Tiers of a Fan: Sports, Programming, and the Referees

*By Raymond L. Gifford & Adam M. Peters**

Professional and college football fans across the country recently found themselves caught in the middle of an increasingly pitched struggle between the providers of sports programming and video distribution platforms. In a Super Bowl XLII preview, the New England Patriots sought to complete a perfect regular season against the New York Giants on The NFL Network and two national broadcast channels in the first multicast of an NFL game since Super Bowl I in 1967. Appalachian State's historic victory over Michigan was carried on the fledgling Big Ten Network, but the spectacle at the "Big House" was not available to Comcast or Time Warner customers.

Sports programming has exploded from Saturday afternoons past "thrill of victory and agony of defeat" to include specialized channels for specific sports (Golf, Fox Soccer), national sports networks (ESPN, ESPN 2), league-specific networks (NBA TV, NFL Network), regional sports networks (MASN, Fox Sports–region), conference specific (Big 10, Mountain), team specific (YES) and team owner-specific (Altitude). With constraints on the amount of bandwidth that video programmers can dedicate to sports on cable and satellite systems, passionate fan demand for access to their specific sports passion, and no immediately principled way to balance pricing access to video platforms with sharing the rents generated by sports programming, what look like simple, bi-lateral contract disputes between programmers and video platform owners turn quickly into first order political and regulatory issues.

The examples from last football season typify the contractual spats between programmers and major cable companies over whether sports networks should be located on special tiers of programming at a higher per-subscriber price or, in the alternative, more widely circulated (and thus more widely paid for) on "enhanced" video subscription packages. While the cable companies point to the spiraling costs of sports programming in an effort to shift some sports content to specialized tiers, the programmers counter that these companies unduly favor their own affiliated sports content by including these channels on basic or enhanced offerings.

The finger-pointing between programmers and distributors has resulted in messaging campaigns which have caught the attention of lawmakers and regulators alike. Some in Congress have threatened to pull the NFL's long-standing antitrust exemption if the league does not seek ways to more widely distribute "must see" games like the Patriots-Giants. State legislatures and regulators at the FCC have considered whether to intervene by mandating the resolution of disputes through an arbitration process. These disputes threaten to submerge what should be the object of commercial negotiations into a regulatory free-for-all—with all the unforeseen and unintended consequences that brings.

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Fragmentation, Exclusive Dealing, and Vertical Integration

The friction in the sports programming market is an outgrowth of a complex set of factors and trends in the market. At its core, sports programming is essential for video distributors to effectively compete. But sport is also a good with powerful, yet varying, demand elasticities and very narrow value windows. This means that the desire for "real-time" viewing runs the gamut of being critically important to some consumers and non-existent for others. This might have been less relevant when national broadcasters and ESPN provided most of the sports content necessary to satisfy the existing demand of the times, but sports programming has since become increasingly fragmented into regional sports networks and channels dedicated to certain sports, leagues, and even teams.

As a result of this phenomenon and the "ESPN effect"—which occurs when a network seeks to leverage the popularity of its content by passing higher league or team royalties through to subscribers—the overall cost of sports programming to consumers has risen at a meteoric pace. For instance, Cox, the nation's third largest cable operator, has estimated that roughly 40 % of the fees its pays go toward sports networks carried on standard cable—even though these channels receive only 10% of its total viewership.

Vertical Relationships

Add to this the impact of exclusive deals or vertical integration between video distributors and sports programmers. DirecTV's exclusive NFL Sunday Ticket, which affords consumers the opportunity to view all out-of-market games, has been widely credited as helping the satellite provider establish a beachhead in the market. However, the NFL purportedly limited this deal to DirecTV because it did not want to disturb its arrangement with national broadcasters, leaving cable companies and their customers in the cold. By contrast, a carriage dispute erupted between the YES Network and Cablevision when the cable company refused to carry New York Yankees games for over a year, and then demanded that the games be carried as a premium channel. Cablevision ultimately relented and began offering the network on an expanded tier; but the legal battle between the companies began as an antitrust claim, with YES claiming that Cablevision was using its status as a vertically integrated distributor in an attempt to protect its "monopoly" over sports programming.

While the FCC generally prohibits cable companies from entering into exclusive deals with affiliated programming vendors, competitors do not have unfettered rights to carry cable companies' affiliated content through a so-called "terrestrial loophole" in the federal Communications Act. While this loophole has been criticized as permitting cable companies to use sports programming to inhibit satellite competition in markets like Philadelphia and San Diego, the geographic "clustering" of cable networks have the benefits of allowing these companies to achieve economies of scale and to compete with telecommunications carriers in voice and high-speed Internet.

To be sure, exclusive deals and vertical integration are largely pro-competitive responses by distributors to differentiate themselves in a market with increasingly vigorous competition between cable, satellite, and telecommunications providers. As these channels find their way onto certain distribution platforms, but not others, though, even an average sports fan may be left with a complex set of choices and the prospect of switching costs, since subscribing to multiple video platforms is not a realistic option for most consumers.

For programmers, placement on an expanded tier virtually guarantees a healthy return through subscriber fees and advertising revenues. But the scarcity of bandwidth on video platforms—exacerbated by the public's apparently appetite for video-on-demand (VOD)—means that distributors must try to maximize the value proposition for all consumers by choosing between thousands of available programming options.

Sometimes this price-value equation just does not add up. Thus, when the NFL Network expanded its programming by showing a limited number of games (announced by the monotone Bryant Gumbel, no less) and sought to ratchet up its price to 70 cents per subscriber in 2006—or when the Big Ten Network demanded $1.10 per subscriber for "second-tier" games in its home region last year—carriage on the coveted expanded tier was far from guaranteed. On the other side of the coin, the NBA recently struck a deal with Time Warner Cable to move NBA TV from a specialized tier *to* an enhanced tier, reducing the per-subscriber license fee from 35 cents per month to around 25 cents per month, because this satisfied the carrier's price-value equation.

While these fights may implicate fans' passions and deeply-held allegiances, from a legal perspective it is tough to see, at first blush, what is problematic. When billion-dollar plus programming platforms and billion-dollar plus sports leagues fight over spoils from consumers' love and willingness to pay for sports, the fights may be nasty and passionate, but they still look like plain old contract negotiations. Nevertheless, because consumers (including politicians) love their sports, because the value of a sports contest peaks and craters during its 'live' window, and because nothing in the communications sphere goes untouched by regulation, sports programming, and its discontents, offer a continuing top-tier regulatory and political struggle.

HD Nation

Coupled with increasing scrutiny by legislators and regulators over the rates charged for tiered programming options, the market dynamics mean that video providers have less flexibility to add more sports programming to their enhanced lineups on today's networks. With the advent and widespread adoption of high-definition (HD) television, the economic tensions endemic to sports programming could reach new heights.

First, pause to consider the broad implications of HD. More HD-ready sets will be shipped by consumer electronics manufacturers than standard-definition models this year, and more than half of HDTV owners will subscribe to a HD service. For sports programming, HD provides a qualitatively superior viewing experience (indeed, it is painfully difficult for some HD subscribers to revert to standard-definition programming). The consumer response to HD is significant. Recent data suggests that ESPN's HD audience in Los Angeles is 22% higher than it is in standard-definition households. Brand recognition of advertisements in HD is estimated to be three times higher than it is for ads in standard-definition format.

For the past several years, there has been tremendous speculation on what "killer application" might arise in the Internet space to fuel further investment in broadband networks. While the impact of video sharing services like YouTube cannot be understated, HD looks like the next killer application, with America's TV-loving culture driving the deployment and adoption of next-generation networks to the home.

And this is just the beginning. The next generation of HD, or ultra-HD, is on the horizon. In an ominous development for news anchors and their makeup artists everywhere, ultra-HD sets are projected to have sixteen times the number of pixels as HD video. These next-generation television sets, which will be powered by the Internet, will also be massive bandwidth hogs.

Unless and until all programming is provided over HD, however, we can expect the emergence of an "HD divide" between programming haves and have-nots. The disputes created by vertical integration and exclusive deals will become more pronounced. And, as HD programming comes with a higher price tag, these costs will need to pass through to consumers. The only question is: Which consumers? Will the costs and revenues be spread out across the broad base of subscribers to video platforms? Or will a subset of consumers pay premium-tier pricing for their interest? The economic stakes are enormous, which means the returns to rent-seeking are likewise.

The Specter of Regulation

Like all forms of television content, many of the issues involved with sports programming boil down to the proper allocation of rents. That said, nothing on television seems to captivate the American viewing public more than live sports; and fans and non-fans alike pay for new ballparks and collegiate sports at public institutions.

In a market with increasing fragmentation, "public interest" considerations are thus more likely to seep into the debate; unless programmers and distributors can reach commercial solutions that are consumer-friendly. Indeed, the historic multicast of the Patriots-Giants game was widely perceived as a concession by the NFL to its fans once the league found Congress to be a less than sympathetic audience. Moreover, the recent negotiations between Major League Baseball and video distributors for the rights to carry the MLB Channel (set to launch in 2009) and the league's Extra Innings package may be a sign of things to come, particularly when DirecTV's exclusive deal with the NFL expires in 2010. (In that case, after MLB reached a deal with DirecTV it offered the same terms and conditions to other major video distributors. A consortium of cable companies ultimately opted in, but not until Congress played its part by pressuring MLB to make the package widely available.)

The failure of commercial solutions in high-profile cases may create the conditions for more drastic government intervention. Members of Congress have already threatened to reconsider the antitrust exemption for the NFL. Last year, the FCC and legislatures in six states considered rules that would require arbitration when commercial negotiations failed. Such an approach would presumably direct distributors on which programming to place in which tiers of service, effectively inserting a government decision-maker into the editorial process. Leaving free speech issues aside, this new age model for state-run television would seemingly require the government to pick winners and losers, since compelled carriage of one channel would likely require another channel to be bumped to another tier or off a video platform entirely.

For those who object to the high cost of sports programming or the specialized tiering of certain channels, a more radical response would require channels to be sold on an *a la carte* basis. Even with *a la carte*, the subject of considerable controversy, government would most assuredly get involved in mandating certain forms of tiering to protect favored types of content, which is precisely what is occurring with *a la carte* in Canada.

In the near term, however, the mere threat of regulation may conspire with market forces and technological advancements to move us in a direction toward de facto *a la carte*. With prices for tiered subscription packages at a virtual ceiling, and with ever-expanding programming options and outlets, video distributors may respond by offering a more diverse array of "smart bundles" of specialized programming, thereby stemming the regulatory tide.

The Next Playing Field: IPTV

While distributors are currently shifting to switched, interactive IPTV platforms through pay-per-view and VOD, programmers increasingly make their television content available on the Internet. As Bret Swanson and George Gilder point out, IPTV is "not necessarily an Internet service," but "television and the Internet over time will merge into something entirely new." For a glimpse of this future, look no further than Apple TV, which beams content from iTunes onto high-resolution screens in people's living rooms.

As this convergence between television and Internet occurs, the existing sports programming model will be turned on its head. Leagues and teams will have a greater ability to offer live content to consumers over unbundled, proprietary applications. This further fragmentation of sports programming also means that the allocation of rents between programmers and distributors may be determined in large part on whether, and to what extent, "network neutrality" rules are in place. Such rules could not only have a bearing on whether exclusive deals and vertical integration can take place, but whether distributors will have the ability to recoup some of their investment in fatter broadband pipes for next-generation television from programmers.

The dynamism of the broadband, consumer electronic, and programming markets meets head-on during two- and three-hour windows when a live sporting event happens. Intense fans care deeply—and will pay dearly—to watch their team. Meanwhile, broad swaths of viewers could care less. This dynamism cries out for government forbearance from interfering in sports programming markets. The economic model for apportioning rents between programmer and video platform owner is not immediately clear. Correlatively, the degree of vertical integration between platform owner, programming owners, and sports team has no *a priori* answer. The answers—or at least the institutions to facilitate the answers—will be discovered through market processes. While bi-lateral monopoly and situational opportunism problems are present in sports programming markets, in the end, programmers need platforms to reach their viewers, and platforms need content that consumers value; and the higher they value content, the better.