

## A La Smart?

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**Key Points**

- \*\*\* **NOT ENOUGH SUPPORT FOR 2004 A LA CARTE LEGISLATION.** Thursday's Senate hearings on cable rates and a la carte pricing did not suggest broad and deep enough support for legislation in 2004 mandating such marketing. However, with the possibility that in 2005 the 1996 Telecom Act will be opened for reconsideration, we believe the issue could be on that agenda.
- \*\*\* **THE INDECENCY NEXUS.** Sen. McCain joined the concepts of indecency and choice, maintaining that consumers should not have to pay for programs they consider offensive and want blocked by cable operators. Politically, this can resonate, but we believe will resonate most in this election year.
- \*\*\* **TYING TOGETHER.** By tying together indecency and choice, Sen. McCain makes it more likely the industry will have to address both issues in tandem, in our view. A successful resolution of the indecency issue could push the a la carte issue on to the back burner, to be possibly resurrected when cable gets closer to full digitization.
- \*\*\* **A CAN OF WORMS.** Unbundling the expanded basic cable package takes wholesale and retail economics into uncharted 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.
- \*\*\* **HEADLINE RISK.** We believe the fundamental risk in this issue for 2004 is moderate. However, we expect some headline risk, especially if the FCC looks at running an a la carte test before year-end.

**Bear Stearns acts as a financial advisor to Walt Disney Co.**

**BACKGROUND.** Thursday's Senate hearings regarding a la carte programming gave air to Senator John McCain's (R-AZ) opinions favoring the basic cable package. The motivation for the hearings was both rising cable rates and the current indecency legislation pending before Congress, in our view.

The hearing seemed to engender a relatively high amount of interest from senators than normally seen at these types of events, with nine actively participating in some of the questioning (even more senators participated in opening statements, but we believe political motivation in an election year accounted for a fair amount of their interest). In general, the tone was open to the idea of a la carte marketing, or, as the proponents put it, consumer choice. Some senators, especially Sen. McCain, joined the concept of indecency with "choice," maintaining that consumers finding certain material offensive should not only have it blocked (already agreed to by the cable industry), but also not be required to pay for it.

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However, we did not perceive broad and strong enough support across the senatorial spectrum for any 2004 legislation mandating a la carte, and we believe none will be forthcoming this year.

**RECAPPING THE GAO REPORT.** The original impetus for the hearings was to be the release of the October 2003 report on cable rates and a la carte pricing from the General Accounting Office (GAO). At the request of Sen. McCain in late 2002, GAO undertook a study on rates, the reasons for their increases exceeding inflation (Sen. Allen in the hearing took issue with using CPI as a benchmark), and the effect a la carte pricing would have upon the marketplace. The report was more benign than we, and we think Sen. McCain, expected, offering no firm policy recommendations, finding cost pressures responsible for much of the rate hikes, and equivocating on whether a la carte would actually benefit consumers, in our view (see our October 27, 2003 First call note, "Cable Dodges a Bullet," for a detailed analysis of the report).

GAO's recommendations were very procedural in nature, as they avoided specific policy recommendations:

- FCC take immediate steps in improving their annual cable rate survey;
- The chairman review the process for maintaining the status of effective competition. The FCC questioned the cost/benefit of doing the latter, but the GAO seemed to stress the importance of this to the decision-making abilities of both Congress and the Executive branch.

The report appeared to be as significant for what it didn't say as for what it did; it didn't recommend rate re-regulation or a la carte pricing. While a la carte would increase choice for some customers, the report said, it 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.

**HOW WAS THE GAO REPORT PRESENTED BY THE GAO WITNESSES?** While the October report was relatively benign regarding the implementation of a la carte, GAO testimony did not have the same tone. The GAO witnesses did equivocate regarding their recommendations and we believe they may have been swayed somewhat by the tough tone of some of the senatorial questioning. Indeed, GAO witnesses, when asked why they recommended against a la carte without conducting a trial first somewhere, said they never recommended against a la carte.

To control rates, the GAO opted for encouragement of competition rather than re-regulation (and Sen. McCain seemed to agree with this finding when he basically called the early-1990s FCC rate rollbacks a failed experiment). The agency warned that any actions taken to lower rates, even if not regulatory, could unleash the "law of unintended consequences".

- **GAO On Competition.** The agency report did not say cable faces effective competition in most cases, finding that in those relatively few franchises where there is wireline competition, rates are an average 15% lower. Indeed, at the hearing they stressed that wireline competition is necessary for there to be effective price competition. One can conclude from this that cable provides a pricing umbrella for DBS, and, without saying as much, we think many of the senators would accept that interpretation.
- **GAO On Rates.** The GAO found that rates were pushed up by program costs and infrastructure investment, with program costs increasing well ahead of inflation (sports leading the way), but recognized that advertising ameliorated some of the former's increase. We believe the GAO's numbers suggested cable companies' incremental video ROIC declined from 1999 to 2002, even with increased rates, with the caveat that they do not include revenue from advanced services that also benefited from infrastructure investment. Our own analysis suggests heavy infrastructure investment depressed ROI below the cost of capital, and while we believe marginal returns are now healthy, average returns are still below costs-of-capital. None of this was brought up at the hearings, although Sen. Allen did make

the connection between the cost to provide a product and the rates charged for that product; he was the only senator to do so.

- **GAO On Rate Regulation.** In its report, GAO did not support rate re-regulation, finding, “Although re-regulation of cable rates stands as a possible option, taking steps to promote competition would help reduce cable rates by leveraging the normal workings of the marketplace. Specific options include reviewing whether modifications to the program access rules would be beneficial, promoting wireless competition, and reviewing whether changes to the retransmission consent process should be considered. Any options designed to help bring down cable rates [*note the wording “bring down” as opposed to “reduce the rate of increase”*] could have other unintended effects that would need to be considered in conjunction with the benefits of the lower rates. We are not making any specific recommendations regarding the adoption of any of these options.” Nothing said at the hearing contradicted these report findings, although Sen. Lott did warn the industry to exercise restraint or run the risk of the government getting involved in some way.
- **GAO On A La Carte & Tiering.** The GAO report did not recommend a la carte, even though they admitted it would increase consumer choice. The report said that, “...an a la carte system can impose additional costs on subscribers in the near term because additional equipment will be required (i.e., set-tops)...Moreover, an a la carte system could alter the current economics of the cable network industry...a fall-off in subscribers can also see an associated decline in advertising revenue....” The report suggested that if a la carte were to happen, cable networks may either cut back on programming investment and/or raise their affiliation fees, at least some of which could be passed on to subscribers. In addition, they said, it could reduce the diversity of cable networks. “A variety of factors-such as the pricing of a la carte service, consumer purchasing patterns, and whether certain niche networks would cease to exist with a la carte service-make it difficult to ascertain how many consumers would be better off and how many would be made worse off under an a la carte approach.” GAO did concede that the creation, “...of a separate tier for sports channels may be viable because this genre of programming has a loyal base of customers”. GAO recognized that the sports leagues would probably oppose this since it would cut their distribution. While none of this was contradicted at the hearing, senatorial questioning focused GAO witnesses on the choice aspect almost totally to the exclusion of the above effects to either the consumer or the industry.

**THE LAW OF UNINTENDED CONSEQUENCES (Part 1).** Consumer Federation of America (CFA) head Gene Kimmelman argued that the government should encourage the industry to trial a la carte to gauge consumer and technical dynamics. There seemed to be some receptivity for this position among some of the senators, and therefore we wouldn't be surprised to see the FCC work in this direction.

The economics of choice will no doubt be interesting, especially if the average household opts for the 10-15 channels they watch and avoid the others to save money. 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.

As a starting point, we assume the average cost to the consumer of basic cable (the free over-the-air broadcast signals) is around \$10, and the average cost of expanded basic cable is around \$40 (including the “mandated broadcast buy-through” we just described, which implies the incremental cost for the cable network signals is around \$30). In Exhibit 1 we summarize the retail cost to the consumer for a package of five popular basic cable networks (The Disney Channel, ESPN, MTV, Fox News, and TBS). Our underlying assumption is that both the network and the cable operator want to preserve their current profitability, and so their pricing reflects lower distribution resulting from unbundling the expanded basic tier, in our view.

## Exhibit 1. Summary Ala Carte Pricing Sensitivity Analysis

	75%	50%	25%
Disney Channel	\$1.97	\$2.95	\$5.90
ESPN	\$5.12	\$7.79	\$15.82
MTV	\$0.64	\$1.06	\$2.32
Fox News	\$0.70	\$1.06	\$2.17
TBS	\$0.69	\$1.12	\$2.42
Mandated Broadcast Buy-Through	\$10.00	\$10.00	\$10.00
<b>Total Bill To The Consumer</b>	<b>\$19.11</b>	<b>\$23.99</b>	<b>\$38.61</b>

Source: Bear, Stearns & Co. Inc. estimates

- **Affiliate Fees.** Loss of distribution is made up through higher affiliate fee payments, with a linear relationship between lost subscribers and higher affiliate fees.
- **Advertising.** Every regional sports network (RSN) has changed from the pay to the basic model since there is more advertising revenue with broader distribution, with greater distribution more than offsetting the loss of the premium channel pricing. Even though as a pay service an RSN may have had more loyal and rabid fans, and therefore more desirable to advertisers, the lower distribution cut down on the casual and inadvertent viewers that provided audience for the advertiser. However, we did not ignore the loyalty of the core fan, and so have reduced advertising revenue for the lower distribution at a rate 33% of the incremental drop in distribution (e.g., if distribution drops to 75% of the original base, advertising drops 8.33%, calculated as follows:  $(1-75\%) = 25\% \times 33\% = 8.33\%$ ). A more linear relationship (as with affiliate fees) would require an even greater increase in affiliate fees to offset the lost advertising.

When the mandated broadcast basic buy-through tier is included, the packages range from a monthly \$19.11 at a 75% take-rate for the services, to a monthly \$38.61 at a 25% take-rate. All these figures exclude any further charges from taxes and franchise fees, the latter adding another potential 5% to the customer's bill (ranging between \$0.96 and \$1.93). Also missing is the equipment charge for the box which we believe could be another \$2.18 monthly assuming a low-end digital set-top is deployed (and also assuming a box and not a trap is used).

What the economics ultimately are will depend on take rates (i.e., distribution), something we are not too optimistic about. While there is little data allowing us to project take-rates for basic cable services marketed a la carte, there are some hints as to what penetrations could be:

- HBO has approximately 30% penetration of basic cable subscriptions;
- When regional sports networks were pay services, we believe their penetration was almost always less than 10%. However, in those days there may have been more free games on the over-the-air broadcast outlet, which kept these penetrations low.

In any case, we believe a la carte take-rates would be considerably lower than the current 100% distribution for most basic networks. And the lower the penetration, the lower the advertising revenue and the higher the affiliate fee necessary to recoup the lost distribution revenue

All-in (networks + equipment + franchise fees), the 25% take-rate scenario is probably more expensive than today's basic + expanded basic package, with only five cable networks and the off-air tier included. 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. There will also be charges for truck rolls (traps) or capital costs (set-top boxes), increased marketing and customer service (dealing with customer requests), billing and systems integration costs, and regulatory costs (note that even the GAO report remarked that increases in the cost for these elements is a possibility). All these could impact rates even more, either eating into cable profit margins or raising rates further to consumers.

**Exhibit 2: What Would Consumers Have To Pay In Order For Basic Networks & Cable Operators To Maintain Their Current Profitability** (\$ and subscribers in millions, except per subscriber data)

	Take-Rate				Take-Rate				Take-Rate				Take-Rate				Take-Rate			
	Current	75%	50%	25%	Current	75%	50%	25%	Current	75%	50%	25%	Current	75%	50%	25%	Current	75%	50%	25%
Subscribers	81.6	61.2	40.8	20.4	88.7	66.5	44.4	22.2	86.8	65.1	43.4	21.7	82.2	61.7	41.1	20.6	88.6	66.5	44.3	22.2
Subscription Revenue	722	722	722	722	2,012	2,012	2,012	2,012	225	225	225	225	254	254	254	254	252	252	252	252
Advertising Revenue	0	0	0	0	737	676	614	553	609	559	508	457	106	97	88	79	553	507	461	415
Other Revenue	11	11	11	11	130	130	130	130	76	76	76	76	5	5	5	5	79	79	79	79
Incremental Subscription Fee from Loss of Advertising <sup>(1)</sup>	0	0	0	0	0	61	123	184	0	51	102	152	0	9	18	26	0	46	92	138
Total Revenue	733	733	733	733	2,879	2,879	2,879	2,879	910	910	910	910	364	364	364	364	884	884	884	884
Monthly Wholesale Subscription Fee per Subscriber	\$0.74	\$0.98	\$1.48	\$2.95	\$1.89	\$2.52	\$3.78	\$7.56	\$0.22	\$0.29	\$0.43	\$0.86	\$0.26	\$0.34	\$0.51	\$1.03	\$0.24	\$0.32	\$0.47	\$0.95
Monthly Incremental Subscription Fee from Loss of Advertising	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.08	\$0.23	\$0.69	\$0.00	\$0.07	\$0.20	\$0.59	\$0.00	\$0.01	\$0.04	\$0.11	\$0.00	\$0.06	\$0.17	\$0.52
Estimated Cost to Consumer <sup>(2)</sup>																				
Percent Change from Current		315%	523%	1145%		36%	106%	318%		48%	145%	435%		36%	107%	321%		46%	137%	410%

<sup>(1)</sup> We assume 33% of the subscriber reductions impact advertising revenue (i.e., a 50% take-rate would translate into a 16.7% reduction in advertising revenue).

<sup>(2)</sup> We assume a 50% gross margin on the wholesale subscription fee for the cable operator (i.e., a 100% mark-up to the wholesale cost).

Source: Bear, Stearns & Co. Inc. estimates

From the programmers' perspective, if they cannot offset their distribution losses (and resulting advertising losses) through higher affiliate fees, they will either watch their profit margins erode or reduce programming investments to preserve as much profit as possible. Further, as mentioned below, we believe programmers would have to step up their marketing activity to appeal to the consumer directly in an a la carte world. This incremental expense could also eat into their programming investment. We believe many of the smaller, nascent networks would find it difficult to survive in an a la carte environment, reducing consumer choice.

**THE LAW OF UNINTENDED CONSEQUENCES (Part 2).** In addition to the economics presented above, we believe the fall-out from any mandated a la carte marketing cannot yet be understood. For instance:

- Mandated Broadcast Buy-Through.** Federal law currently mandates that all cable customers must purchase the price-regulated broadcast basic tier. Being contrary to the spirit of unbundling, we would expect cable lobbyists to push for this mandate to be repealed should a la carte also be mandated, with the case for retaining this tier weakened at best in an a la carte world. Broadcast interests would probably feel differently, in our view, especially in light of the retransmission bullet discussed immediately following. In addition, the broadcast lobbying for retention of this buy-through provision would probably be led by the very same companies facing mandated a la carte marketing for their cable networks (e.g., Fox, Disney, Viacom, and NBC). At the very least, we expect heavy lobbying on this issue.
- Retransmission Consent Scrutinized.** Some witnesses took issue with the broadcast network-owned companies using retransmission consent negotiations to gain carriage for start-up cable networks. Some senators agreed that this forces some cable operators to take unwanted channels and include them in their expanded basic tier, regardless of consumer demand. This behavior is well within the law, but the senators seemed receptive to the arguments that this reduces consumer choice. We think that this, coupled with what we believe is growing broadcasters' desire to get paid in cash for their signal, will move broadcasters towards pay-for-play, perhaps permanently changing the nature of free over-the-air broadcasting. This, in turn, could open up other important issues such as digital multi-casting, inventory sharing between broadcasters and cable operators, and the on-channel placement of the signal, especially for the UHF stations.

- **Demand-Pull Marketing.** Currently much of the cable networks' marketing efforts are directed at the cable operator, with consumer-directed marketing aimed at improving ratings for specific programs. However, in an a la carte world, marketing focus will need to change to the consumer with the dynamic being demand-pull; the network as a whole will have to be marketed and not just specific programs. We believe this changes the nature of networks' marketing, with implications for organizations as well as P&Ls.
- **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. Should this transpire, it could lead to a reduction in the number of networks.
- **Indecency: Be Careful What You Wish For...** A la carte means that what were once basic networks may look more like premium networks, eventually impacting programming content. 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 greater distribution. 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).
- **Franchise Fees & Local Access Requirements.** Change the revenue base of cable services and you potentially change the franchise fees due to the local franchise authority. In addition, if channels cannot be subsidized by others in a bundle, what would be the status of the mandated carriage of local access channels?
- **Not Everyone Wants A Set-Top Box, So Maybe Satellite Is The Test Bed.** To do unbundling, everyone in a cable system needs to be trapped (a costly and cumbersome operational problem, especially if the customer changes his mind on a regular basis) or have an addressable set-top. However, not every cable subscriber wants another box in his/her home. This, then, presents a very practical reason to proceed slowly, in the face of potential consumer resistance to another set-top. However, there are two potential test beds that are 100% addressable box-compatible and can technically test unbundling and a la carte right now; the satellite TV providers.
- **All-Digital Network.** Should consumers be persuaded to take another set-top, operators would probably be best served using low-cost digital converters. This would accelerate the deployment of the fully digitized cable network, with major competitive and revenue benefits we have written about extensively for the past two years.
- **Would CSPN Die?** No. We believe the cable industry will continue to subsidize the channel and include it in the broadcast basic tier, if for no other reason, than to make a political statement.

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Raymond Lee Katz

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