"The Video Marketplace and the Internet Transformation"

Remarks of Commissioner Ajit Pai, Federal Communications Commission

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Patrick, thank you for that kind introduction as well as for inviting me to speak at today's Media Institute luncheon. The Institute has emerged as an important voice on behalf of free expression. I commend you for the fine work you do defending this cherished liberty.

Since I became a Commissioner last May, I've spent a fair amount of time talking about the Internet Protocol (IP) transition or what some are calling the Internet transformation. This profound change in our technological landscape is revolutionizing every sector of the communications industry. Today, however, I want to focus on what the Internet transformation means for the video marketplace and how policymakers should be responding to such dramatic change.

Speaking of change, I celebrated my fortieth birthday last month. And like many of you, I also saw a few movies. "This Is 40," "Life of Pi" . . . to be honest, I sometimes felt as if Hollywood aimed its Christmas-season film slate specifically at me. But on a more serious note, as you hit birthday milestones, you tend to reflect upon how much the world has changed during your lifetime.

When I was born in 1973, there were three commercial broadcast television networks in the United States: ABC, NBC, and CBS. Together, they had a 90 percent prime-time market share. The most-watched prime-time television series in the United States was "All in the Family," which averaged a 33.3 rating. Just think about that: Each week, about one in three American households with televisions was tuning into the same program at the same time. For the three major broadcast networks, the "All in the Family" theme song was apt: "Those Were the Days."

Cable television was in its infancy. Satellite television was an option for a few, but it required a ten-foot wide dish that had to rotate every time you changed the channel. Forget about Direct Broadcast Satellite (DBS), TiVo, and Netflix; there wasn't even Betamax! No, most Americans could choose from three to five broadcast channels, and they could watch a program only when the broadcaster chose to air it. That was it.

Fast forward twenty years to 1993, the year after the last major revision of the Cable Act. The most-popular prime-time television series was "60 Minutes," which averaged a 21.9 rating. FOX was now a nationwide broadcasting network. Cable had become commonplace, at least in urban areas. And cable incumbents dominated the multichannel video programming distributor (MVPD) market with a 95 percent market share. Cable operators and independents had started to challenge the big four on content creation via 70 or so cable programming networks. But Americans still could only choose among a handful of broadcast channels, and usually only one MVPD, when it came to video entertainment.

Now it's 2013, and competition is everywhere. The most-watched prime-time series is "Sunday Night Football," but it has an average rating of just 12.9, barely one-third the ratings of "All in the Family" forty years ago. Television stations broadcast high-definition programming and multiple streams at the same time. Competition between broadcasters and MVPDs is fierce with almost 90 percent of households subscribing to a cable or DBS service. Competition among MVPDs may be stronger. Almost all Americans can choose among at least three MVPDs, and about one-third can choose among at least four. And the market share of incumbent cable operators has dropped below 60 percent. At the same time, content creation has thrived. Over 500 cable and satellite programming networks have been created to fill niche after niche.

But to me, the big story is the IP transition and how the Internet is transforming the business relationship between company and customer in the video market. Consumers are no longer happy to watch content passively in front of a TV. They are actively seeking out what they want, when they want it, at home and on the go.

This development is fundamentally changing the business model of distributing video. It's not clear how the economics will shake out. But we do know that over-the-top providers like Netflix and Hulu have encouraged some consumers to drop cable service and set their own schedule for television viewing. Online storefronts like Amazon Instant Video and iTunes let consumers download episodes of their favorite show, sometimes even before it's broadcast. Almost half of Americans have DVRs that allow them to record programming and watch it when they want to watch it. And connected devices like Roku, TiVo Premiere, and even the Microsoft Xbox 360 let consumers stream Internet programming onto their own TV sets.

Nobody should underestimate these Internet providers just because they are new. Netflix, for example, has over 27 million online subscribers, a customer base larger than any MVPD in the country, and it just premiered the original series "House of Cards," which reportedly cost about $100 million to produce. Hulu Plus has three million subscribers, which would place it among the top ten MVPDs.

But the Internet transformation isn't just breaking down old business models. It's also creating the opportunity for new ones. Take the story of Felicia Day, whom I met last month at the Consumer Electronics Show. She is a talented actress who's had roles in movies and television series, but she is best known for her Internet video work. In 2007, she created and starred in "The Guild," a web series that is currently in its sixth season and has attracted over 12 million views. In 2008, she co-starred in "Dr. Horrible's Sing-Along Blog," which was the #1 video on iTunes for over a month, averaging 2.2 million downloads a week. And last year, Felicia launched a new premium content channel on YouTube called "Geek and Sundry." Geek and Sundry has launched seven series. It has almost half-a-million subscribers. And it has received almost 37 million views.

Reflect on that. Felicia Day doesn't need the permission of gatekeepers at MVPDs or broadcast networks to share her creative vision with the world. Instead, she can distribute content directly to viewers around the world through the Internet. *This* is the power of the Internet: An artist creates and distributes her work in any way she sees fit, and consumers can watch whatever they want, whenever they want it.

What are policymakers to do in the face of this Internet transformation? Our rules should reflect the current technological and competitive landscape, but this challenge can be hard to meet. After all, the Cable Act didn't contemplate such a dynamic marketplace. It was a reaction to a snapshot of the market at a moment in time. It was written for an analog world of monopoly cable operators, based on the assumption of enduring cable domination. As a consequence, that law imposes numerous regulatory burdens on any cable service that falls under Title VI.

In considering whether to develop a new service, the first question cable operators should ask is: Would this add value for our customers? Unfortunately, many in the industry now find themselves pondering a different question: How would this service be regulated? A cable company recently told me that the legal team had to flyspeck every single idea for improving the business to make sure that it was even allowed. Innovation shouldn't be frustrated by worries about regulatory burdens. And it shouldn't be hindered by regulatory uncertainty. But I think that we have reached the point where the Cable Act as it stands is deterring progress, to the detriment of consumers.

Now, nobody here expects a comprehensive rewrite of the Cable Act in the next two years. But even minor statutory changes could yield major benefits.

For example, we could accomplish a lot if the FCC's forbearance authority included MVPDs and cable service. Right now, section 10 allows the FCC to "forbear from applying any regulation or provision of the [Communications] Act to a telecommunications carrier or telecommunications service, or a class of telecommunications carriers or services." Over the years, forbearance has allowed the FCC to remove outdated regulatory burdens from telecommunications carriers. This, in turn, has encouraged infrastructure investment and broadband deployment.

That's great, but we can't take these same steps with respect to laws and regulations aimed at MVPDs. This makes no sense. The video industry is undergoing the same transformation that we are witnessing in the telecommunications sector. Technology is turning voice *and* video into applications transmitted over the Internet. Former monopoly providers are facing intense competition as we move to an all-IP world. So it seems to me that the FCC should have the *same* authority to relieve MVPDs from obsolete rules as we currently have for carriers. Permitting forbearance for voice regulation but not for video regulation is itself an anachronism.

That said, to paraphrase Donald Rumsfeld, we at the FCC go to work with the statute that we have, not the statute we might want to have. And it is our duty to implement that statute faithfully. But as we do so, we should exercise our discretion wherever possible to avoid heavy-handed intrusions into the marketplace.

When it comes to cable regulation, we generally have done that since my arrival at the FCC last May. We ended the prohibition against basic tier encryption. We modified our viewability mandate. We allowed our across-the-board ban on exclusive programming contracts to sunset. The Internet transformation—accompanied by the transition to digital cable and the increased competition in the video market—justified each of these decisions.

But we also made an unforced error. Last year, the Commission decided by a narrow majority that Comcast had discriminated against Tennis Channel by distributing it to fewer homes than Golf Channel and Versus, both of which are affiliated with Comcast. I strongly disagreed with this decision. The record showed that *every* major MVPD in the country at the time distributed Golf Channel and Versus to more homes than Tennis Channel. Indeed, even DISH and DIRECTV, which have ownership interests in the Tennis Channel, distributed that network to fewer homes than both Golf Channel and Versus! So I didn't understand how it could be considered affiliation-based discrimination when Comcast did the same thing.

In a couple of weeks, the D.C. Circuit will hear argument on whether the agency's decision was consistent with the First Amendment, the Communications Act, and the

Administrative Procedure Act. I look forward to receiving the court's guidance. But whatever the court decides, I worry that we have sent precisely the wrong signal to the marketplace.

At a time when consumers have more options than ever before for accessing video content, the FCC shouldn't go out of its way to micromanage MVPDs' programming decisions.

At a time when we would like cable operators to devote more bandwidth to advanced services, we shouldn't force them to carry more channels in order to avoid carriage complaints.

And at a time when video distributors and American consumers alike are complaining about programming costs, we shouldn't order MVPDs—and ultimately, consumers—to pay for programming that they don't want.

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Speaking of unforced errors, it looks like the FCC could make another one as part of the media ownership proceeding. Given the realities of the modern marketplace, I have come to believe that we should relax or eliminate many of our ownership rules. Here, too, the Internet transformation is having a dramatic impact on television broadcasters. The competition that they face for viewers and advertisers is stronger than it has even been. This demands fundamental changes in their business models. The days when Americans' home video options were limited to a few broadcast television channels are long gone. Our regulations have to reflect that reality.

Yet, instead of discussing how best to relax the local television ownership rule, I find it amazing that we are debating whether to tighten it by making Joint Sales Agreements (JSAs) and Shared Services Agreements (SSAs) attributable. I have no doubt that those advancing this proposal have the best of intentions. But if their efforts succeed, I fear that the effects will be quite negative, especially in smaller markets.

As broadcasters' share of the advertising market has shrunk in the digital age, television stations must be able to enter into innovative arrangements in order to operate efficiently. JSAs and SSAs, for example, allow stations to save costs and to provide the services that we should want television broadcasters to offer.

In my home state, for example, a JSA between two Wichita stations enabled the Entravision station, a Univision affiliate, to introduce the only Spanish-language local news in Kansas. Across the border in Joplin, Missouri, a JSA between Nexstar and Mission Broadcasting not only led to expanded news programming in that market but also nearly $3.5 million in capital investment. Some of that money was spent upgrading the stations' Doppler Radar system, which probably saved lives when a devastating tornado destroyed much of Joplin in 2011.

Capturing these efficiencies is particularly important outside of the nation's largest markets. For instance, in Fort Smith, Arkansas, the nation's 100th largest market, the average revenue per television station is *less than one-tenth* that of the average in New York City. In the nation's 200th largest market, Ottumwa, Iowa, the average revenue per station isn't even *one-thirtieth* as large as the average in New York City.

For stations in markets like these, the choice isn't between JSAs or having both television stations operate independent news departments. Rather, the real choice is between JSAs and having at most one television station continue to provide news programming while the other does not. If the FCC effectively prohibits these agreements, fewer stations in small-town America will offer news programming, and they will invest less in newsgathering. And the economics suggest that there likely will be fewer television stations, period.

Losing these stations would be terrible for American media consumers. For unlike some, I don't see broadcasting as a faded relic of the past. Broadcast television remains a critical part of the media landscape. For example, just two days ago, at our field hearings in New York and New Jersey, I learned about the vital service that local broadcasters provided during Superstorm Sandy. When other methods of communications failed, broadcasters transmitted lifesaving information and alerts to the public. As we head into the future, we can't expect to substitute broadband for broadcast. Instead, we should view them as complements.

Finally, as we complete our quadrennial review (or should I say quadrennial-ish review) of our media ownership rules, we need to be mindful of the fact that our antiquated rules are actually making it more difficult for some industries to cope with the Internet transformation. If I might digress from the video market for a minute, I think it's clear that the Internet has revolutionized the print marketplace and I believe it's long past time that we eliminated the newspaper-broadcast cross-ownership rule.

Americans can access an ever-widening range of news and information online at any time, day or night, so fewer and fewer of us choose to subscribe to a daily newspaper. And as online advertising becomes ever more local and mobile, the advertising niche once served by newspapers is fading.

The numbers say it all. Since the newspaper-broadcast cross-ownership rule was enacted in 1975, over one in five newspapers in the United States has gone out of business. During that same time period, while the number of households in our country has increased by over 55%, newspaper circulation has declined by more than 25%. In the last few years, we've seen daily newspapers close in major markets like Denver, Cincinnati, Tucson, Honolulu, and Albuquerque. And in New Orleans, my former local newspaper, the *Times-Picayune*, is printed only three times a week.

By reciting this litany, I don't mean to suggest that newspaper-broadcast combinations are a panacea. But had we eliminated this prohibition a decade ago, the industry's prospects might look brighter today. It might be too late for us to make a meaningful difference at this point. But that doesn't mean we shouldn't try.

Investments in newsgathering are more likely to be profitable when a company can distribute news over multiple platforms. And cross-owned television stations on average provide their viewers with more news than do other stations. Given these facts and the substantial challenges facing the newspaper business, it doesn't make sense to prevent a class of disfavored companies from operating newspapers. If you are willing to invest in a newspaper in this day and age, we should be thanking you, not standing in your way.

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The problems confronting newspapers are symptomatic of a larger truth. The Internet transformation is disrupting business models all across the media market. Broadcasters are searching for new revenue streams to supplement advertising sales. Cable operators are confronting rising programming costs and the need to make significant capital investments to meet their customers' demand for IP-delivered and mobile video. Over-the-top providers, in turn, are trying to find ways to deliver content over broadband in an economical manner.

These are big challenges for those in the business world. But I believe that all of this competition and the technological revolution ultimately are boons for the American consumer.

Fifty-two years ago, then-FCC Chairman Newton Minow famously surveyed the American television landscape and proclaimed it to be “a vast wasteland.” Today, by contrast, we are living in what many are calling the golden age of television. This is the direct result of the evolving structure of the video marketplace.

It used to be that a television show needed an audience of twenty or thirty million viewers to stay on the air. To attract these numbers, programs were designed to maximize breadth of appeal. You couldn’t specialize. What mattered was not how intensely a particular group of viewers liked a particular show but whether enough viewers would choose not to change the channel to one of the other limited options available.

For this reason, television shows in the pre-IP era tended to be written to be easy to understand and required only a marginal amount of previous knowledge. In 1983, all a viewer tuning into the beginning of a Magnum P.I. episode needed to know was that Tom Selleck was an investigator with a mustache and a Ferrari, and that he would resolve the case before Simon & Simon started an hour later.

But today, content providers can focus on maximizing the breadth *and* depth of a program’s appeal. A television show may generate a small but hardcore fan base willing to watch every episode and record it to DVR, re-watch episodes on Netflix or Amazon, and purchase the season on DVD or iTunes. This kind of show can be just as viable as one with an audience that is wider yet only marginally interested.

“Mad Men,” for instance, averaged an audience of approximately 2.6 million viewers last year. These relatively lower viewership expectations allow programmers and content creators to be more innovative and to take more risks. Because dedicated viewers are now able to keep up (or in some cases catch up) with a television show through services like DVR and Netflix, programmers are free to create content that is more complex. They can establish a complicated narrative arc that traverses a season, rather than an episode. They can deploy dozens of characters, rather than a few. And they can design a series to capture a niche audience in a way that would have been rejected out of hand years ago.

Some of these programs—like two of my weaknesses, “The Wire” and “Downton Abbey”—will be sheer delights. Others that are part of the incredibly diverse marketplace, not so much. I doubt, for example, that former Chairman Minow these days watches “Jersey Shore” or “Here Comes Honey Boo Boo” (although one of my interns does tell me that “Duck Dynasty” is quite entertaining). But that’s the beauty of letting the consumer wander through the aisles of a well-stocked store. Some products will make it into a lot of carts. Others will stay on the shelf. But it is *consumers* who decide, one by one. And that element of individual choice makes all the difference.

Take one of my favorite shows: “Arrested Development.” In 2006, it was cancelled during its third season. Although it was critically acclaimed and had won the Emmy for Best Comedy, Arrested Development’s audience was only about four million viewers a week when FOX pulled the plug. And today? Netflix is on the verge of releasing 14 new “Arrested Development” episodes. The lesson is this: A show that could not survive in the marketplace of 2006 may thrive in the marketplace of 2013.

All of this is to say that the video landscape is highly dynamic, fiercely competitive, and rapidly evolving. When it comes to the future of that market, there are plenty of things that we don't, and can't, know. If recent history is any guide, consumers a decade from now will take for granted products and services that none of us in this room can now envision.

So our general approach at the FCC should be to show humility and give the market the leeway to find its own equilibrium, instead of attempting to impose by regulatory fiat the outcome that we might like to see at any given point of time.

Thank you once again for inviting me to speak with you this afternoon. I look forward to answering your questions, and as we move forward in the coming months and years, I hope that we continue our dialogue on these important and challenging issues.