A LA CARTE CABLE PROGRAMMING: ENHANCED CONSUMER CHOICE OR EVASION OF REGULATION?

Robert B. Gibson

I. History:

The battle over rate regulation of per-channel offerings has existed since the dawn of the cable era. The newest form of per-channel offering to enter the battle is "a la carte" service. A la carte programming is a specialized service which offers subscribers the opportunity to purchase cable channels on an individual (per channel) basis. Furthermore, subscribers have the option to purchase all of the a la carte channels at a package price. This option may be more enticing because cable operators regularly offer the entire package at a discount.

The distinction between basic subscriber service and specialized service surfaced two decades ago in the Clarification of the Cable Television Rules and Notice of Proposed Rulemaking and Inquiry ("Clarification"). The Clarification was issued to help settle the boundaries of local and federal regulation of cable rates. The Federal Communications Commission ("FCC or Commission") permitted local regulators to regulate rates for "regular subscriber services," defining these subscriber services as all broadcast and local access channels. In the Clarification, the FCC stated that regular subscriber service "does not include specialized programming for which a per-channel or per-program charge is made." Thus, the Clarification precluded local rate regulation of per-channel offerings. This prohibition of local rate regulation of per-channel offerings is still valid under the Cable Television Consumer Protection Act of 1992 ("1992 Cable Act").

By protecting per-channel offerings from local rate regulation, the Commission sought to encourage the growth of specialized and innovative programming services offered by the fledgling cable industry. The Commission felt that rate regulation of per-channel services would be premature and might deter experimentation by cable operators. But, the Commission left the door open for regulation of per-channel offerings in the future.

In the early 1980s, the cable industry was subject to broad deregulation. Further, the FCC preempted many attempts at local cable regulation. For instance, in Capital Cities Cable, Inc. v. Crisp, the Supreme Court invalidated an Oklahoma statute that prohibited the advertising of alcoholic beverages on cable television. The Court stated that if the FCC had a reasonable basis for preempting an area of cable regulation, any conflicting state or local regulations were invalid.

The Capital Cities decision had a major impact on the cable industry. Many local regulators feared that their regulatory attempts could be preempted by the FCC on almost any issue concerning cable. For local regulators, the specter of FCC regulatory control over the cable industry reached its zenith in the Cable Communications Policy Act of 1984 ("1984 Cable Act"). The 1984 Cable Act limited regulation of cable rates to the basic tier in situations where the cable operator was not subject to effective competition. But this regulation applied to the majority of cable operators, because only three percent of the country's cable operators were subject to effective competition. The 1992 Cable Act, however, broadened the definition of effective competition, thus removing some cable operators from the FCC's regulatory purview.

Several cases prior to the 1984 Cable Act echoed Capital Cities's diminution of local regulatory power, especially in the area of per-channel regulation. In Brookhaven Cable TV, Inc. v. New York State Commission on Cable Television, the Second Circuit held that the FCC had preempted local rate regulation of specialized cable programming. The court determined that the Commission had intended to allow specialized cable services to develop free from rate regulation. The court's decision rested on the rationale that the regulation of specialized services could stifle their development.

In In re Community Cable TV, Inc. ("Community Cable II"), the FCC analogized non-basic tier service to per-channel offerings in preempting an attempt to impose rate regulations on a non-basic tier. The FCC defined non-basic tier services as, "those not regularly provided to all subscribers." Once again, the rationale behind the FCC's ruling was that regulation of specialized services could chill the development of innovative and diverse programming services.

The Commission subsequently reconsidered the Community Cable I decision in In re Community Cable TV, Inc. ("Community Cable II"). There, the Commission upheld its previous decision that regulation of non-basic tier service was preempted. Further, the Commission went on to define non-basic tier service as "services, whether offered singly or in tiers, not provided to all subscribers, for which additional fees are charged.

In the 1992 Cable Act, Congress empowered the FCC to regulate all cable programming services. Congress defined a cable programming service as: "any video programming provided over a cable system, regardless of service tier, including installation or rental of equipment used for the receipt of such video programming, other than (1) video programming carried on the basic service tier, and (2) video programming offered on an per-channel or per-program basis."

The 1992 Cable Act increased regulation of the cable industry by expanding rate regulation beyond the basic tier to cable programming services. But it exempted per-channel offerings from conventional rate regulation, as
long as the FCC does not find the rates to be "unreasonable."

By retaining regulatory control over unreasonable per-channel rates, the FCC does not cede all its power over per-channel offerings. The 1992 Cable Act reiterated the Clarification's ban on per-channel regulation. Per-channel offerings, free from both federal and local regulation, created a loophole for a la carte services.

As these various FCC actions, congressional acts and cases indicate, there is a history of tension towards regulation of per-channel services. Most of these actions, however, took place either when cable was a fledgling industry or during the deregulatory Reagan/Bush era. For example, the rationale behind the Clarification's exemption of per-channel offerings from rate regulation was that rate regulation could chill their development by restricting the fee a cable operator could charge a subscriber for them.

Today, this rationale is antiquated. There are over 100 cable program channels. These channels are no longer in jeopardy of extinction if not offered on a per-channel basis. Before being offered on a per-channel basis, most of these channels were offered as part of a basic tier package. Additionally, many of these channels have been in existence for a fairly long period of time (at least ten years - e.g. CNN, ESPN, and C-SPAN). Thus, these channels should not be viewed as being in their vulnerable developmental stages.

As previously noted, the Cable Acts of 1984 and 1992 were enacted during the deregulatory Reagan/Bush era. The 1984 Cable Act, through its limited rate regulation (just the basic tier when it is not under "effective competition"), gave the cable industry wide latitude. In contrast, the more restrictive 1992 Cable Act, was enacted by a pro-regulatory Congress over the veto of President Bush (the only override during his Administration). Although the 1992 Act imposed many more regulations on the cable industry than the 1984 Cable Act, it still kept per-channel offerings free from rate regulation. As a result of the antiquated underpinnings of the per-channel rate regulation exemption and the pro-regulatory trend in politics, the subsequent rate regulation of a la carte services is justified and inevitable.

II. Creation and Regulation of a La Carte Packages:

Allegedly in response to Section 623(0)(2) of the Communications Act of 1934, cable operators began offering a la carte services. On their face, a la carte services offer subscribers the choice of paying for the channels they want. Technically, if subscribers do not want to purchase all the channels available on an a la carte basis, they are under no obligation to do so. In most a la carte services, however, the cost of the entire package is so deeply discounted that it is not economical to purchase individual channels. One explanation for this pricing strategy may be that the cable operator can make sure that the less popular a la carte channels are purchased by subscribers. If the per-channel and package costs were equal, the less popular channels would be purchased less frequently. Consequently, the cable operator will make less revenue by carrying these channels than by carrying the more popular channels. For example, an a la carte service may offer nine channels at a cost of $3.00 each, or a package cost of only $6.95. Therefore, it is not economical to purchase more than two channels individually. By purchasing the entire package, the subscriber will obtain the less popular channels along with the popular ones, and will provide the cable system with a larger audience for its advertisers. As is evidenced by this example, the choice offered by most a la carte services is illusory.

By offering a la carte services, cable operators reap a two-fold benefit. First, if most subscribers do not take the entire package, cable operators evade rate regulation for the channels within the package under Section 623(0)(2) of the Communications Act. Therefore, the cable operators are free to charge whatever price the market will bear. Second, a la carte services allow many cable operators to increase their "benchmark" rate. The benchmark rate, a product of the 1992 Cable Act, is a figure calculated by the FCC. Theoretically, it represents the price that a cable operator faced with competition would charge for the amount of channels offered. The benchmark rate is determined through a regression table which decreases the benchmark rate as the number of regulated channels offered by the cable operator increases. Because a la carte channels are not regulated, such channels lower the number of regulated channels used in calculating the benchmark rate.

To illustrate this point, assume that a cable system offers fifty channels, thirty-five of which are satellite channels. The benchmark rate for this tier would be $4.75. The operator would receive $23.50 for the entire tier of fifty channels. But if the operator had a five channel a la carte service, the benchmark rate would decrease. Because the a la carte channels are offered at a per-channel price, they are not regulated and are removed from the benchmark formula. By subtracting the five a la carte channels, the benchmark rate increases to $5.50 per channel. Consequently, the operator can charge $22.50 for the forty-five channels in the regulated tier. If the cable operator receives $2.50 from subscribers who purchase the discounted a la carte package, the price for the fifty channels (that cost $23.50 under the original non-a la carte calculation) is $25.00. As the example demonstrates, many cable operators can charge higher rates for regulated channels when they offer a la carte services.

III. The FCC's Response to a La Carte Services:

In response to the offering of a la carte services, on February 22, 1994, the FCC issued a Second Order on Reconsideration ("Second Order"). The purpose of the Second Order was to regulate a la carte services that were created to avoid rate regulation rather than to enhance consumer choice. The Second Order focused on the following four factors to detect impermissible a la carte services:

(1) Whether the introduction of the package avoids a rate reduction that would have been required by the 1992 Cable Act.

(2) Whether an entire regulated tier has been eliminated and made into an a la carte package, or whether a significant number of the a la carte channels come from a regulated tier.

(3) Whether the price for the entire package is deeply discounted when compared to the price of an individual channel.

(4) Whether the package is accompanied by significant service or equipment charges for the failure to
purchase the entire package.

The Commission employed several rationales in compiling the four factors that indicate the existence of an impermissible a la carte service. Generally, the Commission sought to determine whether the service enhances consumer choice or is merely an evasion of regulation. The first factor is based on the rationale that a la carte services adopted after the 1992 Cable Act were intended to avoid rate regulation (as shown above).

The second tier is used to demonstrate that the a la carte channels were taken from regulated tiers. This indicates that the cable operator took formerly regulated channels and transformed them into non-regulated a la carte channels with a possible intent to avoid regulation. Further, the Commission may have been trying to encourage the cable operators to use the new cable channels spawned by the recent retransmission agreements such as FX and America’s Talking, as a la carte channels. This would comport with the rationale of the Clarification that offering new channels at a per-channel price will help them become economically viable.

The third factor is based on the rationale that a deeply discounted package or a la carte service not enhance the subscriber’s choice because it compels the subscriber to purchase the entire package.

The fourth factor is related to the third factor. If a deeply discounted package is accompanied by a service charge that is waived when the entire package is purchased, the economic incentive to purchase the channels individually decreases.

The third and fourth factors may be off point because cable operators who attempt to force subscribers to purchase an entire a la carte service appear to be working against their own interests. If all subscribers purchase the entire a la carte package, a second basic tier, subject to rate regulation, is created. Therefore, the cable operators should be dissuaded from compelling subscribers to take the entire package for fear of both violating the Second Order and transferring non-regulated a la carte services into a regulated second basic tier.

If an a la carte service is found to violate the Second Order, the package will be treated as a regulated tier. The a la carte channels will be added to the benchmark calculation, which will decrease the benchmark rate as well as the overall basic rate. Further, the discovery of an illicit a la carte service may result in sanctions such as forfeitures or refunds against the cable operator.

In sum, cable operators will probably offer a la carte services with great caution. The threat of sanctions, such as refunds, should serve to force compliance with the strict regulation of a la carte services. For large cable operators, this process could result in a loss of millions of dollars. Through these tough measures, it appears that the FCC will prevail in making a la carte services an enhancement of consumer choice rather than an evasion of regulation.

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2. Id. at 199.
4. 46 F.C.C. 2d at 200.
6. Id. at 700.
8. 573 F.2d 765 (2d Cir. 1978).
10. Id. at 1218.
11. Id. at 1207.
13. Id. at 1182.
15. When the bulk of a la carte subscribers do not purchase the entire package, the a la carte service is considered a per-channel offering. But when most subscribers purchase the entire package, the service becomes a regulable second tier. Therefore, under Section 623 (1)(X), when most subscribers do not purchase the entire package, the a la carte service is considered a per-channel offering and is exempt from rate regulation.