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THE ECONOMICS OF ESPN360.COM

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ESPN360.com (ESPN360) is an Internet-based sports programming service that allows users to view popular television sports events over their broadband connections. The service is made available to subscribers of high-speed Internet Service Providers (ISPs) who pay ESPN a license fee. More than 110 U.S. ISPs, including both large carriers like AT&T, Comcast, and Verizon, and small ones like Allwest Broadband, Grande Communications, and the Wabash Mutual Telephone Company, make ESPN360 available to their subscribers.[1] Nearly 50 million households have access to ESPN360.

Recently, the American Cable Association (ACA) has alleged that ESPN360 somehow violates "net neutrality" principles because it does not charge consumers directly for access to its programming, but instead charges ISPs.[2] More broadly, some have expressed concerns that ESPN360's business model might raise costs to broadband providers, ultimately leading to higher broadband prices (and/or lower penetration), and thus harm consumers.[3]

From an economic perspective, these concerns are simply unwarranted. At the broadest level, there is no evidence of market failure in the intensely competitive market for broadband content, and hence no basis for concluding that the market is failing to maximize consumer welfare. More specifically, economic analysis makes clear that ESPN360 increases the value of broadband connections, thereby driving broadband adoption and allowing ISPs to spread the

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[1] See http://espn.go.com/broadband/espn360/affList.
[2] See http://americancable.org/node/1628.
[3] See http://www.independentcable.com/Issues/July-09.pdf at 4.

high fixed costs of their networks over a larger subscriber base. Thus, rather than imposing a charge that ISPs might choose to "pass through" to their customers, ESPN360 can reduce broadband prices *for all consumers*, thereby further increasing broadband penetration. In these respects, ESPN360 is no different from a variety of "free" services ISPs offer subscribers as a means of increasing subscribership, such as anti-virus and content filtering software provided by firms like MacAfee, and online games provided by firms like Oberon Media.

ISPs license ESPN360 because they believe it will attract additional subscribers.[4] It is not surprising that ISPs would reach this conclusion, as sports programming is consistently among the most popular programming with subscribers on any platform. For example, in 2008, market research firm Beta Group found that cable operators ranked ESPN as the most valuable network on their cable systems for the ninth consecutive year.[5] The same survey showed that ESPN also ranked first in helping cable operators sell interactive and broadband services.

Second, by increasing subscribership, ESPN360 and other value-added services benefit both ISPs and consumers by allowing ISPs to capture economies of scope and scale. Economies of scope occur because broadband ISPs typically provide – in addition to broadband – either telephone service, cable TV services, or both (the "triple play"), and there are significant cost savings associated with providing multiple services to the same subscriber. Economies of scale are a result of the fact that broadband networks have high fixed costs and relatively low variable costs, so that the average total cost of serving each subscriber declines with the number of subscribers.

[4] Unlike ESPN's traditional video products, which allow cable operators to earn significant revenues by inserting local advertisements into ESPN programs (known as "avails"), ESPN360 does not currently generate advertising revenue for ISPs.

[5] See www.multichannel.com/article/print/179824-ESPN_Disney_Discovery_Top_Programmers_In_Helping_Ops_Sell_Advanced_Services_Beta_Study.php.

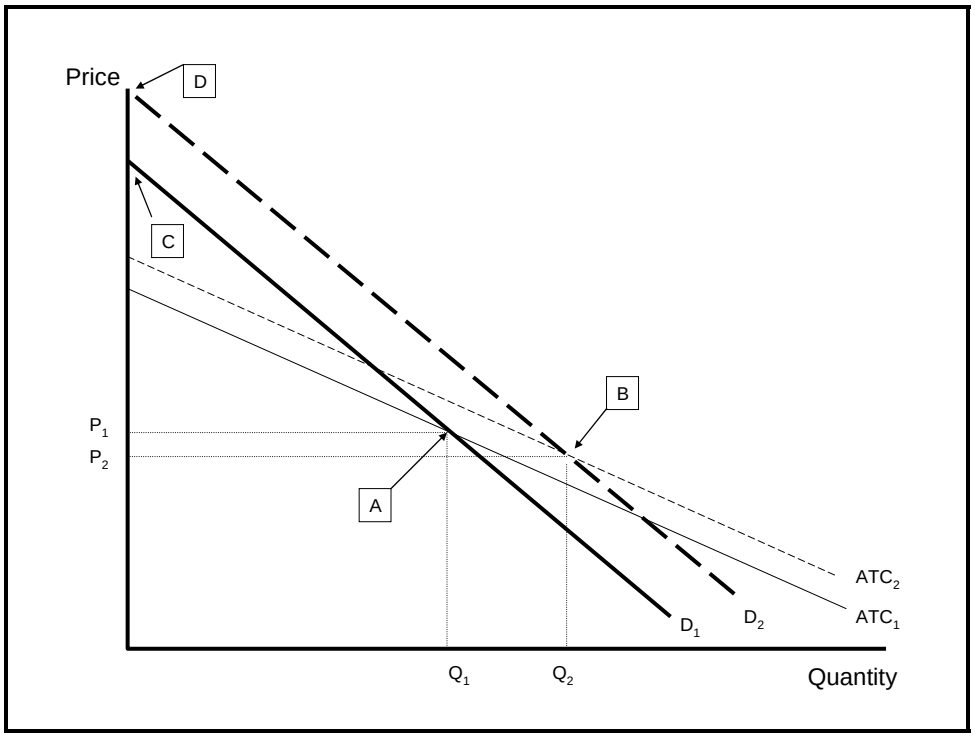
In these conditions, and under reasonable assumptions, a service like ESPN360 *reduces the average cost of providing broadband service*, and thus not only increases the value of the broadband providers' service, but also *reduces prices* for *all* consumers. This effect is illustrated in Figure One, below.

As the figure shows, the initial (pre-ESPN360) equilibrium occurs at point A, where the demand curve, D_1, intersects with the Average Total Cost curve, ATC_1.[6] At this point, the quantity of broadband services purchased (i.e., the number of broadband subscribers, since each household presumably purchases one connection) is Q_1 and the price is P_1. Now, assume that ISPs subscribe to ESPN360, for which they incur a fee, shifting their average total cost curves outward by the amount of the fee, as represented in the figure by the shift in the average total cost curve from ATC_1 to ATC_2. At the same time, however, ISPs incur this fee only to the extent it increases demand for broadband services, as represented by the outward shift in the demand curve, from D_1 to D_2.

As the figure shows, the net effect of these changes is to move the equilibrium from point A to point B, where ATC_2 intersects D_2. The important point about point B, of course, is that $P_2 < P_1$ and $Q_2 > Q_1$ – that is, *the price is lower and the quantity (i.e., the number of broadband subscriptions) is higher than in the pre-ESPN360 equilibrium.*

[6] The ATC curve is assumed to be identical to the supply curve. In equilibrium, firms cannot charge prices below average total cost, since they would incur economic losses and ultimately exit the industry, nor will they charge more than long-run ATC, as doing so would attract entry. See e.g., F.M. Scherer, *Industrial Market Structure and Economic Performance* 2d. ed. (Houghton Mifflin, 1980) at 15-16.

FIGURE ONE:
IMPACT OF ESPN360 ON BROADBAND PRICE AND ADOPTION



The figure also shows the sizeable gain in consumer welfare associated with the introduction of ESPN360. In the pre-ESPN360 equilibrium, consumer surplus is given by the area of the triangle P_1AC, whereas the addition of ESPN360 increases consumer surplus to P_2BD.[7]

It should be noted that these benefits would be less likely to be achieved if ESPN360 were forced to change its business model and sell subscriptions directly to consumers rather than through ISPs, for two reasons. First, by conditioning access to ESPN360's programming on actually having a broadband subscription, ESPN360 both avoids free riding (multiple users of individual accounts) and links the value of its programming directly to increased broadband

[7] It should be apparent from examining the figure that $P_2 < P_1$ is not a necessary condition for either $Q_2 > Q_1$ or for an increase in consumer surplus: That is, both broadband penetration and consumer welfare could increase *even if* broadband prices increased, since ESPN360 both adds value to existing subscribers and attracts new subscribers regardless of whether broadband prices go up or down.

adoption. Second, by offering ESPN360 content as a means by which ISPs can engage in efficient product differentiation, the current business model gives ISPs the ability to more successfully market their service, thus further increasing broadband adoption.[8] Finally, while there are sound efficiency rationales for calculating the charge for ESPN360 on a per-subscriber basis (i.e., it creates efficient incentives for promotion and marketing efforts), a per-subscriber fee structure is otherwise irrelevant to the points made above: Average Total Cost would increase by the same amount, regardless of how the fee is determined.

In sum, by increasing the value of broadband connections to consumers, and by giving ISPs the ability and the incentive to market that increased value proposition to their subscribers and potential subscribers, ESPN360 increases consumer welfare and raises overall broadband penetration.

[8] For an excellent treatment of the importance of product differentiation in declining cost industries such as broadband infrastructure, see Hal R. Varian, "Differential Pricing and Efficiency," *First Monday* 1;2 (August 1996) at 2.