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The FCC, Blackouts, and the Market for TV Program Rights

By Bruce M. Owen

Should the Federal Communications Commission (FCC) step in to prevent temporary programming blackouts caused by bargaining impasses between broadcasters and multichannel video program distributors (MVPDs) such as cable or satellite systems? Blackouts are black eyes for the industry and for the FCC because they garner heavy negative media coverage. But some say that negotiations between cable and satellite companies on the one hand and broadcaster "must carry" and "retransmission consent" rights holders on the other are part of the competitive free-market process, with which the FCC should not meddle. The problem, of course, is that the TV program market is not free and competitive, partly because of rules promulgated by Congress or the FCC itself. Some of these rights yield no productive value for the economy, but merely transfer profits from one industry group to another in a way that is costly to consumers. The rules create rather than correct a market failure.

There are two policy issues here. The first is whether the government should intervene (for example, by requiring compulsory arbitration) to prevent bargaining impasses from harming third parties such as TV viewers. The second and narrower issue is whether the market for TV programming is free and competitive, leading to outcomes that are presumptively efficient. This is important because an intervention to tidy up a seriously distorted market may easily make matters worse.

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A. Bargaining impasse

Let's begin with the blackout problem. Typically, a rights owner, such as a broadcast or cable network, is negotiating with a retail content distributor, such as a cable system. There is potential for both parties to gain from reaching an agreement on the price to be paid for a license. In fact, there are many potential prices at which both parties would be better off than if no agreement is reached. This is a "positive-sum game" in economics jargon.

The economically efficient outcome is for a deal to be reached. In a static world the price of a license itself is not relevant to the efficiency issue. Given that agreement takes place, the price just serves to divide between the two parties the incremental gains from the deal. In a simple bargaining model, we predict that an agreement will be reached, for no other reason than that both sides would gain. It would be *irrational* not to reach an agreement.

But the real world is more complicated than the simple bargaining model suggests. How the gains from the deal are divided matters very much to the parties. They each want as much of it as possible—even all of it. The division of the gains from a deal is a "zero-sum game"—there is no way one party can gain except from the other party's loss.

The outcome of a zero-sum game depends on the economic context of the deal (for example, repeated versus one-time games), the strategies and preferences of the parties, and other factors. There are many circumstances in which it is *rational* for a party to withdraw temporarily or even permanently from the negotiation, creating a blackout. This is a common occurrence—think of labor negotiations, in which strikes and lockouts, while not the rule, are hardly rare events.

Hundreds, perhaps thousands, of TV program agreements are negotiated every year. That some of the negotiations should result in impasses and blackouts is by no means surprising.

Every bargaining impasse creates losses (forgone profits) not just for both parties but also for third parties—such as upstream suppliers and downstream consumers. Some bargaining impasses get a great deal of public attention because the third-party losses appear particularly alarming. Strikes by police, firefighters, and other public service employees are big news. Strikes and lockouts in popular sports like baseball and football also get a lot of attention. And some TV program blackouts fall into the same category when they involve popular programming. Unlike some other goods and services, a TV blackout creates a permanent and unrecoverable loss for TV viewers. In a free and competitive market bad things sometimes happen, even though everyone would gain if a blackout or strike were averted.

Clearly, there is a kind of market failure associated with bargaining impasses that result in permanent, unrecoverable third-party losses. A government intervention, if an effective one exists, would be justified. There are various possibilities: Banning blackouts as a bargaining stratagem is one; requiring compulsory arbitration, perhaps of the "final-offer" variety used in baseball, is another. The FCC already mandates such arbitration in cases involving certain sports programming disputes.

In baseball-type arbitrations each party makes a final offer, and the arbitrator must choose one or the other. Typically, the rule is to select the offer that most closely approximates a competitive market price. One problem with the arbitration approach is that it may become circular. Agreements reached in deals that do not go to arbitration are nevertheless influenced by the parties' expectations about what would happen if the deal did go to arbitration. It may be impossible to observe a truly "free-market" price, unless there are comparable transactions that are not affected by the prospect of arbitration.

Arbitration outcomes also matter if they affect supply-side incentives. It is likely that expectations about future negotiated prices are influenced by the outcomes of previous arbitrations. Investment and supply decisions are based in part on expected future prices. So—if there are no benchmarks reflecting truly free markets, this may distort the arbitration outcomes in a vicious cycle. Whether this distortion is quantitatively significant in any given case, however, is an open question.

In short, government intervention (at least to mandate arbitration in place of blackouts) may or may not yield gains for consumers. A closely related point is that even if free- market prices for certain rights are readily observable, the rights themselves may create inefficiency in the market. This is the subject of the next section.

B. Some TV program markets are not free and competitive

The media business is complex. Media companies buy or produce "content" such as TV and radio programs, comic strips, or news coverage. The media sell or give away content to listeners, viewers, and readers. Media companies also deliver readers and viewers to advertisers. Competition is rampant, not only for audiences and advertisers but for content.

Changing technology presents additional challenges. In the last century many new technologies came along—and in some cases went away. New media technologies included AM and FM radio, digital radio, many forms of recorded music and video, television, color television, cable television, satellite television, digital television, and the Internet. The printing press has survived this onslaught but is now much diminished in importance as a medium of communication. But all this churning bespeaks a market for content that is robustly competitive—except where it isn't. And where it isn't, it's largely on account of regulatory interventions that created new "rights" that no longer make much sense, even if they once did make sense.

What are these new rights, and why were they created? The problem is that industries faced with acute pressure from competition and technological changes often seek assistance from the government. The demand for protection, by its nature, originates from the established firms that aim to stop or at least attenuate inroads by new entrants and new technologies. New entrants and technologies threaten established firms precisely because they offer more or better services and lower prices to consumers. Government protection for the established suppliers often works by depriving consumers of such benefits. Protection for established firms is therefore likely to be harmful to the public, keeping prices high and slowing the availability of new products and services.

Media businesses in particular have made frequent use of government protection. Our elected representatives enjoy photo ops with showbiz celebrities, and they greatly value face time on the local TV evening news. TV broadcasters accordingly have one of the most powerful lobbies in Washington. The FCC does what Congress tells it to do, and it likes to feel that it is useful to the industries it regulates. What could be more useful than maintaining a safe and stable environment for the media businesses that matter to Congress?

Many FCC rules and regulations arise from these impulses to manage competition, though they are often papered over with attempts at public interest rhetoric. Nothing could better illustrate FCC attempts to manage the market than the weird history of TV broadcasts carried on cable television, satellite, and other broadband services.

Decades ago, in the 1950s,

cable systems simply offered better reception for local TV signals. That was fine with the TV stations, and therefore fine with the FCC, which concluded it had no jurisdiction anyway. Then, in the 1960s cable systems started to carry TV stations from distant cities. This was definitely *not* fine with local TV stations, which were losing part of their audience. Suddenly the FCC decided it *did* have jurisdiction, and it ordered cable systems to stop importing distant stations. Clearly, this FCC action harmed TV viewers, who were denied a wider choice of programs. *In effect, the FCC created a new right, the right to be free of competition from out-of-town stations, and awarded that right to all local stations.* Economically, this was equivalent to taxing cable operators and subscribers and using the proceeds of the tax to send out economic security payments to local TV stations.

About a decade later, in the late 1970s, because of low transmission prices resulting from the introduction of domestic communication satellites, there was an explosion of new cable networks such as HBO and CNN. This greatly diminished the competitive significance of distant broadcast signals. Due to the lack of strong broadcaster interest in continued protection, the FCC deregulated distant signal carriage as a sop to reformers. Then, in the 1980s, as dozens and then hundreds of new cable networks became available, cable systems themselves began to lose interest in carrying the less popular (non-network-affiliated-UHF) local TV stations. In a free market, weaker local TV stations probably would have paid cable systems for carriage. But the FCC of course required cable systems to carry all local stations without charge.

The FCC "must carry" rules made cable somewhat less profitable than it would have been, slowing the growth of the cable industry and denying choices to consumers in unwired areas. *Again, the FCC created a new right, which it awarded to TV stations, to be free of the burden of paying for local cable carriage.* Consumers and cable operators once again essentially wrote a check to the FCC, which the FCC passed on to the TV stations. The IRS got nothing out of the transfer, and the public got less than nothing.

The early 1990s brought growing awareness that the future profitability of the broadcast networks was clouded by competition from cable networks, not to mention new broadcast networks such as Fox. CBS led a lobbying campaign to introduce another new property right called "retransmission consent." At that point, cable systems were already paying for programs on TV stations they were obliged or permitted to carry under the FCC's many rules. Since 1976, cable operators have enjoyed by law a compulsory license from the owners of the actual TV programs, for which they pay a small percent of their gross receipts into a central pool redistributed to program producers by the Register of Copyrights.

After passage of the 1992 Cable Act, the popular network-affiliated TV stations could demand to be paid a retransmission consent fee by cable operators. Except for local news shows and the like, broadcasters generally don't own copyrights in their programming. (TV stations merely acquire licenses to broadcast network or syndicated programs in local markets, not the right to license those programs to other distributors.) *Retransmission, in effect, created yet another new property right and assigned ownership of the right to TV network affiliates, the largest and most important of which are owned by the broadcast networks themselves.* Non-network broadcast stations continue to benefit from must carry.

Unlike program producers and networks, TV stations do nothing to earn this right and the

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benefits to them are not rewards for innovation or production of valuable services. The economic value of a retransmission right comes solely from the ability of its owner to extract rents from cable systems and other MVPDs. In fact, now that nearly everyone gets all TV signals by cable, satellite, or Internet, broadcast stations are largely useless relics of a bygone technology, and the spectrum that is still reserved for their use has far better and more valuable uses.[1]

In practice, the broadcast networks have mostly used their retransmission consent rights to induce cable operators and other MVPDs to carry new cable networks owned by the broadcasters.

When a new cable network enters the business, with a relatively low audience share, it must pay cable operators for carriage in order to achieve nationwide coverage. Once that is achieved, the most popular and successful cable networks start charging cable operators for their programming. The retransmission consent right makes it possible for broadcaster-owned cable networks to avoid paying for carriage during their startup periods, and it permits them to reach economic viability much earlier and more cheaply than otherwise. Once again, cable operators and subscribers in effect are writing checks to the FCC, which passes the proceeds on to the wealthiest broadcasters.

The key to this system of taxes and subsidies is the ability of the FCC, with congressional sanction, to create new property rights and to decide who should own those rights. These are powerful tools that *could* be used for worthy ends, such as correcting or reducing the adverse effects of various market failures. But they can also be used to disadvantage consumers and one or another category of competitor in order to benefit a category more favored by the regulatory agency. Such transfers are nurtured and energized by political influence and through the collective action difficulties faced by consumers with relatively small and diffuse interests in any given regulatory issue. Broadcasters, as the only group with the ability to control TV access by politicians to large fractions of local voters, have enormous power in this game. They seldom lose.

It is often difficult to predict exactly what will happen if a regulatory intervention, much less a whole set of interventions, were to be repealed. In this case, however, the prediction is very easy to make. Absent regulatory intervention there would be no TV broadcast industry today and cable operators and other MVPDs would pay nothing to broadcasters. The MVPDs would acquire program rights directly from the program content owners. Without broadcasters to tax MVPDs and viewers there would be more programming and lower program prices. With less certainty, one can say that cable, satellite, and telephone broadband providers would be facing additional competition from wireless broadband suppliers using the spectrum currently devoted to wasteful TV broadcasts. In such a world there would be no need for most FCC regulation, including "net neutrality" or content regulation.

The lesson: By all means, let a competitive market in TV programming operate free of regulatory intervention, unless it can be shown that intervention designed to mitigate bargaining impasses produces net gains rather than additional welfare losses. But first, create a truly free market by repealing artificial and unproductive legacy rights, such as must carry and retransmission consent, which are no longer needed—if ever they were—in today's competitive communications marketplace.

1 There are barriers to efficient reallocation of spectrum from wasteful TV broadcasting. One is that broadcasters would be deprived of assets (their FCC licenses) for which they paid top dollar in free-market transactions. (Only the original licensees, back in the 1940s, enjoyed a windfall.) Both practical politics and fairness suggest that broadcasters keep the proceeds from auctions of their spectrum.

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