

Why not unbundle episodes or innings?

The Temptation of Media Regulation

BY BRUCE M. OWEN

Stanford University

Regarding mass media policy, the bookends of the political spectrum often find common ground. Left and right agree that mass media content is not satisfactory and that more or better federal regulation is the solution. The right seeks to reduce the availability, both to themselves and others, of objectionable media content that threatens family values. The left sees powerful “media barons” dominating an increasingly concentrated industry and distorting media content to serve their own corporate or political interests. Both perspectives find traction with the public, in part because mass media content is, by its nature, highly “available” to public awareness and often intended to trigger strong emotional responses.

Also, while many people can be persuaded that the price of wheat is determined by supply and demand, it is much more difficult to think of television programs or movies in terms of market forces. Objectionable outcomes are easier to ascribe to conspiracy or malign intent when instinctive moral standards seem threatened. All this makes fertile ground for bloggers, radio talk shows, and opportunistic politicians. Rational regulatory policy often seems an impossible goal.

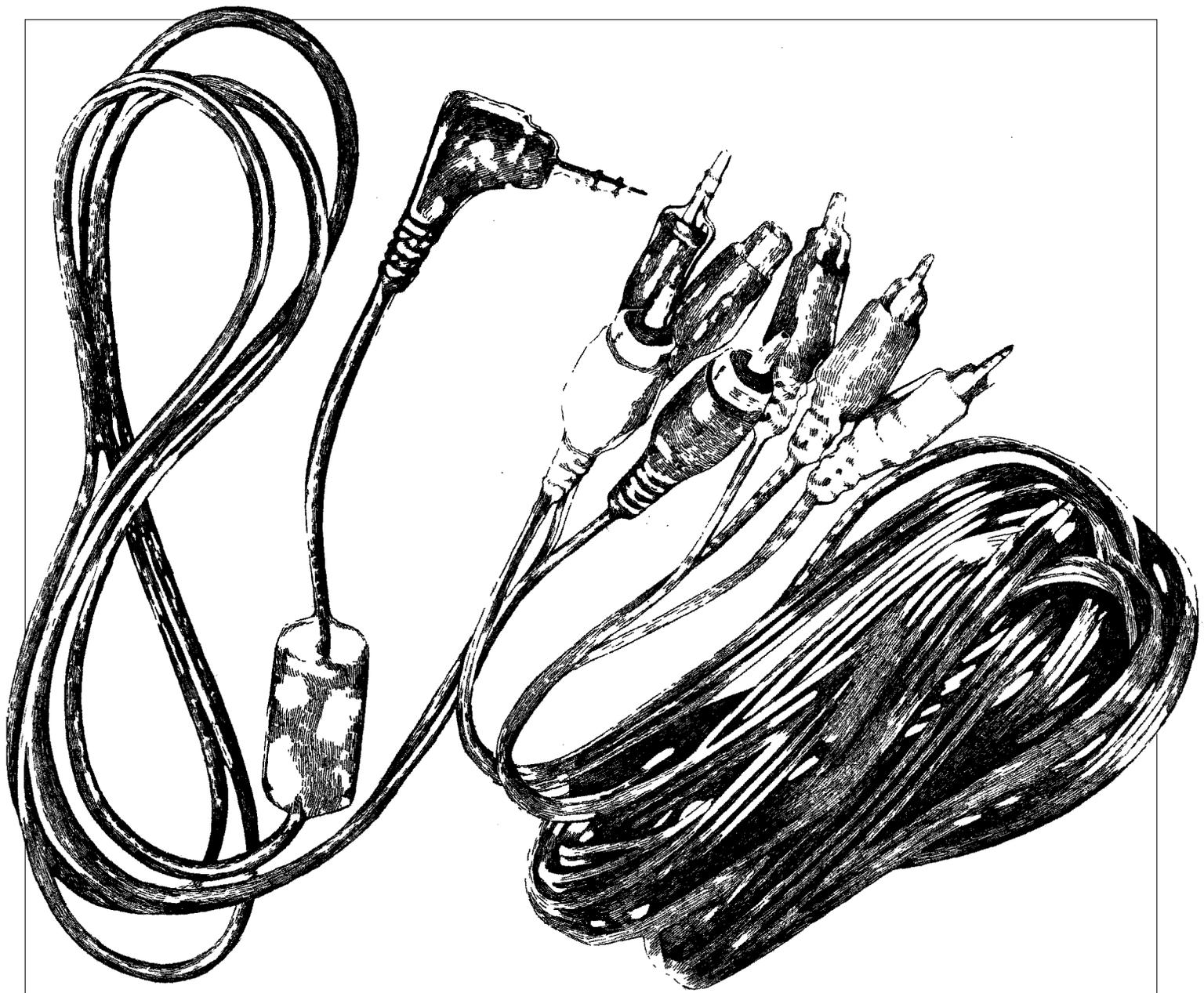
Some markets, of course, are far from perfect. It is easy to find examples of market failure. But regulation also is imperfect. The issue for policymakers is whether intervention will improve matters. Unlike at least some market failures, regulation tends to be permanent. Regulation often creates eco-

nommic rents that would disappear if regulation were withdrawn, and this distorts the political decision whether to persist in a failed attempt to use regulation to repair a market failure. An alternative to regulation is to provide opportunities for changes in technology or entrepreneurial initiative to remedy market failure endogenously, and to limit regulatory interventions to cases where there are clear indications that imperfect regulation will deliver better value than imperfect markets.

U.S. economic policy has a longstanding presumption in favor of competitive market solutions, where feasible. As recently as 1996, for example, Congress opted for increased reliance on competition and deregulation in the media industries. In the years following the 1996 Telecommunications Act, there was a substantial increase in retail video competition, especially from new technologies such as satellite broadcasting and broadband Internet service. This competition continues to grow. Most households a generation ago received only four TV channels (the three networks plus public broadcasting). Today most households can receive a dozen or more over-the-air stations and literally hundreds more on cable, satellite, and the Internet, supplemented by stored content available from video rental stores.

Scarcity of channels was the original constitutional rationale for federal regulation of broadcasting, as established by such rulings as *National Broadcasting Co. v. United States* (1943) and *Red Lion Broadcasting Co., Inc. v. Federal Communications Commission* (1969). The truth is that there never was any more scarcity of stations or channels than the federal government (with helpful advice from industry lobbyists) decided there should be. Today, of course, it is nonsensical to speak of channel scarcity. Nevertheless, deregulation of the media has made little progress. It seems that regulation of the media reflects

Bruce M. Owen is the Morris M. Doyle Centennial Professor in Public Policy at Stanford University and director of the school's Public Policy Program. He is also the Gordon Cain Senior Fellow at the Stanford Institute for Economic Policy Research.



not merely broad acceptance of, but insistence on, political rather than market-determined outcomes.

Four years ago, the Federal Communications Commission voted to bring more rational economics-based standards to bear on the issue of media concentration, and thereby to ease obsolete limits on ownership. That effort to rely on market competition was overturned in *Prometheus Radio Project v. Federal Communications Commission* (2004). A majority of the Third Circuit panel criticized as arbitrary the way the FCC proposed to define and measure diversity — as if there is some accepted method. And late in 2007 the FCC, pushed by its Republican chairman, threatened to increase the extent of its cable television regulation, both by asserting jurisdiction to regulate cable rates and by forcing upstream suppliers of programming to “unbundle” their network offerings. The FCC’s statutory authority to do either of those things is hotly disputed.

The FCC’s recent forays into renewed regulation of cable television are not motivated primarily by concerns that cable rates and profits are excessive, although the proposals enjoy support

from media activists on the left who do voice those concerns. The FCC’s primary goal, according to industry observers, is to pressure the retail cable industry to change its marketing policies — to stop offering only bundles or “tiers” of networks and to offer instead (or in addition) “à la carte” channels. Cable and satellite operators typically offer a relatively small number of tiers, each with multiple networks selected by the operator. A hypothetical cable or satellite subscriber who wishes to view only the Weather Channel nevertheless also receives several dozen other networks, perhaps including MTV and Fox News, as part of the same tier or package, all for one monthly fee.

An end to bundled programming on what the FCC calls “multichannel video program distributors” (MVPDs) is important to a conservative constituency, which includes many who condemn what they see as immoral and antisocial content on television. Such groups want households to be able to block specific unwanted cable networks from their TV sets, or their communities, lest children or others inadvertently view them. Also, many dislike what they perceive as being forced to pay

for content that they do not want for themselves and do not wish to support for others.

FCC chairman Kevin Martin has had little success jawboning the cable industry into unbundling channels. Several large cable companies offered to create family-friendly tiers, but that offer apparently was not acceptable. The FCC proposal to require programmers such as Viacom, Fox, and NBC Universal to unbundle sales of cable networks at the wholesale level is based, apparently, on the idea that cable operators bundle networks at retail because programmers bundle them at wholesale. But the FCC is wrong both about the facts (the data fail to show evidence of what the FCC calls “all or nothing” tying at wholesale) and the theory. Even if programmers did bundle networks, that would not lead cable operators to bundle networks at retail.

TRYING TO REGULATE THE TIDE

One difficulty the FCC faces is that while its ultimate concern is with media content, its policy interventions must be just-

components. It is true that a consumer who places a negative value on all but a few components may be better off with à la carte pricing. But to require à la carte pricing on that account is simply to make some consumers better off at the expense of others, and quite likely in general to reduce aggregate welfare.

There is a species of antitrust offense called “tying” in which a firm with market power in one product is accused of “leveraging” that power into another market by selling the two products only as a unit. Many analysts doubt that such a strategy ever makes economic sense or, if it does, that the benefit to consumers from antitrust prosecution of harmful tying outweighs the cost to consumers from accompanying deterrence of beneficial bundling. However that may be, antitrust experts do agree that it makes no sense to condemn any sort of bundling in the absence of market power.

Program suppliers lack market power. No wholesale video program supplier has as much as 25 percent of the business of supplying cable networks to MVPDs. Even at the retail level,

It is hard to think of a retail product or service that does not consist of a collection of components, each of which could be sold separately.

fied largely in economic terms. But bundling is, in general, both benign and ubiquitous. It is hard to think of a retail product or service that does not consist of a collection of components, each of which may or may not be available separately. Indeed, the packaging of components is itself an extremely valuable service, except perhaps to do-it-yourself hobbyists. Is it economically reasonable to claim that newspaper publishers are engaging in pernicious “all or nothing” tying by including what, for some readers, is an unwanted or even “objectionable” editorial page, or an entertainment section, along with the sports pages? Are monomaniacal sports fans being “forced” by this practice to subsidize editorial views they may oppose or movie advertising they may think immoral?

In the newspaper case it just turns out that there are economies of scope in bundling the sections (or features) of a newspaper. It would cost more to deliver the sections or features separately than as a package. In a sense, everyone is subsidizing everyone else. Getting an unwanted component as part of a retail package is a common experience, usually attributable to limitations in the extent of the market for individual components or economies of scope in packaging. Yet we do not feel the need to regulate poultry farmers who include often-unwanted giblets with their frozen turkeys.

Because of economies in bundling and the inherent value of packaging or assembly services (which necessarily bundles the service with the components and the components with each other), bundling confers considerable benefits on those consumers who also place at least some value on most of the

cable operators now compete with multiple satellite broadcasters and with local phone companies using broadband technology, not to mention other video and non-video media. If consumers are disadvantaged by bundling, surely one of the competitors would be able to increase its market share and profits by unbundling. In fact, it would not be surprising to see unbundling of retail video programming occur as a natural evolution of the market, particularly as a consequence of the growing popularity of Internet video delivery.

Regulation of cable bundling has adverse consequences. One is that it almost certainly implies regulation not merely of the structure of rates (i.e., of bundling) but also of the level of rates. If cable operators (or program suppliers) are required to offer à la carte networks as well as tiers, there will be immediate objections when the tiers are priced, as they inevitably would be, at a discount from the sum of the à la carte prices. When operators offer both bundles and stand-alone channels, à la carte prices always add up to more than bundle prices. The FCC will have to decide whether the individual à la carte prices are “reasonable” — or simply ban cable operators from offering any bundles. Trying to figure out what is a reasonable à la carte price for a video channel or program is a hopeless task. Banning bundling altogether in favor of pure à la carte pricing penalizes the heaviest users of television in order to benefit the picky viewers.

Another problem is created by the industry’s dependence on advertising. When the number of potential viewers decreases, so does advertising revenue. The first-round effect of unbundling retail channels is to reduce the number of poten-

tial viewers for each channel, reducing ad revenue. Reduced ad revenue requires either reduced program production cost (which lowers program quality) or increased prices to consumers, which further reduces audiences. Some channels, of course, may have more viewers once unbundled, and therefore more advertising revenue, depending on how they are priced. The aggregate and distributional welfare effects of the intervention are unpredictable, but potentially disastrous. Why should policymakers favor such a stab in the dark?

Even à la carte channels with more viewers will face the problem that nearly all cable network audiences are too small to measure accurately. Some advertisers are said to rely on the number of subscribers to whom the channel is available rather than guesses about actual viewing. That also reflects the ease with which viewers can channel surf among the channels on a tier. But with no more tiers, there will be no more channel surfing. All this makes it very hard to predict what the industry will look like once all the dust has settled. What unbundling does do is ensure that subscribers never get exposed accidentally to new ideas, at least by channel surfing — hardly an outcome consonant with the FCC’s traditional goal of diversity.

DEFINING THE PLATONIC VIDEO PRODUCT

My favorite absurdity about the FCC chairman’s unbundling crusade is the notion that somehow a TV “channel” is a legitimate product, meriting a standalone price, while a tier of channels is not. Channels (individual networks) are hardly the most obvious legitimate units of video service. Channels are simply columns in the daily TV directory. A more obvious unit is the “episode” or the “game” or the “special” or the “motion picture.” But games and episodes derive at least some of their value from the series (or season) of which they are a component.

From an economic perspective there is no basis for claiming that consumers deserve the right to standalone pricing of channels, but not to more limited components (episodes or games) or more aggregated units (series, seasons, or tiers). How suppliers choose to package their products is commonly left to marketplace determination, and so it should be here. There is no platonic unit of video programming with the unique legitimacy required to deserve standalone pricing, and the FCC is not in a better position than individual suppliers to determine the best way to package such products.

Exercises in taxonomy aside, requiring individual channels to have standalone prices does not solve the family values problem. Objectionable broadcast content — from Janet Jackson’s “wardrobe malfunction” to Don Imus’ racist sports commentary — has never been a matter of channels, but rather a matter of programs or episodes — or portions thereof. Neither of the examples just given occurred on a channel given to extreme content. If having a separate price for every component is the best way to avoid being forced to pay for objectionable content, we will have to price units a lot smaller than channels. Should programmers be required to offer Superbowl halftime entertainment as separate products, act by act?

FACTS SHOULD MATTER

In its Notice of Proposed Rulemaking regarding wholesale

bundling of video networks sold to cable operators and other video retailers, the FCC asserted as fact that such bundling actually takes place. Specifically, the FCC accused suppliers of “all or nothing” tying” of networks in sales at least to small cable systems. If such behavior occurred, one would expect to see that cable systems carrying at least one of the channels of any given supplier would carry all of that supplier’s channels.

Similarly, the FCC, in extending a related regulation, claimed that certain channels were “must have” networks, implying that without such networks no retail video service could survive as an effective competitor. “Must have” networks are thus the equivalent of “essential facilities” — a more familiar antitrust concept, describing truly rare and extreme circumstances such as AT&T’s former monopoly of all local telephone service.

BUNDLES? Together with my Economists Inc. colleagues Michael Baumann and Kent Mikkelsen, I examined data supplied by three of the largest cable network suppliers. Our study showed facts wholly at odds with the FCC’s beliefs, as expressed in its notice. For example, of the NBC Universal (NBCU) cable networks, more than one in six small cable operators taking any NBCU network takes only a single NBCU network. Only 2 percent of the operators took all six networks. No NBCU network was carried by all the operators. (We excluded foreign language and recently launched networks from all the studies described here.)

Similarly, only a minority of all cable systems (19 percent) take all eight Fox networks. Twelve percent take only a single Fox network, and none of the Fox networks were carried by all the systems. These data are not consistent with the allegation that cable systems are presented with a “take-it-or-leave-it” package for all Fox’s nationally distributed programming.

Likewise, of 205 small U.S. cable systems with fewer than 10,000 subscribers that purchase directly from Viacom, about 10 percent take only a single one of Viacom’s 18 networks. More than half of the systems take two, three, or four networks. None of the systems take all, or even 17 of 18, of the Viacom networks. These data show that small systems are not required to take all Viacom networks and that different systems reach different agreements.

We also performed analyses similar to those described above for 11 other major network suppliers, using published trade data. The highest percentage of systems (46 percent) taking all the networks offered by a programmer was for the four channels (A&E, Biography, History, and History International) offered by A&E, a Disney–Hearst–NBC joint venture. With one exception (at 51 percent), no programmer had as much as half of its cable system customers carrying as many as 75 percent of its networks.

Taken together, these studies offer striking evidence that it is not industry practice for suppliers to make “take-it-or-leave-it” offers requiring small cable systems to take all or none of their networks. How could the FCC confidently imply the opposite as fact? The FCC seems to be basing a proposal to regulate wholesale bundling of cable networks on a severe misapprehension of marketplace behavior.

These data also undermine any claim that “must have” net-

works form the lynchpin of forced bundling. If there are “must have” networks, and if they are used for this purpose, then one would expect to see virtually all cable systems purchasing either the entire lineup of networks offered by the owner of a “must have” network or some standard bundle of networks that includes the “must have” network. But the evidence that cable systems do not purchase either complete or uniform bundles of networks implies either that there are no “must have” networks or that they are not used as bargaining leverage in carriage negotiations.

“MUST SEE” TV? Even more bizarre is the FCC’s specific example of “must have” programming: the HBO *Sopranos* series, now in reruns. Here is what the FCC said:

We doubt, for example, that fans of one of the most popular cable programs, such as HBO’s “The Sopranos,” had their competitive MVPD been denied access to the cable-affiliated HBO network, would have regarded the original programming on other premium networks, such as Showtime, an adequate substitute for their favorite show.... We find that access to this nonsubstitutable programming is necessary for competition in the video distribution market to remain viable.

The FCC here infers (from extensive media coverage of the series?) that avid viewers of *The Sopranos* would not be willing to substitute any other network for the one that carries that series (regardless of price?). The Commission claims that the network that carries *The Sopranos* possesses, on that account, market power so great that no cable system or other MVPD could compete effectively without it. That claim is hard to reconcile with the fact that more than 90 percent of the television audience, and over two-thirds of those who subscribe to HBO, did not watch *The Sopranos*. Moreover, consider that for the week of April 9, 2007, *The Sopranos* was the highest-rated show on cable, with 7.42 million viewers. Yet the second and third most popular shows were episodes of *Sponge-Bob* on Nickelodeon and *WWE Raw* on USA, with 5.9 million and 5.7 million viewers, respectively — hardly distinguished company for “must have” programming “necessary for competition...to remain viable.”

The FCC also says, “The record reflects that numerous national programming networks, [regional sports networks], premium programming networks, and [video-on-demand] networks...are demanded by...subscribers and for which there are no adequate substitutes.” Indeed, it seems that the FCC is prepared to view almost every established network as “must have.” Yet no advertiser-supported cable network is viewed, on average, by as much as 2 percent of households with televisions. It is hard to believe that if a cable, satellite, broadband, or other retail video service decided not to carry one or more of these “desirable” networks, its subscribers would stampede for the exits.

One reason the FCC’s claims seem so bizarre in the face of these facts is that it has made a serious analytical error. The economic issue is not whether viewers are willing to substitute one cable network for another. Program suppliers compete to sell to MVPDs. Therefore, what matters in assessing the mar-

ket power of program suppliers is the ability of retail video service providers to substitute one channel for another. Providers who drop one channel may lose some subscribers, but they can gain others by substituting a different channel. The replacement channel need not be of interest to the departing subscribers to be an effective replacement from the provider’s perspective.

Will the exposure of these facts and errors deter the FCC from regulating (apparently nonexistent) wholesale bundling? Not if the objective is political rather than economic. Just as the myth of channel scarcity continues to support the suspension of First Amendment immunities for broadcast and, to a lesser extent, other non-print media, so the regulatory system is quite capable of sailing dead into the wind of fact.

IS THERE A ROLE FOR REASON?

This article has focused on the relatively arcane topic of whether to regulate bundling of cable networks, but video packaging is a metaphor for most of media regulation. We seem willing as a nation to suspend our rational faculties, not to mention simple self control, when it comes to regulation of the media, perhaps in part because the industry’s chief product is the instigation and manipulation of emotion. There are constituencies of “true believers” (to use Eric Hoffer’s phrase) among the public who seem largely impervious to the cognitive dissonance created by rational analysis and debate on media policy. The best explanation may be the one offered by philosopher Steven Pinker in a recent *New York Times Magazine* article:

The moral sense, we are learning, is as vulnerable to illusions as the other senses. It is apt to confuse morality per se with purity, status and conformity. It tends to reframe practical problems as moral crusades and thus see their solution in punitive aggression. It imposes taboos that make certain ideas indiscussible. And it has the nasty habit of always putting the self on the side of the angels.

If the practical problem is the difficulty families face in controlling the availability in their homes of unwanted media content, there are practical solutions. One is for such families to read books, to enjoy family members’ own musical and dramatic performances, to rent or buy prerecorded video material (which is now widely available and easily screened), and to record and preview regular cable programming prior to viewing by children. If the practical problem is dangerous levels of media concentration, perhaps the practical solution is for the FCC to remove the remaining barriers to entry and competition-stifling regulations in broadcasting and in wired and wireless broadband transmission. To achieve practical solutions to real problems, it is only necessary to agree with each other that our moral instincts, like most instincts, are not automatically relevant or mindlessly applicable to public policy decisions. They are subject to review in the court of reason. And our political leaders must exercise self-restraint in exploiting our human vulnerability to cognitive biases grounded in instincts that may once have been, but are no longer, useful. **R**