THE FCC'S FURTHER REPORT ON A LA CARTE PRICING OF CABLE TELEVISION

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Contents

I. Introduction 1

II. The Further Report Fails to Meet Established Standards for Regulatory Analyses 3

III. The Further Report's Conclusions are Incorrect, Unsupported and Misleading 6

A. The Further Report Ignores or Mischaracterizes the Economic Literature on Bundling 6

1. Economists Agree Bundling is Pervasive and is Generally Pro-Consumer 7

2. The *Only* Time Bundling *May* Harm Consumers is When Practiced by a Monopolist 9

3. The Economic Evidence on A La Carte Overwhelmingly Concludes the Costs of a Mandate Would Exceed the Benefits 12

B. The Further Report Relies on Faulty Assumptions About the Existence of Market Power 17

1. The Retail Market for MVPD Services is Competitive 18

2. The Wholesale Market for Video Programming is Competitive 19

C. The Hypothetical Examples Upon Which the Further Report Bases Its Conclusions are Misleading and Inapt 22

IV. Summary and Conclusions 24

Appendices

Appendix A: Analysis of the Further Report's Economic Appendix A-1

Appendix B: Key Findings of Economic Analyses Submitted In MB Docket No. 207 .... B-1

Appendix C: Key Findings of Recent Analyst Reports C-1

I. INTRODUCTION

We have been asked by The Walt Disney Company to evaluate the recently released Federal Communications Commission ("FCC" or "Commission") staff report on "a la carte" pricing for cable television ("Further Report").[1] The Further Report rebuts the Commission's November 2004 Report on the same subject ("First Report"),[2] arguing that the First Report relies on "problematic assumptions" and presents analysis that is "incorrect," "biased,"[3] "flawed," and "incomplete."[4]

Based on an analysis of both reports, as well as relevant economic research and industry information, we conclude the FCC got it right the first time. The First Report provides a comprehensive review of the pricing and bundling practices of Multi-Channel Video Programming Distributors (MVPDs). It is based on an extensive factual record gathered by the Commission through a Notice of Inquiry, and applies accepted economic techniques to evaluate the need for government intervention and the likely benefits and costs of specific alternatives. Its analysis and conclusions are consistent with both the factual record and applicable economic theory. Thus, the First Report constitutes a competent and comprehensive benefit-cost analysis of proposals for government intervention in the market for video programming services. Its conclusion, that government mandated a la carte pricing for cable television likely would harm consumers, is both well supported and, to the extent it is possible to predict in advance the effect of government actions, correct.

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[1] *Further Report on the Packaging and Sale of Video Programming Services to the Public* (February 9, 2006)(available at http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-263740A1.pdf).

[2] *Report on the Packaging and Sale of Video Programming Services to the Public* (November 18, 2004).

[3] Further Report, at 3.

[4] Further Report at 46.

The Further Report, by contrast, is lacking in both factual foundation and sound economic analysis. It fails to establish a sound rationale for government intervention, or even to describe in concrete terms any specific regulatory proposals. It presents little factual information beyond that contained in the initial record, and makes few references to real-world factual information of any sort. Beyond noting an inconsequential methodological error in a private sector report,[5] it presents almost no factual information to rebut the First Report (or the factual record upon which it relied), but asserts (without apparent justification) that the original factual record was "biased." Other than presenting a set of numerical anecdotes (which we show all rely on unsupportable assumptions), it presents no systematic critique of the First Report's analysis. In the end, the Further Report is most notable for what it does not say: *At no point does the Further Report state that an a la carte mandate of any kind would benefit consumers or increase economic welfare, nor does the report provide support for such a conclusion.*

In Section II below, we present a summary of the methodological standards that apply to economic analyses of proposed government regulations, and show that the Further Report (unlike the First Report) fails to meet these standards. In Section III, we show that, as a result of its methodological failings, the Further Report's conclusions are incorrect, unsupported or misleading, and that the "Economic Appendix" to the Further Report relies on assumptions that do not withstand scrutiny. Section IV presents a brief summary.

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[5] As discussed below, the economic analysis performed by Booz-Allen-Hamilton contained a mistaken assumption regarding treatment of the cost of broadcast tier stations. The Further Report asserts that this assumption materially affects the report's findings, when in fact it does not.

II. THE FURTHER REPORT FAILS TO MEET ESTABLISHED STANDARDS FOR REGULATORY ANALYSES

For more than a quarter century, agencies have been required to perform detailed regulatory impact analyses before issuing major regulations. Under E.O. 12291 (issued in February 1981 by President Reagan) and E.O. 12866 (issued by President Clinton and still in effect), government agencies must analyze the expected benefits and costs of major regulatory proposals, as well as potential alternative policies.[6]

E.O. 12866 describes the specific criteria such analyses must meet, including:

- "(i) An assessment, including the underlying analysis, of benefits anticipated from the regulatory action (such as, but not limited to, the promotion of the efficient functioning of the economy and private markets . . . .) together with, to the extent feasible, a quantification of those benefits;
- (ii) An assessment, including the underlying analysis, of costs anticipated from the regulatory action . . . together with, to the extent feasible, a quantification of those costs; and
- (iii) An assessment, including the underlying analysis, of the costs and benefits of potentially effective and reasonably feasible alternatives to the planned regulation. . . ."

The specific analytical techniques to be used in such evaluations are further described in guidance from the Office of Management and Budget ("OMB"). Specifically, OMB Circular A-4, issued September 17, 2003, presents "guidance to Federal agencies on the development of regulatory analyses."[7] Circular A-4 requires that regulatory analyses include "(1) a statement of the need for the proposed action, (2)

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[6] See E.O. 12291 (February 17, 1981) and E.O. 12866 (September 30, 1993).

[7] Office of Management and Budget, Circular A-4 (September 17, 2003) (available at http://www.whitehouse.gov/omb/circulars/a004/a-4.pdf). The circular updates and refines prior OMB guidance. See Office of Management and Budget, *Economic Analysis of Federal Regulations Under Executive Order 12866* (January 11, 1996) (available at www.whitehouse.gov/omb/inforeg/riaguide.html) and Office of Management and Budget, *Memorandum for the Heads of Executive Departments and Agencies: Improving Regulatory Impact Analyses* (June 19, 2001) (available at www.whitehouse.gov.omb/memoranda/m01-23.html)

an examination of alternative approaches and (3) an evaluation of the benefits and costs…." It also requires agencies to "Identify a baseline….normally a 'no action' baseline: what the world will be like if the proposed rule is not adopted."[8] Most importantly, OMB requires that "Before recommending Federal regulatory action, an agency must demonstrate that the proposed action is necessary," and "if the regulation is designed to correct a significant market failure, [the agency] should describe the failure both qualitatively and (where possible) quantitatively. *You should show that a government intervention is likely to do more good than harm*."[9]

The First Report meets these requirements. It presents an extensive evaluation of the basis for government regulation, finding that there are no systematic market failures that would be remedied by an a la carte mandate. It enumerates, and attempts to quantify, the potential benefits and costs of an a la carte mandate, and compares these to a "baseline case" that reflects current and anticipated conditions in the unregulated marketplace. Based on this analysis, it concludes "government intervention through a la carte regulation likely will harm MVPDs, program networks, and especially MVPD subscribers."[10]

As a predicate for potential legislative or regulatory action, by contrast, the Further Report fails to meet virtually all of the OMB standards. Specifically, it:

- fails to describe (beyond factually incorrect references to the existence of market power) the market failure or other basis for government regulation an a la carte mandate would address;

[8] Circular A-4, p. 2.
[9] Circular A-4, p. 3-4. Emphasis added.
[10] First Report, p. 62.

- fails to state specifically what form(s) an a la carte mandate might take, or how it would be enforced;
- fails to establish a "no action" baseline;
- fails to present a systematic assessment, let alone a quantification, of either the benefits and costs of government intervention;
- does not attempt to reconcile the overall benefits of government intervention with the overall costs.

Instead of the systematic analysis required by OMB, the Further Report proffers a set of numerical anecdotes that purport to show that *some* consumers *could* be harmed by bundling under *some* circumstances and, conversely, that *some* forms of a la carte pricing *could* benefit *some* consumers. "In sum," it concludes, "many consumers could be better off under an a la carte model."[11]

Taken at face value, this conclusion is meaningless, since it says nothing about the *probability* that even one consumer *would* be better off.[12] However, even if the report had reached a stronger conclusion and found that some consumers *would* benefit from an a la carte mandate, such a finding would still not meet the OMB standard for regulatory action. First, the Further Report fails to indicate whether the hypothesized benefits to some consumers represent a welfare gain or, alternatively, a transfer payment. The OMB guidelines specifically prohibit counting transfers from one economic group to another as a benefit or cost of a government regulation.[13] To meet

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[11] Further Report, p. 5.

[12] We credit the authors of the Further Report for acknowledging, at least implicitly, that their analysis does not support any stronger conclusion.

13 See Circular A-4, p. 38 ("Transfer payments are monetary payments from one group to another that do not affect total resources available to society….A net reduction in the total surplus (consumer plus producer) is a real cost to society, but the transfer from buyers to sellers resulting from a higher price is

the OMB standard, the Further Report would need to explain whether the benefits received by "some" consumers represent net benefits to society or, alternatively, simply transfers from other economic actors (e.g., consumers, producers or both).

Going a step further, even if the Further Report had concluded that the benefits it imagines represent welfare gains, it would still need to show that those gains exceed any costs associated with the mandate, a step it never even attempts. Thus, the Further Report falls far short of concluding, as it must in order to justify government intervention, that such intervention "*is likely to do more good than harm*."

III. THE FURTHER REPORT'S CONCLUSIONS ARE INCORRECT, UNSUPPORTED AND MISLEADING

The Further Report mischaracterizes the economic literature on bundling, suggesting that bundling is generally inefficient and anti-consumer, when the literature clearly demonstrates bundling is efficient and pro-consumer under all but the most restrictive assumptions. The report assumes the existence of market power where none exists. And, it relies heavily on numerical anecdotes based on false assumptions. When the false assumptions are corrected, the anecdotes illustrate that mandated a al carte would harm consumers rather than helping them.

A. The Further Report Ignores or Mischaracterizes the Economic Literature on Bundling

The Further Report either ignores or mischaracterizes the economic literature on bundling, in at least three respects. First, it fails to acknowledge the economic consensus that bundling is, under general conditions, a pervasive, pro-consumer, pro-competitive practice that increases economic welfare. Second, it fails to acknowledge

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not a real cost since the net reduction automatically accounts for the transfer from buyers to sellers.... *You should not include transfers in the estimates of the benefits and costs of a regulation.*" *Emphasis added.*)

that the economic literature on potential consumer harm from bundling relies on the assumption of monopoly power in the affected markets, as well as a variety of other extremely restrictive conditions. Third, it fails to rebut (or, for the most part, even to acknowledge) the significant body of expert economic and financial analysis that specifically concludes bundling in the MVPD market is efficient and an a la carte mandate would harm consumers.

1. Economists Agree Bundling is Pervasive and is Generally Pro-Consumer

Economists recognize that bundling is a routine and pervasive business arrangement in modern economies. As former FTC Chairman Tim Muris recently put it, "The use of bundles to sell goods or services – that is, the sale of multiple items together, as well as separately – is ubiquitous throughout the American economy."[14] Examples of bundling include round trip airline flights, "triple-play" voice/video/data packages, automobiles with radios, shoes with laces, and computers with software.

Economists are virtually unanimous in agreeing that bundling in competitive markets is efficient and generally pro-consumer. In a recent, authoritative review of the bundling literature, Bruce Kobayashi concludes that "[F]or the vast majority of cases where bundling is observed, the reason why separate goods are sold as a package is easily explained by economies of scope in production or by reductions in transactions and information costs, with an obvious benefit to the seller, the buyer or both."[15] The United States recognized and embraced this economic consensus in its May 2004

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[14] Timothy J. Muris, "Comments on Antitrust Law, Economics and Bundled Discounts," (Submitted on behalf of the United States Telecom Association in Response to the Antitrust Modernization Commission's Request for Public Comments, July 15, 2005), p. 2.

amicus curiae brief before Supreme Court in *3M v. LePages*, when it told the Court that "Bundled rebates are widespread and are likely, in many cases, to be procompetitive."[16]

Bundling is pro-consumer because of the efficiency benefits the practice provides. These benefits can take several forms. In some cases production costs are lowered, through economies of scope between the bundled products when produced jointly. Costs are also avoided through more efficient transactions and provision of information, as when joint purchases are more convenient and less costly to process, and as consumers learn about the benefits of product combinations.

In other cases, bundling enables more vigorous competition. For example, a firm may find it easier to enter a new market, in so doing increasing competition, if it bundles a new product with an existing product in which it has a reputation. Through bundling, a firm can better manage the vertical relationship between itself and its downstream retailers or distributors, giving those firms reason to better promote, support and service the product. Price discounts in the bundle act as a type of competitive advertising, which enhances competition.

The First Report recognized these benefits. Based on a review of both the comments and the relevant economic literature, it concluded: "potentially distinct products are often bundled in order to lower transaction costs, realize economies of scale and enhance the attractiveness or convenience of the product to consumers";

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[15] Bruce H. Kobayashi, "Does Economics Provide a Reliable Guide to Regulating Commodity Bundling by Firms? A Survey of the Economic Literature" Journal of Competition Law and Economics 3(4) (2005), p. 708.

[16] *3M Company FKA Minnesota Mining and Manufacturing Company, Petitioner v. LePages Incorporated*, et al, Petition for Write of Certiorari, Brief for the United States of America (May 2004), p. 12 (Hereafter LePages Amicus).

[b]undling also simplifies consumer decision-making"; and "[bundling] appears to promote fiercer competition between MVPDs."[17]

The Further Report makes no systematic effort to refute the importance of these bundling efficiencies in the MVPD market, relying instead on largely speculative criticisms of particular findings. Thus, for example, it dismisses the First Report's reference to a seminal paper by Bakos and Brynjolfsson (showing that bundling increases competition) by asserting (but not demonstrating) that one of the paper's assumptions "does not ring true."[18] Similarly, its dismisses the consumer information and transactions cost rationales for bundling on the basis of pure speculation. The First Report's conclusion that such efficiencies are significant is based on an extensive discussion of the factual record and is based on an analysis of actual consumer behavior in the marketplace (i.e., recent examples in which consumers have rejected a la carte offerings),[19] The Further Report dismisses these findings in a brief paragraph: "Further consideration," it opines, "suggests the First Report overstates the issue."[20]

2. The *Only* Time Bundling *May* Harm Consumers is When Practiced by a Monopolist

The Further Report criticizes the First Report for overstating the economic benefits of bundling, using italics to emphasize that the economic literature finds

[17] Further Report, pp. 22-3.

[18] Further Report, p. 22.

[19] This "revealed preference" approach is the preferred method for assessing consumer behavior in regulatory analyses. See Circular A-4, p. 24 ("Other things equal, you should prefer revealed preference data over stated preference data because revealed preference data are based on actual decisions, where market participants may enjoy or suffer the consequences of their decisions.) The Further Report uses neither approach, but relies instead on speculation about how consumers and producers "might" behave under an a la carte mandate.

[20] Further Report, p. 22. The "further consideration" referred to consists of three unsupported assertions: That consumers "in other contexts are able to choose from a large variety of choices;" that consumers need to "make a simple yes or no decision on each channel only once;" and that "nothing would prevent MVPDs from suggesting coherent combinations of channels to their customers."

bundling to be beneficial only "*under certain conditions*."[21] As we have seen, however, economists agree that the conditions under which bundling is beneficial represent the general case.[22] By contrast, the economics literature that hypothesizes harmful bundling applies only under very narrow assumptions, and there is virtually no empirical evidence that such conditions exist in the real world, let alone in the MVPD market.

First, virtually all theories of harmful bundling assume the existence of market power. Kobayashi's review finds that "in the overwhelming majority of papers, the degree of competition is limited in one or both markets."[23] Indeed, the majority of papers that postulate harmful effects assume an outright monopoly, or at most a duopoly, in the market for one or both of the bundled products. "Little attention," he concludes, "has been paid to considering how relaxing the assumption of monopoly might affect the predictions of these models"[24] or to "settings where both markets have more competitive market structures."[25] Thus, the Further Report's negative conclusions with respect to bundling rely on models that apply only in the case of monopoly, an assumption that flies in the face of the Commission's many findings (which the Further Report seems to acknowledge) that the MVPD market is competitive and that competition is increasing.

As discussed at length below, the Further Report's conclusions also rely on highly stylized assumptions about consumer preferences and other market specifics.

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[21] Further Report at 21.
[22] See for example, Kobayshi, p. 708 ("[Efficiencies are] certainly the presumptive explanation for bundling when it occurs in highly competitive markets.")
[23] Kobayshi, p. 712.
[24] Kobayashi, p. 713.
[25] Koyayshi, p. 712.

This is not surprising, as virtually all of the economic models that theorize about harmful bundling depend on such assumptions. Thus, former FTC Chairman Muris concludes,

> [W]hile some of these theories raise the *possibility* of anticompetitive harm, they do not show that such harm is likely. We do not know whether such harm exists outside of the articles and working papers of academic economists.[26]

FTC chief economist Michael Salinger finds, "the economics models that suggest that [bundling and tying] might be problematic seem to rest on highly speculative assumptions," and offer little basis for policymaking or antitrust enforcement: "I don't know what we would look to in a particular case to conclude that the practice in fact leverages or preserves market power."[27]

Further, the papers that theorize about harmful bundling generally ignore or minimize the countervailing efficiency benefits of the same practices. Thus, Muris concludes that "Much of the exclusionary or entry deterring conduct by dominant firms would increase consumer welfare, even under the narrow models studied."[28] Similarly, the Kobayashi survey finds, "Generally, use of bundling to induce self-selection or to take advantage of economies of scale, scope or other efficiencies from bundling are not considered in the models. As a result, these models as a whole do not provide a reliable way to gauge whether the potential for harm would outweigh any benefits from bundling."[29] In its amicus curiae brief in *LePages*, the United States agreed, concluding

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[26] Muris, p. 7 (emphasis in original). Kobayashi expresses a similar view regarding the emphasis of the academic literature relative to real world impact; see Kobayashi, "Two Tales," p. 4.
[27] Michael A. Salinger, "Can Economics Bridge the Atlantic?" George Mason University Fall 2005 Antitrust Symposium (September 20, 2005) pp. 2-3 (available at http://www.ftc.gov/speeches/salinger/050920antitrustsymposium.pdf)
[28] Muris, p. 8.
[29] Kobayashi, p. 714.

that the literature on anticompetitive bundling is "recent and sparse" and recommending to the Court that,

> … at this juncture, it would be preferable to allow the case law and economic analysis to develop further and to await a case with a record better adapted to development of an appropriate standard.[30]

The Further Report's case against bundling is thus fundamentally misleading. The Report seeks to persuade the reader that bundling is beneficial only in limited circumstances that are not present in the MVPD market, and that bundling is harmful in more general circumstances, which are present. In fact, the opposite is true.

3. The Economic Evidence on A La Carte Overwhelmingly Concludes the Costs of a Mandate Would Exceed the Benefits

The Further Report fails to respond to, let alone rebut, the large body of economic analysis that has concluded specifically that mandated a la carte for cable television would harm consumers and reduce economic welfare.[31] This research is summarized in Appendix B, which summarizes the findings of the economic analyses submitted to the record in the a la carte proceeding, and Appendix C, which summarizes the findings of recent reports by securities analysts on the likely impact of a la carte.

Of the 10 studies submitted to the FCC that evaluate the benefits and costs of an a la carte mandate,[32] nine conclude that an a la carte mandate would harm consumers,

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[30] LePages Amicus, p. 19. See also n. 9 ("Although there are references to bundled rebates in the scholarly literature, the theoretical and empirical analysis of that practice as a potentially exclusionary mechanism is relatively recent and sparse.")

[31] As a substitute for substantive discussion of the economic analyses referred to below, the Further Report implies they are biased. See Further Report, p. 15. ("[T]he text of the First Report lacks in-depth independent economic analysis, tending to rely on the assertions of industry commenters.")

[32] A total of 11 studies are listed in the First Report. However, one study (Michael G. Baumann and Kent W. Mikkelsen, "The Fair Market Value of Local Cable Retransmission Rights for Selected ABC Owned Stations," Economists, Inc.) focuses on retransmission consent and does not specifically address a al carte.

and only one (submitted by Consumers Union and Consumer Federation of America) finds the potential for consumer benefits. Yet, with the exception of presenting a misleading and erroneous critique of the economic study performed by Booz-Allen-Hamilton, the Further Report ignores the results of the 10 studies and adopts (albeit implicitly) the conclusions of the Consumers Union study.[33]

The 10 studies that conclude that an a la carte mandate would harm economic welfare all reach similar and mutually supportive conclusions. They find that such a mandate would cause most if not all consumers to pay more;[34] reduce the quantity of programming available to the typical viewer;[35] result in higher costs for both MVPDs and programming networks;[36] reduce the diversity and variety of programming networks;[37] reduce the quality of programming;[38] and, make entry into MVPD

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[33] Most notably, the Further Report mimics the Consumers Union study in its repeated use of the word "could" to describe the benefits it attaches to a la carte. See, e.g., Consumers Union at 8. ("We use conditional words – would, could – to describe these possible effects because the results will emerge from the interaction of three forces, cable operator interests, programmer interests and, to a much greater extent than ever, consumer preferences.") As noted above, such watered down conclusions do not provide sufficient basis for government intervention. The Further Report also makes no mention of a letter submitted to the record by seven highly respected economists that rebuts every major finding of the Consumers Union submission. See Letter to W. Kenneth Ferree, Chief, Media Bureau, from Gustavo Bamberger, Michael Baumann, John M. Gale, Thomas W. Hazlett, Michael L. Katz, Kent W. Mikkensen and Bruce M. Owen (November 4, 2004). ("The [Consumers Union and Consumer Federation of America submissions] are based on fundamentally flawed claims, which are grounded in neither sound economic theory nor empirical evidence.")

[34] See, for example, Michael Katz, *Slicing and Dicing*, pp. iii, v, Michael G. Baumann and Kent W. Mikkelsen, p.ii, Thomas Hazlett, pp. 2,3.

[35] See, for example, Booz, Allen and Hamilton, p. 2, Michael Katz, *Wrong Diagnosis*, p. 3.

[36] See, for example, Robert D. Willig, Jonathan M. Orszag, and Jay Ezrielev, p. 6, Statement of Gustavo Bamberger, p. 1, Thomas Hazlett, p. 3.

[37] See, for example, Robert D. Willig, Jonathan M. Orszag, and Jay Ezrielev, pp. 5-6, Michael G. Baumann and Kent W. Mikkelsen, p. ii, Bruce M. Owen and John M. Gale, *Cable Networks*, pp. 5-6, Gustavo Bamberger, p. 2, Michael Katz, *Slicing and Dicing*, pp. iii-iv,v, and *Wrong Diagnosis*, p. 3.

[38] See, for example, Robert D. Willig, Jonathan M. Orszag and Jay Ezrielev, pp. 5-6, Michael G. Baumann and Kent W. Mikkelsen, p. ii, Michael Katz, *Slicing and Dicing*, pp. iii-iv,v, and *Wrong Diagnosis*, p. 3.

programming more difficult.[39] In addition, the studies conclude that the conditions for economically inefficient bundling are not present in the MVPD market,[40] that consumers are unlikely to adopt a la carte pricing offers,[41] and that an a la carte mandate would likely lead to price controls.[42] With one exception, the Further Report simply ignores these studies.

The one economic analysis that receives significant attention in the Further Report is the Booz-Allen-Hamilton (BAH) study, which presented quantitative estimates of the impact of an a la carte mandate. For the most part, the Further Report's critique consists of unsupported or counterfactual suggestions about how various marketplace participants (advertisers, programmers, consumers) might behave in an a la carte environment.

For example, the Further Report critiques the BAH assumption that "all networks would face increased marketing costs under a la carte, to gain subscribers to the network," suggesting that "*some* larger, established networks *might* be able to rely on existing brand name and thus avoid increased marketing costs."[43] Yet the Further Report presents no evidence to support this suggestion or to rebut the extensive record evidence that supports the BAH finding.

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[39] See, for example, Booz, Allen and Hamilton, p. 2, Robert D. Willig, Jonathan M. Orszag and Jay Ezrielev, p. 6, Michael G. Baumann and Kent W. Mikkelsen, p. i.

[40] See, for example, Robert D. Willig, Jonathan M. Orszag, and Jay Ezrielev, p. 5, Michael G. Baumann and Kent W. Mikkelsen, pp. i-ii, Statement of Gustavo Bamberger, p. 1, Thomas Hazlett, p. 2. (As discussed below, Professor Rogerson argues that programmers have market power that could lead to efficiency-reducing bundling in the "upstream" market. We address and refute Professor Rogerson's argument on this count below.)

[41] See, for example, Robert D. Willig, Jonathan M. Orszag and Jay Ezrielev, p. 6, Thomas Hazlett, pp. 3, 43-44.

[42] See, for example, Michael Katz, *Slicing and Dicing*, p. *v*, Bruce M. Owen and John M. Gale, *Cable Networks*, p. 4-5, 53.

[43] Further Report, p. 11. Emphasis added.

The main focus of the Further Report's critique of the BAH study is on its quantitative estimate of the number of channels a consumer could afford to purchase under a la carte without spending more money than under current cable pricing plans. Its criticism focuses on a mistaken assumption in the BAH study, which incorrectly included the cost of broadcast stations when calculating the average cost per cable channel under a la carte pricing.

In a letter to the FCC's Chief Economist,[44] the BAH study's primary author demonstrated that excluding those costs from the study's original calculations has two effects: (1) It reduces the estimated price per a la carte channel and (2) it increases the amount consumers would have to pay for basic service before purchasing a la carte channels. When both adjustments are made, the net effect is not significant: Whereas the original BAH report estimated the "break even point" for digital customers at 7-9 channels and for analog customers at 6-7 channels, the revised calculations indicate digital customers would break even at 8-10 channels and analog customers at 6-8 – still less, in all cases, than the 11 channels cable television viewers regularly view in today's market.

The Further Report makes only the first of the two proper corrections: it calculates a reduced price per a la carte channel, but then fails to account for the increased cost of basic service that must (as a simple matter of accounting) be deducted from the other side of the equation. Thus, the Further Report incorrectly

[44] Letter from Dr. John Frelinghuysen, Vice President, Booz-Allen-Hamilton, to Dr. Leslie Marx, Chief Economist, Federal Communication Commission (December 16, 2005)

concludes that the break even number of channels a consumer could purchase under a la carte is 10-14.[45]

In addition to its failure to rebut the economic analyses submitted for the record, the Further Report ignores recent analyses of an a la carte mandate by financial analysts. As summarized in Appendix C, the analyst community reaches essentially the same conclusions as the economic analyses submitted to the FCC record. For example, Bank of America concludes,

> Contrary to conventional wisdom, it is not clear that consumers want to buy less TV. … [W]e think it is tough to predict whether anyone would benefit from a la carte, even consumers. For the distributors, ARPUs would possibly decline; programmers would likely lose distribution and advertising revenue and have to incur a potentially significant new cost to aggressively market their channels directly to consumers, forcing them to raise prices; some fringe networks could go out of business; and consumers might end up having to pay higher affiliate fees for fewer channels, possibly paying as much, or more, for less.[46]

Similarly, Bear Stearns found that, under an a la carte mandate,

> The Rich Get Richer. With less distribution, cable networks will have to differentiate and market more effectively. This will require money, giving those richer networks an advantage over newer, smaller, and start-up properties, in our view. It could lead to a reduction in the number of networks.[47]

Another respected firm, Bernstein Research, concludes,

> The diversity of voices would almost certainly suffer. The result would be monthly cable bills similar to today's, but with each customer receiving a small number of channels for roughly the same total price as the large number they get today. Many niche programming options would cease to exist. And new channel launches would likely stop altogether.[48]

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[45] Further Report, p. 11.

[46] Bank of America, Analyst Report, Cable and Satellite TV (November 29, 2005), pp, 1,3.

[47] Bear Stearns, Analyst Report, Entertainment, "Much Ado About (Not Quite) Nothing" (November 30, 2005), p. 5.

[48] Bernstein Research Call, Analyst Report, U.S. Cable and Satellite Broadcasting, "Weekend Media Blast #49: a la Carte Dollars and Sense" (December 9, 2005), p. 2.

A Kagan Research senior analyst adds,

> It's ironic that there was this massive push to force multi-channel operators to provide channels on an á la carte basis when it has failed dismally in Canada, France and other countries. Á la carte has been tried in the U.S. over the years with poor results.[49]

Most recently, Deutsche Bank found,

> [I]n our view the vast majority of the 200-channel pay TV universe would not survive in an a la carte system. The average person watches about 17 channels, only up from 12 over the past decade despite the number of available channels tripling. That's 183 channels each customer would no longer subsidize or watch. The reason pay TV prices are only $0.33 per hour is that advertising revenue also covers much of the cost of programming, which would be at risk for those channels no longer with broad distribution. A la carte would absolutely crush diversity of programming.[50]

In summary, there is a large, authoritative and diverse body of expert economic and financial analysis that supports the findings of the First Report – i.e., that the costs of an a la carte mandate very likely exceed the benefits. The Further Report fails to rebut, and for the most part fails even to address, this body of research.

B. The Further Report Relies on Faulty Assumptions About the Existence of Monopoly Power

As noted above, economists agree the existence of monopoly power is a necessary condition for bundling to harm economic welfare. In theory, monopoly power in this market could exist at one of two levels, the retail level (i.e., among MVPD providers) or the wholesale level (i.e., among programmers). The Further Report takes multiple, inconsistent positions on the market power issue – arguing at some points the market is competitive, assuming at others it is a monopoly, and in the end suggesting

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[49] Kagan Insights (December 27, 2005), p. 2 (quoting Kagan Senior Research Analyst Derek Baine).

[50] Deutsche Bank, A La Carte Redux (February 9, 2006), p. 2.

(incorrectly) that it doesn't matter. In fact, neither market evidences the market power that is a necessary condition for harmful bundling.

1. The Retail Market for MVPD Services is Competitive

The Further Report takes two mutually inconsistent approaches to the retail MVPD market. On the one hand, virtually all of its assertions regarding the potential harms of bundling depend on the existence of significant monopoly power, and the examples in the report's Economic Appendix assume that the MVPD provider is a pure monopolist. The Further Report acknowledges and attempts to justify this crucial assumption in two sentences on page 59 of the 61-page report: "An assumption underlying the examples is that the MVPD (or programming distributor) has sufficient market power to raise prices above cost. As noted above, this is probably not an unreasonable assumption given the significant price increases in cable service in recent years."[51]

Even in a complete vacuum of other information, it would be entirely "unreasonable" to infer market power from changes in prices.[52] But in this case, the authors have explicit and extensive evidence that the retail market is competitive. Indeed, the Further Report itself finds that

> MVPD competition continues to provide customers with increased choice, better picture quality, and greater technological innovation. The Commission recently found that almost all consumers now have a choice

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[51] Further Report, p. 59. The "noted above" reference apparently refers to a statement on p. 22, which conflates two ideas (the extent of competition and the question of how many MVPDs consumers patronize at a given time): "Clearly, this type of competition does not exist in the retail video programming market, in
which prices have generally been rising at a rate faster than inflation, and few consumers buy video programming from more than one MVPD."

[52] The existence of rapid price increases is itself a debatable proposition. See Jeffrey A. Eisenach and Douglas A. Trueheart, Retransmission Consent and Cable Television Prices (CapAnalysis, March 31, 2005), pp. 2-9. (Hereafter Eisenach and Trueheart.)

> between over-the-air broadcast television, a cable service, and at least two DBS providers. And in some areas, consumers also may have access to video programming delivered by emerging technologies, such as digital broadcast spectrum, fiber to the home, or video over the Internet. Increased choice in providers should foster increased consumer choice.[53]

This discussion, which mirrors the conclusions in the Commission's annual reports on competition in the market for video programming,[54] is irreconcilable with the bulk of the Further Report's analysis and fundamentally inconsistent with its implied conclusion that an a la carte mandate would benefit consumers.[55]

2. The Wholesale Market for Video Programming is Competitive

The Further Report touches on the issue of market power in the wholesale market only briefly. As noted immediately above, the report acknowledges that its examples depend on the possession of market power by *either* MVPDs *or* programmers. At another point, it argues that "MVPDs may currently be prevented from providing such an option" and states in a footnote that "MVPD executives have testified before Congress that their contracts with programmers prevent them from offering channels on an a la carte basis."[56] Reading between the lines, a reader might infer the Further Report has concluded that programmers have market power and that they use that market power to impose inefficient bundling requirements on MVPDs.

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[53] Further Report, p. 46.

[54] See FCC Press Release, "FCC Issues 12th Annual Report to Congress on Video Competition" (February 10, 2006). (Available at http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-263763A1.pdf). Hereafter MVPD Press Release. See also In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, Twelfth Annual Report (MB Docket No. 05-255, March 3, 2005), at ¶144. ("In the past year, incumbent cable operators' share of all MVPD subscribers continued to decline. As of June 30, 2005, cable operators served 69.4 percent of the 94.2 million MVPD subscribers, compared to 71.6 percent of the 92.3 million MVPD subscribers a year earlier.") (Hereafter 2006 MVPD Report.)

[55] The Further Report makes an unsuccessful effort to reconcile this inconsistency in the last two pages of the Economic Appendix. We explain below why the effort fails.

In fact, the Commission's reports on competition in the MVPD marketplace find that the wholesale (programming) market is, like the retail market, highly competitive. The 2005 Video Competition Report found the programming sector to be competitive, and that competition was increasing:

> Since our last *Report*, the total number of national networks has increased. In 2004, we identified 388 satellite-delivered national programming networks, an increase of 49 networks over the 2003 total of 339 networks. Of the 388, 89 networks (23 percent) were vertically-integrated with at least one cable operator in 2004. Last year, 110 networks were vertically integrated (33 percent) of the 339 total.[57]

Moreover, "[I]t appears there is diverse ownership of the most popular networks: 10 different entities own all or part of the top 20 programming networks in terms of subscribership."[58]

The recently-released 2006 report indicates that the number of programming networks continued to grow in 2005, increasing by 37%, from 388 in 2004 to 531 in 2005, and that other market characteristics continued to be consistent with robust competition:

> In 2005, we identified 531 satellite-delivered national programming networks….Of the 531 networks, 116 networks (21.8 percent) were vertically integrated with at least one cable operator. We also identified, 274, or 51.6 percent, that are not affiliated with any cable operator or other media entity. In addition, we identified 107 national, satellite-delivered nonbroadcast networks that are owned by a DBS operator or one or more national broadcast networks (i.e., Fox, ABC, CBS, NBC Universal, and Univision) and that are not also owned by a cable operator.[59]

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[56] Further Report, p. 49, n. 5.

[57] In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, Eleventh Annual Report (MB Docket No. 04-227, February 4, 2005), at ¶145. (Hereafter 2005 MVPD Report.)

[58] MVPD Report at ¶150.

[59] MVPD Press Release, p. 4.

Similarly, the diversity of ownership of popular networks continued to increase: "Eleven different entities [as compared with 10 in 2004] own all or part of one or more of the top 20 programming networks in terms of subscribership."[60]

The Commission has repeatedly and specifically found that programmers do not have the power to impose anticompetitive conditions on MVPDs. For example, in its Fox/DirectTV Order, the Commission found that:

> Both programmer and MVPD benefit when carriage is arranged: the station benefits from carriage because its programming and advertising will likely reach more households when carried by MVPDs than otherwise, and the MVPDs benefit because the station's programming adds to the attraction of the MVPD subscription to consumers. Thus, the ***local television broadcaster and the MVPD negotiate in the context of a roughly even 'balance of terror'*** in which the failure to resolve local broadcast carriage disputes through the retransmission consent process potentially damages each side greatly in their core business endeavor.[61]

When some commenters in the *a la carte* proceeding misinterpreted the Commission's views on this subject, it took pains in the First Report to clarify them:

> All differentiated products, such as video programming, possess some degree of market power in the sense that there are no perfect substitutes. The critical question in any analysis involving differentiated products is whether the existing degree of market power is sufficient to allow the firm to profitably engage in the hypothesized anticompetitive activity…. ***Thus, nothing in the analysis of the News Corp./DirecTV transaction should be read to suggest that the Commission has concluded that the market power of broadcasters is sufficient to lead to competitive harms in the absence of vertical integration.***[62]

Importantly, the Commission reached these conclusions in the context of local broadcast stations, which the Commission has described as "must have" programming.

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[60] 2006 MVPD Report, ¶163.

[61] *In the Matter of General Motors Corporation and Hughes Electronics Corporation, Transferors and The News Corporation Limited, Transferee for Authority to Transfer Control, Memorandum Opinion and Order* (MB Docket No. 03-124, January 14, 2004) ¶180. (emphasis added).

[62] First Report, p. 70 (emphasis added). For a more extensive analysis of this issue, see Eisenach and Trueheart, pp. 16-24.

If programmers do not have market power sufficient to cause competitive harm with respect to local broadcast stations, it is highly unlikely they have such power over other cable programming.

In fact, at least some programmers do not engage in strict bundling at all, but instead engage in only the most innocuous form of mixed bundling, simply offering discounts on sales of multiple products. The Walt Disney Company, for example, offers MVPDs the option of purchasing its channels either on a stand-alone basis or as part of packages or bundles, which can be negotiated on a case-by-case basis.[63]

Finally, even critics of bundling by programmers agree there is a strong efficiency rationale for this practice.

> [T]here are significant 'economies of scope' for the networks between producing programming for their own use and producing programming that can be shown on MVPD networks. Once the networks were acquiring and/or producing significant amounts of content for use on their broadcast outlets, they found that they could use substantial amounts of in-house content that already existed and produce additional content at a relatively low incremental cost for distribution on affiliated MVPD networks. In many cases, this gave them a competitive advantage over other rivals….[64]

Thus, there is simply no evidence to support the assumption in the Further Report that inefficient bundling is imposed on MVPDs through the anticompetitive practices of programmers.

C. The Hypothetical Examples Upon Which the Further Report Bases Its Conclusions are Misleading and Inapt

As noted above, much of the Further Report consists of speculation to the effect that various market participants *might* behave differently than they have in the past, that the costs of a la carte *might* be lower than the First Report suggests, etc. The apparent

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[63] See Comments of the Walt Disney Company, MB Docket No. 04-207 (July 15, 2004)
[64] Rogerson, p. 14-15.

exception is the Economic Appendix, a 13-page discussion of eight examples which the report says "help illustrate certain effects discussed in the text." While the examples admittedly are "kept simple," the Further Report states that the "effects can be generalized to situations with many goods and consumers,"[65] suggesting that the examples constitute a sound basis for making policy decisions.

According to the Further Report, the examples illustrate that "there are two reasons why MVPDs may not voluntarily provide increased consumer choice…. First, providing increased choice, though in consumers' best interests, may not be profit maximizing for the MVPDs in some circumstances. Second, even in those instances where providing a la carte would be profit maximizing, MVPDs may currently be contractually prevented from providing such an option."[66] While the report never says so directly, the implication is that an a la carte mandate could improve consumer welfare.

In fact, the examples are nothing more than numerical anecdotes. Each example assumes a market in which there are two or three consumers[67] and two to four networks. "Demand" is represented by the particular values each consumer places on each network, and "supply" is represented by the particular programming costs of each network. As we show in Appendix A, the points illustrated by the examples are highly dependent on these assumptions. More broadly, the examples assume away competition, advertising, programming and distribution costs, the benefits of having channels available beyond those consumers "regularly" watch, and profit-maximizing

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[65] Further Report, p. 48.
[66] Further Report, p. 49.
[67] One example postulates 20 consumers.

behavior by MVPDs. In the hypothetical world of the economic appendix, it is literally true that (1) there is no satellite television; (2) there is no advertising on television; (3) implementing a la carte would be costless; (4) television viewers do not channel surf; and, (5) cable TV networks do not maximize profits (or, alternatively, the government will regulate the cable TV prices on a network-by-network basis). In Appendix A, we explain how each of the FCC's numerical anecdotes is affected by these unrealistic assumptions. Most importantly, we show that competition generally will lead to the economically efficient degree of bundling – that is, competition will yield whatever pricing structure (a la carte, bundling or something in between) most benefits consumers.

IV. SUMMARY AND CONCLUSIONS

The Further Report's attempt to discredit the FCC's November 2004 report on the packaging and sale of video programming fails to do so. Whereas the First Report presents a comprehensive and balanced treatment of both the factual evidence and the economic theory, the Further Report relies mainly on speculation, counterfactual assumptions and numerical anecdotes. Unlike the First Report, the Further Report fails to meet the standards for regulatory analyses promulgated by OMB. Most notably, the Further Report does not demonstrate, nor does it claim to demonstrate, that an a la carte mandate of any sort would benefit consumers or increase economic welfare. As the FCC concluded in 2004, it remains true that "The government should not displace the current economic model, which is working to the benefit of MVPDs and their customers, with regulations which will likely distort the marketplace and slow down

advances in technology that will eventually be the answer to the questions posed in this proceeding."[68]

[68] First Report, p. 78.

APPENDIX A

ANALYSIS OF THE FURTHER REPORT'S ECONOMIC APPENDIX

The Economic Appendix of the Further Report consists of eight "examples" which demonstrate that it is possible to make assumptions under which mandated a la carte (and/or mandated mixed bundling) would benefit some consumers. They do not demonstrate, nor does the report suggest that they demonstrate, that mandated a la carte would generate net economic benefits, no matter what assumptions are made.

Moreover, the assumptions upon which the examples rely are highly stylized and generally counterfactual. Each example depends on the assumed valuations consumers (usually two or three) place on each of the two to four assumed networks, as well as the assumed costs of each network. The report does not suggest, nor is it the case, that either the assumed consumers and their valuations, or the assumed networks and their costs, are representative of conditions in the actual MVPD market. Thus, each example is essentially a numerical anecdote based on unrealistic assumptions. As we show below, minor changes in these assumptions are sufficient to change the results.

More broadly, the examples all depend to one extent or another on five "macro" assumptions about the MVPD marketplace – all of which are factually incorrect. Specifically:

False Assumption #1: *MVPDs (and/or programmers) are monopolists*. As discussed above, neither MVPDs nor programmers have market power. Yet, the examples in the Economic Appendix assume falsely that the MVPD is a pure monopolist, or that programmers have market power and use it to impose inefficient bundling. This assumption is crucial to all of the results: In a competitive market, MVPDs cannot set monopoly prices for a la carte and bundling, as the examples

assume. Notably, in the final two pages of the report, the authors relax the assumption of market power, and show that under a particular set of assumptions, "a move to a la carte can benefit consumers even when both retail and wholesale markets are competitive."[69] What the report fails to say is that, in this situation, no mandate is required: As we demonstrate at the end of this appendix, if a la carte is best for consumers, competition will lead to a la carte.

False Assumption #2: *There is no advertising on television.* Advertising is a central feature of the MVPD market, with profound implications for analyses of competition and economic welfare. By ignoring advertising, the examples fail to account for the lost revenues caused by reduced viewership or the effects of the associated need to increase licensing fees. The effect is to bias the examples in favor of a la carte.

False Assumption #3: *Implementation of a la carte is costless.* In fact, even if mandatory a la carte is restricted to only digital subscribers, as the Further Report suggests, its implementation will generate significantly higher operating costs from more complex billing systems, greater customer service demands and increased marketing costs. Adding these costs to the examples would reduce or eliminate whatever advantages a la carte provides relative to bundling.

False Assumption #4: *Consumers don't channel surf.* The examples fail to account for the consumer benefits of channel surfing, both in terms of consumer information (channel surfing allows consumers to sample new channels) and casual viewing (the ability to watch a particular show on a network the consumer does not

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[69] Further Report, p. 61.

watch regularly). Failing to account for these benefits biases the examples in favor of a la carte.

False Assumption #5: *MVPDs won't always maximize profits (or, the FCC will regulate cable prices).* Some of the examples assume MVPDs will offer a la carte at a price that is not profit maximizing, an assumption that violates both the Further Report's own assumption (that the MVPD, as a monopolist, chooses its a la carte or bundled prices to maximize the joint profits of the MVPD and the programmers) and one of the most fundamental principles of economics. In fact, if we maintain the counterfactual assumption that the MVPD is a monopolist, the only way the prices in these examples would occur in the real world is if they were set by regulators. As others have noted, the costs of price regulation in this market would be very high.[70]

Below, we discuss how each of the examples is affected by these stylized and factually inaccurate assumptions. For the purpose of demonstrating the impact of each assumption independently, our discussion of each example leaves in place the counterfactual assumption that the MVPD is a monopolist. At the end of this Appendix, we demonstrate that this assumption alone is sufficient to invalidate the FCC's examples, since competition will lead to the adoption of the pricing structure that

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[70] Other commentators on the al la carte proposal have drawn similar conclusions. "It is very difficult to imagine an effective law or regulation requiring unbundling of MVPD networks, either at wholesale or retail, that was not accompanied by government regulation of the prices and license fees and other terms of trade between cable networks and MVPDs and between MVPDs and retail subscribers. Such regulation would be far more complex than the Commission's attempts to regulate the prices of unbundled elements of local telephone service." [The Fair Market Value of Local Cable Retransmission Rights for Selected ABC Owned Stations. Michael G. Baumann and Kent W. Mikkelsen, Economists, Inc. (An exhibit attached to the Comments filed by the Walt Disney Co.)] "CU/CFA's call for mixed bundling is really a disguised call for cable rate regulation." [Joint Economists Letter to the FCC, November 4, 2004, Gustavo Bamberger, Michael G. Baumann, John M. Gale, Thomas W. Hazlett, Michael L. Katz, Kent W. Mikkelsen, Bruce M. Owen]

maximizes consumer welfare, whether it be bundling, a la carte, or some combination of the two.

Example One

Example One aims to show that "that a la carte can yield lower prices than pure bundling, while generating sufficient revenue to cover costs," and also that "some consumers may increase their purchases" under a la carte. It does so by selectively using consumer valuations that preclude the pro-competitive efficiency reasons for bundling, by assuming some form of price regulation, and by assuming no incremental operating costs related to implementation of mandatory a la carte. In the discussion below, we show how each of these unrealistic assumptions affects the result of the example.

The structure of consumer demand is important in evaluating the efficiency consequences of bundling. In markets where consumers' valuations of two products diverge, bundling can be an efficient mechanism for increasing total sales, capturing economies of scale and increasing consumer welfare. By assuming that the two consumers in this example have similar valuations – each values one network at $3 and the other at $5 – this example essentially assumes away the efficiency benefits of bundling.

Example One begins by assuming the following valuations:

Example One: Assumed Consumer Valuations		
Network	Aaron	Betty
X	5	3
Y	3	5
Bundle	8	8

Based on these valuations, and assuming the cost of each network is $6, the example demonstrates that consumers would be better off if each network were offered a la carte, for $3, than if they were offered at the profit-maximizing (monopoly) bundled price, of $8, and that both networks would still be produced (since each consumer would buy both networks, generating revenue of $6 for each, equal to their costs).

Now consider what would happen if Aaron's and Betty's valuations of the two networks are only slightly more divergent, at $5 for one network and $2 for the other. In this case, it is easy to show (as the First Report did in its version of this example), that bundling is the preferred outcome from an efficiency perspective – even if we maintain the assumption of a monopolized MVPD market.

Example One: Alternative Consumer Valuations		
Network	Aaron	Betty
X	5	2
Y	2	5
Bundle	7	7

In this case, the MVPD's profit-maximizing a la carte price is $5 for each network, generating for each network one sale and revenue of $5. Since this is insufficient to cover the $6 fixed costs of producing each network, an a la carte mandate would result in neither X nor Y being produced. In contrast, a profit-maximizing monopolist that was allowed to bundle would price the two networks at $7, generating revenues of $14, allowing both networks to be produced, and generating net economic welfare of $2.

The Further Report next adds a third person (Charlie) to the story, with the aim of showing that a la carte would cause some consumers to purchase programming who do not purchase under bundling.

In this example, Charlie is assumed to value network X and 3 and network Y at zero.

Example One: Three-Consumer Version			
Network	Aaron	Betty	Charlie
X	5	3	3
Y	3	5	0
Bundle	8	8	3

At the pure bundle (monopoly) price of $8, Charlie buys no programming. However, it network X were offered for $3 a la carte, he would purchase it. What the example fails to note, however, is that this result will not emerge in a monopolized market unless either (a) all bundling is outlawed, including mixed bundling or (b) mixed bundling is still allowed, but cable prices are regulated.

The reason regulation would be needed, as the Further Report acknowledges in a cryptic footnote,[71] is that a profit-maximizing monopoly MVPD would set prices in a mixed bundling environment at levels that induce consumers to choose the bundle over a la carte. In the FCC's example, the monopolists' profit-maximizing strategy is to set the a la carte price at any amount greater than $5 (not $3, as assumed in the example), causing Aaron and Betty to prefer the bundle. The example reaches the opposite conclusion that both customers prefer to buy a la carte under mixed bundling by assuming the a la carte price is "fixed" at $3, i.e., the price *must be set by regulation* at $3. Thus, the example's conclusion that a la carte is preferred is only valid if prices are regulated.

Example One also depends on the assumption that a la carte is costless to implement. It is easy to show that, if a la carte is costly (as it surely would be), some

networks might not be offered under pure a la carte that would be offered under pure bundling. Assume the incremental operating costs to implement a la carte are $1 per consumer. Then under the FCC's example with Aaron, Betty and Charles, the pure a la carte and pure bundling equilibriums are shown below.

Example One: Impact of Implementation Costs						
	Profit-Max Price	Sales	Revenue	Implementation Costs	Fixed Costs	Profit
X	$3	3	$9	$3	$6	$0
Y	$3	2	$6	$2	$6	($2)
Bundle	$8	2	$16	$0	$12	$4

Under an a la carte mandate, network Y would lose $2, and thus would not be offered, whereas in a competitive market, the both networks would be offered as a bundle.

Example Two

This example concludes that a la carte would reduce the total prices paid by consumers who do not value (and thus would prefer not to purchase) some of the content in a bundle, but ignores the fact that, under mandated a la carte, the content preferred by the consumers would not be offered at all. It errs by a) assuming an a la carte price that only can exist with price regulation and b) ignoring the network's cost of producing programming.

Assuming the valuations shown below, the example concludes that the MVPD maximizes profit by offering the bundle XYZ for $20, even though Betty prefers Z not be included in the package (she would prefer a mixed bundling scheme where X and Y are bundled for $17 and Z is sold al la carte for $3). But, since revenues under pure

[71] See Further Report, Economic Appendix, n. 7, which concedes that the MVPD has an incentive to raise the a la carte price to induce consumers to buy the bundle.

bundling ($40) exceed those under the example's mixed bundling scenario ($37), an MVPD monopolist will not voluntarily offer network Z a la carte for $3. Instead, under mandatory a la carte, it will offer Z at a price greater than $3, causing no one to purchase it. Thus, to realize the benefits of mandatory a la carte by this example, it would be necessary to impose price regulation.

Example Two: Consumer Valuations		
Network	Aaron	Betty
X	12	5
Y	5	15
Z	3	0
Bundle	20	20

Further, this example completely ignores programming costs. If each network has programming costs of $6, as the FCC assumed in Example One, then the following table summarizes the MVPD's sales, revenue, costs and profits under bundling and mixed bundling.

Example Two: Impact of Programming Costs					
	Profit-Max Price	Sales	Revenue	Fixed Costs	Profit
Bundle XYZ	$20	2	$40	$18	$22
Bundle XY	$17	2	$34	$12	$22
Mixed Bundling: Bundle XY a la carte Z	 $17 $ 3	 2 1	$37	$18	$19

Example Two also assumes that under an a la carte mandate, Aaron can get networks XYZ by buying the bundle XY for $17 and Z a la carte for $3. But, this is wrong. Z is only offered by the monopoly MVPD under a pure bundling regime. The MVPD will not produce network Z in the mixed bundling environment with mandated a la carte unless the a la carte price is regulated at $3, because its profits are higher if it sells bundle XY, assuming it is barred from selling the pure bundle XYZ. Therefore, it

will price network Z at a price above $3, consumers will not choose network Z at that price, and network Z will not be produced.

Further, using the Further Report's own logic employed in Examples 3 and 6 of the Appendix, the production of network Z under mandatory a la carte would be considered inefficient, because the cost of producing it is $6 and consumers only value it at $3, meaning the net gain to society from producing it is $-3.

Example Three

In Example Three, the Further Report assumes three consumers and three networks, and constructs an example in which a pure a bundling regime would result in one of the three networks (a "niche" network) not being produced, even though its value exceeds its cost, whereas mixed bundling would result in all three networks being produced. A profit-maximizing monopolist would adopt the welfare-maximizing mixed bundling scheme, but the report assumes its contracts with programmers preclude this, implying the upstream programming market is not competitive. As discussed above, there is no basis for the assumption that the upstream market is not competitive.

This report's discussion of this example also ignores the effect of advertising revenues and marketing costs on the programmers' and MVPDs' bundling choices. With competitive markets upstream for programmers and downstream for MVPDs, the contract terms agreed to between programmers and MVPDs result in an efficient production of programming that benefits consumers. Such contract terms, which consider the effect of bundling on advertising revenues and marketing costs, could well include provisions that prevent or limit mixed bundling or a la carte sales by MVPDs. The existence of such contractual provisions, in other words, is not evidence of either market power or consumer harm.

Example Four

Example Four constructs a numerical anecdote that shows the opposite of what was shown in Example Three. This time we have twenty consumers and four networks, two mainstream networks and two niche networks, but instead of the niche network getting "squeezed out" (as in Example Three), this time the example is constructed so that one of the mainstream networks is not produced (even though it is more highly valued than the niche network). In this case, a la carte pricing would have produced the welfare maximizing result, and would also be profit-maximizing for (and thus chosen) by a monopolist MVPD. However, the report again assumes MVPD's contracts with programmers prevent them from offering a la carte. As we explained in Example Three, this assumption is empirically incorrect.

Example Five

In this three-consumer, three-network example, the Further Report constructs another scenario in which socially valuable niche networks are not produced – a result similar to Example Three but the opposite of Example Four. Again, this result is only reached on the basis of the counterfactual assumption of upstream market power. What these conflicting examples actually demonstrate is how easy it is to craft numerical anecdotes to yield any result desired concerning bundling versus a la carte.

Example Six

This example shows it is possible to construct a scenario in which bundling results in programming being produced and carried by monopoly MVPDs even though the value consumers place on that programming is less than the cost of producing it. In addition to the assumption that the MVPD is a monopolist, this example depends on

several unstated assumptions. If implementation costs are introduced, for example, it can easily be shown that bundling is more efficient than mandatory a la carte.

The table below shows the social welfare outcomes of bundling and a la carte pricing using the example's valuations and fixed costs for a profit-maximizing monopolist MVPD, but assuming implementation costs of $1 per consumer.

Example Six: Impact of Implementation Costs								
	Profit-Max Price	Sales	Revenue	Implement-ation Costs	Fixed Costs	MVPD Profit	Consumer Surplus	Total Social Surplus
X	$3	2	$6	$2	$5	($1)	$0[72]	$(1)
Y	$3	2	$6	$2	$9	($5)	$0	$(5)
Bundle	$8	2	$16	$0	$14	$2	$0	$2

As shown in the table, the total social surplus under bundling is $2, compared with negative social surplus of $6 with a la carte. In fact, neither network would be produced under an a la carte mandate as both result in negative profits.

Example Seven

This example claims to demonstrate that bundling can encourage economically inefficient investments in quality. In addition to assuming the MVPD is a pure monopolist, the example assumes away the lower distribution, operating and marketing costs of bundling, and higher advertising revenues, compared to a la carte.

The flaw in the example can be seen through the following analogy. Suppose a newspaper is able to raise subscription fees or advertising rates through an investment that increases the quality of the sports section. Under the logic of Example Seven, the newspaper should be required to sell the sports section a la carte if the cost of the investment exceeds the benefits to only those newspaper subscribers who are regular

[72] Consumer surplus for networks X and Y is $0 under a la carte because these networks are not offered as they as unprofitable for the MVPD to produce under that scenario.

readers of the sports section. In fact, a newspaper has value because it bundles together many different sections – general news, local news, sports, style, business, etc. – in one package that lowers distribution and marketing costs and increases ad revenue. Investments that increase the quality of the bundle are efficient as long as consumers are willing to pay for them. The only way to reach a different result is to assume away, as the Further Report does here, all of the efficiencies and cost savings associated with bundling.

Example Eight

This example demonstrates that themed tiers may help consumers lower their programming costs by avoiding having to purchase networks they do not watch. But, regulation is not required to produce this result, because a profit-maximizing monopoly MVPD will provide the themed tier *voluntarily*, as the example clearly demonstrates. The FCC again suggests beneficial tiered theme bundling will not be offered because programmers impose restrictive contract terms on MVPDs that preclude their creation. As we explained with respect to Examples Three and Four, this presumes the contract terms are anticompetitive and do not represent the outcome of competitive bargaining.

Further, the example is misleading because it implies MVPDs generally will find it profitable to offer themed tiers if required to do so through regulation. Recall that one reason bundling is both welfare- and profit-enhancing is because it homogenizes the divergent valuations consumers place on networks in the bundle. The revenue MVPDs realize from bundling increases the more consumers' valuations diverge. This is more likely to occur the greater is the diversity of the networks included in a bundle. Themed tiers, on the other hand, reduce bundle diversity by grouping together networks with similar content. Thus, the revenue MVPDs realize from a themed bundle likely will be

less than that from a bundle with greater programming diversity, such as an extended basic tier bundle, meaning MVPDs will have little incentive to provide themed tiers.

Newspapers, which offer a bundle of many differently themed sections (news, sports, business, lifestyle, etc.), again provide a useful analogy. There are many daily newspapers offering diverse content, but very few daily newspapers based on a single theme, such as sports or business. And even the few leading business themed newspapers, such as the Wall Street Journal, actually bundle differently themed sections, such as a personal lifestyle section. A competitive marketplace creates the themed newspapers consumers desire and will pay for. In a similar manner, the competitive MVPD and programming markets also will create themed tiers in proportion to consumers' willingness to pay for them.

For example, assume Aaron and Betty have the following valuations:

Example Eight: Consumer Valuations		
Network	Aaron	Betty
X1	5	2
X2	4	1
Y1	2	5
Y2	1	4
Bundle	12	12

Aaron values networks X1 and X2 (say, sports-themed) highly, and places low value on networks Y1 and Y2 (say, business-themed), which Betty values highly. The bundle price for all four networks is $12. Both Aaron and Betty buy the bundle generating revenue of $24. If the fixed programming cost per network is $6, then the MVPD's profit is $0. Now mandate themed theirs, which would group together X1-X2 (sports) and Y1-Y2 (business). The monopoly MVPD maximizes profit by selling the sports-themed tier X1-X2 to Aaron for $9 and the business-themed tier Y1-Y2 to Betty

for $9. At this price Aaron buys only his preferred tier, X1-X2, and similarly Betty buys only her preference, Y1-Y2. But, the revenue the MVPD realizes from selling themed tiers is much less than from selling the general bundle, $18 (2 times $9) compared to $24 for the four-network bundle. Since the cost to produce each themed tier is $12 and the revenue from each is only $9, the MVPD will not produce either.

This is a general result that occurs because the valuations in the themed tier are significantly less diverse than those in the general bundle, causing the themed tier to generate less revenue compared to the general bundle with more diverse programming. Thus, it is socially wasteful and inefficient to require through regulation that MVPDs produce themed tiers, since generally themed tiers are not profitable to produce. The government should allow the marketplace to determine which themed tiers it is profitable for MVPDs to produce and not attempt to social engineer the outcome. Determining which themed tiers consumers desire is a complex process that only the market can resolve to a socially beneficial outcome

Impact of Competition

At the very end of the Economic Appendix, we find a discussion of the impact of eliminating the assumption of MVPD monopoly,[73] and the authors construct one last example, designed to show that "a move to a la carte can benefit consumers even when both retail and wholesale markets are competitive." This sentence conveys a strong impression that a la carte will not arise in a competitive market unless mandated through regulation. To the contrary, as we illustrate below, competition generally will lead to the welfare maximizing pricing structure.

[73] Further Report, pp. 59-61.

The Further Report's example is based on the same set of consumer valuations assumed in the three-consumer version of Example One:

Example One/Eight: Three-Consumer Version			
Network	Aaron	Betty	Charlie
X	5	3	3
Y	3	5	0
Bundle	8	8	3

As we noted above, this example is constructed in such a way that a la carte pricing is the welfare maximizing pricing structure.

Now assume that, instead of a single profit-maximizing MVPD monopolist, there are two profit-maximizing MVPDs, which we will call "Cable" and "DBS." Assume an initial situation in which both MVPDs offer bundling at the competitive price of $6, i.e., the price at which neither makes economic profits. But this outcome does not represent a long-run equilibrium, as each MVPD can increase profits by unbundling the two networks. By doing so, either MVPD can steal consumers from the other, resulting in greater revenues and positive profits compared to bundling.

For example, as shown below, assume DBS offers to sell networks X and Y a la carte for $2.90 and $3.00, respectively. Then, Aaron and Betty buy from DBS because they can get both networks at a lower total cost, $5.90 instead of $6, while Charlie also buys network X for $3. DBS total revenue is $14.70 compared to costs of $12, resulting in profits of $2.70. Thus, competition led DBS to offer a la carte voluntarily, *without* any regulation mandating a la carte. Further, by causing DBS to voluntarily offer a la carte, competition creates greater consumer and social welfare. In the example, initial a la

carte competition increases consumer welfare from \$4 to \$4.30,[74] compared to bundling and increases social welfare (the sum of MVPD profits and consumer welfare) from \$4 to \$7.

	Profit-Max Price	Sales	Revenue	Fixed Costs	Profit	Consumer Welfare	Social Welfare
Beginning State: Competitive Bundling							
XY	\$6	2	\$12	\$12	\$0	\$4	\$4
Initial Stage of Competition: Competitive a la Carte							
X	\$2.90	3	\$8.70	\$6.00	\$2.70	\$2.30	\$5.00
Y	\$3.00	2	\$6.00	\$6.00	\$0.00	\$2.00	\$2.00
Total	\$5.90		\$14.70	\$12.00	\$2.70	\$4.30	\$7.00
Long-Run Equilibrium: Competitive a la Carte with Zero Profits							
X	\$2	3	\$6	\$6	\$0	\$5	\$5
Y	\$3	2	\$6	\$6	\$0	\$2	\$2
Total	\$5	5	\$12	\$12	\$0	\$7	\$7

The same dynamic will continue, with Cable and DBS each undercutting the other's prices, until a final equilibrium is reached where profits are zero. At that point, network X will be offered for \$2, and network Y for \$3. Thus competition benefits consumers by lowering prices and increases consumer surplus to \$7, as shown in the final equilibrium.[75]

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[74] Consumer surplus for a particular consumer equals the difference between the consumer's valuation of a product and the price paid times the quantity purchased. Summing surplus across consumers yields total consumer surplus.

[75] We chose this example to show that, under the "a la carte-friendly" assumptions used in the Further Report's first example, a competitive market results in a la carte. It would be equally easy to demonstrate that, in situations where bundling is the more efficient outcome, the market will result in bundling.

Appendix B:
Key Findings of Economic Analyses Submitted In MB Docket No. 207

Source	Page	Findings
The A La Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity--An Economic Analysis of the Implication of A La Carte Pricing on Cable Customers. Booz Allen & Hamilton	1	Our overall conclusion is that the a la carte and themed tiers scenarios evaluated would reverse recent benefits of programming diversity, while increasing prices for the vast majority of consumers.
	1	Under each of the scenarios evaluated, consumers would be worse off than today. Consumers would either pay more than today for far fewer channels, or would need to select as few as six cable networks to reduce their monthly bill below current levels. Today, most consumers regularly watch nearly three times as many channels.
	1	If the entire "expanded basic" tier were still offered as an option, even those customers continuing with existing service would, under the scenarios, experience an increase in prices of 7% to 15%.
	1	Making services available on an a la carte or themed tier basis would raise the costs incurred by *cable operators*. Services offered on such a basis would need to be offered as *digital* services…Consumers would incur variable costs of adding digital set-top boxes.
	1	A la carte and themed tier options would also adversely impact program networks. Their household distribution would decline dramatically, diminishing their advertising revenues. Moreover, networks' marketing costs would sharply increase…
	2	Networks would therefore likely need to also reduce their expenditures on programming, lowering the quality of current offerings and further eroding advertising due to additional declines in viewing.
	2	Higher costs for cable operators and program networks would result in increased per-channel costs of programming, which would lead to far fewer program services being purchased.
	2	As many as half to three-quarters of emerging networks could fail under each of the scenarios, including a growing number of targeted niche and ethnic program networks, and new network launches would become extremely unlikely.
	2	Moreover, even the most established networks would likely have to reduce expenditures on programming, leading to lower viewing and lost advertising. This would likely lead to further industry consolidation into fewer network groups.

Source	Page	Findings
Slicing and Dicing: A Realistic Examination of Regulating Cable Programming Tier Structures. Michael L. Katz	ii	The analysis shows that these policies ["a la carte offerings" and "themed mini-tiers"] would very likely harm consumers, competition, and economic efficiency.
	ii	The practice of offering multiple products together in a single bundle is widespread: Bundling is a common practice…Bundling is often associated with discounts…Bundled offerings can be an important competitive tool.
	iii	There is no logical or factual basis for claiming that tiers force people to pay for programming they don't want…In fact, once one takes into account the effects on the supply of programming available to cable and DBS operators, economic analysis shows that the use of tiers can lead to situations in which every consumer pays less and receives more programming than he or she would under a la carte pricing.
	iii-iv	There are three mechanisms through which mandatory unbundling would harm consumers. First, eliminating or restricting the use of tiers would harm consumers directly by reducing their abilities to derive the most viewing enjoyment out of existing programming...A second mechanism through which mandatory unbundling would harm consumers is by triggering higher prices for existing programming...A third mechanism through which mandatory unbundling would harm consumers is by reducing the quality and variety of programming.
	v	In addition to increasing distribution costs and reducing consumer benefits (in terms of both the quality and variety of programming available and viewed), policies mandating a la carte or mini-tiers would inevitably engender serious administrative problems.
	v	Policymakers should recognize that program tiers have produced significant consumer benefits and that mandatory a la carte or themed mini-tiers would destroy many of those benefits, leaving consumers with higher prices, less varied and lower quality programming, and less ability to enjoy available programming. In summary, mandatory unbundling of multichannel video programming can be expected to be bad for consumers, bad for many programmers, and bad for cable television system operators.
	24	For the reasons demonstrated above, mandatory unbundling would harm consumers by: (a) inefficiently reducing the benefits derived from existing programming; (b) raising the retail price of existing cable programming; and (c) reducing the range and quality of programming available. Mandating a la carte pricing or the use of themed mini-tiers very likely would significantly harm consumers, competition, and economic efficiencey.

Source	Page	Findings
Cable Program Tiering: A Decision Best and Properly Made by Cable System Operators, Not Government Regulators. William P. Rogerson	6	First, standard economic theory provides a compelling argument that government's current policy of not regulating the tiering structure of programming is the most desirable policy. Standard economic theory suggests that some bundling and tiering of programming is likely to be efficient, that the precise form of the efficient tiering scheme is likely to depend in complex ways on market conditions that cable systems will understand much better than regulators, and that cable systems will generally have an incentive to choose efficient tiering schemes because cable systems can charge subscribers higher prices by providing them with packages of services that they value more highly.
	8	Since economic theory suggests that cable systems should have a relatively good incentive to bundle and package programming into tiers in ways that will provide maximum value to their customers, there is in general no "market failure" that requires government intervention. Therefore I believe that government's current policy of essentially not regulating most program tiering decisions of cable systems is generally the correct policy.
Regarding A La Carte Pricing. Robert D. Willig, Jonathan M. Orszag, and Jay Ezrielev	5	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 a la carte suggests that such proposals will harm economic efficiency and will likely fail to achieve the goals delineated by their proponents.
	5-6	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 consumers who value the benefits of receiving a diverse choice of bundled high-quality programming.
	6	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.
	6	Under one approach being considered, MVPD providers would be encouraged to offer a 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 a la carte programming that they have today. As a result, it is unlikely that there would be significant expansion in a la carte programming options.

Source	Page	Findings
	6	Marketplace evidence suggests that few subscribers would likely choose to purchase networks a 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.
	6	Indeed, proposals to force MVPD providers to unbundle cable programming will likely harm economic efficiency and the public interest.
	26	It would be particularly counterproductive to impose significant new regulations on MVPD distributors and cable programming networks today.
Benefits of Bundling and Costs of Unbundling Cable Networks. Michael G. Baumann and Kent W. Mikkelsen, Economists, Inc.	i	Retail bundling of cable networks provides numerous benefits to consumers as well as networks.
	i	Bundling is a commonplace and efficient method for delivering a wide range of products to consumers.
	i	Bundling is an economically efficient way to offer programming since distributing programming to subscribers costs roughly the same regardless of the number of cable networks delivered—as long as those networks can be bundled.
	i	Bundling offers an enhanced product that most consumers prefer. It allows for occasional and spontaneous viewing of special news, sports, documentary, and movie programming.
	i	By allowing subscribers to sample new programming services, bundling facilitates entry by new cable networks.
	i-ii	Bundling reflects the economic reality that programming is a “non-rivalrous” good—i.e., once a television program has been produced there is no additional production cost associated with letting an additional person view it—that should be provided and priced in a way that does not deny consumers benefits that cost society nothing to produce.
	ii	A government mandate that results in retail unbundling is an inappropriate response to any concern about cable subscription rates and is likely to harm consumers.
	ii	Unbundling is likely to raise rates to subscribers so that consumers could end up paying substantially more than they do now for the present collection of basic cable networks.
	ii	Unbundling may reduce cable network programming expenditures, leading to a reduction in program quality and selection.

Source	Page	Findings
	ii	Unbundling would make advertising less efficient and less valuable, leading to increased subscription rates.
	iii	In aggregate, if all networks sought to maintain their current level of programming expenditure (and cash flow) then the total amount paid by all subscribers not only must equal what was paid before unbundling but must increase to offset the decline in advertising revenue and the increase in marketing costs. Hence, if programming quality on all networks were to stay the same, subscribers on average would pay more.
Cable Networks: Bundling, Unbundling, and the Costs of Intervention. Bruce M. Owen and John M. Gale, Economists, Inc.	2-3	Bundling is an extremely common phenomenon in the American economy. Indeed, it is more the rule than the exception. Bundling presents no presumptive threat to consumer welfare. In fact, bundling generally promotes consumer welfare by lowering the prices of goods and services...Thus, giving each consumer equal weight, consumers as a group will be worse off if bundling is not permitted.
	3	Our empirical research contradicts the idea that suppliers generally require MVPDs to purchase bundles of programming. The cable network industry is competitive...Entry into the business of providing programming to MVPDs is not restricted, as evidenced by the actual entry of more than 200 new networks in the past decade.
	4	Our economic analysis of the competitive forces on cable networks leads us to predict that suppliers would offer MVPDs a substantially lower price in exchange for placing any network on a tier that matches that network's national marketing strategy...Therefore, cable networks will prefer a particular tier placement, and will likely offer a better price to MVPDs who agree to that placement.
	4	Prices cannot be ignored...To understand this, consider whether a shopper who is offered a quantity discount for laundry soap, for example, is required to buy a larger quantity. Assuming for the sake of argument, and contrary to common sense, that the answer is yes, requiring the soap powder to be "unbundled" is no solution unless the government is prepared to regulate both the sizes of the components and their prices.
	4-5	It is very difficult to imagine an effective law or regulation requiring unbundling of MVPD networks, either at wholesale or retail, that was not accompanied by government regulation of the prices and license fees and other terms of trade between cable networks and MVPDs and between MVPDs and retail subscribers. Such regulation would be far more complex than the Commission's attempts to regulate the prices of unbundled elements of local telephone service.

Source	Page	Findings
	5	These calculations, summarized in Table 4, strongly suggest that consumers will end up paying substantially more than they do now for the present collection of cable networks or for any substantial subset of networks. Consumers who wish to subscribe only to a very few of the existing networks, including consumers who currently do not subscribe to any expanded tier, may be better off...In the longer term, there is no assurance that the networks such consumers prefer will survive the change, or, if they do, that they will retain their current levels of program quality.
	5-6	Unbundling clearly will increase the costs to viewers of sampling content on cable networks they do not regularly watch. This provides a firm basis to predict that the effect of the proposed interventions would be to impair the ease of access of all Americans to new ideas and contrary and minority viewpoints.
	6	We consider, last, the proposal to mandate certain bundles of content organized according to specified themes...[U]nbundling only a few specific networks might not reduce the price of the remaining bundle of networks. Further, for reasons explained in Section VI, we think that overall consumer welfare would be adversely affected by mandated unbundling or tiering, and that it would raise substantial First Amendment issues.
	8-9	When we predict reductions in overall welfare we are implicitly giving equal weight to each consumer. This assumption is justified by the absence of any apparent correlation between those likely to benefit from unbundling and the characteristics traditionally associated with unequal weighting of income. In this respect mandatory unbundling resembles an economically inefficient tax that transfers income from one randomly selected group of consumers to another, reducing GNP in the process.
	53	We conclude that mandatory unbundling of cable program services at the wholesale or retail level would be harmful to consumer welfare in the United States. At the wholesale level the evidence suggests that bundling simply is not an important feature of the commercial landscape...At the retail level, complaints about bundling may reflect the false assumption that the sum of the competitive prices for unbundled networks would be the same as current bundle prices. As we have shown, the reality is that the components would likely cost more than the bundle. More generally, bundling is a very common and efficiency-enhancing economic phenomenon. In its absence, costs and prices would increase, making virtually everyone worse off and reducing the output of goods and services.

Source	Page	Findings
	53	Bundling is in part a pricing phenomenon, and it could not be limited without regulating both the definition of what constitutes a bundle for each product or service as well as its price. In contrast to the task of regulating unbundled elements of local exchange services, where the conditions for efficient pricing are relatively straightforward, there is no generally accepted rule for pricing non-rivalrous consumption goods such as video programming that is incentive compatible on the supply side and efficient on the demand side.
Statement of Gustavo Bamberger, Lexecon, Inc.	1	"Bundling" of products is ubiquitous in the U.S. economy, and typically reduces costs and thus is economically efficient.
	1	"Bundling" by MVPD providers reduces costs and is economically efficient.
	2	The imposition of a la carte pricing likely would harm consumers in a variety of ways: (1) fewer networks would be available; (2) consumers would pay more for MVPD service; and (3) MVPD providers would reduce investment, thereby reducing their ability to offer innovative products and services.
Time to Give Consumers Real Cable Choices (After Two Decades of Anti-Consumer Bundling and Anticompetitive Gate Keeping). Mark Cooper	1	This analysis demonstrates that the cable industry practice of forced bundling is anticonsumer and anticompetitive. Forcing consumers to buy large bundles of channels, most of which they do not watch, in order to gain access to the small number that they wish to view results in a higher total bill.
	1	The cable operators' denial of consumer choice and control of programmers' access to the viewing public distort the video programming market...As a result, independent programmers find it very hard to gain access to the market.
	2	Moreover, because the current system inefficiently denies the consumer choice in purchasing programming, the advertising market is inefficient. Because consumers are forced to pay for dozens of channels that they do not watch, advertisers must pay for millions of blank TV screens. The possibility that someone might wander through a niche channel is not very valuable to advertisers, but there is no way to target marketing. Therefore, advertsiers should not be willing to pay much for time on unwatched channels, but the cable industry claims they are paying huge sums for unwatched commercials.
	5	One solution, providing consumers with a choice between bundles and individual channels, is so simple and well justified in the economics literature that it hardly needs defending. "[T]he whole concept of efficient resource allocation is built upon the fundamental belief that the consumer is sovereign – that individual preferences are what count."

Source	**Page**	**Findings**
	6	Pure bundling, the situation in which programs are offered only in packages, and pure component selling, the situation in which packages are outlawed, have consistently been found to be inferior in the economics literature…Under these circumstances [mixed bundling], if consumers were offered the opportunity to choose between bundles and an a la carte menu of the same programs, it is likely that the total rate paid by consumers for the programs they would choose to purchase would be reduced and consumer satisfaction would increase.
	8	We reject the claim that a la carte will fail to discipline cable behavior, like rate regulation did in the early 1990s. The 1992 Cable Act gave regulators a weak set of tools; a la carte rests on a much more powerful force, consumer sovereignty in the marketplace. It is undeniably procompetitive and very likely to be consumer-friendly.
Wrong Diagnosis, Wrong Cure: An Analysis of the Claims Made by Dr. Mark Cooper in "Time to Give Consumers Real Cable Choices. Michael L. Katz	iii	The analysis shows that Dr. Cooper's claims are based on fundamentally flawed and incomplete arguments that lack sound factual or logical foundations…Contrary to Dr. Cooper's unsound claims, mandatory unbundling would very likely harm consumers, competition, and economic efficiency.
	3	A proper economic analysis indicates that mandatory unbundling policies would very likely harm consumers and reduce economic efficiency by: inefficiently reducing the benefits derived from existing programming; raising the retail price of existing cable programming; and reducing the range and quality of programming available.
	3	Under mandatory unbundling, consumers would view a narrower range of lower quality programming and would pay more for that programming on a per-channel basis. Indeed, consumers could quite possibly end up paying higher total bills despite the reduced quality and variety of programming viewed.
The Economics of Cable TV Pricing: A La Carte v. All-You-Can-Eat. Thomas Hazlett	2	Bundling is ubiquitous across goods and services in the economy. The cost structure of cable TV systems and cable TV programming networks is distinct, however, from many other sectors.
	2	"Expanded basic" dramatically lowers distribution costs for program producers and transaction costs for customers who are able to continuously sample a wide variety of programs at no additional cost. Each viewer watches programs that interest them, subscribing based on these preferences – they pay for what they demand...Bundling enables consumers to share the costs of facilities delivering a broad menu of popular services.
	2	No economic gain (or cost saving) would be realized by reducing the size of the bundle generally available to all customers.

Source	Page	Findings
	2	Unbundling results in higher prices and is rejected by consumers in those instances in the multi-channel video market where it has been tried.
	2	Programmers are ardent supporters of tier bundling, indicating that cable operators use such tools to create efficiencies.
	3	Regulation to limit bundling in video markets would likely drive up costs for both suppliers and purchasers, lowering consumer welfare.
	3	Hybrid regulatory schemes, such as 'voluntary' a la carte (rules prohibiting bundling agreements between cable operators and program networks) or mini-tiers (mandates that operators offer smaller bundles of channels on "thematic" groupings), lead to similar anti-consumer consequences.
	3	First, evidence from markets in which a la carte purchases of network services are offered show that consumers overwhelmingly reject such transactions in favor of bundled purchases. This is due, in large part, to the fact that prices tend to be much higher when services are purchased in small increments.
	43-44	Experience in the U.S. C-Band market, DBS, and in the Canadian cable market, suggests that a la carte pricing results in higher prices and attracts few customers, even when subscribers can select between a la carte and bundled channels. Experience in other markets suggests that services are efficiently bundled under cost conditions similar to those prevailing in multi-channel video.
Why a Box of Crayons Has Many Colors, and the "Cable Tax" is Not a Tax; Why Contract Confidentiality Promotes Competition; and Why the News Corp Retransmission Consent Conditions Don't Apply to Other Broadcast Networks. Bruce M. Owen and John M. Gale	1	[B]undling is, in general, a practice highly beneficial to consumers and to competition...Further, the argument that MVPD subscribers are being "taxed" for programming they "do not want" makes no economic sense.
	4	By including more channels, the entire package is more valuable to potential cable subscribers on average, so the cable system sells more subscriptions.
	5	It is always true that each subscriber values the entire package more than the price she pays or she would not choose to subscribe.
	6	But the history of cable television programming is replete with examples of shows carried on obscure cable channels that become very popular. In these instances there have to be consumers who would not have chosen the channel but, after sampling a particular show, are very happy to have the channel in their package.

Appendix C:
Key Findings of Recent Analyst Reports Regarding a A La Carte Mandate

Source	Page	Findings
Bank of America, Analyst Report, Cable and Satellite TV, 12/11/2005	1	…mandated a la carte--which is highly controversial, of questionable legality and has unclear consumer benefits…
	1	In addition, when consumers are given the opportunity to buy less TV, they don't usually take it. And DirecTV offered a family tier several years ago but discontinued it due to lack of demand.
	2	There is little evidence that consumers want family tiers, implying little business impact.
	5	[T]here isn't much evidence that consumers want to buy less programming. The DirecTV Total Choice package offers 155 channels for $41.99 and DirecTV's ARPU is in the mid $70s. Even more telling, EchoStar heavily markets its America's Top 60 package as the "lowest all-digital price in America" at just $31.99 monthly. But EchoStar's ARPU runs in the mid $50 range. As a result, we expect that demand for a family tier would be quite low and would therefore probably have very little practical business impact.
Bank of America, Analyst Report, Cable and Satellite TV, 11/29/2005	1	Mandating a la carte would be a tremendously complex, controversial, and likely litigious process with unclear consumer benefits and numerous potential unintended consequences.
	1	Contradictory findings from prior FCC reports and a prior GAO report about the potential impact of a la carte would likely raise questions about the findings of any new report. In addition, there are too many variables to accurately predict the consumer impact, particularly because there is no way of knowing how much programmers would charge a la carte. There is also the risk that some fringe networks could fail, which would also be counter to the public interest.
	1	Contrary to conventional wisdom, it is not clear that consumers want to buy less TV. EchoStar's mid $50 ARPU illustrates that. In addition, DirecTV offered a family tier years ago and discontinued it owing to lack of demand.
	2	[Mandated a la carte] opens a Pandora's box of issues...A la carte would require new legislation that would face legal challenges; and [i]t is far from clear that it would be good for consumers or that they would even want it.
	2	After all, the extreme outcome is that consumers will pick and choose the handful of channels they actually watch regularly. Consequently cable and DBS bills would be slashed. Programmers would lose distribution and advertising revenue and have to incur a substantial new cost to actively market their channels to consumers. Those offering the highest-priced programming, like sports programming, could be at the most risk. In addition, many niche networks could possibly fail.

Source	Page	Findings
	3	...we think it is tough to predict whether anyone would benefit from a la carte, even consumers. For the distributors, ARPUs would possibly decline; programmers would likely lose distribution and advertising revenue and have to incur a potentially significant new cost to aggressively market their channels directly to consumers, forcing them to raise prices; some fringe networks could go out of business; and consumers might end up having to pay higher affiliate fees for fewer channels, possibly paying as much, or more, for less.
	3	It may not be technologically feasible to offer true a la carte for some time. Today, only about 60% of cable households have a set-top box. And fewer of these are the addressable boxes that would be required to enable a la carte.
Bear Stearns, Analyst Report, Entertainment, "Much Ado About (Not Quite) Nothing," 11/30/2005	1	Unbundling expanded basic takes economics into unchartered territory; while with a la carte you may not pay for what you don't watch, you may pay the same amount for lesschoice.
	3	Our numbers, however, imply that there may be little money saved by any household opting for 15 channels, assuming 10 are on the mandated broadcast basic tier, and five are popular cable programming services.
	4	All-in (networks + equipment + franchise fees), the 25% take-rate scenario is probably more expensive than today's basic + expanded basic package, with only 15 channels, including five cable networks and 10 off-air. While these consumers would get what they want and nothing more, choice is not necessarily facilitated if that is defined as the ability to change one's mind at a reasonable cost.
	5	The Rich Get Richer. With less distribution, cable networks will have to differentiate and market more effectively. This will require money, giving those richer networks an advantage over newer, smaller, and start-up properties, in our view. It could lead to a reduction in the number of networks.
	5	If current basic networks find take-rates precipitously low, and it is just not feasible to raise affiliate fees high enough to offset the distribution loss, they may expand into more "adult" themes to attract audience. The net result may be to therefore encourage more programming someone may consider indecent, running counter to some senators' desire to use a la carte to rein in indecency (although a la carte allows consumers to avoid having it in their homes).
Bear Stearns, Analyst Report, Entertainment/Cable, "A la Smart?", 3/29/2004	1	Unbundling the expanded basic cable package takes wholesale and retail economics into unchartered territory, such as changing basic services into premium pay services, reducing the number of niche networks, and even possibly changing broadcast economics. With a la carte you may not pay for what you don't watch, but you may pay the same amount for less choice.

Source	Page	Findings
	2	[A la carte] could impose extra costs in the near term and significantly alter the economics of the cable network business. GAO concluded that it is difficult to know how many consumers would be better off under a la carte and how many worse off.
	3	Our numbers, however, imply that there may be little money saved by any household opting for 10-15 channels, especially if they are the more popular ones.
	6	With less distribution, cable networks will have to differentiate and market more effectively. This will require money, giving those richer networks an advantage over newer, smaller, and start-up properties, in our view. Should this transpire, it could lead to a reduction in the number of networks.
Bernstein Research Call, Analyst Report, U.S. Cable and Satellite Broadcasting, "Weekend Media Blast #49: a la Carte Dallars and Sense," 12/9/2005	2	...the economics of à la carte are difficult to justify (as we have written at length in the past; relevant reports from 2003 available upon request). For example, even if a channel like Viacom's BET were picked up by every one of the 17% of America's families that are African American, its monthly price (i.e. affiliate fee) would need to rise by 588% for BET to remain revenue neutral.
	2	For this reason, the political appetite for real à la carte appears very low (as evidenced by the strong opposition from the Congressional Black Caucus in 2004). The diversity of voices would almost certainly suffer. The result would be monthly cable bills similar to today's, but with each customer receiving a small number of channels for roughly the same total price as the large number they get today. Many niche programming options would cease to exist. And new channel launches would likely stop altogether.
Kagan Insights, Analyst Report, "A la Carte Pricing Makes Great Theory, But T.V. Ch. Bundling Tough to Beat," 12/15/2005	1	The average package increased to 64 national basic cable channels today...Kagan Research estimates consumers would have to limit á la carte buys to somewhere between 6-9 basic cable networks to beat the bundle price. That small number assumes subscribers will gravitate to the most popular channels such as ESPN and Discovery, that are also the most expensive.
	2	The retail price could easily be increased by a multiple of four in sales to consumers on an á la carte basis.
	2	"It's ironic that there was this massive push to force multi-channel operators to provide channels on an á la carte basis when it has failed dismally in Canada, France and other countries," notes Baine. "Á la carte has been tried in the U.S. over the years with poor results."
Kagan Broadband Advertising, Analyst Report, 2/21/2006	7	A la carte is a bad thing economically all around, for consumers, networks and multichannel operators.

Source	Page	Findings
	7-8	If fewer than half of viewers surf for new channels, by implication, networks today have to find ways to advertise their programming to the remaining MVPD viewers. So, "networks are already confronting the problem of marketing themselves to non-surfers, even with bundling," says the FCC. The FCC suggests this problem could be solved by "mixed bundling" whereby consumers can buy a package of channels, block those they don't want, and get reimbursed for channels they block. This would be problematic for new networks that gradually increase their programming budgets and quality as they garner more and more viewers.
	8	If a network got only five million a la carte subscribers, the audience is unlikely to be large enough (even with a much higher than average percentage of subs viewing than under a bundling scenario) to support the infrastructure and programming costs of a typical network.
Goldman Sachs, Analyst Report, "Americas Media: Cable T.V.," 11/29/2005	1	[A la carte] creates more marketing confusion for distribution – going against “simple is better” notion. Unbundling of programming has not been tested and potentially may not result in lower cost to consumers because of loss of viewership (think ad $s) by content providers. It could result in the loss of minority oriented programs –a key issue for the congress to become comfortable with making a la carte a potential law.
	1	[T]he reduction i[n] cost may be lower than expected as programmers may begin to charge more for their content to compensate for lost viewership of their channels...a channel that loses 50% of its viewership is likely to lose advertising revenues and may consequently begin to charge more for its affiliate fees. As a result, consumers may end up paying equal amount for less choice.
	1	[P]otential loss of minority/diverse programming (owing to loss of carriage and lower viewership) is likely to be a major concern.
Deutsche Bank, Analyst Report, "Media Spotlight: A la carte Redux," 02/9/06	1	The implementation of a la carte…would require re-pricing of channels (much higher), shutting down smaller and niche channels, and resetting ad rates (likely lower).
	1	Quite remarkable to us is the new [FCC] report argues that customers could afford [to] buy the 20 channels they want to watch for the same price they pay now--well how is that a good thing for consumers to go from receiving 80 channels on average to only 20 for the same price?
	2	[I]n our view the vast majority of the 200-channel pay TV universe would not survive in an a la carte system. The average person watches about 17 channels, only up from 12 over the past decade despite the number of available channels tripling. That’s 183 channels each customer would no longer subsidize or watch. The reason pay TV prices are only $0.33 per hour is that advertising revenue also covers much of the cost of programming, which would be at risk for those channels no longer with broad distribution. A la carte would absolutely crush diversity of programming
	2	A la carte would absolutely crush diversity of programming.