.

Nonetheless, the model produces results that are consistent with available marketplace evidence.

57. The model begins with the assumption that only Discovery's current core viewers would choose to receive the network on an à la carte basis. The model assumes that one-third of all Discovery's 53.6 million viewers are "core" viewers. Furthermore, the analysis assumes that 90 percent of these core viewers will continue to subscribe to Discovery on the à la carte basis. Thus, the model assumes that 16.1 million households will subscribe to Discovery under an à la carte regime.

58. According to data provided to us by Discovery, the average number of monthly viewing hours by the top three deciles of Discovery viewers was roughly 10 hours per month. That is, slightly more than 16 million households watched an average of 10 hours per month of the Discovery Channel. Discovery executives note that these core viewers account for 85 percent of all viewership. But it is unclear what percentage of these "core" viewers would be willing to pay several dollars per month for the Discovery Channel; the number of viewers who would ultimately subscribe to Discovery will depend largely on the price of the programming. Assuming that nearly all "core" viewers would subscribe to Discovery likely understates the true impact of proposals to unbundle cable programming on the per-subscriber price for the Discovery Channel.

59. The model then takes into account the fact that the reduction in the number of Discovery viewers will result in smaller advertising revenue for the network in the à la carte world.[45] It is difficult to predict precisely how much advertising revenue will drop due to a move to an à la carte regime. Therefore, the model first assumes that advertising revenue declines proportional to the decline in the number of viewers (70 percent). In order to test the sensitivity of the model to this assumption, it then assumes that advertising revenue decreases by smaller percentages (25 percent and 50 percent) than the percentage fall in total viewers (70 percent).

60. Furthermore, the model assumes that Discovery will incur greater marketing expenses under an à la carte regime. Currently, the Discovery Channel is commonly included in the expanded basic tier of an MVPD provider. Thus, Discovery does not need to incur large expenditures in convincing individual subscribers to choose its programming. Instead, to retain its viewers, the network must produce quality programming, so that its programming will continue to have loyal viewers and so that the MVPD providers continue to be interested in carrying the network. However, in the à la carte world, Discovery would need to engage in additional marketing and promotional activity to persuade subscribers to choose the network on an à la carte basis. Such promotional activity can be quite costly, and the model assumes that total Discovery marketing expenditures would increase by $66.4 million per year.[46]

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[45] The GAO appears to agree that advertising revenue will fall. It stated that, "cable networks could lose advertising revenue." *See* General Accounting Office, "Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry," GAO-04-8, October 2003 at 6.

[46] Discovery developed its estimate of the increased marketing expenditures that would be needed based on the marketing expenditures for the top 100 consumer brand products. Specifically, Discovery's research

61. Combining these factors together, the analysis starts with the fact that Discovery Channel's 2003 revenue totaled $664 million. This figure includes $389 million in net advertising revenue and $275 million in affiliate revenue. Furthermore, the model estimates that under the à la carte regime Discovery Channel's net advertising revenue will be $116.7 million (with a 70-percent fall in advertising), $194.5 million (with a 50-percent fall in advertising), or $291.8 million (with a 25-percent fall in advertising), and its additional marketing expenditures will total $66.4 million. Thus, based on these numbers, Discovery would need to charge a wholesale price of $3.18 per subscriber per month (if there is a 70-percent fall in advertising revenue), $2.78 (if there is a 50-percent fall in advertising), and $2.27 (if there is a 25-percent drop in advertising revenue) in order to retain its current level of economic returns. (According to data from Kagan, Discovery's current wholesale price for the Discovery Channel is roughly $0.25 per subscriber per month.) The Discovery model shows that the per-subscriber wholesale price for the Discovery Channel would be between nine and more than 12 times higher than it is today in order for the network to maintain current revenue levels, if Discovery were forced to sell the Discovery Channel on an à la carte basis

62. In order to calculate an estimated retail price of the Discovery Channel in an à la carte regime, the model assumes a 1.69 multiplier to calculate distributor markup (which translates to approximately a forty-percent MVPD margin on programming.[47] As a result, depending on the drop in advertising revenue assumed, consumers would face an estimated retail price of between $3.84 and $5.38 per subscriber per month if Discovery is to retain its current level of economic returns.[48] Moreover, these per-subscriber prices do not include the effects of the costs of distributors' complying with mandatory unbundling regulations; some of these costs would likely be passed through to consumers in the form of even higher monthly fees.

63. The Discovery model appears to produce results that are consistent with, or perhaps conservative when compared to, historical evidence, even though it does not allow for feedback effects between the retail price and the number of subscribers. Accounting for such feedback effects is difficult because it requires access to detailed data on subscribers' elasticity of demand, as well as assumptions regarding the exact form of the unbundling regulatory regime that would prevail in the future. Since such

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showed that consumer product companies with more than $1 billion in revenue spent an average of eight percent of total revenue on marketing; companies with between $500 million and $1 billion in revenue spent an average of 10 percent of revenue on marketing; companies with between $200 million and $500 million in revenue spent an average of 12 percent of revenue on marketing; and companies with between $100 million and $200 million in revenue spent an average of 15 percent of revenue on marketing. Since the Discovery Channel had $664 million in revenue in 2003, the model assumes that Discovery would need to spend 10 percent (or $66.4 million) of its revenue on marketing (excluding the tune-in marketing that Discovery will continue to utilize).

[47] Based on data provided by Kagan research.

[48] The highest retail price occurs in the scenario in which advertising revenue falls by 70 percent. When advertising falls by 50 percent, the model estimates that the retail price will equal $4.70 per subscriber per month.

elasticity of demand data are, in general, not available, the preferred approach to modeling potential prices in an à la carte regime is not possible.

64. We have compared the results from Discovery's model to marketplace evidence to test the reasonableness of Discovery's results. Prior to becoming an expanded basic channel, the Disney channel was sold à la carte. It was generally priced between $8 per month and $13 per month.[49] HBO is currently sold à la carte, and it is generally sold for between $10 and $15 per month.[50] The Golf Channel is sold à la carte at a price of $4.99 per month.[51] Finally, foreign-language channels are sold on an à la carte basis at prices of up to $25 *per channel* per month.[52] Thus, it would appear to us that an estimate that the Discovery channel will cost consumers between $3.84 and $5.38 per month is consistent with – or perhaps conservative when compared to – what others have charged (and do charge) for à la carte programming.

D. Change in Total Cable Bills in an À La Carte Regime

65. The previous two sections presented evidence that the per-channel price of cable programming networks will likely rise sharply under an à la carte regime. But the rise in per-channel prices will not affect all consumers similarly. Consumers who value many channels will be worse off. Many of them will get the same amount of programming as they do today, but will pay a much higher cost. Other consumers will pay the same or a greater price, but get far fewer channels. There will also be a fraction of consumers who do not value many cable programming channels and may see their total cable bill fall under a pure à la carte regime.[53]

66. The GAO agrees. It wrote that, "it appears that subscribers' monthly cable bills would not necessarily decline under an à la carte system,"[54] and that "if cable subscribers were allowed to choose networks on an à la carte basis, the economics of the cable network industry could be altered, and if this were to occur, it is possible that cable rates could actually increase for some consumers."[55]

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[49] *See e.g.* "The Pitfalls of A La Carte: Fewer Choices, Less Diversity, Higher Prices," An NTCA Policy Paper, May 2004 at 12, available at http://www.ncta.com/pdf_files/NCTA_White_Paper_-_Pitfalls_of_A_La_Carte.pdf (downloaded on July 2, 2004).

[50] For example, DIRECTV sells a package of HBO channels for $12 per month; EchoStar sells a package of HBO channels for $13.99 per month; Cox sells a package of HBO channels for $13.95 per month in Bakersfield, California, and $11.95 per month in Las Vegas. Data are available at http://www.directv.com; http://www.dishnetwork.com; and http://www.cox.com (downloaded on July 3, 2004).

[51] *See* http://ekb.dbstalk.com/119 (downloaded on July 3, 2004).

[52] *See, e.g.,* http://www.dishnetwork.com/content/programming/international/a_la_carte/index.shtml (downloaded on July 3, 2004); http://www.cox.com/PV/digitalcable/pricing.asp (downloaded on July 3, 2004); or http://www.directv.com/DTVAPP/packages/international_services.dsp (downloaded on July 3, 2004).

[53] Even those consumers who may see their total cable bill fall may be worse off under an à la carte regime, if the regime results in a reduction in program quality and a demise of programming networks.

[54] *See* General Accounting Office, "Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry," GAO-04-8, October 2003 at 36

[55] *Ibid* at 34.

E. Impact of Mandatory Pure Unbundling on Programming Diversity and Quality

67. The evidence suggests that an à la carte approach to selling video programming would lower programmers' economic returns. If programmer economic returns are lower, there are three potential impacts: (1) it could lead to lower investments in content or programming quality; (2) it could lead to existing channels going out of business; and/or (3) it could lead to new networks not being launched.

68. These effects may occur, in part, because there would be fewer subscribers to each network, which would lower the return on any investment in new programming content or a new programming channel. Therefore, when a programmer – such as Discovery – considers an investment in high-quality content, the potential audience for the programming will be smaller in an à la carte regime than in the extant tiered-programming regime. Smaller potential audiences, in turn, means lower advertising revenue, which would further reduce incentives to invest in programming.[56]

69. One additional reason why programmers would also likely find it more difficult to launch new channels involves the difficulty in developing loyal viewership. Carriage on a widely distributed tier helps a new network "catch" a casual viewer's eye. While some programmers may be able to provide a new network to consumers for some period of time for no charge, doing so for an extended period of time may not be feasible.[57] We understand that it takes years to build a loyal following. Moreover, it may be more difficult to build more loyal viewers in an à la carte world, if programming quality is harmed. That is, if the quality of programming decreases under the à la carte regime (*e.g.*, because there is less original programming and more repeat programming) then viewership may be more difficult to attract and retain. Discovery executives emphasize that it would be difficult to develop the business case for launching a new network in an à la carte regime. Therefore, programming diversity and consumer choices are likely to be harmed as a result of mandates to unbundle cable programming.

70. To examine the impact that an à la carte regime may have on the ability of programmers to launch new programming, we asked Discovery to examine the financial viability of one of its analog channels in an à la carte environment.[58] The channel was launched in the mid-1990s and is now distributed to more than three-quarters of MVPD households.

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[56] It would also appear that with bundled programming some risk is shared between distributors and programmers. In an à la carte world, programmers would appear to take on more risk. The academic evidence suggests that uncertainty reduces the level of investment by firms. *See e.g.* Avinash Dixit, and Robert Pindyck, *Investment Under Uncertainty,* (Princeton University Press: Princeton, NJ, 1994).

[57] Such a marketing strategy would reduce the costs to consumers of finding out about new programming options, but would increase the costs to programmers if they would still have to pay an affiliate fee to MVPD providers during the period of the promotion.

[58] Discovery asked that we withhold the name of the programming channel so that we do not reveal sensitive business information.

71. However, the financial data for this analog channel shows that it has required many years of investment by Discovery for the channel to generate positive profits. Discovery projects that this programming network will be profitable on an annual basis for the first time only in 2005. If these projections prove to be correct, it means that the network would have sustained losses for *nearly a decade before turning an operating profit.* During the time that the network was losing money, Discovery's financial data shows that Discovery invested approximately $200 million to help the channel succeed.

72. These financial data, therefore, show that launching a programming network is a long, expensive, and risky venture. Such an investment in the launch of a network would only make sense from a financial point of view, if the network would produce financial returns that are sufficiently large to justify undertaking the risk and expense of the launch. If the unbundling proposals have the effect of substantially reducing the networks' revenues, then the economics of launching new programs will become unfavorable. The unfavorable economics for launching new networks will mean fewer network launches and less diverse programming.

73. Based on the financial data provided by Discovery on the launch of this analog network, even a modest change in the revenue or expenses of the channel could swing the channel's launch from being profitable to being unprofitable. For example, if advertising revenue were to fall by only 20 percent and there were no increase in affiliate revenue, the channel would be unprofitable (from an operating profit perspective) in 2006. If advertising revenue, affiliate revenue, and marketing expenses were to change as Discovery executives expect, this popular analog network is unlikely to be profitable on a going-forward basis. As a result, one would expect that Discovery would have decided never to have launched a network that now appears to have a very loyal following of viewers.

74. Such a viewpoint is supported by the GAO and CEOs of various programming providers.

75. For example, the GAO stated that, "Most of the cable networks... believe that programming diversity would suffer under an a la carte system because some cable networks, especially small and independent networks, would not be able to gain enough subscribers to support the network. For example, one network told us that under an a la carte system, fewer networks would remain financially viable and new networks would be less likely to be developed. Three of the cable operators and four of the five financial analysts we interviewed also said that smaller networks or those providing specialty programming would be hurt the most by an a la carte system."[59]

76. A group of four minority programming CEOs recently wrote that, "a la carte packaging and pricing of programming would have a chilling effect on

[59] *See* General Accounting Office, "Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry," GAO-04-8, October 2003 at 36.

programming diversity in America."[60] A group of women programming executives stated that an à la carte regime would "undermine the economic underpinnings of our businesses." They also wrote that "consumers would actually have *fewer* programming choices."[61]

77. Some smaller niche programming networks would not likely be viable as stand-alone à la carte options. Such networks would not be viable in an à la carte pricing regime not because of lack of interest from viewers but because of their decrease in revenues and increase in costs, including transactions costs of selecting, marketing, and servicing such channels in the à la carte world.

F. Summary

78. À la carte programming is not a panacea for concerns about the MVPD industry. Rather, the fundamental conclusion is that in the short run a fraction of consumers will pay less for far less programming, some consumers will pay much more for the same programming, and the remaining consumers will pay the same or more for less programming. But the additional (and perhaps even more significant) potential harm from "pure" unbundling proposals may not be in the short term. Rather, proposals to ban bundles of cable programming would fundamentally alter the economics of the programming industry in a way that would make it more difficult for companies to launch new programming networks or to invest in content quality. Such consequences would likely harm consumers in the long run because they would be denied the opportunity to watch high-quality programming on either existing or new networks. Accordingly, all consumers may be worse off under an à la carte scenario because even the consumers that receive very few channels under an à la carte scenario may receive less content on those channels and reduced program quality. Furthermore, these consumers would be unable to watch the networks that fail to survive under an à la carte regime.

V. An Economic Analysis of The Hybrid Approach to Unbundling

79. Another form of mandatory unbundling would allow MVPD providers to continue to offer bundles of programming (in programming tiers), but would require MVPD providers to offer each network à la carte. Proponents assert that such an option would simply give consumers more choices, and would still allow MVPD providers to offer a bundled option. As a result, proponents claim that consumers who want a bundled offering can get one, but consumers who do not want to "pay for unwanted networks" can choose to buy only the channels they want.

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[60] *See* Letter to The Honorable Joe Barton and The Honorable John Dingell from Debra Lee, Jeff Valdez, Johnathan Rodgers, and Kent Rice, May 12, 2004 at 1, available at http://www.ncta.com/a_la_carte/a_la_carte_minorities_letter_5-04.pdf (downloaded on July 8, 2004).

[61] *See* "An Open Letter to Congress from Concerned Women Programming Executives Opposing A La Carte Pricing of Consumers' Television Channel Choices," May 5, 2004 at 1, http://www.ncta.com/a_la_carte/open_letter_from_women_execs.pdf (downloaded on July 8, 2004).

80. Under one approach being considered, MVPD providers would be encouraged to offer à la carte programming. If it were profitable for MVPD providers to offer a wide variety of à la carte programming today, they would do so today. Even if policymakers pressure MVPDs to offer more à la carte programming, it is unlikely to have a major effect on the practical ability of consumers to choose their programming on an à la carte basis.

81. In fact, marketplace evidence suggests that few subscribers would likely choose to purchase networks à la carte in such a situation. As a result, MVPD providers would incur significant costs to comply with a hybrid unbundling regulation, but few consumers would receive any benefits. Since MVPD providers would pass at least some of its higher costs onto its subscribers, most consumers would likely face *higher* cable prices – and only a fraction of subscribers would choose an à la carte option.

82. Before considering the effects of a hybrid approach to unbundling, it is important to emphasize that MVPD providers can, and do, offer both bundled and unbundled video programs to consumers. That is, consumers can choose to purchase some programming networks either à la carte or in a bundle, although à la carte options are usually confined to premium channels. For example, EchoStar subscribers can purchase Discovery HD either as an à la carte option or through DISH Network's HD Pak bundle (which also includes HDNet, HDNet Movies, ESPN HD, and TNT in HD). Similarly, consumers of most MVPD providers can purchase HBO as an à la carte option or as part of a bundle in the highest tier of service (*e.g.*, in EchoStar's Everything Pack, DIRECTV's Total Choice Premier, or Cox's Digital Choice Hits service).

83. Given that MVPD providers can and do offer both bundled and unbundled programming networks to consumers and that business executives of programming providers are likely rational and seek to maximize economic returns, one must assume that if selling video programs on an à la carte or hybrid bundling basis were the highest return strategy, à la carte or hybrid bundling would be the predominant form of distributing video programming. The fact that general entertainment and niche programming channels are generally sold as a bundle suggests that bundling is the most economically rational means of selling these channels.[62]

84. Therefore, if market participants were forced by government regulations or by pressure from policymakers to offer à la carte services, it would not be surprising to find prices being set for à la carte channels that provide consumers the incentive to choose the bundle of programming (instead of the à la carte option).[63]

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[62] Some may argue that MVPD providers sell bundles of programming channels because of licensing contracts with programmers, and not because bundling is the most economically rational mode of distribution for MVPD providers. However, this argument is misguided. The interests of MVPD providers and programmers are aligned. Where MVPD providers and programmers disagree is over how revenue should be shared between them. Therefore, a marketing strategy that is preferred by programmers (because it produces higher revenues) should also be preferred by MVPD providers.

[63] It must be the case that offering such à la carte prices is not the most economically rational strategy. Otherwise, most general entertainment and niche video programming would be sold on an à la carte basis today.

85. The logic of why prices would be set to encourage consumers to choose the bundled programming can be shown with the following examples. Suppose programmers and distributors were to offer very low à la carte prices. Many subscribers would presumably shift from programming tiers to à la carte service. Since programmers have shied away from offering programming on an à la carte basis, this suggests that such an approach would lower programmers' economic returns. Thus, programmers would not want to encourage such an outcome that would have an adverse effect on their financial viability.

86. On the other hand, if programmers and distributors were to set à la carte prices at such a level that the vast majority of consumers still bought the bundled programming – and only those few consumers who valued a very small number of channels took à la carte options – programmers would not experience as large a loss.

87. Marketplace evidence supports a conclusion that prices will be set to encourage the vast majority of consumers to take the bundle of programming.

88. For example, an EchoStar consumer can choose today to buy Discovery HD for $7.99 per month or a bundle of five HD channels, including Discovery HD, for $9.99 per month. We understand from Discovery executives that nearly 20 times more subscribers take the bundle of five HD channels for $9.99 per month than pay $7.99 per month for Discovery HD alone. We further understand that the percentage of EchoStar subscribers taking Discovery HD alone continues to decline as more and more subscribers take the HD bundle.

89. Similarly, an EchoStar subscriber can choose to purchase two Disney channels (Disney East and Disney West) à la carte from EchoStar for $9.99 per month or the subscriber can choose to purchase the same two Disney channels, along with *58* other national programming channels, for $24.99 per month as part of EchoStar's America's Top 60 programming tier. The fact that the two Disney channels have such à la carte prices is not surprising and is consistent with our conclusion that the profit-maximizing strategy would result in the outcome where the vast majority of subscribers are purchasing bundled programming.[64]

90. In the end, the only subscribers who are likely to take the Disney à la carte option are those subscribers who highly value a small number of particular channels and place little or no value on most other channels. For example, suppose that a consumer were willing to pay $20 per month for the Disney channel and no more than $1 per month for all other channels. In such a case, he or she would likely take the Disney à la carte option, instead of the 60 programming networks that are available for $24.99 per month on EchoStar.

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[64] One website notes that information about EchoStar's Disney à la carte option is "hard to find." *See* http://ekb.dbstalk.com/119 (downloaded on July 2, 2004) One EchoStar customer service agent stated that she had never had a subscriber sign-up for the Disney à la carte option. Phone call by author to EchoStar customer service toll-free number, June 24, 2004.

91. The fact that few people would take the à la carte option is not a consequence of a market failure or anticompetitive behavior by any of the market participants. Rather, it reflects the difficulty in maintaining meaningful "mixed" bundling arrangements when consumers have different preferences for each channel. The reason is that it is difficult to set prices in a way that separates those consumers who prefer an à la carte option versus the bundled option. As a result, pricing will be set in such a way that causes subscribers to gravitate either towards the bundle or towards the à la carte options. The marketplace evidence suggests that prices are usually such that consumers gravitate toward the bundled option.

92. It is not at all clear whether a hybrid approach to mandatory unbundling would benefit even those subscribers who highly value a very small number of channels and place little or no value on all other available networks, because under an à la carte scenario these subscribers may receive reduced program quality and some of the few networks they watch may fail to survive. However, such a hybrid approach would force MVPD providers and programmers to incur significant costs that would in turn harm all other consumers. As described in more detail above, requiring MVPD providers to offer each network on an à la carte basis would involve the following types of costs: (1) costs to consumers of new set-top boxes; (2) costs of training and hiring customer service representatives; (3) costs of implementing new billing systems, since extant billing systems are unlikely to handle the complexities of à la carte pricing options; and (4) the costs of renegotiating programming contracts, since amending the contract terms may be necessary to enable the MVPD providers to offer the à la carte options.

93. MVPDs would likely pass these costs on to all consumers in the form of higher prices for video programming. Thus, even if hybrid unbundling does not result in any significant increase in programming being sold on an à la carte basis, consumers of MVPDs would likely face higher prices as a result of the regulation.

94. Since the rational, economic response by MVPD providers to government regulations requiring them to offer à la carte programming would likely be to set à la carte prices at such levels that few consumers choose the à la carte option, such a government regulation would produce few, if any, consumer benefits – and would likely actually harm consumers (as described above).

VI. Conclusions

95. The most appropriate means to achieve the ends desired by proponents of unbundling proposals is to spur even more vigorous competition in the MVPD industry. In a competitive market, MVPD providers will seek to supply consumers more choices at lower prices with appropriate safeguards to protect consumers from indecent programming. That is, competition will force market participants to provide consumers what they demand.

96. It would be particularly counterproductive to impose significant new regulations on MVPD distributors and cable programming networks today. Most observers believe that the MVPD market is evolving in ways that are hard to predict and may be on the cusp of a major evolution in the way its business is conducted. In particular, MVPD providers are rolling-out new advanced services, which may fundamentally change the business models of programmers. To the extent that VOD options take off, programmers will need to adapt to new market circumstances. How MVPD providers and cable network programmers will react and change as a result of the adoption of VOD is unclear today. (VOD may ultimately achieve the goals of proponents of mandatory unbundling, since VOD may allow consumers to choose to purchase only the content that they want to view.)

97. Economic theory and the experience with past regulatory intervention in the MVPD industry suggest that policymakers would be well served allowing MVPD distributors and cable programming networks to alter naturally their business models in response to promising innovations, rather than mandating certain changes on MVPD distributors and cable programming networks. Finally, if policymakers believe that such changes are not happening quickly enough, the focus should be on new efforts to enhance competition in the MVPD industry.

I declare under penalty of perjury that foregoing is true and correct.
Executed on July 15, 2004

Robert Willig

Robert D. Willig

I declare under penalty of perjury that foregoing is true and correct.
Executed on July 15, 2004

Jonathan M. Orszag

I declare under penalty of perjury that foregoing is true and correct.
Executed on July 15, 2004

Jay Ezrielev

Exhibit B

Declaration of Joe Abruzzese

DECLARATION OF JOE ABRUZZESE

1. My name is Joe Abruzzese. I am the President of Advertising Sales, U.S. Networks, for Discovery Communications, Inc. ("Discovery").
2. National advertisers generally seek to place their advertising message before a large, national audience, and also seek to maximize exposure within particular demographic target groups (*e.g.*, 18-49 year old adults).
3. Currently, the highest demand for commercial time within national television, resulting in the highest commercial costs and the highest advertising CPMs (cost per thousand), occurs during prime time (8:00 – 11:00 PM) on the broadcast networks. Broadcast primetime is seen as having the highest premium standard for advertisers because it is available universally (in 99 percent of US television households) and reaches very large audiences simultaneously.
4. Advertising on nationally distributed cable television offers advertisers an alternative to broadcast. Cable provides national coverage and reaches broad audiences, but at a much lower cost (cable CPMs are less than 50 percent of broadcast CPMs).
5. Advertising pricing on cable is also determined by supply and demand. Networks that have broad national distribution and offer popular programming that attracts a broad audience are able to charge advertisers higher rates. These networks are referred to as "Tier 1" networks. The advertising CPMs on these networks is 50 to 100 percent higher than the Tier 2 and Tier 3 networks.

6. The Discovery Channel is a Tier 1 network. If the Discovery Channel's distribution were to fall below 70 million households, it would no longer be considered to be as strong an alternative to broadcast for advertisers. Lower levels of distribution would have a substantial impact on Discovery's value for advertisers in two ways. First, the Tier 1 cost per thousand would no longer be warranted, and second, both the current and potential audience for programs on the Discovery Channel would decline, further diminishing the value to advertisers.

7. I understand that "a la carte distribution" refers to consumers' ability to pick and choose among networks, as opposed to choosing tiers, or groups, of networks. As I understand it, themed tiering essentially refers to consumers' ability to choose tiers that are much smaller than they are today. From an advertising perspective, these refer to much the same impact, and so, for convenience, I refer to both as "a la carte."

8. If viewers chose cable programming on an a la carte basis to any significant extent, the distribution of even the most popular networks would drop dramatically. Moreover, if viewers chose cable programming on an a la carte basis to any significant extent, the audience of even the most popular networks would also drop.

9. Again, national advertisers base their purchasing decisions primarily on distribution and on audience levels. Were viewers to choose cable programming on an a la carte basis, therefore, national advertisers would be willing to pay significantly less for commercial time on cable networks, in light of the dramatic

reduction in distribution and audience associated with such a model. In an a la carte world, national advertisers would in all likelihood shift their resources to the only entities that would retain current levels of distribution and audience – broadcast networks. This shift would drive up the cost of advertising on the broadcast networks.

I certify under penalty of perjury that the above is true and correct to the best of my knowledge and belief.

Joseph J. Abruzzese
(Signature)
Joe Abruzzese
President, Advertising Sales, U.S. Networks
Discovery Communications, Inc.
7/14/04
(Date)