

THE “SWITCHING EQUATION” AND ITS
IMPACT ON THE VIDEO PROGRAMMING
MARKET AND MVPD PRICING

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One of the most frequently debated questions in media policy is whether direct broadcast satellite (DBS), terrestrial cable overbuilders, or potential new entrants such as the incumbent telephone companies, provide competition to traditional incumbent cable operators, such as Comcast. Specifically, competitors to cable say that if Congress does not provide access to regional sports programming and other programming not covered under the existing “program access rules,”² then cable will continue to raise rates and control the programming market. Independent programmers say they have no chance to get distribution unless they satisfy the demands of the two largest cable companies, Comcast and Time Warner. Cable companies, however, argue that if they raise prices too high or favor inferior affiliated programming over better independent programming, customers will switch to competitors.

Until now, the economic debate between parties has focused primarily on the incentives of the programmers, competitors, and cable incumbents. This white paper suggests that a focus on competition should focus on the *consumer*. In particular, if Congress intends to adopt policy on the basis of predicted competition between incumbent cable operators and potential competitors, Congress must first determine whether or not consumers are likely to switch to competitors. If consumers are unlikely to switch, particularly if the incumbents can use existing market power to prevent successful entry by competitors, then a policy based on deregulation will fail. Cable incumbents will not feel pressure to change either pricing or programming practices if they can reliably predict that few consumers will switch to competitors.

The shift in focus to the consumer shows why large incumbent cable companies continue to exercise market power over consumers, programmers, and other related market actors. Briefly, the average cable subscriber finds it too much of a hassle to switch to a competitor. As long as the cable incumbents can reduce the value of competing offerings by controlling access to “high value” programming like regional sports and drive up costs to competitors by controlling the price of new services like video on demand, cable operators can keep the bulk of subscribers from switching. Since the market power

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²These rules, put in place by Congress in 1992 when cable was clearly a monopoly, prohibit certain anticompetitive practices. Unfortunately, Congress phrased the law in terms of the practices and distribution technology of 1992. In 1992, cable television operators distributed programming via satellite to cable head-ends. As a result, the 1992 Act made programming distributed in such a fashion subject to the program access rules. When technology permitted cable operators to distribute programming, particularly regional programming, terrestrially, the FCC found that the program access rules did not reach terrestrially distributed programming (the “Terrestrial Loophole”). It is also unclear whether new programming, like video on demand, is covered under the existing rules. Finally, unless the FCC takes action before February 2007, even the existing program access rules will end.

to engage in these tactics derives from a combination of incumbent cable operators' existing market share, and is re-enforced by increased regional and national concentration, incumbent cable operators can stymie effective competition indefinitely.

Without Congressional action to promote competition and reduce the ability of incumbents to exercise market power, cable operators will continue to raise prices above competitive levels and make programming decisions based on affiliation rather than quality.

Defining Market Power³

Parties in the “cable wars” frequently use terms that have precise meaning to economists, but very imprecise meaning to non-specialists. Before moving on to the basics, it is therefore useful to define some terms for purpose of this paper. *Market power* means control over so many customers or other valuable resources that the company that has “market power” can tell other people “take my terms or else” and everyone listens. In a monopoly (*i.e.*, where one company controls everything), this is obvious. But it can happen in other markets as well. For example, if one company controls most of the customers, called *market share*, that company can have market power because everyone wants access to its huge customer base. While market share doesn't always give market power, it helps – particularly where customers have a hard time switching to a competitor.

In 1992, when Congress made a first pass at creating competition in what the FCC calls the multi-channel video programming distribution (“MVPD”) market, Congress concluded that cable's monopoly power at the local level gave it power over customers, and that the power to prevent video programmers from reaching customers (“foreclosure”) gave cable operators power over programmers. This, in turn, allowed cable operators to prevent the emergence of effective competitors. Today, however, most people⁴ appear to have a choice between several MVPD providers. If that's true, then how does cable retain market power?

The answer lies in the way consumers behave. For many consumers “I'd rather pay than switch” is, in fact, a rational decision even in the face of high prices and better programming on rivals. This consumer behavior lets cable keep customers and gives incumbent cable operators market power over programmers.

³For a theoretical discussion of regional and national subscriber base as the continuing source of cable market power over “upstream” markets, such as regional and national programming, see David Waterman, “Local Monopsony and Free Riders,” *Information Economics and Policy*, Vol. 8 (1996).

⁴Contrary to the claims of cable operators, not everyone has a choice of competing MVPD provider. Many people lack an unobstructed view of the portion of the southern sky occupied by DBS satellites. In addition, exclusive contracts with landlords prevent many apartment and condo dwellers from using a terrestrial overbuilder. See GAO, “Direct Broadcast Satellite Subscribership Has Grown Rapidly But Varies Across Markets” (2005) (“GAO 2005”).

Some Basic Cable Competition Math⁵

Why does anyone buy a good or a service? Because they think that what they get, what I will call “value” (or “V”) is worth the cost (or “C”) of the service. We can write this as a mathematical equation, which makes it easier to understand visually.

Generally, a consumer will buy a service where the consumer believes the Value of the good or service is greater than or equal to the known Cost of the good or service, or

$$V_s \geq C_s$$

Where V_s is the (perceived) value of the service and C_s is the (perceived) cost of the service.⁶

So I buy cable when I think it is worth it for me to have it. Since cable is a subscription service, I theoretically make this calculation every month I don't cancel the service. So why don't I drop the service when the cable company raises the price? In part, it is because I may discover the service is more valuable when I use it, so I will pay more for it. But it is also because tracking the price increases and turning off the service may have costs of their own, whether in the form of money costs like a termination fee or the cost of hassle.

This equation changes significantly when a competing service, like a Direct Broadcast Satellite (DBS) company or overbuilder, is trying to pull a customer away from cable. This introduces something called “switching costs.” A “switching cost” is any cost associated with switching from one product to another that is over and above the actual price of the new product. This includes not merely money (for example, a termination fee if I end the contract early) but also the general hassle associated with calling in a new provider, terminating the old system, learning the new system, etc.

Let us assume that V_i is the value of the incumbent service (the one the consumer already uses). C_i is the cost of maintaining that system. V_n is the value of a comparable service. C_n is the cost of the new, comparable service. SW is the switching cost of moving from the old service to the new service.

The Switching Equation:

$$V_i - C_i < V_n - SW - C_n$$

⁵For a more detailed theoretical discussion of the impact of switching costs and network effects on customers and their ability to switch to competing providers, *see generally* Joseph Farrell & Paul Klemperer, “Coordination and Lock In: Competition With Switching Costs and Network Effects,” (December 2004). Available at <http://elsa.berkeley.edu/%7Efarrell/index.shtml>.

⁶Later, I will discuss how lack of consumer information or lack of an ability to judge real price enters the consumer decision. But this also explains why many services offer a “free trial” period or rebates. They count on consumers to factor the rebate or free trial into the cost. Subsequently, many consumers find it too much effort to send in the rebate slip or track when the free trial ends.

In plain English, it is not enough for the new service to be “as good as” the old one or even just a bit better. Either the new service must be much better, or the cost must be lower, by more than the difference of the switching cost.⁷

This applies universally but doesn’t impact most daily buying decisions because the things we buy on a regular basis, like groceries, have little or no switching cost. For example, when I decide to buy a new box of cereal, there is no switching cost if both brands are in my local supermarket because I am out of cereal and need to buy more anyway. My decision about which brand to buy will be determined by cost and whatever value I perceive in the brand I chose (do I want to try something new? Do I perceive one brand as better for me?).

But cable is a subscription service. Unless I move to a new house, switching from cable to a competitive rival has significant non-monetary switching costs. I need to deal with the cable company to turn off the cable, deal with the DBS provider, waste a day (at least) waiting for the install, and overcome my fear of learning a new system when I don’t know for sure I’ll like it better.⁸ Statistics from the last few years of cable/DBS competition suggest that consumers are much more sensitive to switching costs and network value than they are to price.⁹

This is the key to market power and competition in video. As a matter of public policy, we want competition to keep down prices, protect consumers from abusive service, and make sure that we have enough diverse news and viewpoints in the media to maintain a healthy democracy. But if competition is an illusion, because we can prove that not enough consumers will switch to make a difference for these things, then policy has to address the issue by making it easier for competitors to get customers.

When Congress passed the 1992 Act, only 60% of the country subscribed to cable and the largest cable systems controlled at most a quarter of that number. Cable systems were scattered around the country, minimizing the ability of any single cable system to block a programmer from an entire geographic region. Today, 90% of the country subscribes to cable or some other kind of MVPD (mostly DBS). The remaining ten percent has been stable for some time, and is unlikely to sign up with an MVPD in mass numbers anytime soon.

⁷In theory, a tie will go to the current incumbent because an “indifferent” consumer will simply stay with the existing system. But the average person does not weigh his or her choices in the neat mathematical fashion these equations suggest.

⁸Some of these apply even if I am moving to a new house.

⁹See, e.g., Andrew S. Wise and Kiran Duwadi, “Competition Between Cable Television and Direct Broadcast Satellite – It’s More Complicated Than You Think,” FCC Media Bureau Staff Research Paper (2005) (“Wise & Duwadi 2005”); GAO 2005.

The issue of “hassle” as a switching cost for consumers, and the need to impose a regulatory solution to encourage effective competition, is well established in telecommunications markets. For example, to make competition a reality in the competing telephone market and cell phone market, Congress and the FCC created rules to let consumers move phone numbers from one service to another. Why? Because switching phone numbers was such a hassle to consumers that if they had to change numbers to switch, not enough of them would do so to bring about the benefits of competition. See *USTA v. FCC*, 400 F.3d 29 (D.C. Cir. 2005). See also Stephen M. Kessing, “Wireless Number Portability: New Rules Will Have Strong Effect,” 2004 Duke L. & Tech Review (June 2004).

According to the most recent FCC Report on MVPD competition, incumbent cable operators have approximately 70% of the total MVPD market (with the five largest providers controlling the bulk of cable subscribers). That means that any competitor must pull new customers away from cable. That would be hard enough, given the problem of overcoming switching cost and consumer uncertainty. But it gets worse for two reasons. First, the national number masks the much higher levels of regional concentration. Not all customers are equal, and clusters of customers in the wealthiest urban areas subscribe to incumbent cable operators,¹⁰ making the level of regional concentration in areas dominated by large cable companies much more concentrated than the 70% national figure. Because a few large cable companies dominate these regions, these cable companies still have market power. Using the market power of their existing subscribers, they can take steps to make it much harder for these customers to switch to competitors and can therefore raise prices, deny programming to rivals, and favor affiliated programming over unaffiliated programming.

Implications for Pricing

Recall the Switching Equation: $V_i - C_i < V_n - SW - C_n$.

We can now explain why cable can keep raising the subscription price even in the presence of a competitor. The “SW” provides a cushion. The cable operator can raise C_n to just about $C_i + SW$, unless a competitor offers a high enough V_n . At the same time, the cable companies can use their market power to increase the cost to the competitor or lower the value of their competing network in ways described below. So the competitor either can’t raise V_n enough to justify the added expense of the switching cost, or drop C_n enough to compensate for switching cost, to attract a lot of new customers.¹¹

Positive and Anticompetitive Responses By Cable To Competition

Cable operators generally have not responded to DBS competition with price cuts (in fact, they have raised prices faster than inflation for the last five years).¹² Instead, incumbent cable operators have

¹⁰GAO 2005 (observing lowest penetration of DBS in urban areas).

¹¹The empirical data in GAO 2005 is generally confirmatory. GAO 2005 reported that an increase in incumbent cable capacity (offering more channels) or offering additional services such as VoD or broadband (all of which increase V_i) reduce DBS penetration. Similarly, denial of local programming to DBS (reducing V_n) significantly impacts competitor penetration. *See also* Wise & Duwadi (2005) (finding that DBS demand is suppressed when DBS denied regional sports programming).

When considering the implications for policy, it is important to remember these are aggregate trends. The specific values, and therefore specific responses, change for each consumer. DBS can attract some customers by offering steep discounts and free equipment (cutting C_n), free installation (cutting SW), or free TiVo (increasing V_n). But, because of the way cable can exercise market power, it can keep DBS costs sufficiently high and network value sufficiently low to avoid losing a critical mass of customers.

¹²They have responded to terrestrial competitors with price cuts, suggesting that consumer uncertainty diminishes when the service “looks the same,” making comparisons easier and consumers more likely to switch. At the same time, they have also been more vigorous in using regional market power to disadvantage terrestrial overbuilders. *See* GAO, “Wire-based Competition Benefitted Consumers in Selected Markets” (2004). The differences in the nature of competition from different competitors goes beyond the scope of this paper. Given the state of competition in the video market

worked to increase the value of their networks (the good response to competition) and have leveraged market power to suppress the value of rival MVPDs or drive up costs to rivals (the anti-competitive or “bad” response). For example, cable operators have increased the value of their package by expanding capacity and introducing additional services, such as video on demand (VoD) and broadband. At the same time, DBS providers like DIRECTV respond by offering free TiVo service (increasing their own V_n), offering free equipment (decreasing C_n) and offering free installation (decreasing SW). Terrestrial overbuilders respond by offering a combination of video, voice and broadband for a “triple play” service, increasing their V_n , and offering savings on the bundle of services, decreasing their C_n . These are the positive effects competition policy should encourage.

At the same time, however, cable operators leverage their market power to reduce the value of new competitors, artificially suppressing V_n . Withholding regional sports network programming is one example of decreasing V_n . Another method is to raise costs to the competitor, artificially inflating C_n . For example, DBS providers have alleged that cable owners of the iN Demand VoD service charge DBS four times as much for programming as they charge other incumbent cable systems.¹³ DBS can either not offer the service (reducing V_n), offer the service and eat the additional cost (since they must keep C_n low to compensate for switching costs), or pass on the cost to customers and attract fewer customers.

Lack of Information and Uncertainty

In addition to switching costs, lack of information and uncertainty will prevent a number of consumers from switching. A new user has no idea whether he or she will actually like a competitor better, or how much hassle is involved in switching. This uncertainty and lack of information will cause the consumer to devalue the competing network and exaggerate the switching costs.¹⁴ The more “risk averse” the consumer, the more impact uncertainty and lack of information has on how the consumer assesses value and makes a choice. The most optimistic (or “risk indifferent”) will assign the highest potential value to the new system and the lowest value to the switching costs. The most risk averse consumers will assign the minimum value to the competing network and the maximum value to the switching costs. Where folks fall on this scale determines when they switch from one system to another.

Again, it is important to recognize that a cable operator does not need to keep *every* customer to

place, however, in which incumbent cable operators continue to control the overwhelming share of the market and where DBS is the most significant competitor by national market share, the differences are not important for the basic competition math.

¹³Complaint of DIRECTV, Docket No. CSR-6901-P. iN Demand does not deny the difference in pricing, but maintains that other factors besides anticompetitive motives explain the difference. See Answer of iN Demand, Docket No. CSR-6901-P.

¹⁴We could therefore tweak our equation to reflect this, as $V_i - C_i < (V_n/U) - (SW*U) - (C_n*U)$, where “U” represents the uncertainty caused by a combination of less than perfect information and risk aversion. But that starts to get too complicated. It’s enough to say that the less information a customer has, and the less certain they are about the network value, the less they will value the competitor’s network and the more they will worry about switching costs and actual costs.

maintain market power. It only needs to keep *enough* customers to maintain market power. In fact, a strategic thinking cable operator will want enough competition in the market to prevent an unavoidable appearance of monopoly and resultant regulation, but not enough to pose a competitive risk.¹⁵ As long as cable operators can consolidate regionally and nationally to keep control of sufficient numbers of high value customers, slight changes in the overall national numbers for MVPDs won't make much difference on real market power.

The cable strategies of increasing their own value while diminishing the value of competitors thus complement each other synergistically. Although consumers can easily evaluate price, lack of information or experience makes it hard to judge other kinds of value. When DBS offered 200 channels and cable system only offered 30, the value difference for DBS looked more impressive than if DBS offers 200 channels and cable offers 125 channels.¹⁶ Again, it is important to stress that, as with the ability to raise price, the switching cost provides a cushion on how much a cable operator must improve service. The cable operator does not have to make $V_i = V_n$. It is enough that $V_i \geq V_n - SW$. So 125 channels is "close enough," especially when the uncertainty about the value of the new networks makes the customer assign it an artificially low value. ("Is getting Current really worth switching to DIRECTV? Nah, it can't be that good . . .")

Increasing Service to Increase Switching Cost

Finally, a new cable service can both increase the value of the incumbent cable operator *and* increase the switching cost. A perfect example of this is broadband, which cable operators generally sell as a bundled service with their video service. (You can get cable television without cable broadband, but cannot get cable broadband without cable television. Or you can get broadband without video, but it costs a lot more than getting both cable and video combined). A subscriber with both cable video and cable broadband is therefore very unlikely to switch to DBS because the switching cost has increased dramatically. Not only will the subscriber have the general hassle of switching email addresses and learning a new system,¹⁷ but because DBS does not have a competing broadband product, the subscriber must find a new broadband provider.¹⁸

¹⁵For example, in 1997, Microsoft rescued its long-term rival, Apple, from possible bankruptcy by investing \$150 million dollars.

¹⁶The fact that most viewers only reliably watch a fraction of the number of available channels also leads consumers to devalue additional capacity. If I can't find more than five good channels with 125 channels on cable, why do I think adding 75 more channels will help?

¹⁷How high a cost it is to switch email addresses is hard to estimate. In the early days of dial up, the change of email address did not cause much hassle as fewer people were online. Today, a change of broadband provider can interrupt subscription services, disrupt home business activity, require readjustment of home wifi systems, etc.

¹⁸DBS providers have tried to compensate for this by engaging in resale deals with other broadband partners. This may minimize SW, but this increases the cost to the DBS provider and so must either increase C_n or cut into the profit of the DBS provider.

The equation gets a little more complicated (and therefore beyond the scope of this "simple" paper) when trying to determine the right equation and value proposition for the predicted competition by telephone companies also providing a "triple play" of voice, video and broadband. Since most consumers have an incumbent telco for voice or voice/broadband, and an incumbent cable operator for video or video/broadband, consumers will incur switching costs either way. It remains to be seen whether the value of a "triple play" to consumers is high enough to overcome SW.

Impact on Programming¹⁹

The Switching Equation and information problems allow cable operators to control the access of independent programmers to the home. Cable operators claim that if they consistently favored programming for reasons other than quality, such as to force an independent to give the cable operator an ownership interest,²⁰ the cable operators would lose customers to competitors with better programming. But the incumbent doesn't need the "best" programming because the incumbent doesn't need to maximize the value of its network. The switching cost provides a cushion. As long as programming remains "good enough," the switching cost will keep the subscriber from following the "better" programming to a competitor.

New independent programmers also have a serious information problem that makes the threat that subscribers will "chase it" to a rival almost non-existent. Let's say programming denied by the incumbent is absolutely wonderful. The incumbent viewer is never going to see it, because it is on the other system. Rival programming channels, oddly enough, are unlikely to take advertising to help viewers discover programming better than their own (unless, of course, the two networks are owned by a single owner, an increasingly common event). How is the incumbent viewer going to acquire an appreciation of the high value for the "superior" programming network if he or she never sees it? Given that the incremental value of a new network to any viewer is likely to be fairly low,²¹ it is rather far fetched that the incumbent cable operator will seriously fear that denying carriage to independents will cost so many subscribers as to overcome the other economic advantages of favoring affiliated programming. Or, more bluntly, as long as the cable operator programming doesn't stink so badly it actively drives viewers away, the cable operator can safely ignore new independents.²²

The experience of overbuilders (such as RCN) that already offer "triple play" suggests that the value of triple play does not compensate for denial of access to regional sports programming and other anti-competitive measures used to artificially suppress V_n .

¹⁹To keep things simple, I'm not going to talk about how local broadcasters and broadcasting networks like CBS enter the equation. The American Cable Association has recently (January 30, 2006) released a study addressing this issue. For purposes of this paper, it is sufficient to note that the presence of broadcast networks and local broadcasters in the equation does not work to the advantage of cable competitors.

²⁰This is an illegal practice alleged to be widespread in the cable industry. The cable industry denies it has market power to force such "equity concessions" as a "price" of carriage.

²¹"Incremental value" means how much does this one change make a difference in overall value of the service. For some programming this may be very high, but for most it is pretty low.

²²Again, empirical studies are confirmatory of the theory presented here and contrary to expectation in a genuinely competitive market. See, e.g., Jun-Seok Kang, "Reciprocal Carriage of Vertically Integrated Cable Networks: An empirical Study," (2005) (submitted in FCC Docket No. 92-264); Dong Chen & David Waterman, "Vertical Foreclosure In the U.S. Cable Television Market: An Empirical Study of Program network Carriage and Positioning," (2005) (submitted in FCC Docket No. 92-264); GAO, "Subscriber Rates and Competition in the Cable Television Industry," (2004); Michael E. Clements & Amy D. Abramowitz, "Ownership Decisions and the Programming Decisions of Cable Operators," TPRC Working Paper (2004) (available at <http://web.si.umich.edu/tprc/papers/2004/289/TPRC2004.pdf>). The FCC, in finding an increase in "independent" programming in the last few years, includes programming that initially achieved widespread carriage when affiliated with cable operators (e.g., Discovery Networks, formerly affiliated with TCI), programming affiliated with broadcast networks (e.g., SoapNet, affiliated with Disney), and programming formerly affiliated with broadcast programmers (e.g., Viacom's networks). Whatever merit in classifying this programming as "independent" for purposes of the

Regional Sports Programming and “Marquee” Programming

The argument that the incremental value of programming gives programmers no leverage is not universally true. Some programming is more “high value” than others. In general, local broadcast stations and some well established cable networks, like ESPN or CNN, are so valuable that any MVPD that wants to compete needs to have it. (Such programming is sometimes called “marquee programming.”) Such high value programming also raises the question of *substitutability*. If I can’t have a specific network, is another similar network an acceptable substitute for consumers?

The answer is, sometimes “yes” and sometimes “no.” Some consumers will be happy with any 24/7 news channel. But someone who values the perspectives and opinions of Fox News will not readily accept the BBC World Report or CNN instead because they are both “news,” and certainly will not accept Comedy Central’s “Daily Show” as a substitute even though both are “video programming.”²³ In economic terms, the person that regards CNN and Fox News as equally acceptable regards them as *close substitutes*. The person that grudgingly accepts CNN over Fox News if he or she has no choice regards them as *substitutes*, but not *close* substitutes. Needless to say, not being able to get the programming you want on the competing system, even if it is a “substitute,” diminishes the value of the competing network.²⁴

Which gets us back to sports. Cable likes to argue that ESPN (which is owned by Disney, not a cable company) and things like NFL Sunday Ticket (a football package on DIRECTV) neutralize any advantage cable operators get from withholding regional sports networks or other local programming. After all, sports is sports, right?

As a simple experiment, ask any Red Sox²⁵ fan if he or she thinks watching the Cleveland Cavaliers play the Los Angeles Lakers²⁶ is “the same” as watching the Red Sox play the Yankees because they are both “sports games.” Then ask if watching the Chicago Cubs play the St. Louis Cardinals²⁷ is “the same.” Ask if the Red Sox fan will give up watching Red Sox games in exchange for all the football he or she can watch, including the New England Patriots.²⁸

FCC’s annual assessment of video competition, it fails to rebut the expectation that those without market power, *e.g.*, new independent programmers, can achieve broad carriage without assistance from the two largest incumbent cable operators.

²³This should also explain why Blockbuster, video iPods, and free TV are not competitors to cable, as sometimes argued. The value proposition between a system that provides hundreds of channels of news and entertainment on a dynamic 24/7 basis, as opposed to the value proposition of a service that merely rents movies and games (or stores them for future play), is so different that no consumer would ever consider them substitutes. Similarly, because free TV is offered as part of the cable package, its value is completely captured in the cable package. It does not “compete” in any usual sense of the word. Rather, it is a question of whether the added value is worth the cost. For the 10% of television homes that do not subscribe to cable or other pay service, the answer appears to be “no.”

²⁴See generally Wise & Duwadi (2005) (attempting to break out numerous factors with regard to competition in MVPD markets, including programming preferences).

²⁵A baseball team in Boston. They have a longstanding rivalry with the New York Yankees.

²⁶Basketball teams.

²⁷Both baseball teams. Like the Red Sox, the Cubs have a devoted following despite consistently losing.

²⁸The football team in the Boston market.

Any Red Sox fan reading this knows the answer. Watching generic “sports,” or even another baseball team with a romantic “curse” doesn’t cut it when the Red Sox are playing the Yankees. There are plenty of sports fans who like to watch “generic sports;” that’s why ESPN is such a popular network. But just because someone likes to watch generic sports doesn’t make it a substitute for a local team. For many people, local sports and “generic sports” are not even substitutes, never mind close substitutes.

Worse, the demand for popular local sports teams varies. I might only watch the Red Sox when they play the Yankees or when they make it to the play offs. But when I want to watch them, I *really* want to watch them. If I have to give up watching local sports to switch, that looks like a huge loss of value to me, even if I only actually watch games not carried on broadcast television (and retransmitted on the competitor) a few times a year. Because many people appear to assign a huge value to this loss of unique programming, denial of regional sports programming seriously devalues the competing network despite the presence of other “generic” sports packages.

On the other hand, refusal to carry regional sports programming will do far less damage to the incumbent cable operator. Again, it is a simple matter of the “cushion” provided by the switching cost. Some fans may switch to a competitor carrying the regional sports team, but the majority of viewers will more likely try to pressure the incumbent cable operator by complaining than by switching to a competitor.²⁹

Cable Replies

Generally, cable operators argue that government regulation is “bad” and “picks winners.” By contrast, they maintain, deregulation creates “an open market” that is “competition driven.” Finally, cable operators they need a “a level playing field” to compete “fairly” with would-be competitors.

The “level playing field” is a myth. Cable did not achieve its current market share, and therefore its existing level of market power, by winning any “fair fights” in an “open, competitive market.” It got them because the government made cable a virtual monopoly in 1984 when it passed the first Cable Act. Congress tried to correct the damage in 1992, then changed the rules back to “fair” in 1996. As a result, any new entrant is already running up hill. If the government lets cable companies slap on a pair of leg-irons by refusing to regulate anti-competitive behavior, competition becomes impossible.

²⁹There are fewer cases where an incumbent has refused to carry the regional sports team than where an incumbent has used its ownership of a regional sports network or market power to force unfavorable terms on competitors or deny competitors the sports programming altogether. Two notable cases demonstrate the difference regional concentration can make. When Cablevision sought to deny carriage on its enhanced basic tier to YES Network (which broadcast the New York Yankees), it stood in marked contrast to other incumbent cable providers in the market. Ultimately, Cablevision was forced to arbitrate the matter – in no small part because customers complained that other incumbent cable operators carried YES. By contrast, in Washington DC, Comcast has a much greater level of concentration. Despite carriage by an overbuilder competitor and DBS competitor, Comcast’s regional concentration apparently provides it with sufficient market power to resist the complaints of subscribers.

The second argument cable operators make is that they invested lots of money in upgrading their systems, so they should be allowed to get a return on investment. I agree. But, like the rest of us, cable operators need to work for a living rather than just leverage their market power. If I buy a shotgun in the expectation I can rob my neighbors, I am not entitled to a “return on investment.” If I build a cable network in the expectation I can use it to deny regional programming to my competitors so I will be able to charge monopoly-level prices to my subscribers, I’m not entitled to a monopoly-level “return on investment.”

Policy Recommendations

Policy must address the market reality. A preference for competition over regulation may be a valid starting point for consideration, but where competition does not emerge, or can be predicted not to emerge, Congress and regulators must step in to take action.

As a nation, we depend on the widespread availability of affordable video distribution to maintain an informed citizenry, and depend on diversity of programming to expose us to new ideas and new perspectives. The Supreme Court has said that ensuring to the people of the United States a video distribution system that provides needed news and diverse views to all Americans is “a government purpose of the highest order.”³⁰ If Congress and the FCC intend to rely upon competition to ensure that the nation’s video distribution systems are affordable and provide innovative and informative programming reflecting the diversity of our citizenry, then they must craft policies that genuinely promote competition in the MVPD market.

This paper provides a suitable framework for addressing regulation to promote competition. In analyzing the existing MVPD market, policymakers should consider policies that make competition viable by limiting the power of incumbent cable operators to manipulate the value of a competitor’s offering, drive up the cost of a competitor’s offering, or increase the switching cost to a subscriber from a cable network to a rival network. These policies should include, at the least, limits on regional and national concentration by cable incumbents (reducing market power directly) and enhanced program access rules (extending existing rules beyond the February 2007 deadline and including both terrestrially distributed programming (such as regional sports) and new “non-linear” programming services (such as video on demand).

In making these assessments, Congress and the FCC should reject simplistic arguments about “deregulation” and “level playing fields.” Unless subscribers can switch from one service to another with reasonable ease, the expected benefits of competition – lower prices, innovation, and diverse high-quality programming – simply will not emerge.

³⁰*Turner Broadcasting System, Inc. v. FCC*, 512 U.S. 622 (1997)

ABOUT MEDIA ACCESS PROJECT

Media Access Project (MAP) is a nearly thirty-five year old non-profit tax exempt public interest telecommunications law firm which promotes the public's First Amendment right to hear and be heard on the electronic media of today and tomorrow. More information is available at MAP's website: <http://www.mediaaccess.org>