REGULATING NETWORK TELEVISION

Dubious Premises and Doubtful Solutions

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WHETHER MEASURED by viewing levels, revenues, or profits, network broadcasting dominates television, far outstripping the activities of the "independents" and public TV. In the 1979–80 broadcast season, ABC, CBS, and NBC captured almost 90 percent of the prime-time viewing audience. And in calendar year 1979 they, along with network-owned stations and affiliates, accounted for more than 90 percent of both the revenues and profits of the TV broadcasting industry.

Network domination of broadcasting has not, of course, gone unnoticed by the Federal Communications Commission (FCC). Indeed, the commission has launched major studies of the "problem" roughly every twenty years. The first occurred in the late 1930s, when the issue was network dominance of radio, and the second in the mid-1950s when the concern had shifted to TV. As an outgrowth of these studies, the commission adopted rules restricting the contractual relationships between the networks and their affiliated stations and between the networks and their program suppliers.

The FCC's third major study of network dominance, announced in 1977, started down an identical track. The mandate contained in the commission's *Notice of Inquiry into Commercial Television Network Practices* was predicated on the same assumption that had provided the basis for previous rulemakings: network dominance is a problem and the way to solve it is to regulate the networks' commercial practices. Thus the original plan of study was to examine the existing rules on network practices and suggest ways for making those rules more effective.

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What Is Network Dominance?

In 1978 the FCC's new chairman, Charles Ferris, asked us to become co-directors of the study. Our first problem was the approach taken by the commission in the Notice of Inquiry. To us, it seemed odd for a number of reasons:

- It ignored a major finding of the previous network inquiry, which had concluded that the basic sources of network dominance "appear to be the shortage of TV stations and the market environment and commercial incentives supporting network-station affiliation . . ." and that dominance will persist in the absence of "major technological change in the nature of the television industry or in the form of telecasting . . ." (*Network Broadcasting*, 1958). That this view was correct was clearer than ever by 1977. Yet the Notice made not a single reference to the subject.

- It disregarded a considerable body of academic literature indicating that past commission policies had actually increased, rather than decreased, network dominance. It was widely argued, for example, that by limiting the entry of networks that make use of new

technologies, such as cable TV, and by placing constraints on the provision of programming financed by direct viewer payments, the commission had sheltered the existing networks from competition.

• The Notice read as if the television industry still consisted only of advertiser-supported over-the-air broadcasting, despite the enormous expansion since the 1950s in the variety of technological alternatives for providing television services. These alternatives include an expanded cable industry, a nascent multipoint distribution system business, embryonic videodisc and videocassette industries, and a visionary direct satellite-to-home broadcasting service.

• There was not the slightest intimation that experience with the last twenty years of regulation had created any doubts about the course the commission had pursued. This omission is especially strange in that the Notice suggested that network dominance might actually be increasing despite the panoply of rules adopted to prevent it.

One should resist the temptation to conclude that these oddities stemmed merely from the commission's failure to read its own staff's report. For the fact is that they are fully in accord with the commission's notion of network dominance. Historically, the FCC has been concerned solely with preventing network practices that restrict competition *within* the existing system. Thus, in its Notice of Inquiry, it took as an indication that network dominance may have increased the fact that network programs were occupying a growing proportion of time on affiliated stations, and it invited comments on whether the increase "would significantly impede the development of additional networks, and other syndicated program offerings in competition with network programming."

Although the commission had long conceded that the networks provide a valuable service by offering a broad array of programs, it feared they might unduly limit non-network sources from selling programs to affiliates. Thus, it had extensively regulated network-affiliate contractual policies. When that failed to prevent the networks from offering and their affiliates from accepting programming that occupied almost all of the most valuable station time, the commission resorted to the prime time access rule (1970). This rule, which forbids affiliates in the top fifty markets from carrying more than three-and-a-half hours of network entertainment programs during the four hours of prime time, is the source of the low-budget game shows that monopolize early evening TV.

It is important to note that the purpose of these rules, and a parallel set of rules placing limits on dealings between networks and program suppliers, was to increase the number of different sources supplying programs to stations, but not the number of competing outlets available to viewers. Indeed, the commission apparently saw no inconsistency in trying to address network dominance by reducing the power of existing networks while at the same time erecting barriers to the creation of new networks.

Clearly, our first task was to redirect the study to correct this shortsighted view of network dominance. A *Further Notice of Inquiry* was issued that emphasized the relevance of examining the barriers to entry confronting new networks and that questioned whether it was realistic to focus exclusively on industry practices within the three-network broadcast system.

The final report of the network inquiry special staff, submitted in October 1980, contained four conclusions quite incompatible with the FCC's traditional approach:

• The commission has failed to understand the function of networking—which is to distribute programs to a large number of geographically dispersed viewers. Networking is not an aberration or a necessary evil, as the commission seems to have thought, but an inevitability—since the costs of producing and distributing a program are largely unaffected by the number of viewers who watch it. Moreover, because there are economies that extend across programs, networks are likely to be formed to offer an extensive array of programs rather than just one. Finally, drawing the line between expansions in network activities that are justified by these economies and expansions designed to deter potential competitors will be exceedingly difficult.

• In adopting policies designed to shift income from networks to affiliates or program suppliers, the commission has frequently confused disputes over the distribution of industry profits with matters affecting the public inter-

est. Furthermore, few if any of these policies are likely to succeed in shifting earnings or, more important, in benefiting viewers.

- The commission has failed to appreciate how difficult it is to regulate an industry by prohibiting a number of discrete contractual practices. Its general approach has been to adopt rules without a detailed analysis of their likely effects on the behavior or incentives of industry participants; and, until our study, it had never examined a single rule in operation. Apparently the FCC thought that simply adopting a rule was sufficient to accomplish that rule's purpose.

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- Most important, the commission has failed to understand how closely the problem of network dominance is linked to its own policies. During the period when it was trying to control network dominance through detailed regulation of contractual practices, it also pursued policies that protected the existing networks and their affiliates against competition from alternative sources of national program distribution. Happily, some of those barriers have been relaxed in the last half dozen years, and we can now anticipate a television system that, although dominated by networks, is dominated by such a large number of them that no one will really care.

The Economics of Networking

The FCC's ambivalence about networking dates back to its early studies of radio broadcasting. In its *Report on Chain Broadcasting* (1941), for example, it conceded that chain broadcasting—that is, networking—gave advertisers a strong incentive to finance expensive programs, thereby benefiting both the listening public and broadcast stations; but it went on to argue that this "does not mean that the prevailing practices of the networks and their outlets are sound in all respects. . . ." In particular, the FCC believed that some network practices effectively kept competitive program sources, including other networks, from gaining access to the time of a network's affiliated stations. As an outgrowth of its *Report on Chain Broadcasting*, therefore, the commission adopted a series of rules that, among other things, prevented the networks from contracting for exclusive affiliations and restricted their ability to acquire "options" on station time. These chain broadcasting rules were extended to television in 1946 and, with some modifications, still govern the network-affiliate relationship in television. In 1977, however, they were deleted for radio on the grounds that the proliferation of competing radio networks had rendered them obsolete. (Because of that increased competition, for example, radio affiliation contracts were often running for only six months compared to the commission's limit of two years.) Nevertheless, the question asked in the commission's initial notice on the television inquiry, issued that same year, was not whether the rules for television should be eliminated but whether they needed to be strengthened.

This theme—that increased access by non-network sources to station time is intrinsically good and that network practices limiting such access are presumptively bad—has guided the commission for forty years, forcing it into lengthy investigations to determine when a particular network practice is "sound in all respects." The difficulty is that the economies yielded by networking are not exhausted in the provision of a single program. Therefore, determining whether a practice is "exclusionary" or "in the public interest" is not a simple matter.

A network that offers an array of programs that extends across the broadcast week clearly can provide its affiliated stations with greater economies than can the purveyor of a single program. To begin with, the existence of a network permits advertisers to purchase time on a large number of stations and programs in a single transaction, knowing that the ad will appear at the same time in each market. This is obviously less expensive than negotiating contracts with each station individually and also makes it easier for the advertiser to predict the audience it will reach. The network form also permits a network and a station to negotiate a single contract that covers the processes of offer and acceptance and the amount and manner of compensation for many programs, thus reducing costs below what they would be if

networks offered service on a program-by-program and station-by-station basis. This undoubtedly is why stations tend to acquire most of their programs from a single source. Finally, a network that provides many programs can spread the risk of program failure and thus predict more accurately its rate of success than can a network offering only a single program. With the networks now financing a substantial portion of the cost of program development, spreading the risk across a large number of programs is a considerable advantage.

In short, a strong case can be made that it is economically efficient for networks to offer an extensive array of programs. Although one can imagine instances in which a network might try to exclude potential competitors by offering more programs than required for efficient operation, it is not easy to know when that line has been crossed. Nonetheless, the FCC has adopted rule after rule predicated on the notion that it knows when the line will be crossed, that it can design ways to prevent it, and that the viewing public will be better off as a result.

Regulating Network Contracts

The FCC's ambivalence about networking probably has been sufficient in itself to doom the commission's efforts to reduce network dominance. But two other failures have exacerbated the problem. For one thing, the commission has frequently regulated network behavior on the dubious premise that shifting profits from networks to their affiliates or program suppliers will cure the evils that networks inflict. For another, it has exhibited an almost inexhaustible capacity for devising rules on network dominance that are ineffective, if not downright harmful to the public interest.

Both failings are dramatically illustrated by the "syndication" rule. Adopted in 1970, this rule provides that networks may not share in the off-network rerun (or syndication) revenues of programs produced by independent suppliers for network exhibition. The rule would further the public interest and reduce network dominance, said the FCC, because if the producer does not have to grant a large portion of its potential profit to a network, its ability to operate profitably in network television "will be greatly enhanced," and it can be expected "to develop into a stable and continuing alternate source of programs and ultimately to compete for network time" (*Competition and Responsibility in Network Television Broadcasting*, 1970).

The syndication rule was adopted in response to pleas from program producers that they "deserved" higher profits but had failed to realize them because of the market power of the networks—who, apparently, were bent on slaying their principal sources of supply. This method of defining the public interest, by comparing the just deserts of industry participants, confuses the regulatory issues posed by network dominance because it fails to distinguish situations where the interests of networks, affiliates, and program suppliers coincide from situations where they diverge.

Networking has been a very profitable business, in large part because of FCC-imposed entry restrictions. It is profitable not only for networks, but for affiliates and program suppliers as well. The simple truth is that these three groups are co-venturers no one of which can succeed without the other two. They have a common interest in maximizing the profits to be gained from networking. Where there is disagreement among them, therefore, it will almost always be over the manner in which those profits should be shared. Consequently, when the commission responds to assertions of network dominance by asking how best to rectify damage inflicted by networks on affiliates or program suppliers, it reacts only to controversy over the distribution of profits, the point at which the interests of these groups diverge. The public interest—the interest of viewers in competition among television firms, in the widest possible program choice, and in local control of broadcast services—is not apt to be affected by the outcome of such disputes.

In the proceedings leading to the adoption of the syndication rule, program suppliers had argued, and the commission had concurred, that if profits could be shifted from networks to producers, the latter would compete more effectively with ABC, CBS, and NBC in supplying programs to stations. But even if the rule had succeeded in increasing the producers' profits, it could not affect their incentive and ability to compete in other markets. If producing programs for sale directly to stations is unprofitable, that fact is not changed

by making sales to the networks more profitable. And it is simply not credible that producers would choose to dissipate any increases in earnings from sales to the networks by undertaking an unprofitable activity. Program suppliers are *not* eleemosynary institutions.

The commission's theory is flawed in another, equally important way. It is highly unlikely, even if a transfer of profits to suppliers would cause them to produce more programs, that regulation of a number of contract terms could produce such a shift.

In adopting the syndication rule, the commission apparently believed that it could prevent program suppliers from agreeing to onerous contract terms that the networks would otherwise impose because of their bargaining power. By contrast, we regard it as virtually a truism that such attempts to rectify imbalances in bargaining power by regulating network contract terms cannot succeed. That approach instructs networks to act contrary to their own interests and therefore gives them every incentive to avoid its intended effect. Moreover, such regulation does not alter the number or identity of network firms, or the structure of the markets in which they operate, and therefore does not diminish the bargaining power that initially gave rise to concern. And that bargaining power will usually enable the networks to alter other terms of the agreement to regain whatever advantage they previously possessed. Thus, for example, our examination of the program supply industry unsurprisingly demonstrated that the complexity of agreements to produce and supply network programs left the networks several alternative methods (including simply lowering the price they paid) to recapture, through different terms, the value of their previous share in syndication revenues.

To assess fully the effectiveness of the FCC's network rules, another (potentially more plausible) basis for regulatory intervention has to be examined. Fearing that the dominant networks might also use their market power to inhibit the entry of additional networks, the commission has tried to prevent such exclusionary behavior. Unlike the attempt to shift profits, this policy is neither illusory nor unrelated to the public interest. Almost without exception, however, the target has been the established networks' success in dominating their affiliates' program schedules, rather than the danger that those networks would prevent the emergence of additional full-time networks employing other outlets.

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Assuredly, ABC, CBS, and NBC have every incentive to prevent further network entry. However, because networks exist only as middlemen among viewers, advertisers, program suppliers, and local broadcast outlets, they can achieve such market power only by monopolizing one or more of these groups. It is quite simply inconceivable that the dominant networks could, through contract or merger, acquire control over enough viewers, advertisers, or program suppliers to affect the prospects of potential networks. It is, however, true that broadcast outlets are limited. The networks conceivably could deter entry by paying these outlets to deny other networks access to them. Such foreclosing tactics can be prevented, however, by forbidding any network firm to obtain control, by ownership or agreement, of sufficient outlets within any local market to enable it to monopolize distribution.

This could be done in most cases simply by applying elementary and widely accepted antitrust principles. But the FCC's network rules, rather than reflecting such understandable proscriptions on the horizontal acquisition of network market power, have involved endless tinkering with the terms of network contracts. The effort has been futile, because the fundamental economics of program production and distribution give networks an overwhelming advantage in any event. And it has been wrongheaded, because the effect has been to inhibit the adoption of efficient arrangements.

For example, from the inception of television networking the FCC has banned the practice known as "option time," whereby networks once acquired guaranteed access to certain parts of their affiliates' broadcast day. But the ban does not improve the prospects for new

networks because option time did not foreclose access to other outlets that a would-be competitor might employ. Nor does the ban substantially improve the ability of non-network sources to sell their programs to affiliates, because it leaves the networks free to structure other terms of the affiliation contract so as to affect the carriage of network programs. One method networks use is to increase the hourly compensation paid to stations for carrying network programs as the total number of hours carried increases; another is to vary the advertising time available for sale by stations within or adjacent to network programs. In other words, what the ban has done is to force networks to use less efficient means, such as graduated compensation plans, for achieving the goals that they formerly achieved through option time.

Since the chain broadcasting rules and the prime time access rule do nothing to reduce network market power or provide benefits to the public, we urge their elimination. This recommendation has been opposed by public interest groups and some industry participants—but, curiously, not on the grounds that our analysis is incorrect. Their position appears to be that "doing something," even if it is ineffective, is better than doing nothing at all.

Commission Policies and the Entry of New Networks

One reason we are so critical of attempts to attack network dominance by regulating contractual practices is that, whatever the benefits of such regulation, other policies would have produced much more significant change. We submit that no one would care how much of a station's time were occupied by a single network if the number of stations and networks were very large. Indeed the commission itself seemed to be operating on this principle when it eliminated the network-affiliate regulations for radio. Even the most ardent advocate of the present television network rules must agree that the only possible way to reduce the market power of ABC, CBS, and NBC and, more important, to expand the range of choice available to viewers is to eliminate barriers to the creation of new networks. Yet during the entire period from 1946 through the mid-1970s, the commission, while claiming to be concerned with network dominance, was pursuing in a more or less systematic manner policies that were cementing that dominance.

The spectrum allocation plan for television adopted by the commission in 1952 guaranteed that there would be no more than three over-the-air television networks for a very long time. This is so for two interrelated reasons. First, instead of allowing stations to serve wide geographic areas, the plan limited coverage so that many stations were assigned communities too small to support more than one or two stations. Second, the plan, which allocated portions of both the VHF and UHF bands for the broadcast of television signals, "intermixed" VHF and UHF stations—that is, it frequently assigned both types of stations to the same market. UHF, then and now a technically inferior service, suffers a handicap in competing in such intermixed markets. Since the plan provided that a very large proportion of viewing households would be able to receive a fourth commercial television station, if at all, only on UHF in an intermixed market, it put a potential fourth over-the-air network at a significant competitive disadvantage. The combined effect of these policies has been to make a fourth network unprofitable, although such a network almost certainly would be profitable if it could obtain coverage equivalent to that of ABC, CBS, and NBC.

Significantly, the commission did little over the years to undo the effect of these early decisions. In the late 1950s it began a set of proceedings designed to "deintermix" certain markets so that UHF stations would compete only with UHF stations. After creating a small number of such all-UHF islands, however, the FCC abandoned the policy under congressional pressure. At about the same time, the commission began to restrict cable television, a competitive technology that emerged, in part, because of the limited over-the-air service available in many markets. Had cable not been restricted, it might have been possible for other networks, composed of broadcast stations in some markets and cable systems in others, to compete with ABC, CBS, and NBC. If the FCC had permitted cable to carry signals of independent broadcast stations into markets served only by three stations, the handicap created for a fourth network by the limited coverage avail-

able to it and the fact that many of its affiliates would have operated in the inferior UHF band might have been overcome. It was only after the distant-signal carriage rules were relaxed in the early 1970s that such a network could come into being.

Until recently, the commission also made it difficult to create networks financed by direct viewer payments (pay-TV) instead of advertiser support. The principal means employed were "anti-siphoning" rules, which limited the amounts and types of movie, sports, and series programs that pay-TV could provide to its viewers. These rules were supplemented for over-the-air pay television (STV) by restricting the number of such stations that would be licensed and the portion of the broadcast day during which pay-TV could be offered.

With each of these policies, the commission limited the ability of new networks to enter the market, sacrificing potential improvement in network competition in order to achieve some other goals. In no case, however, have these other goals been realized. Even after almost three decades of commission attempts to foster the growth of UHF television, relatively few of the stations allocated have come on the air and those that have still suffer under a considerable handicap. Moreover, there is no new over-the-air network making large-scale use of UHF affiliates on the horizon, despite evidence that an additional over-the-air advertiser-supported network comparable in size to ABC, CBS, or NBC and with the same proportion of UHF affiliates in intermixed markets would probably be viable. The constraints imposed on cable TV in order to preserve the over-the-air broadcasting system provided few benefits to that system while imposing substantial costs on viewers, as the commission now concedes. Finally, all the available evidence indicates that the restrictions on programs that could be offered by cable systems for a fee reduced rather than expanded the range of choice available to the public.

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Fortunately, much of this has begun to change. The multipoint distribution system (MDS) has become a potential source of TV service to the home as a result of the commission's 1970 decision to increase its bandwidth to 6 megahertz. In 1978, the year after a federal court found the restrictions on pay cable to be without substantial foundation (*Home Box Office* v. *FCC*), the commission eliminated its anti-siphoning rules for both pay cable and STV, an action that is stimulating the growth of a number of networks distributing pay-TV using cable systems as local outlets. Last year, the commission deleted its remaining distant signal carriage rules for cable television. This action, if upheld in the courts, will free cable systems to pick up and use the signal of any broadcast station and will benefit the growing number of networks that provide satellite interconnection for cable systems carrying the signals of major independent television stations. (See Henry Geller, this issue, page 35.) Also in 1980 the commission began to accept applications for a very large number of newly authorized low-power television stations. A number of these applicants say they intend to link these stations by satellite and provide either pay-TV service or programs that appeal to geographically dispersed households with similar interests.

These policies have substantially improved the prospects for would-be networks. But more needs to be done. In a follow-up to our report, we have recommended to the commission that it eliminate its rule restricting STV stations to markets where there are at least four operating advertiser-supported stations; that it assign additional spectrum space to MDS service; that it adopt the proposal put before it over five years ago to authorize a number of new VHF stations that would operate at higher power than the new low-power service but at lower power than present stations; and that it not restrict the proposed direct satellite broadcast service out of concern about its effect on broadcasting. These measures would do much to undercut the three-network dominance of the industry, an objective the commission has pursued diligently, but ineffectively, for more than three decades.

Even if these recommendations are shunned, however, the changes occurring in

television will continue. Too many irreversible reforms are now working their way through the industry for it to remain for long a system dominated exclusively by three networks. The principal effect of not adopting our recommendations will be to alter the form that change takes, not to prevent change from happening.

If, for example, the commission fails to eliminate barriers to the creation of networks of STV stations, the result is likely to be more rapid growth of pay television over cable. If the commission fails to authorize a direct broadcast satellite service, some other technology, perhaps MDS, will grow more rapidly. If the commission fails to authorize additional broadcast stations, the result is likely to be more rapid growth by cable. And if all are rejected, it should make the producers of videodiscs and videocassettes, which are outside the control of the regulators, very happy indeed.

Conclusions

A question that continues to puzzle us is why the FCC has engaged in the sort of mis-regulation recounted above. Part of the answer seems clear. The familiar principle that regulators are loath to take back benefits once granted explains why the commission did not deal with network dominance by moving against the entry barriers confronting new networks. In 1945, the commission determined that, although television should ultimately be confined to the UHF band, some VHF allocations should be made available immediately in order to permit commercial television to develop. Three years later, when it became apparent that the geographical allocations adopted in 1945 would not work, the commission "froze" all pending TV station applications in order to develop a new allocation plan. That freeze, expected to last only six months, was not lifted until the current plan was adopted in 1952. But by then 108 VHF stations, those fortunate enough to have received authorizations before the freeze, had come on the air. The 1952 allocation plan did not affect a single one of these 108 licenses. Indeed, it was apparent that the commission allowed the existence of these licenses to tie its hands as it was establishing the framework for the national TV system. As a result, television came to be limited to a three-network system.

Later, the commission thwarted new technologies, such as cable, and alternate financing methods, such as pay-TV, on the grounds that their development might undermine the television system established by the 1952 plan. In this truly perverse fashion, the "temporary" decision of 1945 spawned its own vested interests, and the preservation of the system it had created became the determinant of commission policy.

But if there were exactly 108 reasons for the FCC's failure to take actions that promised to erode dominance by the three networks, what explains its repeated promulgation of ineffective regulations aimed at network power? To be symmetrical, it could be argued that the network rules were designed to give the illusion of progress while deflecting attention from the real causes of network dominance. For those who have studied those proceedings, however, such an argument gives the commission far too much credit. To be sure, frustration is part of the explanation. Undoubtedly the rules stemmed in part from a sense that something had to be done about the networks. But at least equally important, we think, was simply a failure of analysis. Unaware of the fundamental economics of networking, confused by assertions that redistribution of private profits would serve the public interest, uninterested in evaluating the empirical results of its rules, the FCC spent over thirty years adopting doubtful solutions based on dubious premises. ■

Selected Readings

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