Cord Cutting Anxiety Oversimplifies Distribution Revolution

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14-17 minutes

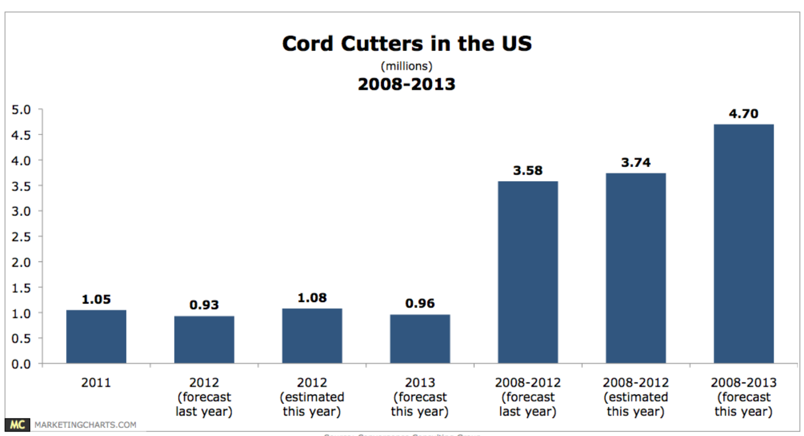
Cord cutting refers to the act of cable and satellite consumers cancelling their subscriptions and opting instead for non-traditional distribution outlets, like streaming media platforms. The trend has been the subject of much debate in the trade press and a source of much concern for the industry. Yet many questions remain unanswered: Is it really a major trend? Does it save consumers money? Can viewers still find the content they love? How do we even “cut the cord” anyway?

For consumers, cord cutting represents the potential for a reconfigured viewing experience, one in which prohibitively expensive pay-TV subscriptions are replaced with an a la carte entertainment diet from the likes of Apple TV, Amazon, and Netflix. For content providers and pay-TV operators, cord cutting challenges long-standing, and quite lucrative, distribution models. However, the trend is just one of many pressures currently upending the way the television industry conducts its business. Thus, the real anxiety is rooted in much deeper fears about a future media environment in which pay-TV operators are no longer kings.

Here are the four things to know about cord cutting:

1. Consumers are responding to a digital media environment that makes cable packages look increasingly anachronistic.
2. A narrow focus on cable subscription rates obscures the relative stability of the pay-TV sector.
3. At stake in any distribution revolution is an extremely lucrative business model.
4. Legacy media companies are more invested in protecting traditional business models than imagining innovative alternatives.

1. Consumers are responding to a digital media environment that makes cable packages look increasingly anachronistic.



The average cost of pay-TV has risen nearly [90 percent] in the last decade and shows no signs of slowing down, much to the [chagrin] of audiences who are increasingly leery of paying for channels they don’t watch. If this rate of increase continues, average monthly subscription costs will reach [$200] by 2020.

Accordingly, cord cutting has emerged as an urgent indicator across market research firms, the mainstream press, and industry trades that the pay-TV sector faces "an affordability crisis." Headlines about cord cutting also do little to offset the sector's astonishingly poor public image; pay-TV currently ranks second to last on the American Customer Satisfaction Index under the information sector category.

We agree change is afoot but the trend is much more broad than cord cutting alone, and the immediate threat it poses to traditional business models remains questionable (see point two and three below). Nevertheless, consumers *are* responding to a digital media environment that makes cable packages look increasingly dated alongside a growing list of alternatives.

Research study after research study confirms cord cutters represent a small, but rapidly growing, portion of the television audience—some recent research puts the number at about 5 percent of the total television market. Other findings suggest the pay-TV sector finally experienced net subscription losses for the first time in 2013, dropping from 100.9 million to 100.8 million, according to researcher HIS.

But cord cutting isn't for everyone. It leaves many fans of particular genres and programming without a suitable way of accessing their favorite content, and with only modest savings. For such consumers, "cord shaving" or "cord trimming" might prove a more beneficial option by combining a downgraded, less-expensive cable or satellite plan with supplementary services, like Netflix or iTunes. In fact, some research suggests customers are more likely to downgrade their cable package than cut the cord altogether.

Other research points to the preference for traditional over-the-air viewing. For example, a GfK Media study indicates over-the-air-broadcasting is the preferred mode in over 19 percent of all households, especially strong amongst minorities and younger viewers. Furthermore, only one-third of these homes were previous pay-TV subscribers, a finding that also raises the specter of the “cord neverer.” Indeed, as the number of occupied households outpaces net subscription gains, pay-TV operators have seen penetration rates drop, meaning a portion of households opt to never connect the cord in the first place.

Driving these trends is a number of factors, including the transition to digital television, the mortgage crisis, retransmission and carriage fees, general economic pressures, and generational change. In fact, the typical cord cutter or cord neverer is young, single, educated, and employed. Roughly one-third of “millennials” consume television online, and about 13 percent of those broadband-only subscribers say they are fully “committed” to a cable- or satellite-less entertainment experience.

Yet, the popularity of over-the-top services perhaps presents the biggest case that traditional distribution models are outmoded. “Over-the-top” technically refers to any device or service that delivers video content to consumers over the top of their existing Internet connection, bypassing traditional pay-TV operators. This includes Internet-connected devices like set-top boxes (Apple TV, Roku), game consoles (Wii, PlayStation, Xbox), smartphones and tablets, and Smart TVs. In fact, as CES 2014 confirms, consumer electronics manufacturers are still betting on Smart TVs to help revive slumping TV sales. Over the top also includes services like Netflix, Amazon Instant Video, and iTunes. Further afield are upstart services like Aereo, which allows subscribers to pick and choose what over-the-air content they want to watch and when, drawing from its DVR-like cloud service. While the service slowly expands to markets across the US, the company has raised the ire of broadcasters who have been quick to frame the service as illegal.

2. A narrow focus on cable subscription rates obscures the relative stability of the pay-TV sector.

In January 2013, Time Warner Cable launched a $50 million ad campaign called "The Better Guarantee." It features testimonials from subscribers who explain why they returned to the nation's second largest cable operator. The campaign garnered media attention *not* because it targeted cord cutters but because it attacked the subpar service of satellite and telecommunications firms.

There are two things worth teasing out from this example. Time Warner's campaign became "news" because it upset what seems commonsense—that cord cutters are the primary force threatening cable's long reign. Yet, more importantly, the campaign gestures to the growing competition cable operators face from the likes of Dish Network and Verizon, meaning cord cutters aren't the only (or most significant) drain on cable subscription numbers.

In fact, telecom firms have helped offset sector-wide declines by picking up cable and satellite defectors, primarily from the country's largest providers Time Warner and Comcast. At the same time, cable companies are experiencing a surge in broadband subscriptions since many telecom firms can't compete with high-speed Internet delivery. Cable operators even scored a record $10 billion in advertising commitments during the 2013-2014 upfront. While cable suffers, the sector as a whole remains relatively stable.

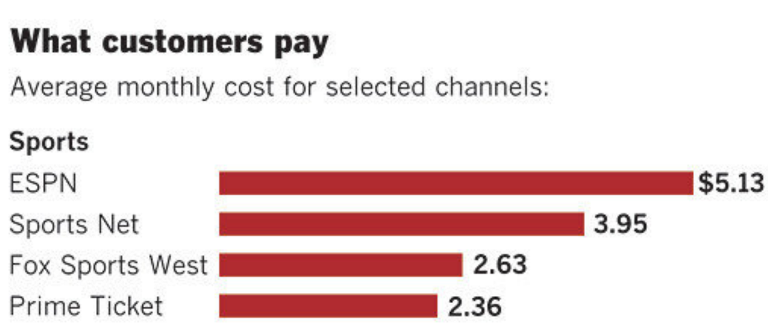
Keep in mind these are large, publicly traded companies beholden to shareholders and business analysts. As corporate bottom-lines increasingly focus attention on short-term results, each quarterly report plays out in the headlines, and distracts from long-term patterns. So, while it is true pay-TV operators experienced a quarterly decline in subscriptions for the first time in 2010, the story's lead buries the fact that net gains each year have compensated for those losses.

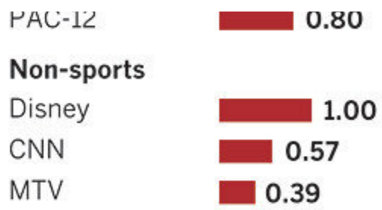
3. At stake in any distribution revolution is an extremely lucrative business model.

In an interview with MIP, *LA Times* Media Reporter Joe Flint says in regards to digital distribution, "you are dealing with an industry that will innovate at gunpoint." We tend to agree but not because the entertainment industry is home to luddites. Rather, at stake in the digital distribution revolution is a highly lucrative business model wherein the steep costs of entertainment production are covered by advertising dollars and carriage fees. It’s currently difficult to imagine a future in which digital downloads can subsidize business in the same way. In 2011, for instance, multi-channel operators shelled out $38.5 billion for programs and retransmission fees while Apple, Netflix, and other over-the-top services spent just $3 billion on programming.

Flint also acknowledges in the same interview that content distributors and programmers often collude to limit the growth of alternative distribution methods. He recalls,

I interviewed a man recently for a story I was doing about this Department of Justice probe into the paid television business that emerged a few weeks ago. The interviewee runs this cable channel called Wealth TV. It’s a very small, independently owned network. He struggles to get any distribution because he's not one of the big five or six media companies. He said that in his contracts it's very clear that if he were to sign on with some sort of over-the-top provider, he would put his distribution agreements in jeopardy. He said that on the record. That was refreshing because most people don't come out and provide that information.





Sources: SNL Kagan, industry estimates

KHANG NGUYEN Los Angeles Times

In addition to anticompetitive contracts and bandwidth caps that limit the market potential for distribution upstarts, a major concern for watchdog groups is “bundling.” In this practice, programmers package less popular or newer channels with more successful ones, effectively subsidizing lesser-watched networks by grouping them with more valuable properties and charging higher fees. Sports programming is one of the best examples, which constitutes approximately 50 percent of pay-TV operators’ programming expenses but accounts for only about 20 percent of their programming. Disney, for example, charges pay-TV operators more than $5 per month per subscriber for ESPN—that’s the highest fee for any cable channel on any service. Yet, a distributor must agree to carry (and pay for) every ESPN channel even if it just wants access to the flagship station. Ultimately, those expenses raise subscription fees for every subscriber, regardless of his or her interest in sports programming.

So, as logical as an a la carte business model might appear to viewers who just want their HBO without a cable package, the tight relationship between content providers and distributors is unlikely to forfeit the billions of dollars in lucrative contracts that underpin it. Likewise, there are additional overhead costs—like customer service, billing, and infrastructure—that any content provider interested in a direct-to-consumer relationship must consider; right now, the pay-TV operators handle those costs, and the likelihood of any brand being strong enough to shift an entire consumer base away from the familiar confines of subscription television makes the initial investment an unlikely prospect.

4. Legacy media companies are more invested in protecting traditional business models than imagining innovative alternatives.

Perhaps it's been fashionable to blame cord cutters because their behavior upsets the *logic* of the pay-TV business model, and easily pits renegade online viewers against legacy media companies in a David v. Goliath narrative. Cord cutting also serves as a handy stand-in for a slew of other challenges dogging pay-TV operators. Similarly, if cord cutting is framed as an urgent problem, then it helps generate support for industry-wide initiatives like TV Everywhere or authentication, which some advocacy groups perceive as efforts to squash the competition before a real threat ever materializes.

Accordingly, in June 2012, the Justice Department launched an ongoing anti-trust investigation to determine whether cable companies, including Comcast and Time Warner, have engaged in unfair business practices to preserve traditional business models. At the heart of the investigation is whether these companies were inappropriately privileging certain content that travels across their broadband networks over others in a ploy to hinder its perceived online competitors, including Netflix and Hulu.

According to the cable companies, data caps help manage the stifling amount of video traffic on the Internet and prevent “heavy users” from overwhelming their networks. Yet competitors suggest such tactics are designed to encourage customers to stick with pay-TV services rather than migrate to online video providers. Moreover, cable companies unfairly privilege their own streaming content—for instance, Comcast does not count content streamed over its Xfinity app for Microsoft’s Xbox 360 against its data caps.

As part of this investigation, in 2013 the DOJ considered allegations that cable and satellite companies were interfering with Intel’s ability to bring on content partners for the company’s now defunct IPTV set-top box.

At stake in these disputes is less an issue of what people want to watch (and where) and more the power cable companies have, and want to maintain, over consumer behavior and broadband traffic. Unfortunately, this investigation is likely to harm consumers more than it helps them, as some suggest the DOJ’s probing will accelerate the shift from unlimited broadband models to tiered pricing structures in which people pay for varying speeds and data caps. Comcast has already announced it will abandon data caps in favor of a tiered pricing structure, forcing its heaviest users to pay for the extra data they use.

Ironically, the struggle to keep pace with technological change while protecting traditional business models risks pitting the various holdings of media conglomerates against each other and the pay-TV operators who distribute their content. For instance, while regulating data usage on broadband networks makes sense as a strategy to maintain network stability and preserve lucrative licensing contracts between content companies and distributors, it equally hinders efforts of digital divisions within media conglomerates who want to connect directly with consumers. As Jennifer Holt's contributions to the Connected Viewing Initiative make clear, questions of policy, specifically net neutrality and data caps, remain central to any discussion of cord cutting and its economic effects on the television industry.