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## Let the Market Decide: The Case Against Mandatory Pick-and-Pay

by

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- The federal government has requested the CRTC to study the feasibility of mandating that Canadian consumers be able subscribe to pay and specialty television services on a service-by-service basis.
- Any proposals to mandate such “pick-and-pay” channel choices are deeply misguided and are largely an exercise in futility in the light of the technological revolution that is unfolding in the communications sector. Any regulation would become irrelevant at best, harmful at worst.
- A more fundamental review of the state of the industry and the dynamic changes it is experiencing is required, including a review of the instruments appropriate for regulatory intervention, such as Canadian content requirements, in this environment.
- Given past and future technological change, it is inevitable that market forces will provide increasing discipline to broadcast distributors in coming years that will lead to optimal forms of content unbundling.

In the Throne Speech of October 16, 2013 and by Order in Council in November 2013, the federal government requested the Canadian Radio-Television and Telecommunications Commission (CRTC) to make a report as soon as feasible on the ability of Canadian consumers to subscribe to pay and specialty television services on a service-by-service basis in a manner that most appropriately furthers broadcasting policy for Canada.

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Further to this Order in Council, and as part of a broader review of the future of Canadian television, the CRTC has released a set of tentative proposals for expanding subscriber flexibility in choosing television programming on a service-by-service basis or building their own packages. That is; they would not leave the choice of packages available largely up to the discretion of broadcast distribution undertakings, or BDUs, which include cable, satellite, and telecommunication service providers.<sup>1</sup> These proposals have set off a firestorm of controversy in the broadcasting industry and amongst public interest groups, eliciting sharply divergent submissions from interested parties at the recently concluded CRTC public hearings on the subject.

Many of the CRTC's proposals are deeply misguided and are largely an exercise in futility in light of the technological revolution that is unfolding in the communications sector (broadly defined). Instead, the government should leave BDUs the discretion to choose program offerings and packages so as to maximize their own revenues and overall consumer welfare.

As they deliberate on these conflicting proposals, and prepare their recommendations for government action, the CRTC commissioners would be wise to consider a key policy objective for the telecom sector set out in an existing government Policy Directive – to rely on the market to the maximum extent possible.<sup>2</sup>

## The Current Regulatory and Competitive Landscape

At present, BDUs are subject to various regulatory constraints on the packages they may offer. One example is the requirement that they distribute a basic service of local news and broadcasting channels to all subscribers before providing other types of programming services. Other requirements mandate that in any package offered by a BDU, a preponderance of programming services are Canadian broadcasting services. Obviously, mandating that BDUs provide all programming to subscribers on a service-by-service basis, without any constraints, would put at risk this preponderance rule, which has hitherto been regarded as one of the bedrocks of Canadian broadcasting content policies.

In a previous C.D. Howe Institute *Commentary* (Hunter et al. 2010), we argued that the evolution of digital technology, especially the Internet, has revolutionized, and will continue to revolutionize, the distribution of, and access to, programming content by viewers. Over the last few decades, the sector has moved from the over-the-air era with a very small number of channels, to the current 500-channel era, to the wired Internet protocol era, especially Internet protocol television, and ultimately to the wireless Internet protocol era. This movement has been accompanied by a dramatic proliferation in the sources of content, range of devices on which consumers can view content, and the times at which content can be viewed.

As we forecast, the trend is away from traditional “push” programming to “pull” consumer preference, where consumers have choices in what, when and where to watch video content. While the instance of “cable cutters” who rely entirely on the Internet for video consumption is still low, the rate of change is rapid and the quantity of video consumption over traditional channels is declining. When one analyzes consumption patterns, the demographic evidence is that younger consumers, who grew up in the Internet age, are much more resistant to the traditional “push” industry model.

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1 See CRTC (2014a,b).

2 See Order Issuing a Direction to the CRTC on Implementing the Canadian Telecommunications Policy Objectives (SOR/2006-355).

One of the most important changes that has occurred in the industry is the introduction of vigorous competition in the video distribution sector. Previously, the cable industry dominated this business with some competition from satellite providers, particularly in rural areas. Now the incumbent telephone companies are effective competitors to the cable platform and have been increasing their market share of subscribers. Just as in the land line telephony business, these two different technological platforms are important competitors with each other. Layer on top the advent of “over the top” Internet television providers (Netflix, for example) and the sector will only become more competitive.

### *Canadian Content Regulations*

In this new technological world, we question the feasibility of maintaining traditional Canadian content policies, in particular exhibition quotas, expenditure quotas, and foreign ownership restrictions. In Hunter et al. (2010) we recommended leaving only production subsidies (increasingly financed out of public revenues) and the maintenance of a national broadcaster (the CBC in English-speaking Canada) as the principal points of policy leverage open to the federal government in promoting Canadian content. However, the reactions of intervenors in their written submissions to the CRTC’s tentative proposals (often by strongly vested interests in the Canadian production, broadcasting, and distribution industries) in many cases propose more, rather than less regulation of the Canadian broadcasting sector (broadly defined), and an expansion of industry-financed subsidies to Canadian production.

For example, under an unconstrained pick-and-pay or build-your-own package regime, there are concerns that many Canadian specialty channels would cease to be financially viable. These concerns have led to proposals to retain the preponderance rule for Canadian content, or some variant thereof. Alternatively, it is argued that (i) existing affiliation agreements between BDUs and broadcasting entities will require modification to address declining subscriber and advertising revenues of many of the latter; and (ii) that existing rules specifying the exclusive genres carried by many Canadian specialty channels may need to be relaxed to permit more flexible competitive responses to viewer preferences.<sup>3</sup>

Related concerns pertain to the pricing of individual channel choices versus the pricing of bundles offered by BDUs. A number of industry players have argued that unconstrained pricing discretion on the part of the BDUs may render the pricing of individual channel choices relative to bundles unattractive to subscribers. Hence, they are not seen as a viable option for them. Similarly, there are concerns over what channels should be included in the basic package that BDUs would be required to offer and whether and how to regulate the pricing of this package. Other concerns relate to the increasing propensity of viewers to download or stream content over the Internet, e.g., from Netflix, and by-pass the licensed broadcasting sector. This rising trend has prompted proposals to extend exhibition quotas, or obligations to contribute to Canadian production funds, to these non-broadcasting content providers.

While “pick-and-pay” or “build-your-own package” proposals seem superficially to be consistent with the movement from “push” era to “pull” era communications technologies, the government and the CRTC seem not to fully understand why BDUs bundle.

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3 Genre protection, sometimes called “genre exclusivity” refers to an approach to licensing whereby pay and specialty services are licensed on a one-per-genre basis. Other services may not use programming formats that compete directly with such services.

## Why do BDUs Bundle?

The first step in a policy analysis of pick-and-pay is to understand why BDUs would bundle in the first place. There is a superficial appeal to the argument that good policy would grant consumers the freedom to buy whatever channels they want, and not to buy those that they do not. After all, in many other market contexts, consumer choice prevails. When a shopper buys groceries, for example, she does not have to buy a banana in order to buy a lemon. The Order in Council from the federal government that mandated an examination of pick-and-pay was probably motivated by an intuitive preference for consumer choice among television subscribers. What this apparent appeal to free-market instincts misses, however, is that the bundles that BDUs presently offer also reflect a market choice by self-interested sellers. They are not, for the most part, the result of regulation, but are presumably in place for market-oriented reasons. An appeal to the free market does not inexorably lead to pick-and-pay, given that bundling is a market choice.

In fact, sellers make the decision to bundle products all the time. Even a grocer bundles when it sells a bag of oranges, or three bags of milk together. In a context closer to the one at hand, newspapers bundle different sections with a variety of news into a single product – local news, business news, sports news, entertainment news, and editorial opinion sections are all purchased when a consumer buys a paper. The question, then, is not whether BDU bundling departs from market principles, but whether the motivation for bundling reflects some kind of market failure that pick-and-pay regulation would address. The relevant kind of market failure would concern competition: that the bundling somehow reflects or contributes to a shortfall of competition. As this section discusses, it is not plausible that bundling hurts competition; most likely, bundling allows for price discrimination, which is not a practice that should invite regulatory intervention.

To begin, consider the most socially undesirable motivation for bundling: exclusion of competition. In particular circumstances, bundling product A with product B can exclude competitors in one of the bundled products, with consequential increases in the seller's market power and harm to competition (see, e.g., Whinston 1990). The following example of Whinston's theory is offered by Carlton and Heyer (2008) (and attributed to Rob Gertner):

Consider the case of a hypothetical island on which there is a monopoly hotel serving many tourists. Natives live on the island. The hotel operates a restaurant, which competes for diners, both tourists and natives, in competition with local restaurants. By tying meals to lodging, the hotel can so diminish the number of tourists dining at local restaurants that, in the extreme, lack of scale prevents any local restaurants from surviving. The hotel thus acquires a monopoly over natives in the provision of restaurant services.

This kind of exclusionary theory of bundling does not apply to BDUs in Canada. For one thing, for the theory to apply, it would be channels that would want to bundle their offerings to prevent other channel providers from being able to compete. It is, however, the BDUs that bundle, and BDUs do not intrinsically have an incentive to undermine competition amongst channels. Furthermore, the CRTC has a clear policy preventing undue preference by vertically integrated content owners and distributors. In any event, given the very large number of channels that compete for viewers within the cable distribution networks, let alone the vast and growing options for consuming video content online, it is simply implausible that bundling is aimed at protecting or gaining significant market power for channels.

Given the robust competitive landscape for video content, the most plausible explanation of bundling by BDUs concerns price discrimination. Bundling can assist sellers in extracting consumer surplus (Stigler 1963). Buyers have different preferences, and thus different demand, for different products. However, variation across buyers in their willingness to pay for a particular product does not necessarily imply variation across buyers in their willingness to pay for a bundle of products. Just as diversification in a stock portfolio reduces variance in the

portfolio's return, bundling can reduce the variance across consumers in their willingness to pay. This allows the seller to charge a price for the bundle that better maximizes its profits.

An example illustrates. Using newspapers as a case study, suppose that some consumers, call them "Entrepreneurs," value business news at, say, \$10 per month, and sports news at \$4 per month; while other consumers, call them "Athletes," value business news at \$4 and sports news at \$10. If the newspaper seller (a monopolist, for ease of exposition) sold business news and sports news separately, and wanted to extract maximum surplus from buyers, it would have to devise means to determine a given consumer's type, which may be very difficult. It must also be able to prevent resale of its products. The paper could then sell business news for \$10 and sports news for \$4 to Entrepreneurs, and business news for \$4 and sports news for \$10 to Athletes.

Bundling is more likely to succeed in extracting surplus: the seller can offer a business-sports news bundle for a price of \$14 to all consumers. Without worrying about identifying consumer types or preventing arbitrage, it is able to extract a surplus from consumers. Without bundling, and assuming price discrimination is not feasible given the difficulty in determining consumer type and in preventing arbitrage, the seller would simply charge \$10 for business news and \$10 for sports news, and would only sell business news to Entrepreneurs and Sports news to Athletes. Bundling increases sales and total economic value relative to the no-price discrimination case. Not all circumstances will result in such perfect surplus extraction with bundling, but the principle applies generally.

Perhaps in light of these advantages, the incidence of bundling in many media products is actually increasing. Netflix itself is a bundle, as is Next Issue in magazines and other products in music and books. As Ken Whyte, the former editor of *Maclean's* said recently: "Almost all the value in media has come from bundling."<sup>4</sup>

Bundling for price discrimination purposes is a plausible explanation of what motivates BDUs. Price discrimination should not invite regulatory intervention: it is possible that price discrimination reduces output and social surplus, but it is also possible that it increases output and social surplus. Given this ambiguity, and the impracticality of determining the net social effects of the practice in a given set of circumstances, the better policy is to permit price discrimination.

Competition law in Canada has moved in exactly this direction, with amendments to the *Competition Act* in 2009 that not only decriminalized price discrimination, but removed reference to the practice altogether. It is curious that the same government that removed price discrimination from the *Competition Act* also ordered the CRTC to explore mandatory unbundling given that the plausible explanation of the bundling in this context is price discrimination.

It is worth noting that some degree of market power is necessary for price discrimination strategies of any stripe to be implemented. If a seller in a perfectly competitive market attempted to charge buyers prices above marginal costs, they would lose customers to the point where the price increase would be unprofitable. BDUs, such as cable companies, and Internet service providers, do not at present face perfectly competitive conditions. This is not to say that there is no competition – there is: viewers can subscribe to traditional cable companies, subscribe to Internet protocol television, or consume content delivered by satellite. But the degree of market power required to impose price discrimination is not especially high, as evidenced, for example, by discounts for children in competitive markets like movie theatres.

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4 "The Netflix effect: Why distracted consumers are bundling up." *The Globe and Mail*, March 21, 2014.

Over time, however, it is predictable that competition facing the BDUs will be even stronger. As we predicted in 2010, more and more consumers are finding video content on the Internet. In a poll of Anglophone Canadians in 2013, Media Technology Monitor found that two-thirds had streamed something on YouTube in the past month, 30 percent had watched a movie and 23 percent had watched news or sports content (Duong 2014). In a concrete indication of Internet video's rising prominence, while online video remains a relatively small fraction of overall media spending, it was the fastest growing advertising category in 2012 (Krashinsky 2012). Once mobile devices become more capable of cost-effectively consuming video, the competitive genie will definitely be out of the bottle: at present, the "last mile" of physical connections to the home for either BDUs or Internet service providers restricts competition.

Competition will affect the ability of BDUs to profitably bundle regardless of regulation. If consumers dislike bundles, they will increasingly be able to shift with little cost to alternatives on the Internet such as Netflix, or channel-affiliated websites. Indeed, there already is evidence of the BDUs adopting strategies to respond to competition. In Quebec, for example, Videotron offers the option of relatively narrow bundles of channels to its subscribers. In addition, Rogers and Shaw recently announced the creation of a streaming service similar to Netflix, called Shomi. Establishing an elaborate regulatory regime to deal with a practice that will soon be subjected to even more intense competition would be a mistake.

In any event, the most plausible explanation of bundling by BDUs suggests that it is a form of price discrimination, which is generally considered benign under competition law, or at least not worth regulating. It is not clear what the economic benefits of mandatory unbundling would achieve, and indeed there is the danger that it would hurt economic efficiency.

## Framing the Choices

The ongoing deliberations of the CRTC into the regulation of video content and television will be an important litmus test as to how the CRTC views its role in this dynamically changing industry, which we frame as questions:

- Will the Commission recognize that technological change is not only inexorable, but frequently more powerful than government regulation and intervention?
- Although intuitively appealing, is there sound fact and analysis to support intervention in the market to allow consumers to only purchase channels they wish, or are there no sufficient public-policy justifications to require mandatory regulation?
- In the guise of consumer choice, will the Commission continue its historical role of allocating economic rents, mainly between content creators, including Canadian content owners, and the increasing numbers of distributors of such content?

None of these questions has easy answers. But we believe the Commission must take a rigorous, analytical approach to these questions to avoid results that will actually be harmful to Canadian consumers, let alone the content and broadcast industry. As we argued in Hunter et al. (2010), it is our view that incremental change is likely counter-productive. A more fundamental review of the state of the industry and the dynamic changes it is experiencing is required, including a review of the instruments appropriate for regulatory intervention in this environment.

Given past and future technological change, it is inevitable that market forces will provide increasing discipline to broadcast distributors in coming years. This alone should cause the Commission to exercise caution in considering possible mandatory unbundling. As options for viewers expand and competition amongst channels

intensifies even further, bundles will only survive in the marketplace if they provide consumers with advantages that consumers would not otherwise realize. Any regulation would become irrelevant at best, harmful at worst.

The objectives established in the government's telecoms sector 2006 Policy Directive are increasingly apt with respect to the broadcast and content industry. Those objectives are (i) to rely on the market to the maximum extent possible, (ii) when intervention is required, to use techniques that are the least restrictive of competition, and finally, (iii) any regulations need to pass a rigorous cost-benefit analysis to ensure that they do more good than harm.

Such a conclusion is even better supported when one considers the extent of regulation that would be required to establish pick-and-pay. Attempting to regulate pick-and-pay or product offerings would launch the CRTC on a more interventionist role in the entire content and video distribution business, once again demonstrating that regulation often begets more regulation. It would almost certainly require the CRTC to supervise the prices for unbundled products, as otherwise, broadcast distributors could offer larger bundles at steep discounts to discourage à la carte consumer choice. In addition, it seems highly likely that moving to a mandated à la carte model will have an important impact on a number of specialty channels, particularly Canadian speciality channels. The result will be disputes between content owners and distributors over affiliation fees and the price for access to the distribution network.

Another perplexing issue would be the current rules regarding the preponderance of Canadian content. If the Commission maintains the rule that every distributor must ensure that each customer subscribes to a preponderance of Canadian signals, it will certainly impose costs on distributors and require consumers to purchase products in which they have little interest. On the other hand, if they only require distributors to "offer" a preponderance of Canadian signals and do not require subscribers to purchase those services, it will lead to disputes regarding the price paid to the Canadian channels that few people are watching.

As we emphasized in our 2010 *Commentary* "Scrambled Signals," attempting to encourage the production or distribution of Canadian content through control of the distribution channels is increasingly inappropriate. In that report we outlined that as competition intensifies and outlets for video programming expand, the traditional means of promoting Canadian content will lose their efficacy and coherence.

But our conclusion that the CRTC should not compel unbundling is not a call to maintain the status quo with respect to the production and distribution of Canadian content. We are agnostic as to the appropriate level of state support for Canadian content. However, if there is to be support, what is required is a comprehensive reassessment of the importance, value, and techniques to protect and promote Canadian content. Such a review is broader than the mandate of the CRTC, and certainly broader than the ambit of the pick-and-pay hearing.

## Conclusion

Our view is that the economically benign character of bundling in this context, the increasingly competitive nature of the industry, along with the complexity of any regulation associated with pick-and-pay, combine to imply that the government should not mandate service offerings to consumers. The only issue that appears to warrant government scrutiny and support relates to Canadian content. And we have serious concerns whether the CRTC is the appropriate body to assess the appropriate level and techniques to support Canadian content. It is precisely because the Commission has historically viewed its role as an economic rent allocator that we are where we are today. But that does not justify the Commission using regulatory techniques and models which are increasingly anachronistic and more market distorting than other instruments such as direct subsidies to Canadian content production.

The government should stick with the objectives of its existing Policy Directive for telecom sector to rely on the market to the maximum extent possible. This approach is consistent with the CRTC's statement in "Let's Talk TV"<sup>5</sup> that, "Regulatory intervention is only warranted where specific outcomes or objectives could not be achievable without it. Where regulatory measures are necessary, the Commission considers that they should be as simple as possible, proportionate and adaptable to change." If this approach is taken seriously, the CRTC will not order mandatory unbundling.

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5 April 24, 2014.

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