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DeDe Lea
Executive Vice President
Government Relations

April 3, 2006

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Federal Communications Commission
Office of Secretary

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
The Portals – Room TWB204
445 Twelfth Street, Southwest
Washington, D.C. 20554

Re: Ex Parte Presentation in MB Docket 04-207

Dear Ms. Dortch:

This letter and accompanying attachment is being filed as notice that representatives of Viacom attended a meeting on March 31, 2006 with Commissioner Deborah Taylor Tate and Dana Shaffer, Legal Advisor. Representing Viacom were DeDe Lea (Executive Vice President, Viacom), Hollyn Kidd Schuemann (Director-Viacom), Brian Philips (Executive Vice President-Country Music Television), Michael Baumann (Economists Inc.), and Alex Vogel (Vogel Mehlman Castagnetti).

During the meeting, the Viacom representatives presented and discussed the attached document.

Sincerely,

DeDe Lea

DeDe Lea
Executive Vice President

Attachment

cc: Commissioner Deborah Taylor Tate
Dana Shaffer, Legal Advisor.

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The FCC "Further Report" on the Retail Marketing of Video Programming Services: An Economic Review

by

Bruce M. Owen

March 28, 2006

Executive Summary

The Federal Communications Commission recently issued a "Further Report" reversing the Commission's previous conclusions about the effects on consumers of selling video programming in bundles of channels, rather than channel by channel. The Commission's reversal invites potentially disastrous increases in the costs of producing and distributing video programming, threatens to reduce the competitiveness of one of America's strongest export industries, and virtually guarantees price increases and reduced program diversity for millions of American television viewers. The Commission's basis for reversing its previous stance is an incomplete, result-oriented and misleading reading of the identical record relied upon in the Commission's earlier report.

Even if the suggestion that bundling is harmful to economic welfare was not a distortion of the economic literature, the "Further Report" ignores the further and related issues that would have to be investigated before a regulatory intervention could responsibly be considered. For example, the report ignores entirely the supply side of the market for video programming: the adverse effects of government intervention on the costs of producing, marketing, and distributing programming, the negative effects on markets reliant on the same sources of supply of programming, the effects on employment in program production, and the risks to one of America's strongest export industries. Even more remarkable, the "Further Report" pays no attention to a regulatory objective the Commission, and Congress, has held paramount for more than half a century—diversity of programming.

Bundling of goods or services is a universal marketing practice. Economists have studied the phenomenon for many years, concluding that bundling is a natural consequence of competitive as well as imperfect markets, the consequences of which vary in complicated ways according to particular market circumstances. Any given instance of bundling is at least as likely to be beneficial to consumers as a group as not, and virtually every instance of bundling, whatever its overall effects, improves the positions of some customers while worsening the positions of others. As the Commission's earlier report recognized, the economic literature provides no basis to impose government intervention in video markets to forbid bundling. The Commission in its "Further Report" distorts this economic learning, and uses selective examples to imply that bundling of video channels is necessarily harmful to consumers.

About the Author

Bruce M. Owen is the Morris M. Doyle Centennial Professor of Public Policy in the School of Humanities and Sciences at Stanford University and Director of the Interdisciplinary Program in Public Policy. He is also the Gordon Cain Senior Fellow in the Stanford Institute for Economic Policy Research. He holds a B.A. from Williams College (1965) and a Ph.D. in economics from Stanford (1970). Dr. Owen was chief economist of the White House Office of Telecommunications Policy (1971-72), and later of the Antitrust Division of the United States Department of Justice (1979-1981). He is the author of a number of books and articles dealing with the economics of regulation and media, including *Video Economics* (Harvard Univ. Press, 1992) and *The Internet Challenge to Television* (Harvard Univ. Press, 1999). The views expressed here are not necessarily those of Stanford University or any of its units.

Mr. Owen is a consultant to the economic consulting firm Economists Incorporated, which he co-founded in 1981 and of which he was CEO until 2003. This review of the FCC "Further Report on the Packaging and Sale of Video Programming Services to the Public" was commissioned by Viacom, Inc. The collaboration of Michael Baumann, John Gale, Kent Mikkelsen, and Matthew Wright of Economists Incorporated in the preparation of this review is gratefully acknowledged.

CONTENTS

Background and Summary of Conclusions

Most of the channels (video program networks) that cable and satellite operators (collectively, "MVPDs") provide are purchased by consumers as part of a package or "tier" of networks. The FCC has recently released a report on this practice titled *Further Report on the Packaging and Sale of Video Programming Services to the Public* ("Further Report").[1] The "Further Report" argues that it *may* be in consumers' interest to force MVPDs to offer networks individually on an à la carte basis, or alternatively in certain theme tiers, in addition to offering them as part of a bundle.[2] This paper reviews the FCC "Further Report" from an economic policy perspective and provides an economic analysis of mandatory unbundling of video channels for MVPDs.

The retail multi-channel video programming services industry is part of a vital U.S. industry that supplies news and entertainment to millions of consumers in the U.S. and abroad. In 2004, basic cable networks in the U.S. incurred programming expenses of roughly $12.1 billion dollars, up from roughly $2.5 billion ten years earlier.[3] Moreover, revenues from foreign sales by the U.S. motion picture, television, and video industries were estimated at $17 billion in 2002.[4] In short, U.S. video programming producers employ vast numbers of people and other resources, and the industry represents an important export market for the U.S.

The production of video programming distributed by MVPDs results from a vast set of supply and demand interrelationships. The process starts with consumers' decisions whether to subscribe to an MVPD and (assuming they do subscribe) which packages of programming to receive. A shift from bundled offerings to mandatory unbundling can affect consumers' prices for networks and thus influence subscription decisions. These

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1 "Further Report On the Packaging and Sale of Video Programming Services to the Public," February 9, 2006.

2 The terms à la carte and unbundled are used synonymously in this review.

3 Kagan Research, Economics of Basic Cable Networks 2005, pp. 16-17.

4 Steven E. Siwek, *Copyright Industries in the U.S. Economy,* Report Prepared for the International Intellectual Property Alliance, 2004, Economists Incorporated.

decisions in turn affect networks' advertising revenues and subscriber fees, as most basic cable networks are dependent on these dual sources of revenue.[5] Additionally, mandatory unbundling can have an impact on the costs associated with programming production, marketing, or distribution, all of which can affect prices to consumers and ultimately the quality and quantity of programming.

The "Further Report" has focused narrowly on the potential effect of mandatory unbundling on a subset of consumers, and even this analysis is incomplete and misleading. The "Further Report" does *not* demonstrate that MVPD consumers as a whole would be better off with mandatory unbundling. The report merely asserts that *some* consumers may pay less for MVPD services with à la carte pricing, but it does not adequately consider the effects on the remaining consumers, who would likely pay *more*.

Even if viewers in general were likely to benefit, which is unproven, it would be extremely unsound economic policy to mandate à la carte pricing of video services in the absence of a careful study of the costs and risks that would be imposed on the American program production industry and its workers, as well as the consequences for continued U.S. competitiveness in this important export sector of the American economy. There are important vertical relationships among the components of the industry, illustrated by the fact that much programming is exhibited successively through a series of media. A regulatory intervention restricting the marketing practices in one part of the industry can have unforeseen adverse consequences in other segments of the industry. The "Further Report" does not even discuss other likely effects, including consequences for the cable networks and programming input suppliers. In short, the "Further Report" gives no convincing reason why bundling in the sale of cable networks to consumers should be eliminated by legislative mandate. It would be folly to mandate a fundamental change in the operation of a major industry that touches the daily lives of most Americans on the basis of this incomplete and largely misleading report.

Specific conclusions of my analysis include the following:

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5 The term "cable network" is commonly used, even though such networks are distributed not only by cable but also by satellite and other means.

- Bundling, the focus of the FCC "Further Report," is a very common feature in the U.S. economy, rarely requiring regulation. Bundling is a particularly natural and effective means of distribution for MVPDs and programming suppliers, both of which face high up-front costs.

- Predicting the effects of mandatory unbundling, even narrowly on cable and satellite video programming service networks, is complex. Some of the most likely effects include the following:

    - Higher prices for many consumers
    - Reduced viewing of individual cable networks
    - Reduced advertising revenues for cable networks
    - Increased marketing costs for MVPDs and cable networks
    - Increased operating costs for MVPDs
    - Increased subscriber equipment costs
    - Decreased diversity in the video programming available to consumers

- Consumers choosing relatively few networks under à la carte may see their subscription fee reduced—although even these consumers may be harmed by reduced programming quality. On the other hand, consumers who enjoy watching many networks may pay more with à la carte. It is impossible to predict confidently the sizes of the "winners" and "losers" groups, although the net effects on consumers as a whole would almost certainly be negative because mandatory unbundling is likely to increase costs to cable networks, MVPDs, and consumers.

- Some of the cable networks available to consumers as part of a bundle are likely to be unavailable to consumers if MVPDs are required to offer them à la carte. Entry by new networks is also likely to become more difficult. Networks appealing to narrow audiences with specialized tastes may be hit the hardest. This would tend to reduce the diversity of programming available to consumers.

- All consumers purchasing cable networks à la carte will lose the ability to "surf" over a broad range of cable networks. This makes it harder for consumers to sample programming and find programs they would want to view and reduces their flexibility in viewing special events. It thus reduces the diversity of viewpoint to which consumers are exposed, even leaving aside the likely reduction in the number of competing networks.

- For those cable networks that survive, increased costs imposed by à la carte pricing are likely to lead to a decrease in program quality and reduced investment in programming by cable networks.

- The industry that produces first run programming for distribution through the various communication media, including motion pictures, faces a likely reduction in revenues if MVDP operators are required to price à la carte. The result will be some combination of reduced output, lower quality, and higher prices for original programming. This will have a negative effect on employment in the United States in the production of such programming and reduced export revenues.

- Finally, the Commission's proposal to implement à la carte regulation is a proposal to create a massive new set of market interventions with effects in a broad swath of the American economy. Such intervention is certain to produce all the usual attendant bureaucracy, inefficiency and market distortion that has attends price controls and regulatory systems, including in this case the likelihood of federal regulation of network and program content. The Commission's report does this without the slightest analysis of the costs of such a regime or the impact on any part of the economy.

Analysis

On November 4, 2004, the FCC released a *Report on the Packaging and Sale of Video Programming Services to the Public* ("First Report"). The "First Report" was based on a substantial record compiled by the Commission in response to an inquiry from Congress regarding the effects of program bundling. Recently, the FCC released a *Further Report on the Packaging and Sale of Video Programming Services to the Public* ("Further Report"). The "Further Report" concludes that "the First Report relied on problematic assumptions and presented incorrect and biased analysis."[6] The following analysis reviews the "Further Report" and addresses more generally issues related to mandatory unbundling of networks offered on MVPDs. It concludes that, if anything, it is the "Further Report" that "relied on problematic assumptions and present[s] incorrect and biased analysis."

Effects of Mandatory Unbundling of Retail Video Services on the Cost and Supply of Programming

Overview

Examination of issues beyond the traditional static analysis of the economics of bundling is particularly important in assessing a proposal to regulate the marketplace determination of the way video programming is packaged and priced. None of these broader issues has been raised or analyzed by the Commission in the "Further Report." To illustrate the importance of supply-side effects, consider a requirement that MVPDs offer all cable networks à la carte, either as the only alternative or in combination with various tiers. It is reasonable to expect that if a cable network were taken out of the bundle and instead offered à la carte it would lose subscribers. Most "basic" cable networks are dependent upon dual revenue streams—advertising revenues and subscriber fees—both of which in turn depend on the number of subscribers. Hence, a reduction in subscribers, holding subscriber fees and advertising rates constant, obviously would reduce revenues to the network from both sources.

In addition, a cable network taken off a tier and offered à la carte would incur additional marketing and associated costs. Marketing consists of competitive tactics, activities and resources designed to generate subscriptions to an à la carte network by stimulating consumer demand and influencing consumer choice. A cable network offered to consumers à la carte would face additional marketing costs in order to overcome the higher search and transaction costs faced by potential viewers, who would no longer have the opportunity to

6 Further Report, p. 3.

"channel surf" in search of new programming, and who could no longer rely on the incentives of cable and satellite operators to vet programming on behalf of retail customers.

Although predictions regarding specific networks are difficult or impossible, some generalizations are possible. Clearly, any loss of subscriber or advertising revenue and any increase in costs would in the first instance be likely to increase consumers' per-network subscription prices, reduce program quality, cause the exit of some networks, and limit the entry of new networks. Hence, the change in pricing would reduce the variety and breadth of programming offered to subscribers. Moreover, it would reduce what a cable network is willing to pay for original programming, syndicated off-network programming, and movies, reducing the quality of cable programming offered to subscribers as well as the quality of certain types of broadcast network programming and motion pictures.[7] Also reduced would be the revenues earned by certain program inputs with associated reductions in the quantity and quality of their output. All of these effects will serve to reduce consumer welfare.

Subsequently, competitive interactions would take place among cable networks and among MVPDs. The effects of mandatory unbundling would unfold as a multistage process, with the impact from one stage influencing the next stage. These effects are difficult to predict and would result from the interactions of a large number of economic actors. The "Further Report" does not consider the wide range of possible effects from mandatory unbundling. Difficult as these issues may be to analyze, they must be addressed and the risks of adverse outcomes assessed before regulatory intervention can be considered.

Effects on the Efficient Distribution of Programming

Almost every product and service purchased by consumers is "bundled," by sellers, from various components that could each, at least in principle, be sold or priced separately. Purchased bundles are then further combined, by customers, into useful consumption ac-

[7] Part of the cost of motion pictures and original broadcast network programming is recouped from subsequent sale of the programming through other distribution channels. If such revenues, such as syndication fees from cable networks, are decreased, creators of original programming will have to reduce production costs, and quality (attractiveness to audiences), of new productions.

tivities. Bundling occurs for a variety of reasons. Probably chief among them is that sellers can assemble parts into bundled units more cheaply and efficiently than customers. Customers get a bundled product for a lower price, which they prefer to a self-assembled product, even though the self-assembled or tailor-made product might more closely match their own special tastes. Sellers obtain competitive advantage from offering bundles of components that are cheaper and/or better suited to the demands of various consumers, and the competitive market process tends to ensure that the driving force behind the assembly of bundles is consumer satisfaction.

While bundling is a pervasive practice throughout the economy, specific characteristics of the video programming services industry help explain its widespread use among MVPDs. Production of television programming is characterized by high fixed costs, and total programming costs are invariant to the number of people viewing the program. Distribution of a network on an MVPD also involves high fixed costs but no marginal costs once the MVPD had decided to carry the network on its system. In economic terms (as the FCC "First Report" noted in its Economic Appendix), consumption of video programming is non-rivalrous, in that one person's consumption does not reduce the amount available to others.[8]

Under these circumstances, bundling can have desirable economic properties. Economically efficient pricing of non-rivalrous goods calls for pricing the goods at zero on the margin, but pricing at zero obviously would not permit cost recovery, so no production would occur. Bundling allows recovery of fixed production and distribution costs by charging households an access charge for the bundle, while encouraging widespread access to programming by allowing consumers to watch any and all networks in the bundle at no additional cost. As the FCC "First Report" notes, bundling in this context represents a form of price discrimination, which is common in industries characterized by high fixed costs and low marginal costs.[9] Thus, bundling can provide a solution to the classic eco-

[8] First Report, p. 84.

[9] First Report, p. 85. See also Thomas W. Hazlett, "The Economics of Cable TV Pricing: À la carte v. All-You-Can-Eat," August 12, 2004, pp 23-24. (hereinafter, Hazlett Report)

nomic problem of financing non-rivalrous goods without restricting consumption below efficient levels.[10] It does so by permitting broader sharing of fixed costs.[11]

In the context of MVPD services, bundling also facilitates consumer sampling without requiring consumers to subscribe in advance to specific à la carte options. Many consumers today sample or "surf" across the various video options available to them, deciding to settle on a particular network based on the attractiveness of a quick sample of the programming. Bundling therefore has option value and reduces information costs for consumers, who need not predict in advance future viewing choices but rather have the freedom to quickly and costlessly access a wide range of possible viewing choices.[12] These benefits from bundling help explain the pervasiveness of bundled offerings among MVPDs, including among those that have entered more recently.[13]

Effects on Costs

Mandatory unbundling will increase the costs of delivering video programming to consumers for many reasons. The "Further Report" focuses primarily on equipment costs, and it asserts that previous analyses' concerns about these costs could be minimized by

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10 This benefit of bundling has been pointed out by numerous other commenters. See, for instance, Michael G. Baumann and Kent W Mikkelsen, "Benefits of Bundling and Costs of Unbundling Cable Networks," July 15, 2004, p. 10 (hereinafter, "Baumann and Mikkelsen Report"), and Hazlett Report, pp. 22-24.

11 Some theoretical economic literature suggests that in certain circumstances, bundling could be used to deter entry, but it is clear that the conditions under which this might be a concern are not present with MVPDs. As the "First Report" indicates, entry deterrence might be a factor if entrants cannot offer the same bundle of programming that existing MVPDs offer. However, MVPDs are generally forbidden from demanding exclusive agreements with program suppliers, and vertically integrated MVPDs are prohibited from unreasonably discriminating against other MVPDs when supplying programming (First Report, p. 86). Indeed, more recent MVPD entrants initially offered bundles of programming when they entered. See Michael L. Katz, "Slicing and Dicing: A Realistic Examination of Regulating Cable Programming Tier Structures," July 15, 2004, pp. 5-6 (hereinafter, Katz Report I). Moreover, MVPD entrants in many cases have attempted to compete by offering larger bundles of programming than incumbent cable systems. Thus, there is no basis for concern about MVPDs using bundling as a means of entry deterrence. Moreover, with the wide range of alternative bundles offered by different MVPDs—including cable systems and more recent entrants—consumers today have many alternatives from which to choose.

12 As I discuss in more detail below, bundling also promotes diversity in the viewing habits of individual consumers because it facilitates "surfing."

13 See the Hazlett Report, pp. 5-7, for a discussion of bundled offerings from more recent MVPD entrants.

imposing mandatory à la carte pricing only on digital customers. There are several reasons that the "Further Report's" analysis of a mandatory unbundling requirement limited to digital customers, and its narrow focus on equipment costs, is misleading and incomplete. [14]

First, as discussed above, unbundling substantially increases transaction costs. Consumers will have to make complex decisions about future viewing choices. Consumers will need to add networks to try them and then drop networks they do not want. Networks also may be added or dropped based on special programming events. MVPDs in turn will have to increase customer service and order processing costs.[15] These cost increases will reduce welfare, and at least a portion of these increased costs will likely be passed on to all MVPD subscribers. Mandatory unbundling would raise consumers' search costs, as viewers would seek to learn much more about future programming choices in order to optimally choose a roster of à la carte choices. Program suppliers and distributors are likely to incur substantial marketing costs in order to compete for consumer attention in a world of mandatory unbundling.

The "Further Report" simply assumes that consumers will have very good information about the content of networks before they make a choice to subscribe. The "Further Report" ignores the significant costs to programmers of providing this information to millions of potential subscribers. The "Further Report" casually dismisses the value of consumer sampling (or "surfing") in order to learn about new networks when it notes that "less than half of viewers find new channels through channel surfing."[16] Of course, this statement, if accurate, also means that almost half of viewers educate themselves about

14 I note that if the "Further Report" envisions mandatory unbundling only for current digital customers, its analysis does not address their concerns about the effects of bundling on MVPD customers that only receive analog service. Also, it is not clear if the proposed unbundling applies only to programming currently on the digital tier or if the "Further Report" has more ambitious designs—such as requiring that cable networks currently on expanded basic analog service would also be made available on the digital tier. The latter would require MVPDs to use system capacity to provide duplicate programming, block the analog expanded tier feed to digital homes, and require homes receiving digital signals to acquire set-top converters for all of their televisions, whereas they may currently only have one converter.

15 See Baumann and Mikkelsen Report pp. 2-3, Hazlett Report, p. 28.

16 Further Report, p. 26.

new networks by sampling, a learning method unavailable to consumers with à la carte pricing. With mandatory unbundling, consumers would also find it more difficult to tune in to sample a show recommended through conversations or programming reviews.

The "Further Report" also assumes, with no empirical support, that consumers will have better information about new programming than a highly motivated and experienced group of MVPD programming professionals. The "Further Report" states that MVPD distribution "indicates only the cable operator's guess about a network's likely popularity and the value it adds to the bundle, not its actual success with viewers. À la carte reflects the viewer's guess about the likelihood of watching a channel, at least as accurate a prediction of likely viewership."[17]

While acknowledging that marketing costs would be higher under mandatory unbundling, the "Further Report" naively assumes away effects of the increased costs involved in marketing to large numbers of consumers rather than the much smaller set of cable operators. The "Further Report" states that "networks would likely find new ways to market were some form of increased consumer choice allowed. While having to solicit subscribers directly could raise networks' marketing and advertising expenses, countless products in numerous markets manage to establish one-on-one relationships with consumers."[18] This statement completely ignores the evidence in the record of the very large marketing costs incurred by premium channels. In reality, cable networks will face additional marketing costs, once unbundled, because they must now sell their programming to consumers as well as to MVPDs. Each network must compete with dozens, if not hundreds, of other networks for the consumer's selection. The network as a whole would have to be marketed, not just specific programs.

One way to estimate the transactional and associated marketing costs that would be incurred were a cable network to be offered à la carte instead of as part of a tier is to consider the number of subscribers to the network and the churn rate. Churn is defined as the

17 Further Report, pp. 24-25.

18 Further Report, p. 27.

percentage of households that discontinue their subscription to the network each month. If a network wants to maintain its number of subscribers, much less grow, it must replace those subscribers it loses to churn. Churn rates can be substantial.[19] For instance, Showtime Networks determined that the average monthly churn rate in 2004 for Showtime, The Movie Channel, HBO, Cinemax and Starz is roughly 5.9 percent.

Consider a network with 25 million à la carte subscribers, or about 27 percent of MVPD households.[20] If the network's monthly churn rate is the same as that for those five premium networks, 5.9 percent, then the average annual "replacement" connects needed just to maintain the subscriber base are 17.7 million households. Using an estimate of $16.90 in costs per connect, the annual transactional and associated marketing costs incurred by the network would be about $300 million just to maintain its subscription level of 25 million—or roughly $1 per subscriber per month.

Adverse Effects in Wholesale Program Markets

Although the FCC has long studied regulatory issues in wholesale programming markets, these markets are hardly addressed in the "Further Report." The FCC analysis focuses on how consumers might be affected by unbundling. The impact on program suppliers or the exact response of program suppliers to changes in the retail pricing and marketing of their networks is not studied in detail.

A program supplier's optimal promotional and marketing strategy and its associated pricing decisions would likely differ if its network is sold à la carte rather than as part of a tier. If a programmer's network is offered à la carte to some customers and as part of a tier to other customers the programmer may need two different advertising messages and marketing campaigns. Indeed, the programmer may be in a difficult position because the programming would need to appeal to the à la carte consumer and to the tier consumer,

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[19] Bruce M. Owen and John M. Gale, "Cable Networks: Bundling, Unbundling, and the Costs of Intervention," July 15, 2004, pp. 39-40 (hereinafter, "Owen and Gale Report").

[20] As of June 2005, there were 94.2 million households in the U.S. that subscribed to an MVPD. (FCC *Twelfth Annual Report In the Matter of the Status of Competition in the Market for the Delivery of Video Programming*, March 3, 2006), p. 4.

and the optimal type of programming to reach theses two types of consumers may be different.

Selling national advertising time on the network may also be more difficult. The Baumann and Mikkelsen Report indicates that networks can experience disproportionate jumps in advertising revenue as their subscribership increases. That report notes that a cable network needs a subscriber base of roughly 50 million homes before national advertisers consider purchasing time on it.[21] Moreover, the Baumann and Mikkelsen Report demonstrates that even more substantial relative advertising revenue increases occur when networks gain roughly 70 to 80 million subscribers, which they attribute to the desire among advertisers for unduplicated reach.[22] These findings suggest that certain cable networks may suffer extremely large drops in advertising revenue if its program service is not marketed uniformly (i.e., on the same type of tier) by most MVPDs. Such a loss of revenue may, in turn, threaten some networks' survival.

There are other potential costs to program suppliers from mandatory unbundling. Programmers are likely to experience greater uncertainty in revenues in an à la carte pricing world. Currently, if a network obtains carriage on an MVPD it is assured a level of license fee revenue. In contrast, under an à la carte structure obtaining carriage does not guarantee any level of revenue. Moreover, a network's revenue would likely be more volatile under à la carte because it is likely that consumers would add and drop channels to which they subscribe. A significant increase in a programmer's uncertainty about revenues over the level of uncertainty that programmers now experience can affect programmers' production costs in several ways. First, uncertain revenues make the programmer's business more risky. Higher risk, in turn, normally translates into a higher cost to attract financing. Higher financing costs could deter some networks from entering or make existing marginal networks unsustainable.

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21 Baumann and Mikkelsen Report, pp. 9-10. Baumann and Mikkelsen attribute this to increased accuracy in measurements of audience size as subscribership increases, and to the fact that the 50 million threshold represents roughly 50% of U.S. television households.

22 Baumann and Mikkelsen Report, p. 8.

Similarly, greater uncertainty about revenues will reduce networks' ability to enter into long-term commitments. Shorter commitments to input suppliers, such as talent and production services, may tend to raise the average cost of acquiring those services to compensate for greater uncertainty and permit them to recover fixed costs over a shorter period. Shorter commitments to MVPDs may reduce the demand for the programmers' product and may reduce the amount of promotional activity that MVPDs are willing to undertake. If increased revenue uncertainty reduces programmers' ability to enter long-term commitments with input suppliers and distributors, this will also tend to make networks less profitable, possibly causing some networks to exit or not to enter.

That a move to mandatory unbundling would likely harm programmers is demonstrated by nearly unanimous opposition both by established programmers and less established networks. The Hazlett Report summarizes the positions of dozens of program suppliers.[23] As Hazlett writes:

> The overwhelming opposition of programmers is based on a crucial economic consideration: *each cable network needs to get its programs to where viewers can see them, and imposing à la carte will make that harder.* Providing customers with a large bundle of channels for a standard monthly fee has delivered exceedingly important efficiencies, and forcing customers to order one network at a time would eliminate those advantages. (Emphasis in original)[24]

Effects on Entry

With mandatory unbundling, new entrants would have a more difficult time in attracting viewers than at present. Currently, new entrants can rely on easy consumer sampling of their programming once an MVPD includes them in a tier of programming networks. With mandatory unbundling, subscribers would not be able to easily sample or "surf" their programs, but would instead have to commit in advance to a network subscription in

23 Hazlett Report, Table 10.

24 Hazlett Report, p. 30.

order to view an entrant's programming. Consumers must therefore overcome potentially high information costs to be convinced to subscribe. Doing so would require increased expenditure on up-front and continuous advertising and promotion by the entrant. These potentially large up-front expenditures, which are a sunk cost that would not be recouped if the entrant does not survive, may discourage entry.

Effects on Diversity

An important policy issue concerns whether the overall number of cable networks will increase or decrease as a result of unbundling. As with the issues addressed above, a more extensive and speculative modeling effort would be required to answer these questions precisely. It is clear, however, that the short-run or partial equilibrium effect of unbundling would be to reduce the number of networks.

Mandatory unbundling of video services will reduce the diversity of programming available to viewers, thus undermining a policy goal that has been so important both to the Commission and to Congress for the past half-century that it has been pursued in spite of possible costs to consumers. The number of networks would likely decrease because of both decreasing revenues and increasing costs for individual cable networks required to be unbundled, as detailed in the above discussion. As is well known, currently many cable networks are, for a variety of reasons, unprofitable or marginally profitable. At least some of these networks will be forced out of existence by unbundling.[25]

Mandatory unbundling would likely impose a particularly high burden on niche programmers, as networks appealing to relatively narrow segments of the population are likely to experience particularly large declines in subscribership. Michael Katz describes how dozens of niche networks, many catering to minority communities, have filed comments opposing mandatory à la carte. Many have commented that while they can thrive

[25] Further, it is possible that there would be a reduction in aggregate expenditure on programming by the surviving networks, which would presumably result in a reduction in average program quality.

as part of a broad, diverse tier, their very existence would be in question if they were forced to compete as an à la carte offering.[26]

Even leaving aside the likely reduction in the number of competing networks, mandatory unbundling is likely to reduce the diversity of programming to which consumers are exposed. With bundling, as I have discussed, consumers can sample or "surf" across the various video options available to them, deciding to settle on a particular network based on the attractiveness of a quick sample of the programming. This facilitates the opportunity for content suppliers to compete for viewer attention across disparate sources and genres. The Baumann and Mikkelsen Report identifies numerous instances in which specific events or especially topical programming has produced spikes in viewership for certain networks.[27] Mandatory unbundling will likely reduce the diversity of consumers' viewing habits by limiting their ability to view special events.[28]

Curiously, the "Further Report" expresses a belief that more programming may not be desirable, in contrast to the long-standing goal of the FCC in promoting diversity of ideas and views. It states that "the First Report ignores the impact of such a mechanism on the amount of programming that is produced; i.e., it assumes that because programming is produced it should be widely distributed, without considering whether *the appropriate amount* of programming is produced."[29] (Emphasis added.) The "Further Report" appears to describe the potential demise of niche networks as a positive result of à la carte pricing. "As discussed below, à la carte pricing could weed out those networks that consum-

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[26] Michael L. Katz, "Wrong Diagnosis, Wrong Cure: An Analysis of the Claims Made by Dr. Mark Cooper in 'Time to Give Consumers Real Cable Choices,'" August 8, 2004, pp. 25-27 (hereinafter, "Katz Report II").

[27] Baumann and Mikkelsen Report, pp. 4-6.

[28] A more recent example of consumers choosing to view a network after sampling occurred during the Winter Olympic Games. MSNBC carried the Olympic sport of curling and saw a huge increase in viewers, "MSNBC averaged 1.6 million viewers for its U.S.-U.K. curling match, which NBC Universal said was its highest viewership delivery since the Iraqi war coverage on April 6, 2003." *The Hollywood Reporter*, February 22, 2006. It is unlikely that this increase would have been forecast by NBC or consumers, "For example, curling on CNBC from 5 to 8 p.m., Eastern, Monday through Wednesday generated a rating that is 67 percent above what CNBC produced for various sports during the 6 p.m. to midnight period during the Salt Lake Games." *The New York Times*, February 17, 2006..

[29] Further Report, p. 16.

ers value at less than the networks' costs, thereby shifting some viewers to more valuable networks."[30]

The "Further Report" also claims that a popular network could have increased viewership with à la carte pricing due to the loss of variety to consumers. It states that "if a large percentage of consumers choose to purchase a channel, then the channel's subscriber base would be relatively unchanged, and *with fewer alternative channels to surf through,* we would expect consumers purchasing the channel to watch it with greater intensity."[31] (Emphasis added.) The "Further Report" does not appear to support the position that increased diversity is a benefit that may be worth some extra cost to some consumers.[32] Again, this appears to be at odds with the Commission's traditional support for programming diversity.

The Same Analysis Applies to Theme Tiers and Mixed Bundling

The "Further Report" also raises the possibility of mandating theme tiers. There are several problems with mandating theme tiers. First, to the extent that MVPDs compete with one another (there are now at least three major MVPDs, and sometimes more, available to nearly every consumer), a theme tier requirement would constrain the industry away from its competitive equilibrium. Policymakers generally accept the legitimacy of competitive market outcomes, if not because such outcomes optimize consumer welfare, then because there is no basis for improving matters with a regulatory intervention. In this case, forcing MVPDs to market their services in a way that differs from the strategy that best serves consumer demand seems likely to reduce economic welfare.

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30 Further Report, p. 25.

31 Further Report, p. 8.

32 Later, the Further Report provides an example where bundle pricing increases the incentives of a cable operator to carry niche programming, "As Example 4 shows, an MVPD may prefer to add niche programming that appeals to a small set of subscribers rather than add additional mainstream programming if existing mainstream programming is sufficient to attract the mainstream consumers." (Further Report, p. 32) Interestingly, the Further Report also reports the diametrically opposite result that MVPDs will have less incentive to carry niche programming when bundling: "As shown below, networks with small, dedicated audiences may not be appealing to MVPDs providing bundles, because they may not generate enough revenue to MVPDs to be profitable to carry." The Further Reports therefore claims that when bundling, an MVPD has less incentive to carry niche networks and less incentive to carry broadly popular networks. It appears unusual that both effects could be true simultaneously.

More generally, government-mandated tiers entail many of the same problems as à la carte pricing. Mandated tiers would reduce subscriber and advertising revenues because of reduced circulation for each network included on a tier that was not chosen by all current subscribers. Dividing the basic bundle into tiers would require consumers to pay for set-top boxes as with à la carte pricing of networks. Tiering would increase marketing, transactional, and customer support service costs. Transactional costs may even be higher than with à la carte pricing because a programmer would have to convince consumers to subscribe not just to its network, but to some tier of programming that will likely differ from one MVPD system to another. Indeed, a programmer's transactional expenditure will benefit not only itself, but whatever networks it is packaged with on the tier. Strategic interaction among networks in each tier might result in promotional expenditures greater or less than optimal levels.

Another proposal contained in the "Further Report" is "mixed bundling," whereby an MVPD must offer all the networks à la carte as well as in a bundle. Again, breaking networks out of a tier taken by all subscribers would reduce a network's subscriber and advertising revenues because of reduced circulation for the network, with attendant effects on entry and diversity. Offering any of the networks à la carte would also require consumers to pay for set-top boxes and would lead to increased marketing, transactional, and customer support service costs.[33] Thus, the effects of mandatory theme tiers or mixed bundling are likely to be directionally equivalent to other forms of mandatory unbundling.

While it is difficult to predict how *much* programming markets will be affected by mandatory unbundling, it seems clear that the likely effect would be to reduce the supply of programming, raise entry costs, and reduce programming diversity. These changes may in turn have wide-ranging effects. For instance, the reduction in programming production will certainly affect inputs into cable programming production. Perhaps less obvious are the potential effects on other related markets. How would advertisers be affected by a re-

[33] In a mixed bundling regime, consumers who subscribe to the bundle may not need a converter box.

duction in the quantity and diversity of cable network programming? What would be the impact of reduced windowing opportunities for certain programming? What effect would mandatory unbundling have on the export of U.S. produced video programming, as a result of the almost certain reduction in quality and supply of such programming?

These and many other important questions are unexplored in the "Further Report." A major regulatory intervention such as mandatory unbundling should be based not only on a strong showing that the economics of bundling supports such a change, but also on a showing that all affected markets are not unduly disrupted, and that other policy goals are not unduly threatened. The "Further Report" meets none of these requirements. It would be irresponsible to propose this radical change without carefully considering the potentially wide-ranging effects in all of the markets involved in cable program production. Regulatory interventions, once instituted, are difficult to reverse.

The "Further Report's" Unsound Analysis of the Welfare Economics of Bundling

The one relevant subject that the "Further Report" does attempt to address is the welfare economics of bundling video services. In deciding whether the "Further Report" provides a basis for a major policy intervention such as mandatory unbundling, an important issue is the MVPD practice of offering bundles or tiers of services to retail subscribers. Does this practice harm or benefit consumers? More specifically, what would be the effect on the economic welfare of cable networks and consumers of a regulation requiring MVPDs to offer all programming à la carte, either by network or by program, with or without continued bundling?

The first part of this question was addressed at a conceptual level above and in the many economic analyses submitted in the record before the FCC. Bundling is a universal feature of the economy, and greatly improves consumer welfare by enabling consumers to share the fixed costs of creating goods and services from component parts.[34] Based on current knowledge, there is no more reason to assume that bundling of cable networks

[34] Nevertheless, it is possible to construct hypothetical circumstances in which bundling is harmful. These circumstances are technical, not easily characterized, and differ from one market to another.

into tiers is harmful to consumers than it would be to assume that bundling individual programs into schedules (i.e., networks) is harmful, or that bundling tires with new cars is harmful.

The "Further Report's" Incomplete Analysis of Effects in Retail Markets

The "Further Report" attempts to address this issue, in large part, by revising some of the assumptions of a Booz Allen Hamilton study.[35] The "Further Report" focuses myopically on an alleged numerical error in a Booz Allen study, itself a small part of the record, without giving adequate consideration to the comments and analyses of numerous other parties. (This review does not directly analyze or rely upon the Booz Allen study, except to note that the work of many other commenters provides ample support for its core conclusions.)

At a more conceptual level, it is inappropriate for the "Further Report" to infer consumer benefits simply by comparing costs of a large bundle of networks with the potential costs of a smaller set of à la carte networks. As noted above, a large bundle of networks is likely to be inherently more valuable than a smaller set of networks sold on an à la carte basis because a household derives value from the option to engage in "channel surfing" and from those occasions when it chooses to sample programming that does not appear on its regularly viewed networks. Therefore, the simplistic cost comparison between bundled and à la carte offerings overstates any potential consumer benefits from the latter.

Even putting aside these flaws, the "Further Report" suffers from a more fundamental shortcoming. The "Further Report" concludes that some consumers *may* be better off under mandatory unbundling. In doing so, the "Further Report" arguably does nothing more than make the obvious point that in the economics literature there are results where bun-

[35] Booz Allen Hamilton, "The A la Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity, July 2004 (hereinafter "Booz Allen study").

dling can either benefit consumers or harm consumers.[36] In a recent paper Timothy Brennan summarized this point:

> "*The economics of bundling has a long and complex history*, characterized mainly by a set of results that focus on price discrimination. As with the price discrimination literature generally, bundling has been regarded as a practice with highly ambiguous consequences. Analyses of bundling by monopolists are either indeterminate or depend heavily on virtually unobservable variables such as correlations of inframarginal valuations across bundled products."[37] [footnotes omitted]

The "Further Report" provides no basis for a policymaker to determine the likelihood that any significant number of consumers might benefit from mandatory unbundling. The "Further Report" offers no new data or empirical observations of "correlations of inframarginal valuations" that would support a claim that mandating à la carte pricing would benefit consumers. Thus, the "Further Report" proposes a major regulatory intervention in the competitive marketing practices of a key industry simply on the basis of the observation that mandatory unbundling might benefit a subset of consumers that prefer to purchase few channels and who might therefore have a lower total video programming bill with à la carte pricing.

In making this argument, the "Further Report" does not acknowledge that even if some consumers were better off, other consumers would almost certainly be worse off. When consumers purchase a bundled tier of networks from an MVPD, they pay a single price for the bundle but no explicit price for the individual networks contained in the bundle. In contrast, an à la carte pricing system necessarily imposes a positive price on viewing additional networks.[38]

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36 "For example, results in the economics literature show that a change from bundled pricing to à la carte may either increase or decrease economic efficiency…" p. 15.

37 Timothy J. Brennan, "Competition as an Entry Barrier? Consumer and Total Welfare Benefits of Bundling," AEI-Brookings Joint Center for Regulatory Studies, Working Paper, June 2005, p. 1.

38 In addition to the explicit price for subscribing to an additional network, there would be implicit associated transaction costs.