A La Carte Regulation of Pay TV: Good Intentions vs. Good Economics

*By Jeffrey Eisenach & Adam Thierer**

In his insightful works on political economy, Professor Thomas Sowell warns of the dangers of lawmakers allowing good intentions to trump good economics when crafting public policy. It is a theme which Friedrich Hayek,[1] Milton Friedman[2] and others articulated before him, of course, but Sowell has more fully developed this cautionary principle in books like *A Conflict of Visions* and *The Vision of the Anointed*. Sowell teaches us that noble intentions alone do not necessarily translate into sound public policy, and cautions against the hubris that leads policymakers to believe that they can easily improve on market outcomes. Even the best-intentioned policies can spawn unintended consequences, giving rise to still more regulatory interventions as policymakers seek to rectify past mistakes.

The Federal Communications Commission (FCC) would be wise to heed Sowell's advice in the ongoing debate over "a la carte" regulation of cable and satellite television networks and programming. The notion—giving consumers the right to pay for only the cable TV channels they want, without having to purchase a full bundle—is highly appealing on the surface, and well-intended advocates on both sides of the political divide, including the Consumer Federation of America's Mark Cooper and FCC Chairman Kevin Martin, are no doubt acting out of the best of intentions. But a closer look suggests that a la carte regulation would be a classic case of what we refer to as Sowell's Law of Wishful Thinking. Indeed, it would likely have *the exact opposite effects* of what its proponents intend, leaving consumers and families worse off than they are today.

I. Today's Pay TV Marketplace

On the face of it, the pay TV marketplace appears to be functioning efficiently. By any conceivable statistical measure, consumers today have access to more video outlets and options than at any time in history, and 86% of Americans subscribe to cable, satellite or telco-provided television services.

Certainly there is no shortage of programming. Indeed, the long-heralded "500-channel" cable universe is now a reality. The overall number of video programming channels available in America has skyrocketed, from just seventy channels in 1990 to 565 channels in 2006.[3] The resulting diversity "on the dial" has been astounding . There is hardly any human interest or hobby that is not covered by some video network. As the FCC concluded in its 2003 Media Ownership Proceeding, "We are moving to a system served by literally hundreds of networks serving all conceivable interests."[4] Exhibit 1 below shows the sheer diversity of programming on pay TV today.

Cable and Satellite TV Programming Options

News: CNN, Fox News, MSNBC, C-Span, C-Span 2, C-Span 3, BBC America

Sports: ESPN, ESPN News, ESPN Classics, Fox Sports, TNT, NBA TV, NFL Network, Golf Channel, Tennis Channel, Speed Channel, Outdoor Life Network, Fuel

Weather: The Weather Channel, Weatherscan

Home Renovation: Home & Garden Television, The Learning Channel, DIY

Educational: The History Channel, The Biography Channel (A&E), The Learning Channel, Discovery Channel, National Geographic Channel, Animal Planet

Travel: The Travel Channel, National Geographic Channel

Financial: CNNfn, CNBC, Bloomberg Television

Shopping: The Shopping Channel, Home Shopping Network, QVC

Female-oriented: WE, Oxygen, Lifetime Television, Lifetime Real Women, Showtime Women

Family / Children-oriented: Animal Planet, Anime Network, ABC Family, Black Family Channel, Boomerang, Cartoon Network, Discovery Kids, Disney Channel, Familyland Television Network, FUNimation, Hallmark Channel, Hallmark Movie Channel, HBO Family, KTV – Kids and Teens Television, Nickelodeon, Nick 2, Nick Toons, Noggin (2-5 years), The N Channel (9-14 years), PBS Kids Sprout, Showtime Family Zone, Starz! Kids & Family, Toon Disney, Varsity TV, WAM (movies for 8-16-year-olds)

African-American: BET, Black Starz! Black Family Channel

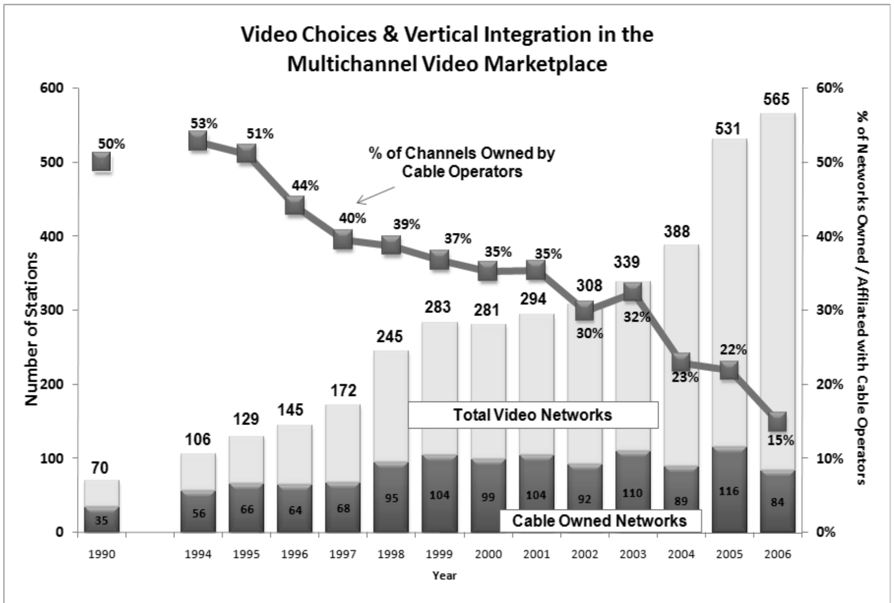
Foreign / Foreign Language: Telemundo (Spanish), Univision (Spanish), Deutsche Welle (German), BBC America (British), AIT: African Independent Television, TV Asia, ZEE-TV Asia (South Asia) ART: Arab Radio and Television, CCTV-4: China Central Television, The Filipino Channel (Philippines), Saigon Broadcasting Network (Vietnam), Channel One Russian Worldwide Network, The International Channel, HBO Latino, History Channel en Espanol

Religious: Trinity Broadcasting Network, The Church Channel (TBN), World Harvest Television, Eternal Word Television Network (EWTN), National Jewish Television, Worship Network

Music: MTV, MTV 2, MTV Jams, MTV Hits, VH1, VH1 Classic, VH1 Megahits, VH1 Soul, VH1 Country, Fuse, Country Music Television, Great American Country, Gospel Music Television Network

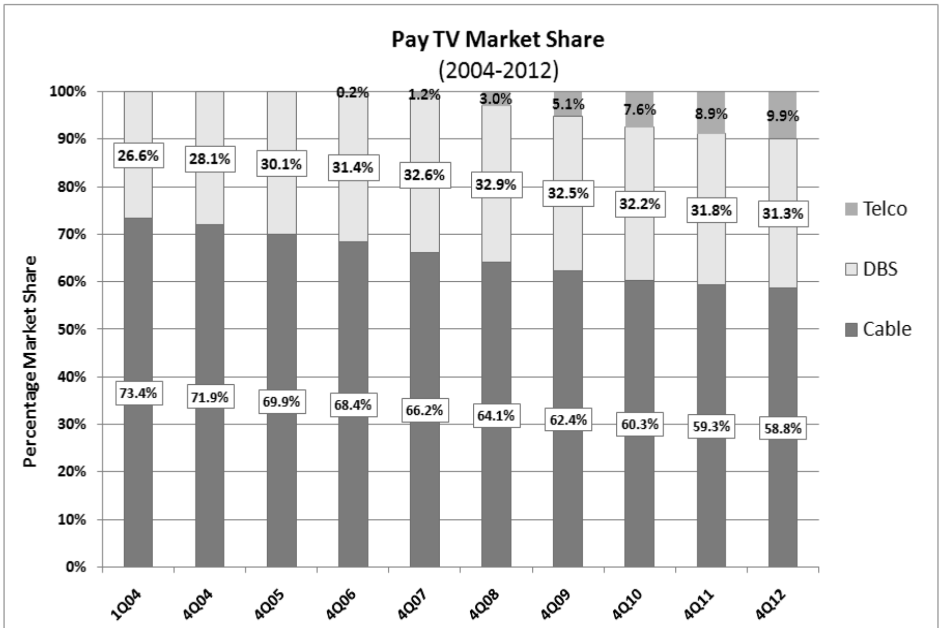
Movies: HBO, Showtime, Cinemax, Starz, Encore, The Movie Channel, Turner Classic Movies, AMC, IFC, Flix, Sundance, Bravo (Action, Westerns, Mystery, Love Stories, etc.)

Not only is programming diverse, so, too, is the universe of programmers. While the FCC and cable industry critics have often expressed concern about vertical integration between cable operators on the one hand and programmers on the other, the reality is that vertical integration in the video marketplace has plummeted. Since 1990, the number of cable-owned or affiliated channels has increased only slightly, while the number of independently-owned and operated video networks has exploded. Thus, as shown in Exhibit 2 (top), the percentage of cable channels owned and operated by cable operators has dropped from 50% in 1990 to just 14.9% today.



Source: FCC, various *Annual Video Competition Reports;* data not available for 1991-93

Competition is also growing on the program delivery front. While local cable operators were once monopolies, competition from satellite, cable overbuilders, and, most recently, telephone companies like AT&T and Verizon is cutting deeply into cable's market share. As shown in Exhibit 3 (bottom), competition in the program delivery market is increasing rapidly.



Source: Bernstein Market Research

Growing competition is not only offering consumers more choice, but also increased quality. Cable, satellite, and telephone companies have invested hundreds of billions of dollars in recent years to provide more channels, digital delivery, video-on-demand, and, most recently, high-definition. As the FCC itself concluded in its most recent report on the video programming marketplace, "competition in the delivery of video programming services has provided consumers with increased choice, better picture quality, and greater technological innovation."[5]

Given these results, what is the case for regulation? Proponents of an a la carte mandate suggest that they can improve on the market in two primary ways. First, since people would no longer be forced to pay for channels they do not watch, they would pay less for cable television. Second, since people could choose not to buy certain channels, they would no longer be forced to subsidize programming (particularly "racy" programming) of which they disapprove. Thus, an a la carte mandate is presented as both economic regulation, designed to reduce prices, and social regulation, designed to "clean up the airways."

II. A La Carte as Economic Regulation

The economic case for an a la carte mandate rests on two premises. First, it is argued, cable prices are rising faster than inflation, and government action is therefore appropriate to give consumers lower prices. Second, a la carte regulation would reduce the prices people pay for cable programming. Neither premise withstands scrutiny.

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If cable prices were rising faster than inflation, there might well be a strong political (though not an economic) case for regulation. Indeed, much of the case for a la carte has been premised on this notion, with advocates pointing, for example, to the most recent FCC report on cable prices, which shows that the average price paid for the basic tier of cable channels rose 93% over the ten-year period between 1995 and 2005, compared with the consumer price index, which increased only 28%. But there are two problems with this data.

First, the FCC's data is three years old. More recent data from the Bureau of Labor Statistics shows that cable price increases have moderated and, indeed, that cable prices in 2007 and 2008 have actually risen less rapidly than the Consumer Price Index (CPI). Perhaps this change is due to increased competition, or to efficiencies associated with the increasing ability of cable companies to spread the fixed costs of their infrastructures over multiple services, such as broadband and telephony. Whatever the reason, cable price increases have slowed, and the political case for regulation has thus weakened.

The second problem with the price increase argument is more fundamental, and ultimately more important: the price increase figures cited by a la carte advocates fail to account for changes in quality, which can be captured by taking into account either the number of television channels included in the basic tier or the time people spend watching cable TV. When cable prices are looked at in terms of the price per channel, the real price of pay television has fallen throughout the past decade.[6] And because television viewing overall is increasing, and cable's share of viewing hours is also going up (relative to over-the-air TV), the price paid per viewing hour has actually declined *even in nominal* terms.[7] Thus, the basic underlying political argument for economic regulation of cable is, to be blunt, a lie: by the most accurate measure, cable prices are not only not rising faster than inflation, they are actually going down!

Most people would agree, of course, that rising prices—even if they were rising—would not by themselves constitute a basis for regulation. Rather, regulation should be considered only if a case can be established for market failure—in which case it might be possible, at least in theory, for regulation to improve on the market outcome and lead to lower prices in the long run. But a la carte advocates have failed to demonstrate that bundling constitutes a market failure of any sort.

Bundling is, course, pervasive throughout the economy, and while the economics of bundling are complex, economists universally agree that it is generally efficient and beneficial to consumers. Bundling improves economic efficiency in a variety of situations, including when there are economies of scope and scale. One particularly significant and relevant efficiency motivation, advanced many years ago by Nobel Prize winner George Stigler,[8] occurs when there are high fixed costs of production and consumers have differing preferences for various "flavors" of a product. A simple example illustrates the point.[9]

Suppose there are two cable TV channels, "sports" and "business," each of which costs $10 to produce. Suppose further that there are two consumers, one of whom is willing to pay $7 for the sports channel and $4 for the business channel, while the other is willing to pay only $4 for sports, but will pay $7 for business. If the two channels are offered separately, there is no price at which demand will be sufficient to cover cost: if each is offered for $10 (its cost), no one buys either channel; if each is offered at $7 and is purchased by one consumer, revenue is $7 and each channel loses $3; and, if each is offered at $4 and purchased by both consumers, revenue is $8, and each channel loses $2. In short, in an a la carte world, neither channel is produced.

If bundling is permitted, on the other hand, the two channels can be offered together for $10, and both consumers (each of whom values the two channels at a total of $11) will purchase. Revenues are now $20, covering the costs of both channels, and each consumer receives $1 in consumer surplus.

This argument is only one of several that explain why bundling of cable TV channels is economically efficient. Bundling also provides a means for cable channels to expand their distribution, thereby increasing advertising revenues (and defraying costs that would otherwise be passed on to consumers in the form of higher subscription fees); it allows consumers to sample cable channels, thereby reducing marketing costs; and, it reduces transactions costs by avoiding the need for cable operators to constantly add and subtract channels from individual consumers' feeds.[10]

Economists also recognize that bundling can, in certain (very limited) circumstances, be a sign of market power, and a la carte advocates have suggested this is the case in cable TV.[11] But they have failed miserably to prove their case. Indeed, as noted above, competition in pay TV is growing: virtually all consumers now have a choice among at least one cable TV provider and two satellite providers, and many can also choose to get their service from cable overbuilders or telephone companies. If a la carte was an economically efficient business model, we would expect to see at least some of the firms in a competitive market to offer it voluntarily, yet none have done so.

Back in 2004, when the FCC first considered (and rejected) a la carte regulation, a group of respected economists wrote to the agency's Media Bureau warning that the proposal would not achieve its purported objectives. Their conclusion: "(1) mandatory a la carte distribution would very likely raise overall prices; (2) consumers' viewing decisions would very likely be distorted and their ability to sample alternative networks and shows would very likely be suppressed; and (3) mandatory a la carte distribution would very likely harm new and niche networks, which would result in fewer viewing options for consumers."[12]

In short, when it comes to a la carte, the economics of cable TV are clear: Rather than reducing prices and increasing choice, as proponents hope, it would do precisely the opposite.

III. A La Carte as Social Regulation

A la carte proponents point to another supposed benefit of regulation: it could help "clean up" the character of pay TV. Many policymakers have expressed a desire to extend content controls to cable and satellite TV, but realize that *direct* efforts to regulate subscription-based media platforms would likely be held to be in violation of the First Amendment.[13] A la carte regulation has been pitched by some of those lawmakers as an *indirect* method of accomplishing that same objective.[14] But will it really work? It is highly unlikely, at least in the fashion many lawmakers and family groups hope for.

The reason is two-fold. First, as made clear above, a la carte regulation threatens the wonderful diversity of programming on television today. That also explains why a la carte proponents are wrong when they suggest that it would "clean up" pay TV and allow us to purchase just the "good stuff." The "good stuff" is not likely to survive in a world of mandatory a la carte regulation. Most family-focused/children's networks, female-oriented channels, and religious programmers oppose a la carte mandates for this reason. They understand that their programs attract only a small subset of the overall universe of viewers. If their networks are not bundled alongside other channels, they might disappear entirely. Colby May, director of the Faith and Family Broadcasting Coalition, which represents religious broadcasters, last year called a la carte regulation "a dagger aimed at the heart of religious broadcasting in America," and predicted that it would "decimate religious broadcasting and the wholesome, family-oriented programming carried on niche cable channels."[15]

Second, the channels that some lawmakers want driven off basic cable—MTV, F/X, Comedy Central, Spike, and so on—will likely continue to do just fine. They are all among the Top 20 networks on cable and satellite TV today and have a strong following on DVD and the Internet. Even under a new regulatory regime, people will still flock to these networks in fairly large numbers.

So the "choice" consumers will be left with in a world encumbered by a la carte regulation is one of fewer choices of television programming. If smaller, niche-oriented networks begin to disappear, lawmakers will be dismayed obviously, but they will be absolutely furious if the channels that they *really* wanted to see vanish end up surviving anyway.

Again, wishful thinking cannot change the basic rules of markets and economics. Policymakers might like to see "racy" programming disappear and "family" programming rule the "airwaves," but imposing a la carte regulation would likely have precisely the opposite effect.[16]

CONCLUSION

From a policy perspective, a la carte regulation is worse than a solution in search of a problem; it is a problem waiting to happen. As prices rose and programming became less diverse in the wake of an a la carte mandate, policymakers would find themselves besieged by consumers and interest groups demanding yet another "solution." Perhaps they would frankly admit error and reverse course, repealing the misguided policy they had so recently put in place. On the other hand, it is just possible that they would proffer still more regulatory solutions—price controls, for example—which would be politically attractive on the surface, but equally flawed in their underlying economics. No doubt the new rules would also be motivated by the best of intentions.

Endnotes

1 *See generally* F.A. Hayek, The Fatal Conceit, (1989).

2 *See generally* Milton Friedman, Capitalism and Freedom (1962).

3 "FCC Adopts 13th Annual Report to Congress on Video Competition and Notice of Inquiry for the 14th Annual Report," Fed. Commc'ns Comm'n, *Press Release,* Nov. 27, 2007, at 3, http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-278454A1.pdf.

4 Fed. Commc'ns Comm'n, *In the Matter of 2002 Biennial Regulatory Review – Review of the Commission's Broadcast Ownership Rules and Other Rules Adopted Pursuant to Section 202 of the Telecommunications Act of 1996*, FCC 03-127, June 2, 2003, at 48-49, http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-03-127A1.pdf.

5 *See* Fed. Commc'ns Comm'n, *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Twelfth Annual Report, MB Docket No. 05-255 (Mar. 3, 2006), at ¶5.

6 *See, e.g.,* Jeffrey A. Eisenach & Douglas A. Trueheart, "Retransmission Consent and Cable Television Prices," The CapAnalysis Group, LLC (March 2005).

7 *See* Steven S. Wildman, *Assessing Quality-Adjusted Changes in the Real Price of Cable Service*, Mich. St. Univ. (Sept. 10, 2003).

8 George J. Stigler, *A Note on Block Booking*, *in* The Organization of Industry (1968).

9 For a more complete discussion, see Jeffrey A. Eisenach & Richard Ludwick, *The FCC's Further Report on A La Carte Pricing of Cable Television*, The CapAnalysis Group, LLC (March 6, 2006).

10 For an excellent discussion of the economic efficiency rationales for cable bundling, see Federal Communications Commission, Report On the Packaging and Sale of Video Programming Services to the Public (December 2004) at 20-26.

11 For example, Chairman Martin has suggested that bundling might constitute an illegal "tying" arrangement. Ted Hearn, *Martin: Expanded Basic a Tying Arrangement*, Multichannel News, Sept. 14, 2006.

12 Joint Economists Letter to Kenneth W. Ferree, MB Docket 04-207, November 4, 2004.

13 *See* Adam Thierer, "Thinking Seriously About Cable and Satellite Censorship: An Informal Analysis of S. 616, The Rockefeller-Hutchison Bill," Progress & Freedom Foundation *Progress on Point* no. 12.5, Apr. 2005, http://www.pff.org/issues-pubs/pops/pop12.6cablecensorship.pdf; Robert Corn-Revere, "Can Broadcast Indecency Regulations Be Extended to Cable Television and Satellite Radio?" Progress & Freedom Foundation *Progress on Point* 12.8 (Progress and Freedom Foundation May 2005), http://www.pff.org/issues-pubs/pops/pop12.8indecency.pdf.

14 *See, e.g.,* Chairman Martin's remarks at "Open Forum on Decency," in the Senate Commerce Committee in November 2005 (http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-262484A1.pdf) as well as his comments on Capitol Hill on June 14, 2007 applauding the introduction of an a la carte legislative proposal (http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-274169A1.pdf).

15 "Religious Broadcasters Oppose FCC Chairman's Call for Pay-Per-Channel Legislation," *Press Release*, Faith and Family Broadcasting Coalition, April 17, 2007, http://www.ncta.com/DocumentBinary.aspx?id=575. The late the Rev. Jerry Falwell also opposed a la carte regulation for the same reason, saying "Though well-intentioned, the fact is that a la carte would threaten the very existence of religious broadcasting and the vital ministry conducted over the television airwaves." Quoted in Ted Hearn, "Falwell's 11th Commandment: No a La Carte," *Multichannel News*, Nov. 17, 2004, http://www.multichannel.com/article/CA481169.html.

16 The better approach would be to encourage the continued development of even more family-friendly and educational fare and then let parents simply block those channels they do not desire with the parental control tools available in every set-top box today. That's a win-win strategy that demands no further regulation of pay TV markets while ensuring parents access to an expanding array of enriching programming for themselves and their children. *See* Adam Thierer, "Parental Controls and Online Child Protection: A Survey of Tools & Methods," Progress & Freedom Foundation *Special Report*, Version 3.0, Spring 2008, http://www.pff.org/parentalcontrols.