UNITED STATES GOVERNMENT

# memorandum

DATE: December 29, 2005

TO: Donna C. Gregg

FROM: Donald K. Stockdale, Jr.

SUBJECT: Peer Review of December 21, 2005 Draft *Further Report on the Packaging and Sale of Video Programming Services to the Public*

In response to your request, I reviewed the December 21, 2005 draft of a staff report entitled "*Further Report on the Packaging and Sale of Video Programming Services to the Public (*"Further Report*")*. This *Further Report* was undertaken in response to questions raised regarding the appropriateness of certain assumptions and conclusions in a 2004 report, prepared by the Media Bureau of the Federal Communications Commission entitled *Report on the Packaging and Sale of Video Programming Services to the Public (*"First Report*")*.

The First Report examined the "'efficacy of providing a la carte and themed-tier services to cable and satellite subscribers.'"[1] The report concluded that a la carte regulation would increase operational expenses for MVPDs, increase marketing expenses and reduce advertising revenues for programmers, and likely result in higher costs for customers purchasing at least nine networks.[2]

The Further Report examines the assumptions, methodologies, and conclusions in the First Report. Among other things, the Further Report criticizes: (1) the First Report's analysis of the potential benefits and costs of pure bundling; (2) the First Report's reliance on a study by Booz Allen Hamilton ("BAH Study"), which concluded that under a la carte pricing customers purchasing at least 9 networks would likely face an increase in their monthly bills; and (3) certain other assumptions made by the First Report. The Further Report also explores three alternatives to the current "pure bundling" regime: (1) mixed bundling, (2) "themed tiers," and (3) subscriber-selected tiers.

As discussed below, I find that the economic analysis contained in the Further Report is sound and that its criticism of the First Report is well founded. The Further Report examines the economic analysis of bundling contained in the Economic Appendix of the First Report. It criticizes that analysis for failing to provide a "balanced view of the consequences implementing an a la carte option." Citing relevant economic literature, the Further Report correctly notes that, while price discrimination schemes (like bundling) will increase profits for the seller, they will not necessarily make consumers or society better off. Using simple numerical examples, the Further report further shows, *inter alia,* that: (1) pure a la carte can yield lower prices for consumers compared with bundling, while generating sufficient revenue to cover network costs; (2) pure bundles can preclude customers from purchasing programming that they would purchase under an a la carte regime; (3) bundling may cause minority or niche programming not to be produced; (4) bundling may cause less preferred networks to be carried instead of networks that are more strongly preferred by a smaller group of consumers; and (5) bundling may cause a network to be

[1] Federal Communications Commission, Media Bureau, *Report on the Packaging and Sale of Video Programming Services To the Public,* rel. Nov. 18, 2004 ("First Report").
[2] *Id.,* at 6.

carried even though its cost exceeds its value to consumers. These various examples all appear correct and serve to illustrate the fact that bundling does not always benefit consumers or increase economic efficiency. The Further Report criticizes other aspects of the First Report, including its analysis of the impact of a la carte on advertising revenues, license fees, and marketing costs. I found no economic errors or misstatements in any of these discussions.

The Further Report also examines the First Report's reliance on the BAH Study. Among other things, the Further Report correctly points out that the BAH Study failed to net out the cost of broadcast stations in estimating the number of networks consumers could purchase on an a la carte basis without increasing their monthly bill. Correcting for this error increases the break-even number of a la carte channels to between 10 and 14. The Further Report also reasonably questions the assumption in the BAH Study that under a la carte there would be a 23% decrease in viewing. Although the Further Report's discussion of the BAH Study might be made more accessible by including a more detailed explanation of the study's assumptions and methodology, the criticisms of the BAH Study appear well grounded.

The report concludes by considering three alternative approaches for providing increased consumer choice, which the Further Report claims that the First Report failed to analyze adequately. These alternatives, which would only apply to channels offered in digital format, are: (1) "mixed bundling," under which consumers could choose to purchase networks individually at set prices or to pay a single price for the bundle; (2) "themed tiers," under which MVPD would offer one or more tiers of digital programming with a particular theme, such as family oriented programming, sports or foreign language programming; and (3) "subscriber-selected tiers," under which a consumer could select a prescribed number of channels for a set price from among the MVPD's digital offerings. The Further Report correctly notes that these options raise questions as to the pricing of the options and that how prices are set will significantly affect whether consumers realize significant benefits from the additional choices they gain.

In sum, I found no mistakes or incorrect economic assertions in the Further Report. Rather, it appears to present sound economic criticism of the First Report, including pointing out the potential costs of bundling and benefits of a la carte through the use of simple numerical examples and pointing out errors in the BAH Study (upon which the First Report relied). The Further Report appears to present a reasonable counterbalance to certain mistakes, inaccuracies, and omissions contained in the First Report.

Respectfully submitted,

Donald K. Stockdale, Jr.