

GAO

Testimony

Before the Committee on Commerce,
Science, and Transportation, U.S. Senate

For Release on Delivery
Expected at 9:30 a.m. EST
Thursday, March 25, 2004

TELECOMMUNICATIONS

Subscriber Rates and Competition in the Cable Television Industry

Statement of Mark L. Goldstein, Director
Physical Infrastructure Issues





Highlights of [GAO-04-262T](#), a testimony before the Committee on Commerce, Science, and Transportation, U.S. Senate

Why GAO Did This Study

In recent years, rates for cable service have increased at a faster pace than the general rate of inflation. GAO agreed to (1) examine the impact of competition on cable rates and service, (2) assess the reliability of information contained in the Federal Communications Commission's (FCC) annual cable rate report, (3) examine the causes of recent cable rate increases, (4) assess the impact of ownership affiliations in the cable industry, (5) discuss why cable operators group networks into tiers, and (6) discuss options to address factors that could be contributing to cable rate increases.

GAO issued its findings and recommendations in a report entitled *Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry* (GAO-04-8). In that report, GAO recommended that the Chairman of FCC take steps to improve the reliability, consistency, and relevance of information on cable rates and competition in the subscription video industry. In commenting on GAO's report, FCC agreed to make changes to its annual cable rate survey, but FCC questioned, on a cost/benefit basis, the utility of revising its process to keep the classification of effective competition up to date. GAO believes that FCC should examine whether cost-effective alternative processes could help provide more accurate information. This testimony is based on that report.

www.gao.gov/cgi-bin/getrpt?GAO-04-262T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Mark Goldstein at (202) 512-2834 or goldsteinm@gao.gov.

TELECOMMUNICATIONS

Subscriber Rates and Competition in the Cable Television Industry

What GAO Found

Competition leads to lower cable rates and improved quality. Competition from a wire-based company is limited to very few markets. However, where available, cable rates are substantially lower (by 15 percent) than in markets without this competition. Competition from direct broadcast satellite (DBS) companies is available nationwide, and the recent ability of these companies to provide local broadcast stations has enabled them to gain more customers. In markets where DBS companies provide local broadcast stations, cable operators improve the quality of their service.

FCC's cable rate report does not appear to provide a reliable source of information on the cost factors underlying cable rate increases or on the effects of competition. GAO found that cable operators did not complete FCC's survey in a consistent manner, primarily because the survey lacked clear guidance. Also, GAO found that FCC does not initiate updates or revisions to its classification of competitive and noncompetitive areas. Thus, FCC's classifications might not reflect current conditions.

A variety of factors contribute to increasing cable rates. During the past 3 years, the cost of programming has increased considerably (at least 34 percent), driven by the high cost of original programming, among other things. Additionally, cable operators have invested large sums in upgraded infrastructures, which generally permit additional channels, digital service, and broadband Internet access.

Some concerns exist that ownership affiliations might indirectly influence cable rates. Broadcasters and cable operators own many cable networks. GAO found that cable networks affiliated with these companies are more likely to be carried by cable operators than nonaffiliated networks. However, cable networks affiliated with broadcasters or cable operators do not receive higher license fees, which are payments from cable operators to networks, than nonaffiliated networks.

Technological, economic, and contractual factors explain the practice of grouping networks into tiers, thereby limiting the flexibility that subscribers have to choose only the networks that they want to receive. An à la carte approach would facilitate more subscriber choice but require additional technology and customer service. Additionally, cable networks could lose advertising revenue. As a result, some subscribers' bills might decline but others might increase.

Certain options for addressing cable rates have been put forth. Although reregulation of cable rates is one option, promoting competition could influence cable rates through the market process. While industry participants have suggested several options for addressing increasing cable rates, these options could have other unintended effects that would need to be considered in conjunction with the benefits of lower rates.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to report on our work on cable rates and competition in the cable television industry. In recent years, cable television has become a major component of the American entertainment industry, with more than 70 million households receiving television service from a cable television operator. As the industry has developed, it has been affected by regulatory and economic changes. Since 1992, the industry has undergone rate reregulation and then in 1999, partial deregulation. Additionally, competition to cable operators has emerged erratically. Companies emerged in some areas to challenge cable operators, only to halt expansion or discontinue service altogether. Conversely, competition from direct broadcast satellite (DBS) operators has emerged and grown rapidly in recent years. Nevertheless, cable rates continue to increase at a faster pace than the general rate of inflation. As you know, on October 24, 2003, we issued a report to you on these issues, and issued a subsequent report to the Senate Judiciary Subcommittee on Antitrust, Competition Policy and Consumer Rights on similar issues.¹ My statement today will summarize the major findings from our October 2003 report, and additional findings from our February 2004 report.

At the request of this committee, we have (1) examined the impact of competition on cable rates and service; (2) assessed the reliability of the information contained in the Federal Communications Commission's (FCC) annual cable rate report on the cost factors underlying cable rate increases, FCC's current classification of cable franchises regarding whether they face effective competition, and FCC's related findings on the effect of competition; (3) examined the causes of recent cable rate increases; (4) assessed whether ownership of cable networks (such as CNN and ESPN) may indirectly affect cable rates through such ownership's influence on cable network license fees or the carriage of cable networks; (5) discussed why cable operators group networks into tiers, rather than package networks so that customers can purchase only those networks they wish to receive; and (6) discussed options to address factors that could be contributing to cable rate increases.

¹See U.S. General Accounting Office, *Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, GAO-04-8 (Washington, D.C.: Oct. 24, 2003) and U.S. General Accounting Office, *Telecommunications: Wire-Based Competition Benefited Consumers in Selected Markets*, GAO-04-241 (Washington, D.C.: Feb. 2, 2004).

To address these issues, we developed an empirical model (our cable-satellite model) that examined the effect of competition on cable rates and service using data from 2001;² conducted a telephone survey with 100 randomly sampled cable franchises that responded to FCC's 2002 cable rate survey, and asked these franchises a series of questions about how they completed a portion of FCC's survey that addresses cost factors underlying annual cable rate changes; interviewed representatives of the cable operator, cable network, and broadcast industries; and developed empirical models that examined whether ownership of cable networks by broadcasters or by cable operators influenced (1) the level of license fee (our cable license fee model) or (2) the likelihood that the network will be carried (our cable network carriage model) based on data from 2002. For a more detailed description of our scope and methodology, see appendix I.

This testimony is based on our report issued October 24, 2003, for which we did our work from December 2002 through September 2003. We provide additional information based on our report issued February 2, 2004, for which we did our work from May 2003 to December 2003. We performed our work for both assignments in accordance with generally accepted government auditing standards.

My statement will make the following points:

- Wire-based competition is limited to very few markets; according to FCC, cable subscribers in about 2 percent of all markets have the opportunity to choose between two or more wire-based operators. However, in those markets where this competition is present, cable rates are about 15 percent lower than cable rates in similar markets without wire-based competition in 2001. In our February 2004 report, we examined 6 markets with wire-based competition in depth and found that cable rates in 5 of these 6 markets were 15 to 41 percent lower than similar markets without wire-based competition in 2003. DBS operators have emerged as a nationwide competitor to cable operators, which has been facilitated by the opportunity to provide local broadcast stations. Competition from DBS operators has induced cable operators to lower cable rates slightly, and DBS provision of local broadcast stations has induced cable operators to improve the quality of their service.

²Our model was based on data from 2001 since this was the most recent year for which we were able to acquire the required data on cable rates and services and DBS penetration rates when we began our analysis.

-
- As we mentioned in our May 6, 2003, testimony before this Committee, certain issues undermine the reliability of information in FCC's cable rate report, which provides information on cable rates and competition in the subscription video industry.³ Because the Congress and FCC use this information in their monitoring and oversight of the cable industry, the lack of reliable information in FCC's cable rate report may compromise the ability of the Congress and FCC to fulfill these roles. To improve the quality and usefulness of the data FCC collects annually, we recommend that the Chairman of FCC take steps to improve the reliability, consistency, and relevance of information on rates and competition in the subscription video industry
 - We found that a number of factors contributed to the increase in cable rates. On the basis of data from 9 cable operators, programming expenses and infrastructure investment appear to be the primary cost factors that have been increasing in recent years. During the past 3 years, the cost of programming has increased at least 34 percent. Also, since 1996, the cable industry has spent over \$75 billion to upgrade its infrastructure.
 - Some industry representatives believe that certain factors related to the nature of ownership affiliations may also indirectly influence cable rates. We did not find that ownership affiliations between cable networks (such as CNN and ESPN) and broadcasters (such as NBC and CBS) or between cable networks and cable operators (such as Time Warner and Cablevision) are associated with higher license fees—that is, the fees cable operators pay to carry cable networks. However, we did find that both forms of ownership affiliations are associated with a greater likelihood that a cable operator would carry a cable network.
 - Today, subscribers have little choice regarding the specific networks they receive with cable television service. Adopting an à la carte approach, where subscribers could choose to pay for only those networks they desire, would provide consumers with more individual choice, but could require additional technology and could alter the current business model of the cable network industry wherein cable networks obtain roughly half of their overall revenues from advertising. A move to an à la carte approach could result in reduced advertising revenues and might result in higher per-channel rates and less diversity in program choice. A variety of factors—such as the pricing of à la carte service, consumers' purchasing

³See U.S. General Accounting Office, *Telecommunications: Data Gathering Weaknesses In FCC's Survey Of Information on Factors Underlying Cable Rate Changes*, [GAO-03-742T](#) (Washington, D.C.: May 6, 2003).

patterns, and whether certain niche networks would cease to exist with à la carte service—make it difficult to ascertain how many consumers would be better off and how many would be worse off under an à la carte approach.

- Certain options for addressing factors that may be contributing to cable rate increases have been put forth. Some consumer groups have suggested that reregulation of cable rates needs to be considered, although others have noted problems with past efforts at regulation. Other options put forth 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 could have other unintended effects that would need to be considered in conjunction with the benefits of lower rates. We are not making any specific recommendations regarding the adoption of these options.

Background

Cable television emerged in the late 1940s to fill a need for television service in areas with poor over-the-air reception, such as mountainous or remote areas. By the late 1970s, cable operators began to compete more directly with free over-the-air television by providing new cable networks, such as HBO, Showtime, and ESPN. According to FCC, cable's penetration rate—as a percentage of television households—increased from 14 percent in 1975 to 24 percent in 1980 and to 67 percent today. Cable television is by far the largest segment of the subscription video market, a market that includes cable television, satellite service (including DBS operators such as DIRECTV and EchoStar), and other technologies that deliver video services to customers' homes.

To provide programming to their subscribers, cable operators (1) acquire the rights to carry cable networks from a variety of sources and (2) pay license fees—usually on a per-subscriber basis—for these rights. The three primary types of owners of cable networks are large media companies that also own major broadcast networks (such as Disney and Viacom), large cable operators (such as Time Warner and Cablevision), and independent programmers (such as Landmark Communications).

At the community level, cable operators obtain a franchise license under agreed-upon terms and conditions from a franchising authority, such as a local or state government. During cable's early years, franchising authorities regulated many aspects of cable television service, including subscriber rates. In 1984, the Congress passed the Cable Communications

Policy Act, which imposed some limitations on franchising authorities' regulation of rates.⁴ However, 8 years later in response to increasing rates, the Congress passed the Cable Television Consumer Protection and Competition Act of 1992. The 1992 Act required FCC to establish regulations ensuring reasonable rates for basic service—the lowest level of cable service, which includes the local broadcast stations—unless a cable system has been found to be subject to effective competition, which the act defined.⁵ The act also gave FCC the authority to regulate any unreasonable rates for upper tiers (often referred to as expanded-basic service), which include cable programming provided over and above that provided on the basic tier.⁶ Expanded-basic service typically includes such popular cable networks as USA Network, ESPN, and CNN. In anticipation of growing competition from satellite and wire-based operators, the Telecommunications Act of 1996 phased out all regulation of expanded-basic service rates by March 31, 1999. However, franchising authorities can regulate the basic tier of cable service where there is no effective competition.

As required by the 1992 Act, FCC annually reports on average cable rates for operators found to be subject to effective competition compared with operators not subject to effective competition. To fulfill this mandate, FCC annually surveys a sample of cable franchises regarding their cable rates. In addition to asking questions that are necessary to gather information to provide its mandated reports, FCC also typically asks questions to help the agency better understand the cable industry. For example, the 2002 survey included questions about a range of cable issues, including the cost factors underlying changes in cable rates, the percentage of subscribers purchasing other services (such as broadband Internet access and telephone service), and the specifics of the programming channels offered on each tier.

⁴Under the 1984 Act and FCC's subsequent rulemaking, over 90 percent of all cable systems were not subject to rate regulation.

⁵Under statutory definitions in the 1992 Act, substantially more cable operators were subject to rate regulations than had previously been the case.

⁶Basic and expanded-basic are the most commonly subscribed to service tiers—bundles of networks grouped into a package—offered by cable operators. In addition, customers in many areas can purchase digital tiers and also premium pay channels, such as HBO and Showtime.

Some franchise agreements were initially established on an exclusive basis, thereby preventing wire-based competition to the initial cable operator. In 1992, the Congress prohibited the awarding of exclusive franchises, and, in 1996, the Congress took steps to allow telephone companies and electric companies to enter the video market. Initially unveiled in 1994, DBS served about 18 million American households by June 2002. Today, two of the five largest subscription video service providers are DIRECTV and EchoStar—the two primary DBS operators.

Competition Leads to Lower Cable Rates and Improved Quality and Service among Cable Operators

Competition from a wire-based provider—that is, a competitor using a wire technology—is limited to very few markets, but where available, has a downward impact on cable rates. In a recent report, FCC noted that very few markets—about 2 percent—have been found to have effective competition based on the presence of a wire-based competitor.⁷ Our interviews with cable operators and financial analysis firms yielded a similar finding—wire-based competition is limited. However, according to our cable-satellite model that included over 700 cable franchises throughout the United States in 2001, cable rates were approximately 15 percent lower in areas where a wire-based competitor was present. With an average monthly cable rate of approximately \$34 that year, this implies that subscribers in areas with a wire-based competitor had monthly cable rates about \$5 lower, on average, than subscribers in similar areas without a wire-based competitor. Our interviews with cable operators also revealed that these companies generally lower rates and/or improve customer service where a wire-based competitor is present.

For our February 2004 report to the Senate Judiciary Subcommittee on Antitrust, Competition Policy and Consumer Rights, we developed an alternative methodology to examine the relationship between cable rates and wire-based competition. In particular, we developed a case-study approach that compared 6 cities where a broadband service provider (BSP)—new wire-based competitors that generally offer local telephone, subscription television, and high-speed Internet services to consumers—has been operating for at least 1 year with 6 similar cities that do not have such a competitor. We compared the *lowest price available* for cable

⁷See Federal Communications Commission, *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, Ninth Annual Report, FCC 02-338* (Washington, D.C.: Dec. 31, 2002).

service in the market with a BSP to the price for cable service offered in markets without a BSP.

We found that cable rates were generally lower in the 6 markets we examined with a BSP present than in the 6 markets that did not have BSP competition. However, the extent to which rates were lower in a BSP market compared to its “matched market” varied considerably across markets. For example, in 1 BSP market, the monthly rate for cable television service was 41 percent lower compared with the matched market, and in 2 other BSP locations, cable rates were more than 30 percent lower when compared with their matched markets. In two other BSP markets, rates were lower by 15 and 17 percent, respectively, in the BSP market compared to its matched market. On the other hand, in 1 of the BSP markets, the price for cable television service was 3 percent *higher* in the BSP market than it was in the matched market.

In recent years, DBS has become the primary competitor to cable operators. The ability of DBS operators to compete against cable operators was bolstered in 1999 when they acquired the legal right to provide local broadcast stations—such as over-the-air affiliates of ABC, CBS, Fox, and NBC—via satellite to their customers.⁸ On the basis of our cable-satellite model, we found that in areas where subscribers can receive local broadcast stations from both primary DBS operators, the DBS penetration rate is approximately 40 percent higher than in areas where subscribers cannot receive these stations from the DBS operators. In terms of rates, we found that a 10 percent higher DBS penetration rate in a franchise area is associated with a slight rate reduction—about 15 cents per month. Also, in areas where both primary DBS operators provide local broadcast stations, we found that the cable operators offer subscribers approximately 5 percent more cable networks than cable operators in areas where this is not the case. During our interviews with cable operators, most operators told us that they responded to DBS competition through one or more of the following strategies: focusing on customer service, providing bundles of services to subscribers, and lowering prices and providing discounts.

⁸In 1999, the Congress passed the Satellite Home Viewer Improvement Act, which allows satellite operators to provide local broadcast stations to their customers. Prior to this act, satellite operators were limited to providing local broadcast stations to *unserved areas* where customers could not receive sufficiently high-quality, over-the-air signals. This practice had the general effect of preventing satellite operators from providing local broadcast stations directly to customers in most circumstances.

Concerns Exist about the Reliability of FCC's Data for Cable Operator Cost Factors and Effective Competition

As we mentioned in our May 6, 2003, testimony before this Committee, weaknesses in FCC's survey of cable franchises may lead to inaccuracies in the relative importance of cost factors reported by FCC. Cable franchises responding to FCC's 2002 survey did not complete in a consistent manner the section pertaining to the factors underlying cable rate increases primarily because of a lack of clear guidance. These inconsistencies may have led to unreliable information in FCC's report on the relative importance of factors underlying recent cable rate increases. Overall, we found that 84 of the 100 franchises we surveyed did not provide a complete or accurate accounting of their cost changes for the year. As such, an overall accurate picture of the relative importance of various cost factors, which may be important for FCC and congressional oversight, may not be reflected in FCC's data.

FCC's cable rate report also does not appear to provide a reliable source of information on the effect of competition. FCC is required by statute to produce an annual report on the differences between average cable rates in areas that FCC has found to have effective competition compared with those that have not had such a finding. However, FCC's process for implementing this mandate may lead to situations in which the effective competition designation may not reflect the actual state of competition in the current time frame. In particular, FCC relies exclusively on external parties to file for changes in the designation. Using data from FCC's 2002 survey, we conducted several tests to determine whether information contained in franchises' survey information—which was filed with FCC in mid-2002—was consistent with the designation of effective competition for the franchise in FCC's records. We found some discrepancies. These discrepancies may explain, in part, the differential findings regarding the impact of wire-based competition reported by FCC, which found a nearly 7 percent reduction in cable rates, and our finding of a 15 percent reduction in cable rates.

Because the Congress and FCC use this information in their monitoring and oversight of the cable industry, the lack of reliable information in FCC's report on these two issues—factors underlying cable rate increases and the effect of competition—may compromise the ability of the Congress and FCC to fulfill these roles. Additionally, the potential for this information to be used in debate regarding important policy decisions, such as media consolidation, also necessitates reliable information in FCC's report. As a result, we recommended that the Chairman of FCC improve the reliability, consistency, and relevance of information on cable rates and competition in the subscription video industry by (1) taking immediate steps to improve its cable rate survey and (2) reviewing the

commission's process for maintaining the classification of effective competition.⁹ In commenting on our report, FCC agreed to make changes to its annual cable rate survey in an attempt to obtain more accurate information, but questioned, on a cost/benefit basis, the utility of revising its process to keep the classification of effective competition in franchises up to date. We recognize that there are costs associated with FCC's cable rate survey, and we recommend that FCC examine whether cost-effective alternative processes exist that would enhance the accuracy of its effective competition designations.

A Variety of Factors Contribute to Cable Rate Increases

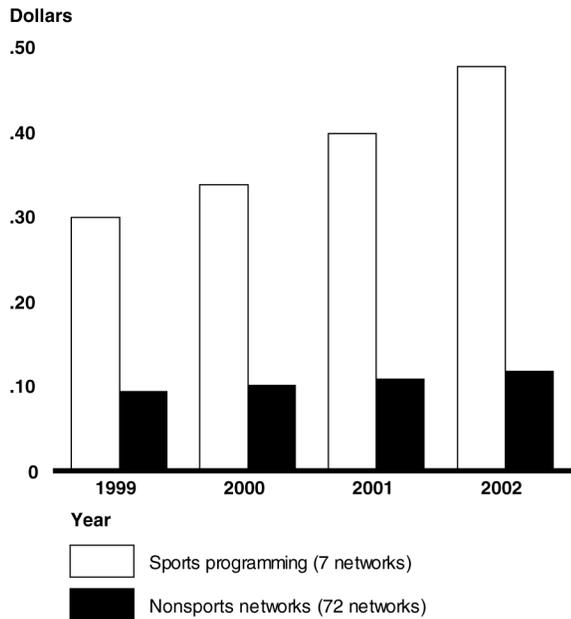
Increases in expenditures on cable programming contribute to higher cable rates. A majority of cable operators and cable networks, and all financial analysts that we interviewed told us that high programming costs contributed to rising cable rates. On the basis of financial data supplied to us by 9 cable operators, we found that these operators' yearly programming expenses, on a per-subscriber basis, increased from \$122 in 1999 to \$180 in 2002—a 48 percent increase.¹⁰ Almost all of the cable operators we interviewed cited sports programming as a major contributor to higher programming costs. On the basis of our analysis of Kagan World Media data, the average license fees for a cable network that shows almost exclusively sports-related programming increased by 59 percent, compared to approximately 26 percent for 72 nonsports networks, in the 3 years between 1999 and 2002.¹¹ Further, the average license fees for the sports networks were substantially higher than the average for the nonsports networks (see fig. 1).

⁹See U.S. General Accounting Office, *Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, GAO-04-8 (Washington, D.C.: Oct. 24, 2003), page 45 for a full discussion of our recommendations.

¹⁰Using data from Kagan World Media, we found that the average fees cable operators must pay to purchase programming (referred to as license fees) increased by 34 percent from 1999 to 2002.

¹¹The seven national sports networks that we included in our analysis were ESPN, ESPN Classic, ESPN2, FOX Sports Net, The Golf Channel, The Outdoor Channel, and the Speed Channel.

Figure 1: Average Monthly License Fees per Subscriber—Sports Networks v. Nonsports Networks, 1999-2002



Source: GAO analysis of Kagan World Media data.

The cable network executives we interviewed cited several reasons for increasing programming costs. We were told that competition among networks to produce and show content that will attract viewers has become more intense. This competition, we were told, has bid up the cost of key inputs (such as talented writers and producers) and has sparked more investment in programming. Most notably, these executives told us that networks today are increasing the amount of original content and improving the quality of programming generally.

Although programming is a major expense for cable operators, several cable network executives we interviewed also pointed out that cable operators offset some of the cost of programming through advertising revenues. Local advertising dollars account for about 7 percent of the total revenues in the 1999 to 2002 time frame for the 9 cable operators that supplied us with financial data. For these 9 cable operators, gross local advertising revenues—before adjusting for the cost of inserting and selling

advertising—amounted to about \$55 per subscriber in 2002 and offset approximately 31 percent of their total programming expenses.¹²

In addition to higher programming costs, the cable industry has spent over \$75 billion between 1996 and 2002 to upgrade its infrastructure by replacing degraded coaxial cable with fiber optics and adding digital capabilities. As a result of these expenditures, FCC reported that there have been increases in channel capacity; the deployment of digital transmissions; and nonvideo services, such as Internet access and telephone service.¹³ Many cable operators, cable networks, and financial analysts we interviewed said investments in system upgrades contributed to increases in consumer cable rates.

Programming expenses and infrastructure investment appear to be the primary cost factors that have been increasing in recent years. On the basis of financial data from 9 cable operators, we found that annual subscriber video-based revenues increased approximately \$79 per subscriber from 1999 to 2002. During this same period, programming expenses increased approximately \$57 per subscriber. Depreciation expenses on cable-based property, plant, and equipment—an indicator of expenses related to infrastructure investment—increased approximately \$80 per subscriber during the same period. However, because these infrastructure-related expenses are associated with more than one service, it is unclear how much of this cost should be attributed to video-based services. Moreover, cable operators are enjoying increased revenues from nonvideo sources. For example, revenues from Internet-based services increased approximately \$74 per subscriber during the same period.

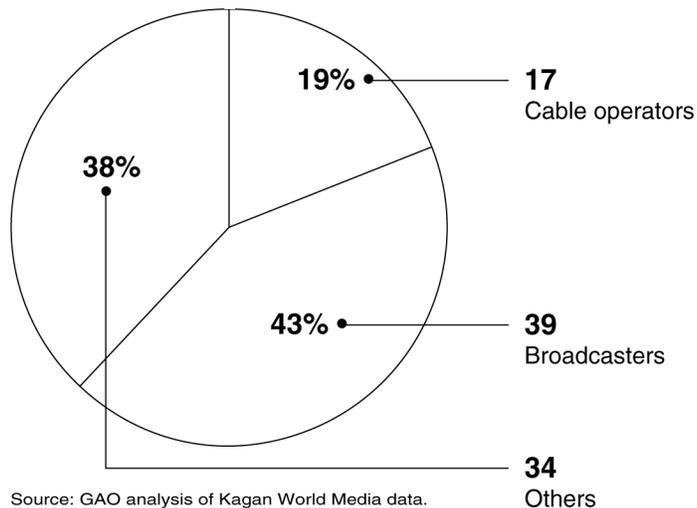
¹²Advertising sales revenues net of expenses incurred to insert and sell local advertising would offset a lower percentage of cable operators' programming expenses.

¹³For example, FCC reported that approximately 74 percent of cable systems had system capacity of at least 750 MHz, and that approximately 70 percent of cable subscribers were offered high-speed Internet access by their cable operator in 2002.

Some View Ownership Affiliations as an Important Indirect Influence on Cable Rates

Several industry representatives and experts we interviewed told us that they believe ownership affiliation may also influence the cost of programming and thus, indirectly, the rates for cable service. Of the 90 cable networks that are carried most frequently on cable operators' basic or expanded-basic tiers, we found that approximately 19 percent were majority-owned (i.e., at least 50 percent owned) by a cable operator, approximately 43 percent were majority-owned by a broadcaster, and the remaining 38 percent of the networks are not majority-owned by broadcasters or cable operators (see fig. 2).

Figure 2: Ownership Affiliation of the 90 Most Carried Cable Networks



Note: Cable networks were assumed affiliated if the ownership interest was 50 percent or greater.

Despite the view held by some industry representatives with whom we spoke that license fees for cable networks owned by either cable operators or broadcasters tend to be higher than fees for other cable networks, we did not find this to be the case. We found that cable networks that have an ownership affiliation with a broadcaster did not have, on average, higher license fees (i.e., the fee the cable operator pays to the cable network) than cable networks that were not majority-owned by broadcasters or cable operators. We did find that license fees were statistically higher for cable networks owned by cable operators than was the case for cable networks that were not majority-owned by broadcasters or cable operators. However, when using a regression analysis (our cable license fee model) to hold constant other factors that could influence the level of the license fee, we found that ownership affiliations—with

broadcasters or with cable operators—had no influence on cable networks' license fees.¹⁴ We did find that networks with higher advertising revenues per subscriber (a proxy for popularity) and sports networks received higher license fees.

Industry representatives we interviewed also told us that cable networks owned by cable operators or broadcasters are more likely to be carried by cable operators than other cable networks. On the basis of our cable network carriage model—a model designed to examine the likelihood of a cable network being carried—we found that cable networks affiliated with broadcasters or with cable operators are more likely to be carried than other cable networks. In particular, we found that networks owned by a broadcaster or by a cable operator were 46 percent and 31 percent, respectively, more likely to be carried than a network without majority ownership by either of these types of companies. Additionally, we found that cable operators were much more likely to carry networks that they themselves own. A cable operator is 64 percent more likely to carry a cable network it owns than to carry a network with any other ownership affiliation.

Several Factors Generally Lead Cable Operators to Offer Large Tiers of Networks Instead of Providing À La Carte or Minitier Service

Using data from FCC's 2002 cable rate survey, we found that with basic tier service, subscribers receive, on average, approximately 25 channels, which include the local broadcast stations. The expanded-basic tier provides, on average, an additional 36 channels. In general, to have access to the most widely distributed cable networks—such as ESPN, TNT, and CNN—most subscribers must purchase the expanded-basic tier of service. Because subscribers must buy all of the networks offered on a tier that they choose to purchase, they have little choice regarding the individual networks they receive.

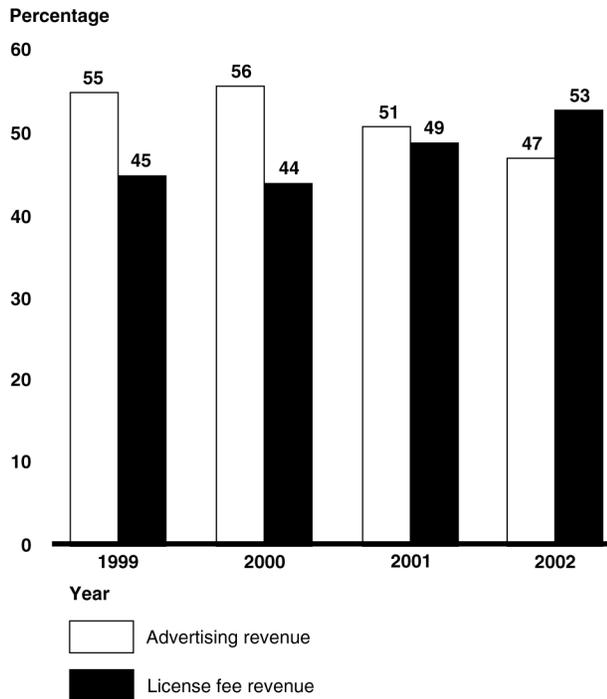
If cable operators were to offer all networks on an à la carte basis—that is, if consumers could select the individual networks they wish to purchase—additional technology upgrades would be necessary in the near term. In particular, subscribers would need to have an addressable converter box on every television set attached to the cable system to unscramble the signals of the networks that the subscriber has agreed to purchase.

¹⁴In the cable license fee model, we regressed the average monthly license fee for 90 cable networks on a series of variables that might influence the license fee. See [GAO-04-8](#) for a list of variables included in that model.

According to FCC's 2002 survey data, the average monthly rental price for an addressable converter box is approximately \$4.39. Although cable operators have been placing addressable converter boxes in the homes of customers who subscribe to scrambled networks, many homes do not currently have addressable converter boxes or do not have them on all of the television sets attached to the cable system. Since cable operators may move toward having a greater portion of their networks provided on a digital tier in the future, these boxes will need to be deployed in greater numbers, although it is unclear of the time frame over which this will occur. Also, consumer electronic manufacturers have recently submitted plans to FCC regarding specifications for new television sets that will effectively have the functionality of an addressable converter box within the television set. Once most customers have addressable converter boxes or these new televisions in place, the technical difficulties of an à la carte approach would be mitigated.

If cable subscribers were allowed to choose networks on an à la carte basis, the economics of the cable network industry could be altered. If this were to occur, it is possible that cable rates could actually increase for some consumers. In particular, we found that cable networks earn much of their revenue from the sale of advertising that airs during their programming. Our analysis of information on 79 networks from Kagan World Media indicates that these cable networks received nearly half of their revenue from advertising in 2002; the majority of the remaining revenue is derived from the license fees that cable operators pay networks for the right to carry their signal (see fig. 3).

Figure 3: Percentage of Cable Network Advertising Revenue Compared with License Fee Revenues for 79 Cable Networks, 1999 – 2002



Source: GAO analysis of Kagan World Media data.

Note: Although cable networks have other sources of revenues, advertising and license fee revenues comprise the vast majority of cable network revenues.

To receive the maximum revenue possible from advertisers, cable networks strive to be on cable operators' most widely distributed tiers because advertisers will pay more to place an advertisement on a network that will be viewed, or have the potential to be viewed, by the greatest number of people.¹⁵ According to cable network representatives we interviewed, any movement of networks from the most widely distributed tiers to an à la carte format could result in a reduced amount that advertisers are willing to pay for advertising time. To compensate for any decline in advertising revenue, network representatives contend that cable

¹⁵Most contracts negotiated between cable networks and cable operators specify the tier that the network must appear on. We were told that cable networks include these provisions in their contracts because their business models are developed on the basis of a wide distribution of their network.

networks would likely increase the license fees they charge to cable operators. Because increased license fees, to the extent that they occur, are likely to be passed on to subscribers, it appears that subscribers' monthly cable bills would not necessarily decline under an à la carte system. Moreover, most cable networks we interviewed also believe that programming diversity would suffer under an à la carte system because some cable networks, especially small and independent networks, would not be able to gain enough subscribers to support the network.

The manner in which an à la carte approach might impact advertising revenues, and ultimately the cost of cable service, rests on assumptions regarding customer choice and pricing mechanisms. In particular, the cable operators and cable networks that discussed these issues with us appeared to assume that many customers, if faced with an à la carte selection of networks, would choose to receive only a limited number of networks, which is consistent with the data on viewing habits. In fact, some industry representatives had different views on the degree to which consumers place value on networks they do not typically watch. While two experts suggested that it is not clear whether more networks are a benefit to subscribers, others noted that subscribers place value in having the opportunity to occasionally watch networks they typically do not watch. Additionally, the number of cable networks that customers choose to purchase will also be influenced by the manner in which cable operators price services under an à la carte scenario. Thus, there are a variety of factors that make it difficult to ascertain how many consumers would be made better off and how many would be made worse off under an à la carte approach. These factors include how cable operators would price their services under an à la carte system; the distribution of consumers' purchasing patterns; whether niche networks would cease to exist, and, if so, how many would exit the industry; and consumers' true valuation of networks they typically do not watch.

Industry Participants Have Cited Certain Options That May Address Factors Contributing to Rising Cable Rates

Industry participants have suggested the following options for addressing the cable rate issue. This discussion is an overview, and we are not making any specific recommendations regarding the adoption of any of these options.

- Some consumer groups have pointed to the lack of competition as evidence that reregulation needs to be considered because it might be the only alternative to mitigate increasing cable rates and cable operators' market power. However, some experts expressed concerns about cable regulation after the 1992 Act, including lowering of the quality of

programming, discouragement of investment in new facilities, and imposition of administrative burdens on the industry and regulators.

- The 1992 Act included provisions to ensure that cable networks that have ownership relationships with cable operators (i.e., vertically integrated cable operators) generally make their satellite-delivered programming available to competitors. Some have expressed concern that the law is too narrow because it applies only to *the satellite-delivered programming* of vertically integrated cable operators and it does not prohibit exclusive contracts between a cable operator and an independent cable network. Given these concerns, some have suggested that changes in the statutory program access provisions might enhance the ability of other providers to compete with the incumbent cable operators while others have noted that altering these provisions could reduce the incentive for companies to develop innovative programming.
- DBS operators have stated that they are currently not able to provide local broadcast stations in all 210 television markets in the United States because they do not have adequate spectrum to do so while still providing a wide variety of national networks. As part of the so-called carry one, carry all provisions, these companies are required to provide all local broadcast stations in markets where they provide any of those stations. Some suggest modifying the *carry one, carry all* provisions to promote carriage of local stations in more markets. However, any modifications to the DBS carry one, carry all rules would need to be examined in the context of why those rules were put into place—that is, to ensure that all broadcast stations are available in markets where DBS providers choose to provide local stations.
- In the 1992 Act, the Congress created a mechanism, known as retransmission consent, through which local broadcast station owners (such as local ABC, CBS, Fox, and NBC affiliates) could receive compensation from cable operators in return for the right to carry their broadcast stations. Today, few retransmission consent agreements include cash payment for carriage of the local broadcast station. Rather, agreements between some large broadcast groups and cable operators generally include provisions for carriage of broadcaster-owned cable networks. As a result, cable operators sometimes carry cable networks they otherwise might not have carried. Alternatively, representatives of the broadcast networks told us that they did not believe that cable networks had been dropped and that they accept cash payment for carriage of the broadcast signal, but that cable operators tend to prefer carriage options in lieu of a cash payment. Certain industry participants with whom we met advocated the removal of the retransmission consent provisions and told

us that this may have the effect of lowering cable rates, but others have stated that such provisions serve to enable television stations to obtain a fair return for the retransmitted content they provide and that retransmission rules help to ensure the continued availability of free television for all Americans.

Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have at this time.

Contact and Acknowledgments

For questions regarding this testimony, please contact Mark L. Goldstein on (202) 512-2834 or goldsteinm@gao.com. Individuals making key contributions to this testimony included Amy Abramowitz, Stephen Brown, Julie Chao, Michael Clements, Andy Clinton, Keith Cunningham, Bert Japikse, Sally Moino, Mindi Weisenbloom, and Carrie Wilks.

Appendix I: Scope and Methodology

To respond to the first issue—examine the impact of competition on cable rates—we used an empirical model (our cable-satellite model) that we previously developed that examines the effect of competition on cable rates and services.¹ Using data from the Federal Communications Commission’s (FCC) 2001 cable rate survey, the model considers the effect of various factors on cable rates, the number of cable subscribers, the number of channels that cable operators provide to subscribers, and direct broadcast satellite (DBS) penetration rates for areas throughout the United States. We further developed the model to more explicitly examine whether varied forms of competition—such as wire-based, DBS, multipoint multichannel distribution systems (MMDS) competition—have differential effects on cable rates. In addition, we spoke with an array of industry stakeholders and experts (see below) to gain further insights on these issues.

The second issue consists of two parts. To respond to part one—assess the reliability of the cost justifications for rate increases provided by cable operators to FCC, we conducted a telephone survey (our cable franchise survey), from January 2003 through March 2003, of cable franchises that responded to FCC’s 2002 cable rate survey. We drew a random sample of 100 of these cable franchises; the sample design was intended to be representative of the 755 cable franchises that responded to FCC’s survey. We used data from FCC, and conversations with company officials, to determine the most appropriate staff person at the franchise to complete our survey. To ensure that our survey gathered information that addressed this objective, we conducted telephone pretests with several cable franchises and made the appropriate changes on the basis of the pretests. We asked cable franchises a series of open-ended questions regarding how the franchise staff calculated cost and noncost factors on FCC’s 2002 cable rate survey, how well the franchise staff understood what FCC wanted for those factors, and franchise staff’s suggestions for improving FCC’s cable rate survey. All 100 franchises participated in our survey, for a 100 percent response rate. In conducting this survey, we did not independently verify the answers that the franchises provided to us.

Additionally, to address part two of the second issue—assess FCC’s classifications of effective competition—we examined FCC’s classification of cable franchises regarding whether they face effective competition.

¹See U.S. General Accounting Office, *Telecommunications: Issues in Providing Cable and Satellite Television Services*, GAO-03-130 (Washington, D.C.: Oct. 15, 2002).

Using responses to FCC's 2002 cable rate survey, we tested whether the responses provided by cable franchises were consistent with the various legal definitions of effective competition, such as the low-penetration test. Further, we reviewed documents from FCC proceedings addressing effective competition filings and contacted franchises to determine whether the conditions present at the time of the filing remain in effect today.

To address the third, fourth, fifth, and sixth issues (examine reasons for recent rate increases, examine whether ownership relationships between cable networks and cable operators and/or broadcasters influence the level of license fees for the cable networks or the likelihood that a cable network will be carried, examine why cable operators group networks into tiers rather than sell networks individually, and discuss options to address factors that could be contributing to cable rate increases), we took several steps, as follows:

- We conducted semistructured interviews with a variety of industry participants. We interviewed officials and obtained documents from FCC and the Bureau of Labor Statistics. We interviewed 15 cable networks—12 national and 3 regional—from a listing published by the National Cable and Telecommunications Association (NCTA), striving for a mixture of networks that have a large and small number of subscribers and that provide varying content, such as entertainment, sports, music, and news. We interviewed 11 cable operators, which included the 10 largest publicly traded cable operators and 1 medium-sized, privately held cable operator. In addition, we interviewed the four largest broadcast networks, one DBS operator, representatives from three major professional sports leagues, and five financial analysts that cover the cable industry. Finally, we interviewed officials from NCTA, Consumers Union, the National Association of Broadcasters, the National Association of Telecommunications Officers and Advisors, the American Cable Association, the National Cable Television Cooperative, and the Cable Television Advertising Bureau.
- We solicited the 11 cable operators we interviewed to gather financial and operating data and reviewed relevant Securities and Exchange Commission filings for these operators. Nine of the 11 cable operators provided the financial and operating data we sought for the period 1999 to 2002. We also acquired data from Kagan World Media, which is a private communications research firm that specializes in the cable industry. These data provided us with revenue and programming expenses for over 75 cable networks.

-
- We compared the average license fees among three groups of networks: those that are majority-owned by a broadcaster, those that are majority-owned by a cable operator, and all others. We performed t-tests on the significance of these differences. We also ran a regression (our cable license fee model) in which we regressed the license fee across 90 cable networks on the age of the network, the advertising revenues per subscriber (a measure of network popularity), dummy variables for sports and news programming, and a variety of factors about each franchise.
 - We conducted several empirical tests on the channel lineups of cable operators as reported to FCC in its 2002 cable rate survey. We developed an empirical model (our cable network carriage model) that examined the factors that influence the probability of a cable network being carried on a cable franchise, including factors such as ownership affiliations and the popularity of the network. Further, we developed descriptive statistics on the characteristics of various tiers of service and the channels included in the various tiers.

This is a work of the U.S. government and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.

GAO's Mission

The General Accounting Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through the Internet. GAO's Web site (www.gao.gov) contains abstracts and full-text files of current reports and testimony and an expanding archive of older products. The Web site features a search engine to help you locate documents using key words and phrases. You can print these documents in their entirety, including charts and other graphics.

Each day, GAO issues a list of newly released reports, testimony, and correspondence. GAO posts this list, known as "Today's Reports," on its Web site daily. The list contains links to the full-text document files. To have GAO e-mail this list to you every afternoon, go to www.gao.gov and select "Subscribe to e-mail alerts" under the "Order GAO Products" heading.

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are \$2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. General Accounting Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
 TDD: (202) 512-2537
 Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm

E-mail: fraudnet@gao.gov

Automated answering system: (800) 424-5454 or (202) 512-7470

Public Affairs

Jeff Nelligan, Managing Director, NelliganJ@gao.gov (202) 512-4800
U.S. General Accounting Office, 441 G Street NW, Room 7149
Washington, D.C. 20548