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CABLE & TELECOMMUNICATIONS ASSOCIATION FOR MARKETING**



Thank you for having me here and for the kind introduction.



I'd like to start by looking at some of the headlines in the recent news. The headlines make it seem as if a new paradigm in television delivery has already taken off.

New technologies to access digital media are making a splash everyday and are allowing consumers to start downloading, time-shifting, and streaming a seemingly endless library of content. And it's evident the industry is in upheaval trying to respond: We have regulatory challenges, piracy issues, shifting business models, declining sales, and consumers who are becoming more difficult to track.



I want to take a step back today and put things in context before you break out into panels during the rest of the conference. And, to begin, I think it's important to remember that just because new technologies are getting the headlines, doesn't mean they're always here to stay.

Today I won't tell you what technologies will and won't succeed, but I will spend some time helping to dispel the myths and explore what's really happening. Then I'd like to give you a framework to help address changes accurately and with focus.



If you'll indulge an analogy, I often think the headlines would lead us to believe the new paradigm in television delivery is an agile Gulfstream V speeding down the runway – all it needs is 4,000 feet to take off—it's almost off the ground and leaving us behind.

In truth, the world of digital media technologies is a fully-loaded 747, and it's going to need the full length of a 10,000 foot runway to get off the ground. What do I mean? There's still a long way to go before most consumers really come to rely on new technologies to deliver their entertainment content. Let me give you some numbers. These are things you and I know, but I think they serve as a good reminder.

A lot of people own video iPods, so everyone is watching video on them, right?

What if I told you that just 4% of adult internet users are willing to buy videos on iTunes?

TiVo is everywhere, right? It's become a name that seems almost as ubiquitous as Coke.

Well, what if I told you that, with all versions of TiVo combined, less than 2 million households have a TiVo branded box sitting in their dens.

Everyone's watching YouTube, right?

What if I told you that only 15% of online adults have viewed user generated content at all?

Here's the truth: many new technologies are just leaving the hangar and have a long haul before they're off the ground.

There are a few reasons for this. First, I think this is because consumers, in many ways, don't have compelling reasons to change. Second, I think the business models to do things differently simply aren't in place yet.

Let's address the consumers first.

One of my favorite books is by former UBS analyst Pip Coburn, entitled *The Change Function*, in which Coburn describes his time at UBS during the dot com bubble. He writes about the long line of companies trekking through his office — all of them talking about their marvelous Web-based service, or their "can't lose" plan to get eyeballs. They talked about their "depth as a team".

But the one thing they didn't talk much about was the customer. Coburn said that "Most of the companies couldn't have told us what their end users really wanted if we'd asked!"

He believes that the tech industry lost focus on the customer, plain and simple. It's only when consumers take out their wallets and spend money that we move from hobbies to actual commerce.

I couldn't agree more.

I believe technology needs to be a 1+1=3 experience. Of course, we all know every technology Microsoft has rolled out has been a great success among consumers. 😊

In all seriousness, something new *must* add value if consumers are going to take the time and hassles to invest in it — if it's just another way to do the same thing, people aren't going to change — no matter how cool it is. Going back to the slide I showed of failed technologies, we can all think of cutting-edge technologies that consumers didn't like. For my airplane analogy, many consumers prefer to be where they are and are saying, "I'll let the plane take off without me before I put my money down and buy a ticket."

Another aspect of this is giving consumers too much choice. Consumers want it simple. Malcolm Gladwell highlights this point in his book *The Tipping Point*. Gladwell recounts an experiment by a researcher who set up a tasting booth with a variety of exotic gourmet jams at an upscale grocery store in Menlo Park. Sometimes the booth displayed six different jams, and sometimes it had 24. Conventional wisdom says that the more choices consumers have, the more likely they are to buy, because it's easier for them to find the jam that perfectly fits their tastes. But they found the opposite was true: 30% of those who stopped by the 6-choice booth ended up buying jam, while only 3% who stopped by the super-stocked booth bought anything at all!

This experiment applies to technology too. It's important to remember that the same headlines you're reading are being read by consumers, and they're often confused about where it's all going. Many are looking at the plane and saying, "I'm not ready to choose a destination yet."

I also mentioned that business models prevent some seemingly cutting-edge things from working in the real world.

I recently spoke at a Bernstein Research media and entertainment conference in New York at which another speaker was a Harvard Business School professor – Anita Elberse – who has been researching consumption patterns and the topic of “Long Tail Content.”

Professor Elberse started her research with some logical assumptions. She believed that the best thing about these new massive online libraries of content is that we can get the niche content we want exactly when we want it—online stores don’t run out of shelf space. And she believed online stores would be thriving because niche content often provides higher margins for content distributors. What a business model – right? People get more of what they want - quickly, with very few search costs, and technology companies or online distributors will make a much higher margin on each purchase.

But in reality, Elberse found that many of today’s business models aren’t working this way.

In one study she found that consumers who purchase one title from the top 10% of titles – that is, if they buy one “mega-hit,” 60% of their other choices will also be “mega-hits.”

But most interesting of all, Professor Elberse found that if they purchase a “niche” offering – an offering in the 10% of most obscure offerings, only 8% of their purchases will be in the “niche” category, and around 60% of their purchases will still be within the top 30% of popular films. That is, even if you’re one of the few willing to purchase a very obscure movie, you’re still spending most of your money on the hits.

The conclusion? Much of the content people are buying when offered a wide choice isn’t the niche content these distributors have spent time negotiating for — and a tidy sum compressing, ingesting and storing.

You either need a business model that ensures your success regardless of what people buy, or, even better, you need a business model that caters to people of different tastes who all get their music and movies in different ways.

Let’s challenge the business model of a proposition currently on the table for some – one that I know is frequently discussed, even by members of Congress and the FCC Chairman. Some believe that a la carte cable is right around the corner and is a must-deliver for consumers. Consumers like choice in concept—they think “I can download a single song from iTunes or Zune Marketplace or Amazon for 99¢, why can’t I get the same thing in cable?” The truth, which you know, is that it just doesn’t work like this and the folks advocating it haven’t done their homework.

Forrester looked into this and asked cable viewers to consider how much they would pay, if anything, to subscribe to any of 46 top cable channels, up to \$10 a channel per month. Viewers chose a simulated bundle with an average of 26 channels, but were only willing to spend \$24 a month, less than \$1 a channel, and about half of what they pay now! Given the 8 hours of TV that US households tune into daily, that’s about 10¢ per hour, compared with the \$2.00 per hour we pay to rent a new release on DVD or purchase a TV show from iTunes or Xbox Live.

To contrast that, an hour of prime time costs advertisers 60¢ per head. At 10¢ per hour, à la carte pricing would *never* work: Producers and cable companies wouldn't get paid enough to survive, and consumers would lose desired content.

In a recent Bernstein Research weekly Media Blast, they looked into this in even greater detail...They said: Imagine a channel like ESPN, which charges approximately \$3 per subscriber per month to cable MSO and DTH operators. Suppose that only 25% of subscribers opted in for the channel – vs. the 100% receiving it today because it's on the basic tier? That means that Disney would need to charge \$12 per month for the channel to remain revenue neutral.

But wait... just under half of ESPN's revenue comes from advertising.

Now, let's say that half of that advertising comes from "casual viewership;" that is, people who watch it because it's there, but who fall outside of that core 25% of opt-ins. That means the à la carte price would need to be \$18. And we're not done yet! ESPN also pays the bills for ESPN II, ESPN Classic, and other sister channels that would probably disappear if they operated on their own. Let's make it \$25.

And don't forget the advertising! No – not the advertising they receive – but the advertising spend they'd have to commit to if they suddenly had to convince customers to subscribe – much like HBO does. That bumps the cost up even higher – let's call it \$28 per month. Just for ESPN! So even though a la carte pricing sounds great, the business model just won't work right now – and it may never work assuming they continue to carry programming for which they have to pay multi-billion dollar license fees such as NFL football rights.

So, either because consumers don't want it – or because business models can't sustain it – many of the technologies you're worried about just won't get off the ground in the near term. It means we have some time to put some serious thought into what really needs to be done to succeed, and develop solutions that make sense. Let's use that full 10,000 feet of runway.



Until now, only a couple of innovations in our industry have actually changed *how* people engage with content. First we had terrestrial over-the-air TV. Then primarily to address signal issues, cable was strung. In the early '90s DirecTV arrived, proving to be the real challenge for cable. VHS was followed by DVDs. Black and white – then color. Tube televisions - then flat screens. All great innovations, but, at the end of the day, you're still flipping through channels.

We're beginning to see, for the first time, you can get many of the same shows on your PC, your phone, your laptop and your Xbox 360. Some consumers would be perfectly content to drop their video service and rely entirely upon broadband. Today you can start watching a movie on your PC then finish it on the train. You can get your content from any number of online sources, record it at the touch of a button, or watch it streaming from your mobile operator. For the first time there is choice in the marketplace, and this choice is driving *segmentation* as different people respond to their choices in different ways.

Let's explore this a bit. Most families have access to the same technologies. For example, mobile phones, PCs, internet access, and digital cameras can be found in more than 50% of US homes. And over 90% of adults 18 to 63 use the computer to check email. About half of online users, no matter how you divide them by age, use the internet to review products they are looking to purchase. In other words – most of us have access to the same technology and could use it to access media if we wanted to.

This doesn't mean that everyone is using technology the same way. It means they have more choice and are taking advantage of choice – some even doing it despite the consumer desire for fewer choices I

discussed earlier. For example, let's take something simple, like listening to a CD on a computer. About half of 18-27 year olds who actually purchase CDs are listening to them on their computers, but less than 20% of their parents – the 52-62 year old demo – are doing the same!

We've come a long way from the days when the whole family used the same VCR and watched a movie together.

Let's take a look at the developing segments of the population that are beginning to develop technology preferences. I like to break them down into five categories, but I'm sure some of you in this room have far more advanced breakdowns. Note that these segments often overlap, with some people being a part of two or more categories.

Some people will never break from traditional cable. They want that remote-in-one-hand, beer-in-the-other-hand experience, nicely reclined on their BarcaLounger. Sometimes nothing beats the convenience of coming home, hitting a button, and having great content without having to think about it. Even among DVR owners, 60% are active; using the DVR to command their viewing, and 40% are passive, still watching most shows live – not DVR'd.

Second, there's what I call traditional plus, or those willing to have an interactive experience with their DVRs—recording, saving, watching, and re-watching their favorite shows—really using their DVRs. This is the 60% of DVR owners.

Then there are those who watch content on their Xbox 360. Some of you may think that's crazy. But we have a service at Microsoft called Xbox Live Video Marketplace, and we've discovered that Xbox owners love watching movies in standard and high-def that they can download right from their gaming platform. We're up to nearly 4,000 hours of movies and TV shows now available – and this past November we rolled out this service in the UK, Germany, France and Canada.

There is no doubt that entertainment over IP is taking off. As Scot will tell you, CES saw a host of new TVs that directly access internet programming. Sony has a new Bravia model, as well as sets from Panasonic and Sharp – are coming to market with Ethernet connections.

Many viewers are watching television *right from their PCs*. I recently spoke at Southern Methodist University where I asked a room of about 60 students how many use their PCs to watch TV, vs. the traditional television set. To my amazement, 90% of the room raised their hands – effectively abandoning the television most of us know. According to Nielsen, 25% of adults have watched a full length TV episode streamed online in the last three months.

Now here is the really interesting part: The amount spent on getting content on the PC nearly tripled between 2006 and 2007, growing from about \$100 million to about \$280 million. But the buying resided largely within the same group—they're just spending more each year.

My final category is mobile viewers. While a quarter of adults 18 to 24 say they would be interested in full length movies on mobile phones, only 16% in the same category say they would watch a live broadcast. While a sizeable segment are up for this, 43% of consumers say they have no interest in mobile video –ever...demonstrating that this segment is very separated from the others.

So we have these five segments. Many of us – and I'm guilty of this – *think* we know who is using what. I'd like to challenge this assumption.

You may have read the recent book *Microtrends* by Mark Penn. In the book, Penn highlights about 100 categories of trends sprouting up where none existed before. From politics to food, education to technology, Penn provides advice for marketers looking to reach out to different segments of the population.

In the technology section, Penn describes the *Video Game Grown-Up*. He highlights that, while in 2005 the average video game player was 24 years old, in 2006 that age climbed to 33 years old. In fact, gamers under 18 make up less than one-third of all players. One of the star attractions at AARP's 2006 national convention was...the Wii! Even women, stereotyped as non-gamers, comprise 30% of the video game market, substantially outnumbering boys under 18. My point is that when looking at segmentation, we can't assume adults are stuck in the traditional categories. Know your consumer. Discover the segments out there and find a way to deliver what they want, how they want it.



RECOMMENDATIONS

Almost all of these segments provide challenges. As NBC Universal's Jeff Zucker has said dozens of times in the past few weeks, "We don't want to replace analog dollars with digital pennies."

In addition to the long runway, the industry is in a good place right now. You are well positioned. For example, TiVo gained momentum and demonstrated what many consumers want as part of their TV experience. MSOs responded with TiVo-like functionality in set top boxes. Networks are adding shows online for free. Some MSOs allow their customers to get primetime network shows on demand with the fast forward button disabled. That trade-off with the consumer may become more common than we realize today. With the threat of IP-based television, Comcast recently announced dramatically increased internet transfer speed capability. While competition is probably driving a lot of this, it does address consumer demand, just as the DVR has.

The current issue of *The Economist* features an article entitled "Who needs Blu-ray and HD DVD Anyway?" Many believe Blu-ray and HD DVD will go the way of the Laserdisc. Verizon and AT&T have been laying fat optical pipes over the "last mile" from their local central offices to people's homes, aiming to bundle television and broadband internet access along with telephone services. Verizon's FiOS (fiber-optic service) can deliver raw data at speeds up to 50 megabits per second. That's twice the speed needed to deliver the video quality of a Blu-ray or HD DVD movie. AT&T's U-verse isn't far behind.

So there are a lot of great opportunities right around the corner to help us adapt to a segmented world.

It *seems* like every household has made a decision on pay TV service today. But over the next five years, there will be almost 12 million new pay TV subscribers – 6 times the number of people who have TiVo today. One in seven households is open to a different TV service next year, and 30% of analog subscribers are open to new service next year. That's an opportunity!

Another opportunity is in the upcoming DTV changeover. In 2006, about 20 million households – 17% – received their TV signal over-the-air. And 9.5 million more households with pay TV services in 2006 had an over-the-air TV. That's a significant number that might be open to new options during the transition. While many of these either cannot afford some of the pay TV services offered today or have another reason for not signing up, they do provide a solid category to reach out to in a segmented world.

Research tells us that those who upgrade to digital cable will be either new subscribers or those who need set top boxes replaced. How can we use this as an opportunity? We should be seeing DVR use as a way consumers are embracing interactivity. How are we using this and how can we give depth to the content offerings?



I have three rules for winning the segmentation battle and seizing your opportunities:

First, focus on and know the consumer. Things *need* to be clear. $1+1$ *must* equal three. You have a long runway to drive consumer change. The time is now. Change on the competitive landscape is

accelerating by the day. Even at Microsoft, keeping up is no small task and we have 1,000's of employees focused on delivery of content.

Second, examine your business model. You can't spend \$3 to make \$2, no matter how *cool* your offering seems. As Ram Charan, a highly regarded consultant to many CEOs, whom I have had the good fortune to work with, repeatedly says to his clients – “remember, there can be no sacred cows” if you hope to survive and win. Unwillingness to let go of sacred cows has taken its toll on the music industry, newspapers and we're beginning to see it taking its toll on much of the media and entertainment sector.

Just yesterday, during the Disney quarterly earnings call, CEO Bob Iger said, referring to the TV sector, “business as usual just does not work, and what that primarily means is an attack on costs”.

I suspect some sacred cows are going to be “shot” – and certainly won't be limited to just ABC – or Disney – or only a few companies. Fasten your seat belts. It's going to be a bumpy ride.

Third, take the long- range view. The answer might not be one big innovation across your entire platform; it might be many small steps that bring your offerings closer to each segment within your customer base over the long term.

As you go into your panels today and take deep dives, remember that you have a long runway and *plenty* of opportunity to make a soft landing in a world of changing headlines. Take advantage of this time to step back and plan your successful future.

Thank you. I'm happy to take your questions.

