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FINANCIAL TIMES
New economy policy forum

Pricing 'free' New Economy goods

April 16, 2004

By Thomas Hazlett

There are two curious things about the emergence of satellite competition to US cable television. The first is that it is fabulous, offering subscribers an awesome number of additional viewing choices. The second is that it has raised prices. Cable rates have risen much faster than inflation since 1997, just as satellite was stealing 25 per cent of its market.

Price rises in response to competitive entry? Surely, thirty million economic textbooks can't be wrong. Relax - they're not. The twist is in how one measures price, being careful to account for changes in the value of the product sold.

The array of programming that makes satellite such a seductive rival to the erstwhile cable monopolies has provoked a furious response. Cable TV systems have upgraded with massive capital outlays (over $70bn between 1996 and 2002), digitizing technology, beefing up capacity and increasing programme budgets. Consumer outlays (from higher nominal rates) fund additional networks on "digital cable" tiers, and pay for steeply rising licensing fees for popular stalwarts such as Lifetime, Discovery, MTV and Fox News. These networks are spending more than ever, improving old shows and offering a wide variety of new ones.

Satellite operators compete by offering more - and better - programmes at higher prices, and cable incumbents have been forced to respond in kind, upgrading content (including clearer pictures on digital tiers). While cable's inflation-adjusted rates rise, consumers believe they get more value per dollar.

Nonetheless, the menace of outrageous cable rate rises screams out to policymakers. Hearings are held, cable company executives bashed, headlines written. Yet what can be done? Rate controls flunked the market test in 1992-94, when subscription fees were slashed about 10 per cent by regulators, only to see cable programming (i.e. service quality) deteriorate so dramatically that subscriber growth declined - revealing that consumers were fleeing from the "consumer protection".

So, a new plan. Senator John McCain (R-AZ) and others want to force cable systems to price networks à la carte, giving subscribers the option to select, say, the History Channel, Toon,TNT and CourtTV while passing on TBS, Lifetime and C-SPAN1. If you only pay for channels you actually want to watch, you will save lots of money.

Guess again. Because à la carte pricing prompts the operator to re-price, the customer's quality-adjusted rate is likely to rise.

Suppose a cable system sells two channels of programming to two subscribers. The package (including both channels) is priced at $10 per month. Total revenue - $20 - covers operating costs and a generous profit. Suppose further that either customer subscribes to the package primarily to view their favourite channel, and that each has a different favourite.

Now pop in the á la carte rule. What happens?

The operator is likely to post a $10 per channel price, based on two considerations. First, the marginal cost of delivering video to an additional subscriber is zero, so the supplier focuses on maximizing revenue. Second, given that each household was previously driven to spend $10 because they desired access to their favourite channel, they will predictably continue to purchase this viewing option. Both will pay the same fees.

What's different? We have eliminated one-half of the video programmes available to viewers. Society gains nothing - not a penny of cost savings - by removing these signals from potential eyeballs. In fact, it wastes time and money for customers to order specific networks weeks or months prior to show-time. What good is a TV remote control if you have had to pre-select your programme choices?

Unconstrained, the marketplace offers customers a big bundle. This attracts a wide range of buyers, most of whom may not be interested in most of the programmes in the package. But here is the bonus: in addition to making life easy (when everyone takes Basic Cable, no need to plan August viewing in July), the shows you don't feel like paying for are essentially tossed in for free. Sample away, you channel surfing junkie.

A well organised constituency is already irate: cable programme networks detest à la carte. ESPN (owned by Disney) is the most profitable basic cable channel. Its president, George Bodenheimer, told Congress last month: "It would be a consumer disaster for Congress to force ESPN and other channels out of the expanded-basic line-up." Such networks want viewers to be able to sample their shows, and have fought for years to be included on basic tiers, avoiding "premium" status. The US General Accounting Office (GAO), non-partisan and not anxious to toss cold water on popular proposals, has politely concluded that, "An à la carte approach would… require additional technology and customer service… some customers' bills might increase." In GAO-speak, that is a harsh warning.

Information goods are tricky. The first unit often costs oodles to create, while the next billion units are free. So with video, where cost-based pricing becomes moot, and capitalists conjure ways to push their products out to mass audiences. That is a good thing. So is the competition with satellite TV, forcing cable monopolists to pump up quality. The political reaction to the illusion of higher prices offers to help customers by taking away channels. That is a bad thing. A la carte? Au contraire - prix fixe for the all-you-can-eat buffet, garçon.