

Research Notes

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Actionable Research on the Broadband, Media & Entertainment Industries

A La Carte – Upon Further, Further Review

Written by Bruce Leichtman, president and principal analyst for Leichtman Research Group. Reprinted with permission from March 15, 2006 issue of SkyREPORT.

The headline of a recently released FCC study proclaimed “Report Finds Substantial Benefits in A La Carte Model of Delivering Video Programming.” Press coverage of the report quickly latched onto the statement that consumers would save up to 13 percent, and newspaper editorials championed the cause, using the same statistic as justification that consumers should be able to buy only the channels that they want (the apparent irony that newspapers do not allow consumers to buy only the sections that they might want notwithstanding). Consumer groups also lauded the report's findings as a potential victory for consumers, and politicians rushed to find ways to mandate the delivery of a la carte cable programming. Unfortunately, it is unclear if these individuals actually read the report, because the report's content

does not necessarily corroborate the headline, or the spin.

The primary objective of the Media Bureau of the FCC's Further Report on the Packaging and Sale of Video Programming to the Public (“Further Report”) was to reexamine “the conclusions and underlying assumptions of the earlier Media Bureau report on a la carte” conducted by Booz Allen Hamilton and submitted to Congress in November 2004.

The Further Report painstakingly delineates flaws in the Booz Allen report, using the prior study as a straw man to expound the hypothesis that a la carte “could be in consumers’ best interest.” It seems that rather than slogging through the plethora of examples of “mistakes” found in the Booz Allen study, many accepted as fact that somewhere in this new report was the definitive answer on the potential impact of a la carte.

The bottom-line finding of the Further Report, however, wasn't very hard to piece together:

“... Assuming 6 broadcast stations, this implies that a consumer could receive 15 channels without seeing an increase in his monthly bill ... When another mistake is corrected, the break-even number of a la carte channels (in addition to the broadcast channels) is between 10 and 14 ... correcting for the

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study's mistakes, the study's own assumptions show that a consumer purchasing 11 cable channels would face a change in his bill ranging from a 13 percent decrease to a 4 percent increase, with a decrease in 3 out of 4 cases.”

With all the “mistakes” corrected, this implies that with a la carte:

- Consumers would get about 16-20 channels for the same amount that they are currently spending

Clearly, stating the Further Report's finding this way, however, would have made a less enticing story.

The FCC Report states that “a critical limitation of the (Booz Allen) study is its reliance on projections without underlying data.” Unfortunately the Further Report offers no underlying industry-specific data either. Rather than using generic “economic literature concerning bundles” to assess the financial implications of a la carte for cable and DBS subscribers, it is best to apply models, assumptions and facts that are germane to the industry. One key industry-specific fact is that a la carte can not be delivered without digital set-top boxes on every TV in the household - which cost consumers about \$5-\$8 each per month.

“The concept of being able to choose and pay for only the channels that you want initially sounds appealing to many consumers, but in assessing bona fide interest in an à la carte offering, it is important to provide consumers with the actual implications of receiving such a service,” said Bruce Leichtman, president and principal analyst for Leichtman Research.

- Red Herring
March 16, 2006

The FCC Report emphasizes the potential cost reductions from a la carte for digital cable subscribers because they already have set top boxes, but it should be noted that LRG research has found that only about half of the 3-plus TV sets in digital cable homes have a set-top box. More importantly, those who subscribe to digital cable commonly make the

choice because they want more channels (not less). Digital cable subscribers spend on average about \$65 per month to receive over 100 channels - and about 60 percent of this group subscribes to premium services.

The more realistic target for an a la carte offering would be the 55 percent of cable subscribers who have, thus far, chosen to remain analog cable subscribers. These analog subscribers currently spend about \$43 per month on average for cable television service and receive 55-60 channels. And just 14 percent of the TVs in analog homes have any type of set-top box.

Given the FCC's “corrected” average cost per channel ranging from \$2.54 to \$3.37; \$6 per month per set-top box; and a Basic Broadcast cost of \$12.50 per month, we find that for the same cost as what they are spending today, with a la carte:

- Analog subscribers with two TV sets would be able to choose 5-7 channels, and those with three TVs would be able to choose 4-5 channels
- Digital subscribers with three TVs could choose 10-14 channels (but not including current premium channels)

This is hardly information that would make consumers rush to get a la carte, or that should inspire government to mandate cable and satellite TV providers offer a la carte.

If a la carte made it more costly to get lots of channels, as Leichtman says, many networks might resign themselves to smaller audiences and have to focus more on viewers coveted by advertisers. That means more channels, like movie marketers, would chase teens. Or, like many magazines, they'd lust after only the affluent.

- USA Today
March 16, 2006

The Further Report acknowledges that “competition continues to provide consumers with increased choice.” Today, satellite TV providers have over 27 million subscribers in the U.S. - with about 20 million of these subscribers living in areas where cable TV is available. Also, the telcos are once again limbering up for a possible entry into the video market.

Consumers have lower cost choices in video packages. While 45 percent of cable subscribers choose to get digital cable, a lower price Expanded Basic offering is universally available, and a Basic Broadcast-only service is widely available for about \$12.50-\$15 per month. On the DBS side, DISH Network's Basic package costs \$34.99 per month and a newly introduced Family Pak costs only \$24.99 per month (including locals). Also, SkyAngel offers a package of Christian and Family entertainment programming for \$14.99 per month. Of course, consumers could actually decide not to pay for any multichannel video service and stick with off-air broadcast channels.

The concept of a la carte may initially sound appealing (and politically correct to champion), but the economic and technical realities of the marketplace do not necessarily produce a compelling consumer proposition. With more competition than ever before in the video arena, if a la carte makes sense, the market, not headlines, should decide.

Consumers Express Limited Interest in A La Carte Programming

New consumer research from Leichtman Research Group, Inc. (LRG) finds that 40% of consumers are initially very interested in being able to choose and pay only for individual channels from cable and satellite TV companies, a service commonly known as a la carte. But interest in a la carte significantly diminishes when consumers are informed of the number of channels they would be likely to

receive with an a la carte system, and the equipment requirements of the service.

To gauge consumers' interest in a la carte, LRG split a sample of 1,586 adults over age 18 living in households with at least one TV set into two groups:

- Those in the first group were initially asked a question to measure general interest in a la carte. They were then given information that, by choosing a la carte, an average subscriber would receive less than one-third the number of channels that they get for the same price today, and that they would need to have set-top box receivers on each TV set. This group was again asked their interest in a la carte given these implications.
- Those in the second group were given the implications of receiving a la carte service first, and then asked their interest in a la carte.

	Group One	Group Two
Very Interested in A La Carte (General)	40%	N/A
Very Interested in A La Carte (Given Implications)	17%	17%

The survey found that 40% of adults are very interested (8-10 on a 10-point scale) in the general concept of a la carte. When provided with the channel limitations and equipment requirements of receiving a la carte, 17% of respondents in both of the two groups were very interested in subscribing to an a la carte service.

The concept of being able to choose and pay for only the channels that you want initially sounds appealing to many consumers, but in assessing bona-fide

interest in an a la carte offering, it is important to provide consumers with the actual implications of receiving such a service. When consumers are informed of the requirements and consequences of receiving a la carte, we find that about one out-of-six consumers are very interested in a la carte as it would appear in reality.

VOD and DVR Make an Attractive Combination

New consumer research from Leichtman Research Group, Inc. (LRG) finds that digital cable subscribers are recognizing the benefits of having both Video-on-Demand (VOD) and a Digital Video Recorder (DVR). Nearly three-quarters of VOD users who have a DVR from their cable company strongly agree that their cable service is better because they have both services. In addition, just 15% feel that, because they have on-demand service, they don't really need a DVR, and 19% feel that, because they have a DVR, they don't need on-demand service.

In a few short years, predicts Bruce Leichtman, principal analyst of the Leichtman Research Group in Durham, N.H., 42.5 million U.S. households, roughly one-third of the country, will own DVRs.

**- Fort Worth Star-Telegram
November 4, 2005**

Nearly two-thirds of these key high-end subscribers are very satisfied with their cable operator, and few report that they

are likely to switch providers. While over 14% of cable subscribers in the markets studied say that they are likely to switch from their current cable provider in the next six months, fewer than 6% of digital cable subscribers who have used VOD and have a DVR say that they are likely to switch.

These findings are based on a survey of 1,400 total households representing four markets in the United States where VOD is available, and are part of a new LRG study, *Consumer Opinions in Four On-Demand Markets*. This is LRG's fourth annual study of this type.

But media analyst Bruce Leichtman has some doubts about viewers agreeing to pay for broadcast repeats in VOD. "On demand has grown through delivering free programming," said Leichtman. "Consumers have not necessarily shown a willingness to pay for programs."

- **MediaWeek**
March 13, 2006

Other key findings in the four markets include:

- Among VOD users who have a DVR:
 - Mean spending on cable TV service is \$76.65 per month (43% above average)
 - 78% also get high-speed Internet from cable
 - Mean annual household income is 42% above average

- 65% of current digital cable subscribers have used VOD
 - There are few differences in overall satisfaction and likelihood to switch between digital cable VOD users and non-users
 - However, just 7% of Premium-on-Demand users say that they are likely to switch – compared to 15% of all other digital cable subscribers
- Just 16% of current VOD users report that they would be very likely to pay \$0.99 to get a primetime program on-demand

Usage of VOD services continues to grow, with between 55%-83% of digital cable subscribers having used VOD in the four markets that were studied. DVR households are also rapidly expanding where cable operators deliver the service. For consumers (as well as providers), however, it does not come down to an either/or decision for DVR and VOD, but rather how the combination of the two creates the most compelling on-demand offering.

2005 Was Another Record Year for Broadband Internet

Leichtman Research Group, Inc. (LRG) found that the twenty largest cable and DSL providers in the US – representing about 94% of the market – achieved record net high-speed Internet additions in 2005. Combined net additions for the year totaled over 9.6 million subscribers – a total that

exceeded the previous record set in 2004 by over 1 million subscribers.

Other key findings for the quarter include:

- As of the end of 2005, the top broadband providers accounted for over 42.8 million high-speed Internet subscribers
- The top cable broadband providers now have a 57% share of the overall market versus DSL and account for over 24.3 million high-speed Internet subscribers compared to 18.5 million for DSL
- The top DSL providers netted 54% of the broadband additions in 2005
- DSL providers added over 5.2 million broadband subscribers in 2005 – about 1 million more than in 2004
- Cable operators added about 4.4 million broadband subscribers in 2005 – a nearly identical total as in 2004
- The fourth quarter of 2005 was the best quarter ever for DSL providers, adding nearly 1.5 million net additional DSL subscribers,

In the past year, AT&T and Verizon have cut their introductory broadband prices to \$14.95. The low-cost strategy has worked: in 2005, the Bells added more broadband customers than the cable companies for the first time, according to the Leichtman Research Group.

- New York Times
March 13, 2006

capturing 57% of the net 2.64 million high-speed Internet additions for the quarter. Cable operators added virtually the same number of subscribers during the quarter as a year ago, while DSL providers added about 350,000 more subscribers than in the fourth quarter of 2004

With about 10 million additional broadband subscribers in the US in 2005, the number of net broadband additions has increased every year this decade. Cable operators have added virtually the same number of broadband subscribers in each of the past three years, while DSL providers have grown the market primarily by offering lower priced services.



LRG's own Bruce Leichtman will be running in the 110th Boston Marathon, April 17, 2006 as part of the Dana-Farber Marathon Challenge to raise money to benefit the Claudia Adams Barr program in innovative basic cancer research at the Dana-Farber Cancer Institute.

*To make a contribution, please visit Bruce's donation page at:
http://www.leichtmanresearch.com/dana_farber.html*

Industry by the Numbers – (as of the end of 2005)

Top 10 Cable MSOs in the U.S.

	Passings	Subscribers	Availability	Penetration	Net Adds in 2005	Net Adds in 2004
Basic Cable	109,668,000	58,066,750		52.9%	(268,700)	(639,200)
Digital Cable	109,350,000	26,845,000	99.7%	24.6%	2,884,300	2,575,000
Broadband Internet*	107,450,000	24,093,000	98%	22.4%	4,370,900	4,355,400
Telephone [^]	55,120,000	5,068,500	50%	9.2%	1,928,400	764,600

Sources: The Companies and Leichtman Research Group, Inc.

Totals reflect pro forma results from system sales and acquisitions, includes LRG estimates for Cox and Bright House Networks.

* Internet data does not include RCN.

[^] Telephone data does not include Bright House Networks.

DBS

	Subscribers	Net Adds in 2005	Total New Subscribers	Subscriber Acquisition Cost*	Average Revenue Per Sub/Month**
DIRECTV	15,133,000	1,193,000	4,170,000	\$642	\$66.61
EchoStar	12,040,000	1,135,000	3,397,000	\$668	\$57.81
Total DBS	27,173,000	2,328,000	7,567,000		

Sources: The Companies and Leichtman Research Group, Inc.

* Includes leased equipment and unreturned box costs.

** Includes revenue from commercial accounts and other non-consumer spending.

Top Broadband Internet Providers in the U.S.

Broadband Internet Provider	Subscribers at end of 4Q 2005	Net Adds in 2005
Cable		
Comcast	8,520,000	1,526,000
Time Warner	4,822,000	909,000
Charter	2,196,400	312,800
Adelphia*	1,707,450	314,625
Cablevision	1,694,334	341,793
Mediacom	478,000	111,000
Insight	470,400	139,900
RCN	244,000	21,598
Cable One	234,100	55,800
Major Privately Held Companies**	3,970,000	660,000
Total Top Cable	24,336,684	4,391,716
DSL		
AT&T	6,921,000	1,817,000
Verizon^	5,144,000	1,659,000
Bell South	2,882,000	786,000
Qwest	1,480,000	443,000
Sprint	693,000	201,000
Covad	567,175	33,975
ALLTEL	397,696	154,371
CenturyTel	248,706	106,131
Cincinnati Bell	162,500	31,700
Total Top DSL	18,496,077	5,232,177
Total Broadband	42,832,761	9,623,893

Sources: The Companies and Leichtman Research Group, Inc.

* Adelphia subscriber counts are adjusted from prior quarters to account for the sale of some properties

** Includes combined LRG estimates for Cox and Bright House Networks

^ Total includes wireline broadband connections along with DSL

Top cable and DSL providers represent approximately 94% of all subscribers. Company subscriber counts may not represent solely residential households.



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