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Market Dynamics and Public Policy Issues in the Video Programming Industry

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Summary

In the past 15 years, the successful introduction of new technologies, coupled with changes in government rules, has created strong market forces for fundamental structural change in the video programming industry. About 80 percent of U.S. households subscribe to cable or satellite systems offering multiple channels of programming. These alternatives to broadcast television now attract more than half the total viewing audience, although broadcast television still attracts a majority of viewers during prime-time when popular broadcast network fare is aired. Similarly, movie producers today receive more than twice as much revenue from the rental and sale of video cassettes and DVDs as they do from movie theaters.

At the same time, there has been widespread vertical and horizontal integration in the video programming industry. The industry is increasingly dominated by a small number of firms that finance the development of new programming through a wide variety of arrangements with content providers (including joint ventures and direct ownership), own extensive libraries of existing programming, own a variety of distribution channels for bringing content to the public, and also own retail pipelines such as local broadcast stations and video store chains (and, currently proposed, a direct broadcast satellite system).

These fundamental changes in the market structure affect the public policy issues that Congress faces. Today, there are more pipelines into the home and more distribution networks than ever before, but a limited number of big media players control a large portion of both programming and distribution. This has engendered debate on how well the existing FCC ownership rules address the impact of consolidated ownership of programming and distribution on the public interest goals of diversity, competition, and localism, and whether new rules that re-regulate the industry could or should be formulated that would better serve those goals.

The purposes of this report are:

- to explain how and why underlying market forces have created strong pressure for vertical integration across segments and horizontal mergers within segments;
- to explain how that market consolidation could be used to benefit or to harm consumers; and
- to identify public policy issues that may arise as a result of the vertical and horizontal consolidation.

See CRS Report RL32027 for background and detail on the structure of the video programming industry.

This report will be updated as events warrant.

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Market Dynamics and Public Policy Issues in the Video Programming Industry

Introduction

Over the past 15 years, technology-driven market forces and changes in government rules have led to widespread vertical and horizontal integration[1] in the video programming industry. Some of these integrated firms are very large, with extensive holdings that cross both functional segments (i.e., content production, distribution and packaging, and pipelines to end user customers) and technologies (broadcast, cable, direct broadcast satellite (DBS), VCRs, and DVDs).[2] This has raised concerns in some quarters that these firms could use their market positions to harm competition and that media concentration reduces the diversity of independent voices and lessens sensitivity to local needs, interests, and standards. Other policymakers have found benefit to consumers from efficiency gains made possible by such consolidation, and have pointed to some empirical evidence that media consolidation has increased the amount and quality of local news programming.

The purpose of this report is to describe the market dynamics driving vertical and horizontal consolidation in the video programming industry, to show the potential benefits and harm to consumers from such consolidation, and to identify potential public policy issues that may be raised by the consolidation.

Market Dynamics

Viewers Tend to Value New Viewing Options

The emergence of new technologies for the provision of video programming to end users -- cable television, direct broadcast satellite, and video cassette and DVD rental and sales all represent relatively recent alternatives to traditional broadcast television and movie theaters -- has increased the options available to viewers. In 2001 cable television service was available to 96.7 percent of U.S. households and 65.0 percent of households subscribed, while 17.7 percent of U.S. households

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[1] Horizontal integration occurs when firms that compete directly with one another combine. Vertical integration occurs when firms that are in a supplier-customer relationship combine. The supplying firm can be providing products (e.g., programming) or services (e.g., distribution services) that are inputs for the customer.

[2] The structure of the video programming industry and the interrelationships among the functional segments and technological alternatives are discussed in detail in CRS Report RL32027.

subscribed to satellite service.[3] The average cable system devotes 82.5 channels to video delivery.[4] In addition, in 2001, 85.2% of U.S. households had VCRs; 13.0% had DVD players.[5]

Viewers clearly value these options. As shown in Table 1,[6] Americans continue to increase the amount of time they spend watching video programming, and subscribers to multiple channel systems in particular have increased their viewing.

Table 1. Television Viewing by Cable and Non-Cable Households, 1990-91 and 2000-01

(hours per week)

	1990-1991 Broadcast-Only Households	1990-1991 Cable Households	2000-2001 Broadcast-Only Households	2000-2001 Cable Households
Total Television Viewing	**41.6**	**54.7**	**45.3**	**63.0**
Total Broadcast Viewing	**41.6**	**31.9**	**45.3**	**26.8**
Network Affiliates[a]	29.4	24.0	29.4	20.8
Independents[b]	10.3	8.1	12.9	4.7
PBS	1.9	1.3	3.0	1.3
Total Cable Viewing	**–**	**22.8**	**–**	**36.2**
Advertiser-Supported Cable	–	18.2	–	29.8
Premium Pay Channels	–	4.6	–	4.0
All Other Cable[c]	–	–	–	2.4

Source: Cablevision Advertising Bureau, *Cable TV Facts* 1992 ed., p. 6 and 2002 ed., p. 41.
a. Network affiliates ABC/CBS/NBC in 1990-1991 and ABC/CBS/FOX/NBC in 2000-2001.
b. WB/UPN/PAX affiliates and independents.
c. This category was not listed separately in 1990-1991. It includes cable networks neither advertising-supported nor premium pay, e.g., pay per view, home shopping.

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[3] Jonathan Levy, Marceline Ford-Livene, and Anne Levine, "Broadcast Television: Survivor in a Sea of Competition," OPP Working Paper 37, Federal Communications Commission, September 2002, Table 1, p. 4.

[4] *Implementation of Section 3 of the Cable Network Consumer Protection and Competition Act of 1992, Statistical Report on Average Prices for Basic Service, Cable Programming Services, and Equipment*, MM Docket No. 92-266, Report on Cable Industry Prices, 17 FCC Rcd at 6313, Table 11 (2002).

[5] Jonathan Levy, Marceline Ford-Livene, and Anne Levine, "Broadcast Television: Survivor in a Sea of Competition," OPP Working Paper 37, Federal Communications Commission, September 2002, Table 1, p. 4.

[6] Reproduced from Jonathan Levy, Marceline Ford-Livene, and Anne Levine, "Broadcast Television: Survivor in a Sea of Competition, OPP Working Paper 37, Federal Communications Commission, September 2002, Table 8, p.20.

The alternatives to broadcast television now attract more than half the viewing audience, though broadcast television still attracts a majority of viewers during prime-time when popular broadcast network fare is aired. According to the National Cable & Telecommunications Association,[7] basic cable networks and pay cable services captured a 59 share of the viewing audience in 2002, while broadcast stations captured only a 53 share.[8] The FCC reports[9] that the prime-time share of all cable networks increased from 51.9 in July 2000 - July 2001 to 56.5 in July 2001 - June 2002, while the prime-time share of all broadcast television networks fell from 63 to 59 during the same period.[10] Similarly, the FCC reported that in 2000, of $29.9 billion in total U.S. end-user expenditures for filmed entertainment, $22.45 billion came from home video and only $7.45 billion from box office receipts.[11]

Viewers also have demonstrated a willingness to pay for programming. Table 2[12] shows how end-user expenditures on various video media grew, in current dollars, from 1990 to 2000. During that period, the consumer price index grew by 32.5%;[13] consumer spending on each and every video medium grew at a faster pace, in most cases at a substantially faster pace. As shown in Table 2, cable video subscription revenues increased from $16.1 billion in 1990 to $31.9 billion in 2000, while direct broadcast satellite subscription revenues increased from zero to $8.4 billion, and the rental and sale of video cassettes and DVDs increased from $11.1 billion to $22.4 billion during the same period. Although the growth in demand for these new video services siphoned off viewers of traditional video outlets, those outlets too continued to enjoy revenue growth. As shown in Table 2, from 1990 to 2000, advertising revenues for broadcast television and box office receipts from movie theaters

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[7] "Viewing Shares: Broadcast Years: 1991/92–2001/02," *Cable Developments 2003*, National Cable & Telecommunications Association, at p. 16, citing data from Nielsen Media Research and Cable Status Report Data, published by the Cablevision Advertising Bureau in *Cable TV Facts*, 1993 through 2003.

[8] A program's or network's "share" is defined as the percentage of the television households watching television at a given time that are tuned to that particular program or network. The sum of all shares typically exceeds 100 because in some households there will be multiple televisions being watched at the same time.

[9] *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Federal Communications Commission, MB Docket No. 02-145, Ninth Annual Report, released December 31, 2002, at pp. 5 and 6.

[10] For a more detailed discussion of broadcast and cable market shares, see CRS Report RL32027.

[11] Jonathan Levy, Marceline Ford-Livene, and Anne Levine, "Broadcast Television: Survivor in a Sea of Competition," OPP Working Paper 37, Federal Communications Commission, September 2002, Table 2, p. 6, citing Veronis Suhler, "Communications Industry Forecast," July 2001.

[12] Reproduced from Jonathan Levy, Marceline Ford-Livene, and Anne Levine, "Broadcast Television: Survivor in a Sea of Competition, OPP Working Paper 37, Federal Communications Commission, September 2002, Table 2, p.6.

[13] U.S. Department of Labor, Bureau of Labor Statistics, Consumer Price Index, All Urban Consumers, U.S. city average, All items, [ftp://ftp.bls.gov/pub/special.requests/cpi/cpiai.txt], viewed 7/28/2003.

continued to rise. In all, end user and advertising expenditures on video programming increased from $61 billion in 1990 to $128 billion in 2000.[14]

New Viewing Options Fragment Viewing Audiences

Despite the increase in the overall size of the market for video programming, the availability of additional options has resulted in the fragmentation of viewing audiences for individual channels. As shown in Table 3,[15] the market share of broadcast television continues to fall. The three major networks and their affiliates captured 80 to 90 percent of the audience in the 1950s through 1970s. Today, there are seven networks, but they and their affiliates have only a 39 percent market share.[16] As described by Kagan World Media,[17]

> Thanks to a tremendous rise in competition from cable networks, a low rating on broadcast TV 20 years ago would be a high rating today. The top 10 average of 12.7 in the 2001-2002 season was dangerously close to the bottom 10 average of 12.0 in 1980-1981.

Although cable networks in aggregate now command half the viewing audience, that aggregate audience is shared by more than one hundred cable networks; no single cable network commands as much as a two percent rating.[18]

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[14] Standard & Poor's estimated that in 2002, U.S. consumers would spend $44 billion for TV programming (delivered via basic cable, pay cable, and satellite programming), $9 billion for theatrical movies, and $22 billion for rental and purchase of prerecorded videocassettes and DVDs, and that the television industry also would be supported by $61 billion in advertising expenditures, yielding total industry revenue of $136 billion. Tom Graves, "Movies and Home Entertainment," Standard & Poor's Industry Surveys, November 14, 2002, at p. 7.

[15] Reproduced from Jonathan Levy, Marceline Ford-Livene, and Anne Levine, "Broadcast Television: Survivor in a Sea of Competition, OPP Working Paper 37, Federal Communications Commission, September 2002, Table 25, p.62.

[16] These market shares do not match up exactly with the share of television households data presented on p. 3 above, in part because the "share" being measured is different, in part because the time period covered is different. But all the data show the same pattern – the broadcast television market share is falling, and no network or individual program attracts audiences of the size or market share that existed before the successful entry of cable and satellite systems.

[17] Kagan World Media, *The Economics of TV Programming & Syndication 2002*, August 2002, at p. 6.

[18] According to the Television Bureau of Advertising, for the 2002-2003 season, TNT, the highest-rated advertiser-supported cable network, had a rating of only 1.56%. (A program's or network's "rating" is the percentage of total television households (approximately 107 million) viewing that program or network. In April 2003, the highest ranked ad-supported cable program came in at number 146 for the month, with a 3.2% household rating. *See* "HH Ratings - Primetime Broadcast and Ad-Supported Cable Season-to-Date 2002-2003 v. Season-to-Date 2001-2002," "HH Ratings - Primetime Top Ranked Ad-Supported Cable Networks Season-do-Date 2002-2003 v. Season-to-Date 2001-2002," and "Top 100 Programs on Broadcast & Cable: Apr-2003," Television Bureau of Advertising,

(continued...)

Table 2. End-User Expenditures on Various Video Media, 1990-2000

(millions of current dollars)

	1990	1995	2000
Total Broadcast Television	**$26,716**	**$32,720**	**$44,802**
Network Advertising Revenues	$9,963	$11,600	$15,888
Syndication Advertising Revenues	$1,109	$2,016	$3,108
Stations' Advertising Revenues (local + national sport)	$15,644	$19,104	$25,806
Total Cable Video-Related Revenues	**$18,401**	**$26,870**	**$44,808**
Total Cable Television Operators' Revenues[a]	$16,604	$22,898	$3,435
Operators' Video Subscriptions[b]	$16,128	$21,823	$31,992
Operators' Advertising Revenues	$476	$1,075	$2,430
Basic Cable Network Advertising Revenues	$1,797	$3,972	$10,456
Total DBS Revenues	**$0**	**$663**	**$8,467**
DBS Video Subscriptions	$0	$63	$8,440
DBS Advertising Revenues[c]	$0	$0	$27
Total Subscription Video-Related Revenues	**$18,401**	**$27,533**	**$53,275**
Filmed Entertainment[d]	**$16,129**	**$21,023**	**$29,906**
Box Office	$5,022	$5,494	$7,453
Home Video	$11,107	$15,529	$22,453

Sources: Broadcast Television Revenues: Television Bureau of Advertising, "Trends in Advertising Volume," [http://www.tvb.org/tvfaxts/trends], visited June 26, 2002; Cable Operator Revenues: Kagan World Media, *The Economics of Basic Cable Networks* (date and pages not provided); DBS Revenues: Kagan World Media, *The State of DBS 2002*, Dec. 2001, at p. 16; Filmed Entertainment Revenues: Veronis Suhler, "Communications Industry Forecast," July 2001, at p. 203.
a. Only video-related revenues are listed here. Revenues from installations, equipment, and non-video services like high-speed Internet access services and telephony are not included.
b. Includes home shopping commissions.

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[18] (...continued)
[http://www.tvb.org/rcentral/viewertrack/monthly/top100-b-c/top100.asp?ms=Apr-2003.html], viewed 6/20/03. Premium cable networks, such as HBO and Showtime, that offer premium programming for monthly subscriber charges have attained ratings of 6.0 and higher for several successful programs, such as *The Sopranos* and *Sex and the City*. *See*, e.g., "Ratings: Weekly Pay Cable," [http://www.allyourtv.com/ratingscablepay.html], viewed 7/15/2003.

c. DBS advertising is the equivalent of cable's "local avails," though they are sold as national time.
d. Filmed entertainment in this table includes movie theater box office and video stores. The data source for filmed entertainment includes expenditures on television programming as a third category. Because programming is an input into television, cable, and DBS services, it is not listed separately under filmed entertainment.

Table 3. Estimated Share of U.S. TV Home Set Usage by Program Source
(annual averages)

	Early 1950s	Early 1960s	Early 1970s	Early 1980s	Early 1990s	Early 2000s
ABC/CBS/NBC	60%	58%	55%	54%	31%	21%
DuMont	4%	–	–	–	–	--
FOX/WB/UPN/PAX	--	--	--	--	2%	8%
Network Affiliates[a]	30%	29%	25%	23%	18%	10%
Independent Stations[b]	6%	11%	16%	20%	16%	11%
PBS Stations	–	2%	4%	3%	3%	3%
Pay Cable	–	–	–	4%	4%	6%
Basic Cable[c]	–	–	1%	3%	20%	35%
VCR Play	–	–	–	–	5%	5%
Video Games	–	–	–	1%	1%	1%
Pay Per View	–	–	–	–	–	[d]
Average Hours of Set Usage (Weekly)[e]	35	39	46	51	54	62

Source: Media Dynamics, TV Dimensions 2001 Report (2001).
a. Includes syndicated shows.
b. Excludes WTBS and FOX or other on-air networks; includes syndicated shows.
c. Includes WTBS.
d. Less than 1 percent.
e. Counts multiple-set usage to different sources at the same time as separate exposures.

Costs Continue to Rise for Popular Programming

As entry has fragmented audiences, the costs of producing programming continue to increase at least at the rate of inflation. *Electronic Media*[19] estimates that

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[19] Michael Freeman, "TV's new math: How the economic models for producing TV shows have changed," appendix to "Special Report: The New Economics of TV – Forging A (continued...)

the cost of producing scripted television series for prime time has increased by about 30% since the early 1990s, and that the costs of production have increased from the $1.1 - $1.4 million range to the $1.4 - $1.6 million range for a one hour drama and from the $400,000 - $900,000 range to the $550,000 - $1.2 million range for a half hour situation comedy.[20]

It is important to understand, however, that production costs vary from these average levels in significant ways. On one hand, successful existing network programs that have demonstrated the ability to generate larger audiences than the average program – hit programs such as *Friends* or certain sports events – become more expensive to produce precisely because they are successful. Costs increase as the talent associated with those programs (athletes, actors, directors, producers) are able to renegotiate contracts to command a larger portion of the revenues they generate. Popular programming that attracts a large audience (or perhaps attracts a somewhat smaller audience that has a high intensity of demand) typically generates large revenues, either from advertisers or from direct subscriber charges. These higher than average revenues are shared by the owners of the programming, in the form of profits, and by the talent (actors, directors, athletes), in the form of high renegotiated salaries that include what economists call "economic rents." These economic rents become part of the cost of the programming.

The costs associated with each episode of a successful network program at the peak of that program's popularity therefore could be many times the average costs identified above. For example, the license fee per episode in the 2001-2002 season was $8.2 million for *ER*, $5.6 million for *Frasier*, and $5.5 million for *Friends*, and at least seven other programs has license fees per episode exceeding $2 million.[21] These license fees often do not cover the full costs of production because the owners of the programming can generate additional revenues from syndication of reruns and from international markets. Sometimes such costs can be built into production before a new (pilot) series has demonstrated audience appeal. Talent with a proven track record sometimes can command high salaries in advance.

ESPN recently announced a rate increase of 20 percent, the fifth consecutive year it has had an increase of that size.[22] A portion of that increase goes to the sports

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[19] (...continued)
Model for Profitability," *Electronic Media*, January 28, 2002.

[20] Similarly, movie production costs continue to rise. Although it does not provide quantitative data, Standard and Poor's states that "expenses are going up due to more frequent and spectacular special effects in action and science fiction films; projects that must be shot on location as opposed to a controlled studio environment; and astronomical star salaries." Tom Graves, "Movies and Home Entertainment," Standard & Poor's Industry Surveys, November 14, 2002, at p. 11.

[21] Kagan World Media, *The Economics of TV Programming & Syndication 2002*, August 2002, at p. 16.

[22] Apparently, a number of years ago many cable system operators contractually agreed to a 20% annual escalator in ESPN license fees. This year, ESPN has offered an alternative to the 20% escalator, offering to start dropping the rate of increase first to 16 percent
(continued...)

leagues and thus indirectly to the athletes. More generally, James M. Gleason, chairman of the American Cable Association, an association of small cable operators, claims that "programming costs for 14 top cable networks have risen 66.6% over the past five years – an increase of more than 5 times the Consumer Price Index."[23] Presumably these networks have a substantial proportion of programming that have successfully found audiences and these charges include the economic rents accruing to the talent that produced the programming.

From the perspective of the viewing public, the extremely high economic rents to talent that drive up these costs – which ultimately are passed on to consumers through higher cable charges or higher advertising charges that raise the prices for advertised goods and services – are beneficial if they generate additional programming of the sort that the public prefers. If these "windfalls" are ploughed back into the production of equally popular programming, or innovative programming that might not otherwise be produced, the public benefits. But to the extent most talent – athletes, writers, directors, producers, etc. – would continue to perform at the same level even if they could not command such high prices for their services, the public does not benefit from a system that fosters extremely high economic rents.

At the same time, there is a lot of original programming being produced at much lower cost directly for basic cable networks (such as Discovery and A&E) with much smaller expected audiences and revenues.[24] These independent producers are providing hundreds of programs for dozens of series on budgets of less than $100,000 per hour of programming.[25]

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[22] (...continued)
annually and eventually to 11 percent in exchange for wide distribution and relatively high license fees for all its products, including ESPN Classic, start-up Spanish-language service ESPN Deportes, and a new pay-per-view service. Further, ESPN wants long-term commitments and pricing schedules for more-uncertain products, such as a high-definition ESPN feed, a nascent interactive-TV product, video-on-demand packages, and a high-speed Internet product. The 20% price increase will go into effect as of August 1, 2003, if operators do not agree to the alternative arrangements. As of mid-July, no major multi-system operator had agreed to those arrangements. *See* John M. Higgins, "ESPN, MSOs FACE OFF:Cable operators wary of network's proposed alternative to annual 20% license-fee hike," *Broadcasting & Cable*, April 28, 2003, at p. 1, and John M. Higgins, "Does ESPN Have a Plan C?", *Broadcasting & Cable*, July 14, 2003, at p. 10.

[23] Written testimony of James M. Gleason before the Senate Committee on Commerce, Science, and Transportation Hearing on Media Ownership, May 6, 2003

[24] See, for example, John M. Higgins, "It's Production On the Cheap," Broadcasting & Cable, 4.28.03, pp. 38-39.

[25] The most successful of these series is "Trading Places," a household make-over program. It should be noted that once a production team has had a successful track record, it may be able to demand a higher price for its services.

Rising Costs and Fragmented Audiences May Increase Risk That Could Be Mitigated by Consolidation

Despite these cost differences, most program producers face a similar underlying cost situation. They have substantial up-front production costs and they do not have any prior guarantee that their programming will ever reach an audience, no less capture such a large audience that they will be able to renegotiate a larger portion of the revenues generated. As a result producers face very high up-front risk and it is generally in their interest to attempt to reduce that risk. There are two general ways to accomplish this: (1) to produce many different programs, so that the fate of the company does not depend on the success of individual programming projects, but rather on the overall success rate of the full portfolio of projects, and (2) to negotiate a joint venture with a program distributor or retail provider of video programs in which the latter makes an up-front investment in the production in return for a share of the profits or a lower price for programming.

As a result of audience fragmentation and generally increasing programming costs, in most situations no single retail channel (e.g., broadcast television or movie box office) reaches enough viewers to allow the producer to fully recoup the costs of producing the programming solely through that channel. At the same time, advertisers seeking to reach a wide audience no longer can reach their full target audience through advertiser-supported programming on a single channel. Thus, the old system of producing programming primarily for one retail channel is in most situations no longer financially viable.

These market forces are affecting market behavior and structure in several ways. First, the pressure on program producers to expand and diversify their programming or to enter into joint ventures with distributors or retailers has encouraged both horizontal mergers among producers and vertical mergers with distributors and retailers. To the extent reducing overall risk fosters the production of more programs or the undertaking of higher-risk projects, such consolidation will benefit consumers.

Second, audience fragmentation is forcing producers to market their products through multiple retail channels. This is known as "windowing"[26] when it involves motion picture programming and "repurposing"[27] when it involves television programming. For example, a producer may schedule a new product to first be released through first run movie theaters, then after some delay to be released on pay-per-view cable or video channels, then after additional delay to be made available for rental or sale at video stores, finally after yet additional delay to be shown on non-pay cable, DBS, or broadcast television channels.[28]

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[26] For an excellent discussion of the economic forces underlying windowing, see Bruce M. Owen and Steven S. Wildman, *Video Economics*, Harvard University Press, Cambridge, Massachusetts, 1992.

[27] For a detailed discussion of repurposing, *see, e.g.,*Michael Freeman, "Forging a Model for Profitability," *Electronic Media,* Vol. 21, Issue 4, 1/28/2002.

[28] In the case of repurposing, the delays between pipelines may be quite short. In several (continued...)

The reason for doing this is to take advantage of the fact that different customers have different intensities of demand for video programming. Those with the highest intensity pay the most to see the video in movie format at a first run theater as soon as it is released. Those with somewhat lower intensity accept a delay and pay somewhat less to watch the video as a movie on pay-per-view. Those willing to wait longer and pay still less, wait until the video is available for rent or purchase at a video store. Finally, those with the lowest intensity wait to view the programming when it is on non-pay cable, satellite, or broadcast channels. These options allow the viewing public to select their preferred mode of obtaining video programming, based on their sensitivity to price and to time delay. In turn, by not having a single price for video programming that would be lower than some viewers would be willing to pay and higher than others would be willing to pay, this viewer selection allows producers to maximize the revenues generated by their programs.[29] Windowing allows more programming to be profitable than would otherwise be the case and therefore more programming is produced for viewers.

However, it is not easy to negotiate the many pricing and timing variables across the production, distribution, and retail segments of the industry, as well as across multiple retail channels, especially when those channels compete with one another for audiences and, in some cases, for advertisers. One way to simplify this process and perform windowing efficiently is to vertically integrate across the production, distribution, and retail segments, and to consolidate across channels within a segment.

Third, in their efforts to gain viewers among the fragmented audience, program distributors and retailers have the incentive to take fullest possible advantage of whatever successes they have with their existing programs. One way to do that is to create brand identity for a network and extend that identity to affiliated networks. For example, the Discovery Channel, once successful, spawned a number of affiliated programming networks – Discovery Civilization, Discovery En Español, Discovery Health, Discovery Home & Leisure, Discovery Kids, etc. These, in turn, provide the opportunity for cross-marketing of programs among the co-branded networks. This

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[28] (...continued)
recent repurposing deals between broadcast networks and cable networks, the programs have been rerun on the cable network within about a week of its initial broadcast. Apparently this has not hurt ratings for the programs, though there is some concern that such initial saturation will lower the value of the programming for later syndication. *See*, e.g., Michael Freeman, "Special Report: The New Economics of TV – Forging A Model for Profitability," *Electronic Media*, January 28, 2002.

[29] It is interesting to note that a major strategy that the networks have used to contain programming costs – the creation of "reality television" programming – does not lend itself to windowing since the programs lose their appeal once viewers know who won the competition. Thus, although these programs reduce up-front production costs, they lack a "back-end" revenue stream. Similarly, most sports programs do not lend themselves to windowing and where they are expensive to produce this typically results in very high charges to the retail channels that carry the sports programming, since there will be little or no back-end revenue stream. Recent price increases in sports programming have been a source of controversy, particularly where producers and distributors have not allowed cable systems to place those sports programs on premium channels.

same formula has been followed by many programming networks, including FOX, HBO, BET, ESPN, and MTV.[30] Independent networks cannot perform such cross-marketing as effectively. These branding and cross-marketing activities need not be limited to a single industry segment and, in fact, can be facilitated by vertical integration. Many of the most successful examples involve branding and cross-marketing that goes beyond the video industry, into books, magazines, comic books, newspapers, musical recordings, and amusement parks that all build off a single recognizable character or concept. Branding and cross-marketing frequently can be most efficiently and effectively accomplished within a single corporate family.

Fourth, given the consolidation that has occurred in cable system ownership,[31] with just a handful of multi-system operators (MSOs) controlling access to the majority of cable viewers, individual content providers need to take whatever steps are necessary to create leverage in their dealings with MSOs, and an obvious choice is to join forces with programming conglomerates or with the large MSOs, themselves. Although most local cable (and satellite) systems now have capacity to carry 80 or more networks, with more than 300 existing cable networks it is becoming increasingly difficult for new networks to get onto systems. As start-ups in a business with high up-front production costs, they face even more directly than existing networks the need to get onto as many local cable systems as possible, as quickly as possible. One strategy that new networks have used is to offer their programming to MSOs and local cable systems without charging any per subscriber license fee – or even paying the cable systems to carry their programming. This limits the cable networks' revenues to advertising revenues, and unless they are carried by many local systems they cannot command very much in terms of advertising rates. As a result, start-up networks have increasingly been forced to follow one of two strategies. Some new cable networks have agreed to give the major MSOs – especially Comcast and AOL Time Warner – substantial equity interests in their networks in exchange for being carried on their systems.[32] Alternatively, some new cable networks have agreed to give "mega-programmers" such as Viacom, Discovery Networks, or Disney, substantial equity interests in their networks in exchange for becoming part of those companies' line of cable channels,

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[30] The efficiency advantages from combining into networks or in other ways is not new. Broadcast networks for many decades have put together weekly program schedules that are intended to maximize viewership by carefully analyzing the optimal order in which programs are presented in order to hold onto audiences once they have tuned into a particular network to watch a particular program. It would be much more difficult for individual stations to perform the market research needed to optimize program schedules.

[31] The ten largest multi-system operators serve almost 60 million of the approximately 72 million households receiving basic cable service (83.3%); the five largest serve 71.2%, and the two largest serve 45.2%. (National Cable & Telecommunications website, [http://www.ncta.com/industry], citing data from A.C. Nielsen Media Research and Kagan World Media, *Cable TV Investor*.)

[32] *See*, e.g.,R. Thomas Umstead, "Indie Nets Face Barren Landscape: New Programming Ventures Find It's Hard to Stake a Digital Claim Without Corporate Ties," Multichannel News, 6/9/2003. "Operators are seeking steep ownership stakes in new programming services in return for carriage."

taking advantage of those larger entities' ability to negotiate carriage with the MSOs. Data on cable network television household penetration from 1994 through 2001[33] show that the only new networks able to gain rapid and high levels of household penetration during that period were owned in whole or in part by one of the major program distributors or MSOs.

All four of these factors are at play currently in the market for cable programming. Kagan World Media, which follows the cable industry very closely and publishes a number of annual cable reference books, has described this situation in several recent publications:

> The environment for launching a cable network has changed dramatically over the last decade: With cash-for-carriage fees and periods with no license fee now common, a daunting economic equation has developed for cable network start-ups. That's why the majority of new networks launched have been owned by major media companies and even well-heeled international players like the BBC and National Geographic have chosen joint ventures rather than go it alone. It's simply too expensive and risky for many companies to join the long list of nets seeking carriage, and the odds for success get better if a partner with leverage can team up with a powerful backer such as Discovery.[34]
>
> For independents, there are a number of challenges. First, they don't have the built-in-ad-sales and affiliate-relations infrastructure giants like Discovery Networks and MTV Networks that enable them to launch new channels at low cost. The media giants are also at an advantage in the programming-cost department – they use "recycled" programming already aired on their core networks, which results in low incremental costs. That's why a number of the networks listed among upcoming/pending/past launches have fallen by the wayside. They just haven't been able to raise the capital to make it through the long haul.[35]
>
> A network launching from scratch, without a big infrastructure in place for administration and sales, could easily burn through more than $100 mil. to get to breakeven, versus less than $25 mil. for a Discovery spinoff. Additionally, an independently owned network would have a hard time getting the attention of cable and satellite operators, as it wouldn't have the brand-name panache of a Discovery or MTV Networks...[T]he economics [is] so different between analog and digital networks and between independent networks and those owned by media conglomerates....[36]

It is noteworthy that this consolidation results in economies of scale and scope that lower costs, which benefit consumers to the extent those reductions are passed

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[33] "Cable Network TV Household Penetration," Kagan World Media, *Economics of Basic Cable Networks 2003,* September 2002, at pp. 36-37.

[34] Kagan World Media, *Economics of Basic Cable Networks 2003*, September 2002, at p. 9.

[35] *Id.*, at pp. 12-13.

[36] Kagan Media World, *Benchmarking Cable Network Financial Statistics 2002*, July 2002, at p. 5.

through as lower consumer rates, but at least partially at the expense of program diversity, as a major source of costs savings for Discovery and its counterparts is to recycle old programming on their new cable channels.

One observer has raised another market-driven dynamic – to bypass existing bottlenecks to technological advancement – that may at least be motivating the proposed News Corp.-DirecTV merger. In his testimony at the June 18, 2003 Senate Judiciary Committee hearing, Scott Cleland, CEO of Precursor Group, stated that the combination of News Corp.'s content with DirecTV's DBS distribution platform would allow News Corp. to become "a fully digital distributor, legally bypassing the snail-pace, snake-bit, all-cost-little-gain, migration of over-the-air broadcast analog businesses to HDTV." He also stated the merger would allow "more of Fox's programming to be transmitted over the more secure and controlled DBS distribution platform and less over the over-the-air broadcast platform, which is increasingly vulnerable to piracy from Napster-like file-sharing and to pricing pressure from ad-zapping via TIVO-like technology."

Consolidation Also Could Be Used for Strategic Purposes That Harm Consumers

In addition to these incentives to consolidate to exploit production and marketing economies and efficiencies that may benefit consumers, individual companies may have incentives to expand vertically or horizontally to extend market power in a fashion that does not benefit, and indeed may harm, consumers. These opportunities typically arise when a company has some market power that conveys to it the ability to dictate the terms, conditions, and/or rates at which it either buys or sells (or refuses to buy or sell) its services or products because it enjoys a superior market position.[37] One potential source of market power is control over highly sought after programming. Another potential source of market power is control over scarce spectrum, such as broadcast spectrum.

When a company possesses market power that yields a superior negotiating position, that does not, by itself, mean that consumers will be harmed. For example, a company with popular programming might elect to follow a strategy of making its programming available at a low price in order to garner as wide an audience as possible and using the strength from its programming to enforce low retail rates. One might imagine, for example, the producer of children's movies setting and enforcing such low rates for video cassettes.

There are situations, however, where a company has both the incentive and the ability to use its market power in a monopolistic fashion that harms consumers. For example, if a company has the ability to increase short term or long term profits by tying the sales of its highly-demanded programming to purchases of its lightly-

[37] For example, in his testimony before the Senate Judiciary Committee Antitrust Subcommittee, Scott Cleland, CEO of the Precursor Group, identified one motivation for News Corp.'s proposed merger with DirecTV to be "Un-leveraged to Leveraged Distribution: NewsCorp understands that negotiating leverage increases dramatically with other programmers, if you are also a major distributor."

demanded programming, and in so doing consumers do not get their preferred programming or are forced to pay excessively for programming, then there will be consumer harm. There have been a number of allegations that some of the large integrated media companies are doing this. For example, in his testimony at the May 6, 2003 Senate Commerce Committee hearing, James M. Gleason, chairman of the American Cable Association, stated:

> Obviously, some of our customers want ESPN or Fox Sports. But ABC-Disney and Fox/News Corp. will not let us buy ESPN or Fox Sports. Oftentimes, in order to get the local ABC or Fox affiliate, Disney and Fox will force us through retransmission consent to take and pay for other channels we know our customers don't want. This abuse of retransmission consent goes further – in order to get consent to carry a local broadcast station in one market, our members are forced to carry Disney or Fox's satellite programming in other markets, where Disney or Fox do not even own the broadcast station. For example, is it really in the public interest for all of my customers to pay for recycled soap operas, a programming for which most of them have absolutely no interest, just so some of my customers can be permitted to watch the ABC affiliate? Adding to the absurdity of the situation, these conditions for carriage often outlive the terms of the retransmission consent period for the local broadcast station by many years. As a result, these mandated conditions clog a cable system's channel capacity ... while denying that capacity to independent ... programmers. The end result is ... increased[d] costs and decrease[d] choice for consumers. It gets worse. One solution might be to offer the expensive services in tiers or a la carte. This would allow consumers to choose whether or not they wish to pay for the expensive services. But all of the [integrated] programming companies force their programming onto the lowest, basic levels of service, making our companies and customers pay for all of their programming whether they want it or not.

This reference to the retransmission consent requirements provides an example of how consolidation can affect the impact of existing rules on firms' negotiating positions and acquisition decisions. In the early 1990s, in response to the general concerns of all local broadcast stations that they should be able to control how their programming is used by other parties, and to the specific concerns of the smaller broadcast stations that they would be placed at a competitive disadvantage if the local cable monopoly did not carry their signals, Congress enacted copyright and cable statutes allowing each broadcast station to choose between allowing local cable systems within its service area to carry its signal, with no compensation, under a "must carry" obligation, and negotiating with the local cable systems compensation for carrying its signal, under a "retransmission consent" agreement.[38] If no agreement is reached, the cable system is not allowed to carry the broadcaster's signal.

The retransmission consent requirement subsequently was extended to direct broadcast satellite companies. The law denies the FCC the ability to regulate the terms, conditions, and agreements of those retransmission consent agreements, beyond a good faith negotiations standard and a prohibition on providing any pipeline exclusive retransmission consent. Thus, there are no restrictions against a vertically

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[38] The Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, 106 Stat. 1460, codified at 47 U.S.C. § 521 *et seq*.

integrated company with broadcast stations and cable networks requiring local cable companies that seek to retransmit the company's local broadcast signals also to carry the company's cable networks. Subsequent vertical integration has rewarded local broadcast station owners with the ability to tie retransmission consent to carriage of multiple cable channels owned by their parent company, a result that probably had not been contemplated when the rules were established.

There is another powerful market dynamic driving consolidation. Mergers often upset existing equilibrium among market participants and therefore foster additional mergers. Thus, for example, in his testimony at the June 18, 2003 Senate Judiciary Committee hearing, Robert Miron, chairman and CEO of Advance/Newhouse Communications, stated that the relative equilibrium between the large programming conglomerates and the large MSOs would be broken if News Corp. were to acquire DirecTV, since it would give News Corp. unique access to a multi-channel pipeline to end users that it could use as leverage when negotiating with MSOs. That is, it could take a very tough stance when negotiating the terms, conditions, and rates at which it would make its popular cable or broadcast network programming available to MSOs, knowing that it could always provide the programming to end users over its satellite system. According to Mr. Miron, this market advantage likely would trigger an attempt by another large programming conglomerate to purchase the only other DBS system, EchoStar, in order to obtain the same market leverage. More generically, mergers create the need for other companies to respond in kind in order to protect their negotiating leverage. It is therefore possible that the effect of an individual merger on consumers, in isolation, may be positive or neutral, but that merger could start a chain reaction of mergers that would, in aggregate, harm consumers. No firm wants to be party to the merger that breaks the camel's back and elicits government rejection, however, and therefore each firm will have the incentive to respond quickly to other mergers.

Some Fundamental Questions Remain Unanswered

Although there has been a lot of heated debate over the impact of media consolidation, many fundamental factual and analytical questions about the dynamics in the video programming industry remain unanswered.

- Most observers acknowledge that the high profits from successful programs are needed to fund other programs, since much programming does not generate enough revenues to cover all costs. No systematic analysis has been performed, however, to determine whether a consolidated market structure is required to generate the cash flow needed to produce additional popular and innovative programming. Similarly, no systematic analysis has been performed to determine the extent that the extremely high economic rents that currently accrue to key talent behind popular programming fosters the production of additional popular and innovative programming – or whether a consolidated market structure fosters those high economic rents.

- Prices for basic cable service continue to increase at a significantly faster rate than inflation,[39] but to date no systematic analysis has been conducted to determine the extent to which those price increases are attributable to heavy infrastructure investment and real increases in programming costs that have been attenuated by efficiencies gained from consolidation vs. the extent they are attributable to vertically integrated cable networks with successful programming and large multi-system operators of local cable system monopolies using their market power to maintain above-cost rates.

- In the debate about whether to allow broadcast networks to own and operate local television stations whose signals reach more than 35 percent of total U.S. television households, one still unanswered underlying economic question of interest to policy makers is why ownership of these additional local stations would be more valuable to the acquiring broadcast network than they are to the current owner. (If they weren't more valuable to the network, no sale would take place.) One possibility is that the network would be able to exploit scale or scope economies that would not be available to the current owner and these economies would be passed through to end users, perhaps by providing additional cash for the network to use to bid successfully on sports programming highly valued by viewers. Another possibility is that, unlike the current owner, the broadcast network also own cable networks, and when negotiating a retransmission consent agreement with a local cable system it could not only demand a certain price for retransmission of its local broadcast signal but also could insist that the local cable system carry all of its cable networks and that the parent MSO carry all of its cable networks in markets where it did not have a local broadcast station. If the programming on these tied cable networks are less highly demanded by the MSO's subscribers than the programming that would otherwise be carried, the broadcaster's acquisition of the independent broadcast station would harm consumers.

- Both the broadcast networks that sought to increase the 35 percent cap and the local television stations owners who opposed lifting the cap agreed that local television stations are highly profitable.[40] Viacom President Mel Karmazin argued that broadcast networks are not as profitable as stations and, as a result, the networks need to

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[39] According to the FCC's Report on Cable Industry Prices released July 8, 2003, the average monthly rate for cable service increased by 8.2% over the 12-month period ending July 1, 2002. During that same period, the consumer price index increased just 1.5%.

[40] For example, at the May 13, 2003 Senate Commerce Committee Hearing on Media Ownership, Mel Karmazin, president and chief operating officer of Viacom Inc., and Jim Goodmon, president and chief executive officer of Capitol Broadcasting Company, agreed that local television stations are highly profitable, with profits in the range of 30 to 50 percent. They did not specify, however, whether local television stations in small markets are profitable.

> own additional local stations that generate profits in order to be able to bid successfully against cable networks for sports events. Without the additional funding from profitable owned and operated stations, he claimed that sports events would end up going by default to cable networks and thus not be available to households that cannot afford to pay for their television programming. The local affiliates and their broadcast networks share the need for good network programming and the desire for the network to be able to bid successfully. Yet the affiliates oppose allowing the network to acquire additional local stations that might help the broadcast networks accomplish this. An alternate way for the broadcast networks to obtain the funds needed to compete for sports programming is to reduce the compensation they currently pay to their affiliates (or, in the extreme, to require the affiliates to pay compensation to them). Affiliates oppose this as well. Given that affiliates do have options available to them, albeit distasteful ones, some observers have questions whether there is a public interest reason – prospects of greater diversity, more local programming, or lower rates for consumers – for government intervention into the network-affiliate relationship.

Public Policy Issues

The various rules in place today were adopted to foster diversity of voices, localism, and competition in an environment of technology-constrained availability of broadcast spectrum. Primarily, they impose horizontal ownership limits on entities. The one set of federal rules that explicitly addressed vertical integration – the financial interest and syndication rules – was repealed in the early 1990s.[41]

The continued high profitability of local broadcast stations[42] and the prices local broadcast stations fetch in the marketplace,[43] indicate that broadcast television spectrum remains scarce, and that those entities that control it (especially in large markets) enjoy market power, even as technological alternatives now exist that provide consumers with many new options. At the same time, there are strong market dynamics pushing toward consolidation – both vertical and horizontal integration. Some of those forces involve drives toward efficiency that should

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[41] *Evaluation of the Syndication and Financial Interest Rules*, 8 FCC Rcd 3282 (1993) and *Review of the Syndication and Financial Interest Rules,* 10 FCC Rcd 12165 ¶ 21 (1995).

[42] Data from the National Association of Broadcasters, *Television Financial Report*, 2001 edition, at pp. 2-3, show the profits and cash flow of commercial television stations were positive for every market size in 2000, and were especially robust for stations in large markets. This is consistent with the testimony of Mel Karmazin, president and CEO of Viacom, Inc., and Jim Goodmon, president and CEO of Capital Broadcasting Company, Inc., at the May 13, 2003 Senate Commerce Committee hearing, that local stations in medium and large markets enjoy profits in the range of 20 to 50 percent.

[43] *See*, for example, John M. Higgins, "Big Four Look Small in the Margin Column," *Broadcasting & Cable,* June 20, 2003, at pp. 1, 3.

benefit consumers, some involve drives toward maximum exploitation of pockets of market power that would harm consumers.

Given these market forces and the relative absence of vertical ownership restrictions or ownership restrictions across the old (broadcast) and new (cable and satellite) technologies, a few big media players have come to control a significant percentage of both programming and distribution. A question now facing policy makers is: Could or should new rules be formulated that would better safeguard the goals of diversity of voices, localism, and competition?

Consolidation in the video programming industry unquestionably has generated one type of diversity – in the scope of proposals for government action (or inaction) in the video programming market. The debate focused initially on structural rules because those dominate under the current regulatory scheme and have been the focus of scrutiny in the FCC's biennial review. But a number of parties have proposed the imposition of conduct rules. And some parties propose leaving things entirely to the market.

Station Ownership Rules

Ownership rules can cover a range of parameters depending on the policy goal they are intended to foster. If the focus is on diversity of voices, ownership rules are most likely to focus on maintaining the *number* of independent stations or voices. If the focus is on competition, ownership rules are most likely to focus on some measure of the *market share or market power* of entities. If the focus is on localism, ownership rules are most likely to focus on some measure of *ownership ties to the local community*. Of course, the number of stations owned by an entity also will affect competition, and an entity that captures the largest share of the market will in effect have the loudest voice in the market. The existing FCC rules sometimes incorporate two or more parameters in a single rule. For example, the local television multiple ownership rules restrict the total number of television stations an entity can own in a market *and* allows only one of the stations to be among the top four in ratings at time of purchase.

The existing local television ownership, local radio ownership, and cross ownership rules address horizontal markets.[44] Because they involve a mechanical counting of television stations, radio stations, or newspapers (except for the "only one in the top four" requirement in the television ownership rule), they do not give weight to the size of the firm under scrutiny or to any market power it may have in that market or in upstream or downstream markets.

During the most recent FCC biennial review process, Chairman Michael Powell stated that he wanted to develop a "diversity index," in some way analogous to the Herfindahl-Hirschmann Index employed at the Department of Justice and Federal Trade Commission to make preliminary judgments about whether proposed mergers

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[44] The national television ownership rule has a vertical element to it, in that its intent is to limit entities' ownership of local broadcast stations in order to limit the leverage of broadcast television network when negotiating with non-owned affiliate stations.

required additional antitrust scrutiny, that could be applied to individual media mergers.[45] Although there was no public articulation of the diversity index, it was suggested that the diversity index would take into account, for example, whether the acquiring entity were an independent company or a vertically integrated media giant with cable network and other programming interests. Critics of such an approach claimed that any measure of diversity was inherently subjective and application of a diversity index analysis to proposed mergers would increase uncertainty and discourage mergers that might be beneficial. Ultimately, the FCC chose only to use a diversity index for setting the restrictions in the rules, and explicitly refused to apply its diversity index to individual mergers. Moreover, its diversity index did not take into account the market share or market power of individual media outlets, but rather gave the same weight to each television station, the same weight to each newspaper, etc.

The only FCC rule designed, at least in part, to address the issue of concentrated ownership of both video programming and distribution is the National Television Ownership Rule, but that rule only addresses broadcast television, not cable or satellite television.

Programming Ownership Rules

Although there are more pipelines into the home and more distribution networks today than in the past, a few big media players control a large portion of both programming and distribution. This has raised concerns in some quarters that such vertical consolidation could threaten the diversity of voices, localism, or competition. The Coalition for Program Diversity, an umbrella organization that includes Wolf Films, Sony, Carsey-Werner-Mandalbach, the Directors Guild of America, the Screen Actors Guild, and AFTRA, has proposed that the FCC adopt a rule that would require the four major broadcast television networks to purchase 25 percent of their prime-time programming from independent producers, which would include any studio or production company not affiliated with a major network. The intent of the proposed rule, which is derivative of the FCC's old financial interest rule, is to increase program diversity.

The Coalition members, representing writers, producers, and other creative talent, claim that – with consolidation – decisions about airing programs are made by a single organization or person, and once a decision is made not to include a show in the network schedule there is a significantly lessened ability to shop the show around to other networks or pipelines. They allege that this has reduced the amount of innovative programming aired and fostered copy-cat programming.

Programming ownership rules do not directly address the three U.S. telecommunications policy goals of diversity of voices, localism, and competition. Diversity of voices has traditionally referred to news and informational voices, rather than entertainment voices. Television broadcasters – networks and stations alike – have always produced their own news programming. For the most part, that function

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[45] *See* Bill McConnell, "The Cap as Hot Potato," *Broadcasting & Cable*, March 10, 2003, at p. 1.

has not been left to independent producers. The networks do not produce local news or entertainment programs and thus network vs. independent ownership of production studios does not affect localism. Although repeal of the fin-syn rules opened up the gates for significant vertical integration and the loss of many independent program producers, to the extent consolidation was driven by market forces to reduce risk and gain marketing efficiencies consumers have arguably benefitted. The majority of complaints about abuse of market power – as opposed to complaints about relative negotiating power – involve tie-ins made possible by consolidation that crosses technologies, from broadcast to cable or satellite, or vice versa. By contrast, the programming ownership rules proposed to date all are limited to broadcast programming.

From a public policy perspective, an examination of programming ownership rules might hinge on whether it can be demonstrated that vertical integration somehow gives the consolidated entity the ability to command higher profits from its successful programming but does not foster the production of more, or more innovative (and, hence, risky) programming for consumers – and whether it also can be demonstrated that such additional programming would be forthcoming with programming ownership restrictions. Neither the FCC nor any other party has performed such analysis. Nor has anybody performed analysis to determine how consolidation across the broadcast, cable, and satellite technologies will effect the relationship between high profits (and economic rents) for successful programming and the supply and diversity of programming.

Non-Discriminatory Access to Programming

Most of the programming provided by the large vertically integrated cable networks is distributed to cable systems via satellite. This programming is known as "satellite cable programming" or (if the original programming is from a distant broadcast station, such as the Turner "Superstation") "satellite broadcast programming." The FCC has adopted program access rules designed to increase access to video programming for all providers of multichannel video programming by prohibiting unfair or discriminatory practices in the sale of satellite cable programming and satellite broadcast programming distributed by a cable network programmer (a cable network) that is vertically integrated with a cable system. The rules prohibit unfair and discriminatory practices in the sale of satellite cable and satellite broadcast programming and prohibit or limit the types of exclusive programming contracts that may be entered into between cable operators and vertically-integrated programming vendors.

The FCC program access rules do not cover all situations. For example, they do not cover cable or broadcast programming that is distributed over terrestrial wireline (landline) facilities rather than satellite. Also, they do not apply to cable networks that are vertically integrated but where that integration is with a satellite system serving end users rather than a cable system serving end users.[46] Nor do they

[46] In its application for approval to merge with DirecTV, News Corp., which is a large programmer with many cable networks, agreed to abide by these rules, even

(continued...)

apply to local broadcast signals, which are subject to the retransmission consent rules.

Where program access rules are in effect, they eliminate one potential harmful impact of vertical integration – a vertically integrated company with "must have" programming refusing to make that programming available to companies that compete with its multi-channel program distribution (cable or satellite) unit, or making that programming available in a discriminatory fashion at inferior terms, conditions, or rates.

But program access rules do not protect against the vertically integrated company making its "must have" programming available at very high rates that raise the costs to both its own satellite or cable system and also to all other satellite and cable systems. These high rates are a "wash" to the vertically integrated company – the higher costs to its satellite or cable system are matched dollar for dollar by the higher revenues for its cable network. But the higher rates represent real costs for the competitive satellite or cable system. This can raise rivals' costs in an anticompetitive fashion.[47]

Equally important for consumer welfare, program access requirements do not restrict vertically integrated cable networks with market power from raising rates to all cable and satellite systems, thereby forcing them to raise rates to consumers. To the extent consolidation strengthens firms' market power and ability to raise prices, program access rules do not protect against those higher rates. But any harm to consumers will be ameliorated to the extent these higher rates generate revenues that are used by the integrated entities to produce more, and more innovative, programming.

Retransmission Consent

The bulk of the complaints raised by small competitors against large vertically integrated video companies have been about the ability of the latter to tie the purchase of "must have" programming to the purchase of less desirable programming. As discussed above, one frequently cited mode for accomplishing this has been the practice of integrated companies with local broadcast stations and cable networks tying retransmission consent for the broadcast signal to carriage of an entire suite of cable networks. It has been alleged that these tie-ins sometimes extend beyond carriage on the local cable system to requiring multi-system operators to carry the suite of cable networks on all their cable systems and/or for time periods that extend far beyond the period covered by the retransmission consent. Such tie ins can

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[46] (...continued)
though they formally apply only to cable networks affiliated with cable systems, not those affiliated with satellite systems.

[47] *See*, e.g., William P. Rogerson, "An Economic Analysis of the Competitive Effects of the Takeover of DirecTV by News Corp.," filed in FCC Docket MB Docket No. 03-124, "*In the Matter of: General Motors Corporation, Hughes Electronics Corporation, and the News Corporation Limited Application to Transfer Control of FCC Authorizations and Licenses Held by Hughes Electronic Corporation to the News Corporation Ltd.*"

result in cable system operators providing programming their customers do not prefer or passing through high programming charges to customers.

The current law does not authorize the FCC to regulate the terms, conditions, and agreements of those retransmission consent agreements, beyond imposing a good faith negotiations standard and a prohibition on providing any pipeline exclusive retransmission consent. If Congress chooses to restrict the ability of vertically integrated local broadcast television licensees from tying retransmission consent to carriage of non-broadcast programming, it would have to change current law.

A La Carte

Most cable television networks, especially those supported in part by advertising revenues, are available to subscribers only as part of large packages of networks. Proposals have been put forward to require local cable systems to make cable networks available to subscribers on an a la carte basis that allows customers to choose, and pay for, individual cable networks. These proposals have been controversial. As discussed below, there could be both benefits and harms to consumers if an a la carte option were mandatory.

When large media companies with multiple cable networks require local cable system operators to purchase packages of their cable networks and/or local cable system operators require subscribers to purchase packages of cable networks, without an option for the purchase of individual cable networks, some purchasers will be forced to buy more programming than they want, and perhaps at an outlay that is greater than they would make if allowed to purchase individual networks.[48] Thus, some purchasers are worse off when forced to purchase packages than they would be if they could purchase individual channels.

At both the Senate Commerce Committee hearing on June 4, 2003, and the Senate Judiciary Committee hearing on June 18, 2003, Senators asked panelists their opinions about a rule that would require large media companies that own multiple cable networks to make their networks available to local cable systems and satellite systems on an a la carte basis *and* that would require the local cable systems and satellite systems to make those cable networks available to consumers on an a la carte basis. The large media companies and local cable system operators could continue to offer packages of cable networks, but would have to make the a la carte option available. The purpose of such a rule would be twofold: to allow cable and satellite systems to carry the programming that they think their customers prefer, without being forced to carry less preferred programming, and to allow end user customers to choose the programming that they prefer and not have to pay for other programming.

Proponents of such a rule have expressed concern that absent such a rule the large media companies could use their market power from control over "must have"

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[48] For most consumers, the local cable system is owned by one of the large multi-system operators (MSOs) and the packaging decision is made at the MSO level, not at the local level.

programming to force cable and satellite systems to carry less popular affiliated programming at the expense of both consumer preferences and independent programmers. They also have expressed concern that absent such a rule consumers, especially low income consumers, are forced to pay much higher prices for basic cable service because the basic service package includes high-cost sports programming that they do not care to receive. An a la carte requirement could restrict large media companies from imposing tie-in arrangements on cable and satellite systems (by not allowing the media companies to condition access to one cable network on the carriage of other cable networks) and also might allow end users to select only the programming they prefer.[49]

An a la carte rule also might constrain the rents that athletes, performers, and producers earn – and that raise the costs (and prices) of such programming – if substantial numbers of subscribers with low intensities of demand for the sports or entertainment programming choose a la carte options that do not include the high-cost programming. As described earlier, sports programming is highly valued by a small portion of cable subscribers, but currently such programming often is funded by imposing higher rates on all subscribers to enhanced basic service. If that programming had to be supported only by subscribers with high intensity of demand, either those subscribers would have to pay more, or the talent producing that programming would have to accept lower rents.

But an a la carte requirement also could have some effects that would harm consumers. Packaged service offerings make it less risky for a cable or satellite system to introduce a new cable network. With a package, the new cable network does not sink or swim based on its immediate audience reception. Rather, the system owner can allow the new cable network to acquire an audience by having viewers accidentally tune in to the network. By contrast, under a la carte, viewers must make the up-front decision to pay for a new cable network, perhaps without having had the opportunity to see any of its programming in advance.

Similarly, with a packaged offering, the local cable system operator can efficiently market new networks by advertising the new networks on their existing networks. This marketing strategy is less efficient if, as in an a la carte environment, many of the viewers receiving the marketing messages on the existing networks are not subscribed to the new network and therefore cannot easily check out that network in response to the marketing message.

Also, the availability of a large package of networks will increase overall audience size because at any particular time viewers who pay a la carte may not have any programming they choose to view on the channels they have paid for and therefore might turn off the television altogether, but if they had access to the basic

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[49] Of course, local cable system operators would select an a la carte option from the large media companies, and subscribers would select an a la carte option from their local cable system operators, only if the price of the a la carte option relative to the price of the enhanced basic service package option was favorable. For example, if the per network a la carte price were $10.00 per month and the price for an 80-channel enhanced basic service package were $35.00, then only those customers with very narrow video tastes that are satisfied by three networks would select the a la carte option.

enhanced service package they might find programming they enjoy when surfing all the channels offered in the package.

As a result of these lost efficiencies, it is possible that the sum of the individual prices for each network that a typical household subscribes to in an a la carte environment could be higher than the single price for a basic package. At the same time, the choices available to consumers could be reduced both because they would only have available to them the networks they paid for and because there are likely to be fewer new networks because of the higher risk associated with an network launch when many subscribers make a la carte network purchases.

The extent to which these potentially harmful effects of an a la carte requirement will actually occur will depend on the proportion of subscribers that choose the a la carte option vs. the enhanced basic service package. If the a la carte option is chosen only by a very small portion of subscribers with narrow video tastes that can be met by a limited number of networks, it may only create a very weak disincentive for new network launches. But if the a la carte option is widely selected, the disincentive could be substantial.

Some Nielsen Media Research data presented by the Television Bureau of Advertising[50] indirectly shed light on this. Nielsen asked the question, "As the number of channels available to a TV household increases, as it has in recent years, what is the effect on the number of channels actually viewed?" It found that "... after reaching the 50-channel level, additional channels produce no significant increase in the number of viewed channels. The viewing remains in the 15- to 19-channel range. Even the 121+ channel group averages only 17.9 viewed channels out of an average of 195 available channels." These data are only for a single week of viewing. It is possible that over a longer period of time subscribers view far more channels. But the data suggest that many subscribers do not seek the great diversity of networks provided by enhanced basic service offerings and, if a la carte pricing were not set in a way that made the package preferable even when subscribers only sought a handful of networks, there could be substantial migration to a la carte purchasing, which could discourage new network launches.

Programming Requirements

At the June 4, 2003 Senate Commerce Committee hearing, in a free-wheeling discussion of how to ensure localism and diversity of voices, one approach mentioned in passing was to return to the old requirement, dating from the 1970s, for each station to provide some minimum amount of local programming (perhaps more narrowly couched as local news and informational programming). This approach has the advantage of ensuring a certain level and diversity of such programming. It addresses concerns about the many broadcast television stations that are no longer

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[50] "TV Basics: Channels – Received vs. Viewed," Television Bureau of Advertising, [http://www.tvb.org/rcentral/mediatrendstrack/tvbasics/10_Channels-RecVsViewed.asp], citing Nielsen Media Research, National People Meter Sample, Aug. 20-26, 2001, viewed on July 15, 2003.

locally owned and operated, and about stations getting feeds from distant locations that purport to be local but are not.[51]

It is not clear what the impact of such a rule would have in the marketplace. On one hand, in large and middle-sized markets, local broadcast television news programming tends to be very profitable and will be offered with or without the rule. On the other hand, in small markets, where local stations may not have the financial wherewithal to produce local news programming, such a requirement could drive stations out of business or could foster further consolidation with a newspaper or with a larger television group, which could have the consequence of lessening the diversity of voices.

Fairness Doctrine

Some observers also have suggested that the Fairness Doctrine be re-imposed. That requirement, which was repealed in the mid-1980s,[52] required broadcasters to cover issues of public importance and also to provide "balanced" coverage of such issues. The Commission repealed it because it tended to have an unintended effect. In order to avoid the costs and bad publicity associated with a Fairness Doctrine complaint, broadcasters simply shied away from controversial topics when covering issues of public importance. Thus, rather than fostering public debate, the rule tended to impede it.

The dynamic forces at play today in the video programming industry as a result of technological change will continue to play out and foster further market consolidation. That consolidation may or may not prove to be consistent with the U.S. telecommunications policy goals of competition, diversity, and localism. As a result, Congress is likely to continue to face important policy issues relating to the video programming industry.

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[51] This concern was raised during the Senate Commerce Committee markup of S. 1264, the FCC Reauthorization Act of 2003, on June 26, 2003.

[52] *Syracuse Peace Council,*2 FCC Rcd 5043. This decision was based in large part on a Commission study, known as the "1985 Fairness Report, of the impact of the fairness doctrine on broadcast practices. *See* 102 FCC 2d 145 (1985).