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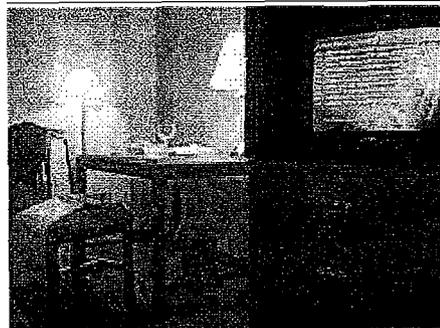
Wall Street Meets Pornography

By TIMOTHY EGAN

PROVO, Utah — The video-store chain that Larry W. Peterman owned in this valley of wide streets and ubiquitous churches carried the kind of rentals found anywhere in the country — from Disney classics to films about the sexual adventures of nurses. Mr. Peterman built a thriving business until he was charged last year with selling obscene material and faced the prospect of bankruptcy and jail.

Just before the trial, Mr. Peterman's lawyer, Randy Spencer, came up with an idea while looking out the window of the courtroom at the Provo Marriott. He sent an investigator to the hotel to record all the sex films that a guest could obtain through the hotel's pay-per-view channels. He then obtained records on how much erotic fare people here were buying from their cable and satellite television providers.

As it turned out, people in Utah County, a place that often boasts of being the most conservative



Susana Raab for The New York Times

A selection of pornographic movies available from On Command for guests to view in the privacy of their rooms at a hotel in Norfolk, Va. On Command says it reaches 835,000 hotel rooms in the United States and would like to reach a million more.

EROTICA INC.*A special report.***Audio**

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area in the nation, were disproportionately large consumers of the very videos that prosecutors had labeled obscene and illegal. And far more Utah County residents were getting their adult movies from the sky or cable than they were from the stores owned by Larry Peterman.

Why file criminal charges against a lone video retailer, Mr. Spencer argued, when some of the biggest corporations in America, including a hotel chain whose board of directors includes W. Mitt Romney, president of the Salt Lake City Olympics organizing committee, and a satellite broadcaster heavily backed by Rupert Murdoch, chairman of the News Corporation, were selling the same product?

"I despise this stuff — some of it is really raunchy," said Mr. Spencer, a public defender who described himself as a devout Mormon. "But the fact is that an awful lot of people here in Utah County are paying to look at porn. What that says to me is that we're normal."

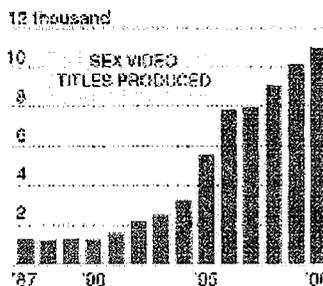
It took only a few minutes for the jury to find Mr. Peterman not guilty on all charges. His case illustrates what has happened to an industry that used to be confined to the margins of commerce, in the seedy parts of most towns, run by people who never dreamed of taking their companies to Wall Street.

Spurred by changes in technology that make pornography easier to order into the home than pizza, and court decisions that offer broad legal protection, the

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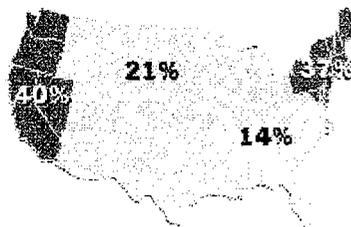
Producers and Consumers in the Pornographic Movie Market

Pornographic video production is rising ...

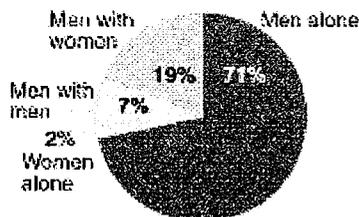


... and on the consumer end, there are strong geographical and gender bases.

PERCENTAGE OF SEX MOVIES IN HOME VIDEO MARKET, 2000



SEX MOVIE RENTALS BY GENDER, 1999



Source: Adult Video News

The New York Times



Deseret News

business of selling sexual desire through images has become a \$10 billion annual industry in the United States, according to Forrester Research of Cambridge, Mass., and the industry's own Securities and Exchange Commission filings.

Larry W. Peterman, right, with his lawyer, Randy Spencer, at Mr. Peterman's trial. Mr. Peterman, a video-store owner, was acquitted of obscenity charges.

Whatever the phenomenon may say about the nature of American society, the financial rewards are so great that some of the biggest distributors of explicit sex on film and online include the country's most recognizable corporate names.

The General Motors Corporation, the world's largest company, now sells more graphic sex films every year than does Larry Flynt, owner of the Hustler empire. The 8.7 million Americans who subscribe to DirecTV, a General Motors subsidiary, buy nearly \$200 million a year in pay-per-view sex films from satellite, according to estimates provided by distributors of the films, estimates the company did not dispute.

EchoStar Communications Corporation, the No. 2 satellite provider, whose chief financial backers include Mr. Murdoch, makes more money selling graphic adult films through its satellite subsidiary than Playboy, the oldest and best-known company in the sex business, does with its magazine, cable and Internet businesses combined, according to public and private revenue accounts by the companies.

AT&T Corporation, the nation's biggest communications company, offers a hard-core sex channel called the Hot Network to subscribers to its broadband cable service. It also owns a company that sells sex videos to nearly a million hotel rooms. Nearly one in five of AT&T's broadband cable customers pays an average of \$10 a film to see what the distributor calls "real, live all-American sex — not simulated by actors."

For all the money being made on sex — legally — by mainstream corporations, the topic remains taboo outside the boardroom. The major satellite and cable companies do very little marketing of their X-rated products, and they are not mentioned in annual reports except in the vaguest of euphemisms.

None of the corporate leaders of AT&T, Time Warner, General Motors, EchoStar, Liberty Media, Marriott International, Hilton, On Command, LodgeNet Entertainment or the News Corporation — all companies that have a big financial stake in adult films and that are held by millions of shareholders — were willing to speak publicly about the sex side of their businesses.

"How can we?" said an official at AT&T. "It's the crazy aunt in the

For hotels, the sex that can be piped through television generates far more money than the beer, wine and snacks sold from the rooms' mini-bars. Just under 1.5 million hotel rooms, or about 40 percent of all hotel rooms in the nation, are equipped with television boxes that sell the kind of films that used to be seen mostly in adults-only theaters, according to the two leading companies in the business. Based on estimates provided by the hotel industry, at least half of all guests buy these adult movies, which means that pay-per-view sex from television hotel rooms may generate about \$190 million a year in sales.

At home, Americans buy or rent more than \$4 billion a year worth of graphic sex videos from retail outlets and spend an additional \$800 million on less explicit sexual films — all told, about 32 percent of the business for general-interest video retailers that carry adult topics, according to compilations done by two trade organizations that track video rentals. Chains like Tower Records now stock nearly 500 titles in their so-called erotic category, far more than films about history or dinosaurs.

On the Internet, sex is one of the few things that prompts large numbers of people to disclose their credit card numbers. According to two Web ratings services, about one in four regular Internet users, or 21 million Americans, visits one of the more than 60,000 sex sites on the Web at least once a month — more people than go to sports or government sites.

Though estimates have been greatly inflated by some e-commerce sex merchants, analysts from Forrester Research say that sex sites on the Web generate at least \$1 billion a year in revenue, providing a windfall for credit card companies, Internet search engines and people who build Web sites, among others in the commercial food chain.

Some of the most popular Web properties — which feature quick links to sites labeled "Virgin Sluts" and "See Teens Have Sex" — are owned by a publicly held company in Boulder, Colo. That company, New Frontier Media, has stock traded like any other, and it expects its video network to be in 25 million homes within a few years. It does business with several major companies, including EchoStar and In Demand, the nation's leading pay-per-view distributor, which is owned in part by AT&T, Time Warner, Advance-News, Cox Communications and Comcast.

Another company, LodgeNet, whose chairman is Scott C. Petersen, does \$180 million in annual business selling sex videos and other forms of room entertainment to hotels. LodgeNet is a major employer in Sioux Falls, S.D., its home base. It is a client of the accounting giant Arthur Andersen, and nearly a fifth of the company's public shares are held by a Park Avenue investment firm, Red Coat Capital

"We feel good about what we do," said Ann Parker, a spokeswoman for LodgeNet, which trades on the Nasdaq market. "We're good corporate citizens. We contribute to local charities."

The biggest provider of hard-core sex videos and adult Web content, Vivid Entertainment Group of Van Nuys, Calif., whose founders and principal owners are Steven Hirsch and David James, has been making the rounds of investment bankers of late, preparing for an initial public stock offering next year that could ultimately lead to the first porn billionaire.

"The adult entertainment business is just exploding," said Bill Asher, the president of Vivid, whose offices are in a new granite and glass building that houses investment and venture capital firms. "Right now there are a lot of people making a lot of money. Somebody's got to take control of it, and we figure it might as well be us. We see ourselves as the designated driver of this business."

To the astonishment of Mr. Flynt, who began in the pornography business by selling poor-quality pictures of naked girls as a way to build interest in his strip clubs, his competitors in the \$10 billion annual adult market are mainstream corporations whose board members are among the American business elite.

"We're in the small leagues compared to some of those companies like General Motors or AT&T," Mr. Flynt said. "But it doesn't surprise me that they got into it. I've always said that other than the desire for survival, the strongest desire we have is sex."

The Technology Factor

Look, Ma,

No Staples!

Thirty years ago, a federal study put the total retail value of hard-core pornography in the United States between \$5 million and \$10 million — or about the same amount that a single successful sex-related Web site brings in today. It seemed likely that the industry would remain where it had always been — largely out of sight, but profitable, and faced with consistent legal problems.

What kept the market relatively small, in the view of people in the industry, were the barriers between consumer and product. Typically, a person would have to go to a run-down part of town, among people considered less than savory, to find hard-core adult films or bookstores. These retail outlets frequently were raided by law enforcement authorities, further adding to the risk for a consumer — a risk of

sname, or arrest.

In 1975, the Sony Corporation released the videocassette recorder to the broad market, and within 10 years, about 75 percent of all American households owned a VCR. Once the venue had moved from theater to the privacy of the home, the adult entertainment industry was never the same. For example, a single film, "Deep Throat," generated more than \$100 million in sales, thanks in large part to the popularity of VCR's, Frederick S. Lane III writes in his book "Obscene Profits: The Entrepreneurs of Pornography in the Cyber Age" (Routledge, 2000).

But even with most Americans owning VCR's, people still had to take a trip to the video store, risking some embarrassment. Pay-per-view television and the Internet removed the final barriers.

Cable and satellite programmers allow people to buy a variety of sex-based programming, from Playboy, on the lighter side, to the Hot Network, owned by Vivid, and the Erotic Television Network, distributed by New Frontier, on the more explicit end of the spectrum. Consumers could watch movies of people having sex without ever leaving home.

What investors and bigger corporations soon discovered was the vast audience for pornography – once the privacy barrier was eliminated. Twenty percent of all American households with a VCR or cable access will pay to watch an explicit adult video – and 10 percent will pay frequently, according to the distributors New Frontier and Vivid. That interest explains, in part, why the production of pornographic films has grown tenfold in the last decade. There are now nearly 10,000 adult movies made every year, according to an annual survey of the films produced in the Los Angeles area.

Last year, there were 711 million rentals of hard-core sex films, according to Adult Video News, an industry magazine that is to pornographic films what the trade publication Billboard is to records. It even has its own film awards – modeled after the Oscars.

But video rentals have reached a plateau over the last two years. The future is pay-per-view at home – driven by the easy access and good technical quality of digital television – and pay-per-view from the Internet, driven by the technological innovations of new cable and phone lines that carry far more images, more quickly, to a computer screen.

"Videos changed the way people could view porn because they were able to watch in the privacy of their homes," said Barry Parr, an electronic commerce analyst with International Data Corporation. "Internet pornography takes that a step further – they can do it with absolute privacy."

The number of people visiting sex sites on the Web doubled over the last year, outpacing the number of new Internet users. Some of the more popular sex Web sites attract in excess of 50 million hits, or visits, a month, according to the ratings services Nielsen/ Net and Media Metrix. About one in a thousand people who visit a site will subscribe, for fees averaging \$20 a month, according to some of the leading Web pornography providers and Flying Crocodile Inc., a company based in Seattle that tracks and services the sexual-content market.

At the same time that technology was making it easier for people to view pornography, legal obstacles were falling. The 1973 Supreme Court case *Miller v. California* established a threshold for defining illegal pornography; a major test was that it had to be considered obscene to the "average person, applying contemporary community standards."

Initially, the case helped prosecutors clamp down on publications and movies. But that proved to be short-lived. If "Deep Throat" could sell \$100 million worth of copies, then what was the community standard?

"The court may have handed off the determination of obscenity to the local community, but the standards of local communities had fundamentally changed," writes Mr. Lane in "Obscene Profits."

When Mr. Peterman was prosecuted for distributing obscene material in Utah last year, he became one of the few video retailers in the nation charged with such a crime in recent years. In a state long regarded as a bastion of family-values morality, more than 4,000 people signed petitions supporting his prosecution.

But Mr. Peterman showed that he had 4,000 regular customers for sex videos. His lawyer argued that Mr. Peterman was not violating community standards, because people in Utah County bought 20,000 adult sex videos from one satellite programmer alone in the period that Mr. Peterman was said to have broken the law; it was double the volume in most cities the size of Provo. And in the Provo Marriott, guests were paying for nearly 3,000 explicit adult videos every year, according to court testimony. After the Peterman trial, that hotel dropped its adult movies.

"My client was just a little guy," Mr. Spencer said, "a mom-and-pop dealer in a very big business."

The Corporate Factor

It's the Demand,

At a time when political campaigns from the presidential level down to that of the local school board have made an issue of sexual excess in broadcasting, the corporate entanglements in the pornography business have blurred the lines of the debate.

In Missouri this year, Senator John Ashcroft, a Republican, ran ads denouncing "Hollywood's decaying influence" on society, singling out his Democratic opponent, Gov. Mel Carnahan, for accepting donations from Christie Hefner, the Playboy executive.

Mr. Carnahan, who died last week in a plane crash, had countered by pointing to donations to Mr. Ashcroft from Charles W. Ergen, chief executive of EchoStar, which sells adult pay-per-view through its fast-growing DishNetwork satellite division.

"If he's going to start that, he's in greater trouble than I am," Mr. Carnahan had said.

Mr. Ashcroft's supporters had replied that there was still a distinction between the two companies: EchoStar did not produce pornography — it merely sold it, while Playboy created its own videos and pictures, they said.

"We added adult at the request of our customers," said Judiann Atencio, a spokeswoman for EchoStar. "We have something for everybody, from Irish hurling to cricket. Adult is there if you want it."

When AT&T announced that it would start offering the hard-core Hot Network to its 2.2 million digital cable subscribers beginning in August, they were castigated by critics and pressured by religious and civic groups that hold stock in the company.

A group of mutual-fund investors, which included the Sisters of Charity of New York, the Evangelical Lutheran Church of America and the Mennonite Church, told AT&T its members did not want their three million shares invested in a company that sold pornography.

"At the heart of our concern is the concept of mainstream companies getting into hard-core pornography," said Mark Regier, who manages a mutual fund for 800,000 members of the Mennonite faith. "For a company with AT&T's tradition and its charitable work to be involved with pornography at this level is unbelievable. And I don't think many people understand what it means to take away the barriers to this kind of material, such as AT&T is doing."

For AT&T, there are sound business reasons to start carrying the highly profitable Hot Network. Unlike distributors of mainstream

HOLLYWOOD PICTURES, SEX-FILM DISTRIBUTORS typically offer the programmers a split of 80 percent of the revenue, compared with 50 percent or less for routine features.

Impulse buys, in which customers tap a code into a remote and a movie follows, have also spurred in-home sales of pornographic films.

"Impulse technology – that's been just incredible," said Mr. Asher of Vivid Entertainment, which makes hundreds of adult films and claims that it sells a million copies a month to cable, satellite, home video and hotel retailers. "You have about 35 million homes with this kind of technology now," Mr. Asher said, "and it's growing enormously. It's easy and it's private – that's the key."

Although the companies that program explicit sex films will not give out their revenue figures for this category, a report by the Showtime Event Television company found that adult pay-per-view took in \$367 million last year – a more than sixfold increase from the \$54 million of 1993, easily outpacing the growth of pay-per-view "events" like boxing and wrestling.

Time Warner, EchoStar, General Motors and AT&T all say they are simply responding to a growing American market that wants pornography in the home. At the same time, the companies say new technology makes it possible for parents to keep such programming away from children.

"We call it choice and control," said Tracy Hollingsworth, a spokeswoman for AT&T Broadband, the company's cable division. "Basically, you use your remote to block out any programming you don't want. But if you want it, we offer a wide range of programming that is available in the market we're in."

Hotel chains have made similar decisions when, this year, several groups urged them to get rid of the adult pay-per-view programs that are in nearly 60 percent of all middle- to high-end hotels. Only one chain, the relatively small Omni Hotels, chose to remove the sex films.

"What we noticed was that early on, the content was R-rated, but then it migrated rather quickly to really raunchy stuff – just hard-core porn," said Jim Caldwell, the president of Omni. "I thought: What are we doing? We don't have topless waitresses in the restaurant."

Mr. Caldwell said more than 50 percent of all guests were buying the sex films. "The anonymity is the big thing," he said.

Omni's decision to remove pay-per-view sex videos from the company's 15,000 rooms will cost the company more than \$1.8 million a year, Mr. Caldwell said. But he said he had received phone calls and letters of thanks from 50,000 people – more than for any other corporate

decision.

Much larger hotel chains, like Marriott, which calls itself the world's largest hotel management firm, with nearly 300,000 rooms in the United States, and Hilton, with 290,000 rooms under its control, have not made changes.

Some critics said Marriott, run by several prominent members of the Mormon Church, though not affiliated in any way with the church itself, should drop its adult movies, given the stand against explicit sexual materials that Mormons have long taken. But company officials said they were mostly franchisers, and could not make unilateral decisions for the hotel owners who paid to be a part of the Marriott chain.

The two companies that provide hotels with pornographic films are both traded on Wall Street and have enjoyed big run-ups in their stock prices over the last few years. The leader, On Command, based in Denver, is worth more than \$400 million, and its principal owner is Liberty Media, controlled by John C. Malone, the cable and telecommunications magnate who sits on the board of AT&T and recently agreed to buy up to 15 percent of the shares of Mr. Murdoch's News Corporation.

The chairman and chief executive of On Command is Jerome H. Kern, a former New York corporate lawyer active in civic and volunteer causes, serving on the board of New York University and as a director of Volunteers of America in Colorado.

On Command would not discuss how much money it is making on adult films. But in its annual report, the company said it was generating \$23 a room each month for the 835,000 hotel rooms it reaches. The company goal is to get into an additional one million hotel rooms. Analysts say at least half the revenue comes from adult films. The company recently began offering all-day erotic television to hotel customers, for a single price of \$15.99.

"Talk about your captive audience," said Mr. Asher of Vivid. "I've heard that in some hotels, 85 to 90 percent of all profits from in-room spending comes from adult channels."

The Money Factor

Big Profits Now,

Bigger Ones on Way

While the big companies that deliver sex films to homes and hotels will not talk about how popular explicit sexual materials are, the

testimony and documents that were made public in the Peterman case also offered some insight into the profit potential.

"Despite the fact that this material isn't marketed, revenue-wise, it's one of our biggest moneymakers," said Peggy Simons of TCI Cable, in court testimony in Mr. Peterman's case. TCI, controlled by Mr. Malone, has since been bought by AT&T.

"When we talk to the companies one-on-one, they tell us we're great, that we're a huge moneymaker for them," said Mr. Asher, whose company owns the Hot Network, which is available in 16 million homes. "And by the way, I tell my biggest customers – don't say you ever met me."

In trying to take public his company, which now does about \$80 million a year in sales, Mr. Asher said, "The biggest problem I have is the image of the adult business. People think it's run by the mob, or a bunch of guys with gold chains. I grew up in Paris, Illinois. I have a master's of business administration degree."

The Hot Network portrays people having sex in a variety of methods – what the company calls "widely accepted sexual activity" – and prohibits scenes of violence, nonconsensual sex, drug use, forced bondage and sex with minors.

Analysts of electronic commerce and telecommunications say the mainstream sex market might be leveling off, but new technology is likely to bring in even more consumers.

"The novelty of it has not worn off yet, and I don't believe it will wear off," said Sean Calder, a vice president for e-commerce at Nielsen/Net Ratings, which gauges the popularity of Web sites. "The numbers point to a huge personal need. We see lots of people logging on at 3 in the morning."

The \$30 billion project to rewire the cable industry with lines capable of bringing more material, and allowing people to buy on impulse, will play a big part in the emerging home pornography market.

"These companies like AT&T, they're thinking ahead to a time, perhaps in 10 years, when 50 million Americans will have broadband capability and all their television and Internet will be interactive through one big box," said Bryn Pryor, technology editor for Adult Video News, the trade magazine.

"But it's not just technology that made the big boys get into it," Mr. Pryor said. "This just happens to be a business where you can't lose money."