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ABSTRACT

This paper argues that the United States television industry is in a transitional period between the dominance of an advertiser-supported system and an advertiser-subscription system, and that a "dual revenue stream" system of subscription and advertising will eventually relegate the advertiser-only support system to a secondary role. The paper reviews the economic environment for television programming and projects current trends a few years ahead to suggest how the transformation to subscription television can take place. It then describes the effects of such a transformation, and finally, explores public policy issues and options arising from the new television system. The paper's sections are as follows: (1) The Developing Television System; (2) The Future for Broadcast-Only Consumers; (3) The Future for Cable Subscribers; (4) Cable's Role in the Advertising Marketplace; (5) Public Policy Implications for Broadcast-Only Consumers; (6) Public Policy for Cable Consumers; and (7) Conclusion. Thirty-four references are attached. (SR)

Public Policy Implications of The Transition to a Subscription-Based Economic Structure for the Television Industry

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This paper advances the thesis that the U.S. television industry is in a transitional period between the dominance of an advertiser supported system and an advertiser-subscription system. Once a mechanism is in place to permit subscription to television programming, then the system with a "dual revenue stream," subscription <u>and</u> advertising, will eventually relegate the advertiser-only support system to a secondary role. We can see this happening in the United States now, as cable television is becoming capable of buying mass appeal programming at a quality standard competitive with television broadcasting. The same transition is in process in many other countries, albeit at an earlier stage.

In this article we will review the economi ironment for television programming and project the current trends a few years to suggest how the transformation to subscription television can take place, then describe the effects of such a transformation and finally, explore public policy issues and options arising from the new television system.

THE DEVELOPING TELEVISION SYSTEM

<u>The limits on advertising-only support</u>

The economic value of one exposure of a person or household in a television audience to a television commercial is circumscribed by the marginal persuasive power of the message, the cumulative effects of previous advertising for the product and competitive products, the fleeting attention the commercial may win, and the wastage that results from many members of a mass audience, who for one reason or another, are not in the market for the product advertised. The ceiling on the value of an advertising message cannot be rationally exceeded. The ceiling has very little to do with the intensity of the demand for the program by viewers. Since broadcasters in the U.S. are unable to sell an individual program or all of the programs on a frequency to the viewer, advertising is the only source of revenue.

If the rational expenditure ceiling on units of advertising time limits broadcast television's ability to generate revenue growth, is there potential growth in the amount of advertising time, audience share, overall television viewing time or in new television households? The fear that advertising clutter diminishes the impact of advertising messages and disturbs viewers, circumscribes the number of commercials in any time period. Cable television, and to a much lesser degree, other multichannel television technologies such as backyard dishes, MMDS and SMATV, have taken a consistently increasing audience share. While this does not necessarily predict the future, all three commercial broadcast television networks, at least, have conceded loss of share to other television media and expect some future loss.[1]

Most observers also agree that television cannot command much more of the consumer's time. While there have been fairly consistent gains in household television usage over many years, the increases have plateaued recently[2] leading to an obvious assumption that we have reached the ceiling dictated by the need to sleep, work and go to school.

Nor can the total television audience increase much as a function of television household growth. The U.S. has long ago reached the assumed maximum percentage of household, with television at just under 100 percent. The number of television households, then, can only grow as a result of population growth. This can be expected to be only 1.5 percent per year.[3]

Thus, broadcast television revenues in the U.S. at best can be expected to increase at a relatively slow rate in real terms in view of the constraints discussed here. The commercial broadcast system may still be the most efficient means of distributing certain kinds of mass appeal ogramming. But broadcasting has become vulnerable to the multichannel television services in their traditional role of diverting some of the potential broadcast audience to a large selection of specialized channels. This vulnerability is exacerbated if the multichannel services begin to compete with broadcasting for the high-demand, mass appeal programming. In this bidding broadcasters are up against their advertising revenue ceiling while subscription services are just beginning to exploit advertising revenues and revenue sources beyond advertising.

Potential for the subscription/advertising system

The cable industry owes its development to a national multichannel medium, to the consumer under-investment in television and its technical capacity to supply a subscription service.[4] The cable industry has clearly demonstrated the under-investment in television by attracting a majority of its potential market at an average monthly fee per household of nearly $25 despite the fact that about two-thirds of the cable households' viewing time is spent with broadcast television.[5] Other evidence of consumer under-investment in television is, of course, the high volume of videocassette rentals at some inconvenience and modest cost and the purchase of cassettes at a relatively high cost.

Since cable households still spend so much time with the mass appeal programming of broadcast television it is clear that the U.S. subscription/advertising system has only scratched the surface of its revenue potentials. (Cable is the most developed of such systems in the U.S. so the discussion which follows focuses primarily on cable.)

The developing scenario

Cable revenues can be expected to grow steadily as a result of: (1) higher basic service subscription rates (given the inelastic demand for basic),[6] (2) greatly increased advertising sales volume and rates,[7] (3) somewhat lower pay service subscription rates attracting more pay subscribers (given an elastic demand for some pay services),[8] (4) increasing the number of homes passed by cable,[9] and (5) increasing penetration among homes passed.[10]

As cable gains revenue the following scenario is likely to unfold. Cable will spend more for programming. It will be in a better position to lure the best writers, performers and producers of mass entertainment television to its channels. It will buy television rights to sports and special events. Cable will therefore be in a position to buy "breakthrough" programs for each of the mass appeal networks (ESPN, CBN, TNT, WTBS, USA, etc.) or create a single "flagship network" that is highly competitive with the three commercial broadcast television networks. At this point cable will become a necessity for most television viewers. Penetration will increase further, monthly rates will rise, and advertising revenues will grow commensurate with audience. The majority of these gains will be at the expense of "free" television broadcasters since the viewing of cable-only options (basic, pay and pay-per-view) can be expected to increase from the present 32 percent among cable subscribers.[11] Broadcasting would still get its 100 percent share of the non-cable households, but if 65 percent of all U.S. television homes subscribe to cable there will be only 31 million broadcast-only homes. The reduction in broadcast-only homes and in broadcast share of viewing in cable homes would significantly reduce broadcast revenues. In such a scenario, the ability of broadcasting networks to compete would be drastically reduced. Under these circumstances broadcasting would likely become largely a second run medium. Cable would play the best mass appeal programming first, then, to help recover some of the costs, syndicate it to broadcast television. Those paying high basic cable prices would get the first chance at viewing the best programming. This seems more consistent with the U.S. economic system than the present situation where the people paying most for television--cable subscribers--have no better access to much of the best mass entertainment programming than the people who are receiving it "free."

Revenue growth impact on programming

The cable industry is beginning to make significant programming investments that will make this scenario work. Program spending for the major basic cable networks has increased from $381 million in 1985 to $489 million in 1986 to $552 million in 1987 to $646 million in 1988.[12] Although total basic cable programming investment does not yet come close to the annual programming expenditure of a single broadcast network, about $1.5 billion, it has been increasing at a rapid rate.

Initially cable networks do not have to spend as much for programs as broadcast networks. One or two highly valued programs on a few cable networks justifies the subscription price for the consumer.

Additionally, cable networks, basic and premium, have an important advantage over broadcast networks in that they do not have to achieve a high audience level with each program to protect adjacencies. Some cable programs may be fillers or appeal to a narrow audience to keep network costs down without harming the cable operators' profitability.

A few cable mass appeal showcases injure broadcasting in two ways. They attract a large audience from a fixed pool reducing the broadcast audience. In helping to attract more cable subscribers who are then exposed to many other program options the broadcast audience is not only hurt in the time slot of the hit cable program, but across the day (due to audience flow effects).

There are already many signs that U.S. cable is developing according to the scenario described above. ESPN bid successfully, with the broadcast networks, for the National Football League. This resulted in record ratings and advertising ratings for ESPN and its cable affiliates. With just a few exceptions, all affiliates paid the substantial surcharge to carry the games. ESPN believes that the one percent increase in basic cable subscribers which occurred during the football season was due to the NFL games.[13] ESPN has subsequently purchased rights to major league baseball.

As a result of increased advertising and subscription revenues other cable networks have also substantially increased the proportion of original programming in their schedules. For example, USA Network claims that 40 percent of its programming is originally produced for the network.[14]

Likewise, the cable industry is upgrading its use of syndicated programming. Many syndicators are now looking at cable as a pre-broadcast window for off-network syndicated programs. This has been particularly true of one-hour series such as "Cagney and Lacey," "Miami Vice" and "Murder She Wrote" which are more difficult for broadcasters to programs in syndication.

Finally, most of the big multiple system operators in cable are making capital investments in mass appeal cable networks. This investment strategy serves a dual purpose. In the long run some of the mass appeal cable networks will be quite profitable. In the short run, it will increase cable operator profits by supplying increasingly attractive programming capable of maintaining and/or increasing subscribership in spite of very substantial increases in basic rates.

Cable leaders are urging their industry to also invest in programming by paying larger monthly per-subscriber fees for receiving cable networks.

These trends foreshadow the major shift toward cable dominance of television programming proposed here. There is no doubt that cable programming is making a very strong improvement on its meager beginnings as the stepsister to broadcasting.[15] Any improvement in cable programming, as noted earlier, weakens broadcasting's position. In response, broadcasters can improve their programming to stay ahead of cable. In fact broadcasters have raised the quality of their programming in an attempt appeal to the more upscale cable viewers. These programs are generally above the norm in cost, however, and cannot fill the whole schedule.

THE FUTURE FOR BROADCAST ONLY CONSUMERS

In addition to the mass appeal programming discussed above, cable brings a diversity to television content that can be suited to individual needs and tastes. Several new television formats have evolved--music video, 24-hour news, 24-hour weather, home shopping, consumer, minority, business, religious, education and children's channels. Cable offers the option of commercial-free television for those willing to pay a premium. Repetition and 24-hour channels permit much greater convenience in accessing programs. Cable has opened the door to new talent and new enterprise. Public, educational and government access channels provide opportunity for free expression and public service programming. Cable has also opened the television door, for the first time, to specialty and limited-market advertisers.

But there are some consequences of a fully-developed subscription television system that deserve attention.

Lower quality broadcast service

The household that chooses not to subscribe to cable for economic or other reasons will be served by a weaker broadcast service. As discussed above, broadcast stations, and perhaps networks, may eventually have to rely heavily on off-cable syndication. Such second-hand programming would not be as fresh or topical as original programming. Thus, broadcasting's programming fare would be less appealing and useful than at present.

Fewer broadcast stations

There will also be fewer broadcast stations. As cable-exclusive programming increases its viewing share, broadcast audiences will be reduced particularly for marginal stations some of which will not be able to survive on the reduced advertising revenues. Additionally, there may be fewer broadcast networks. Some industry professionals are now saying that available national advertising revenues cannot sustain four commercial networks (ABC, CBS, NBC, Fox) with a level of programming that is competitive with multichannel services and VCR cassette rentals. Therefore, broadcast-only households are likely to have less choice in the future. This would be quite serious in television markets which currently have only a small number of stations.

The changing picture for television news

Eventually cable could divert audience from local and national broadcast network television news. At this point there has been little evidence of large scale diversion of audiences.[16] But there is an indication that some cable subscribers watch local news from distant stations.[17] Broadcast network news audiences are declining.[18] CNN, CNN Headline News and Financial News Network, CNBC (Consumer News and Business Channel) and C-SPAN are increasing their access to subscribers. For noncable subscribers there are few alternatives to news viewing during network and local station news periods. For cable subscribers there may be 30 or more alternatives. If local and network broadcast television news programs lose significant audience share to cable alternatives, some of the programs may not survive for the broadcast-only audience.

Cable news can teach new habits. The convenience of television news at any time could develop a dissatisfaction with fixed schedule broadcast news. If cable operators were to decide to compete with broadcasters for the local news audience, they would have the advantage of 24-hour service and the opportunity for much more extended coverage of major events.

If a single clustered cable multiple system operator (owning most of the cable systems within a television market), or cable systems in a television market, pool resources in an interconnect, such a cable unit could supply 24-hour news service with zoned editions (splits) for areas within the market. It could be sustained by advertising alone, subscription alone, or advertising and subscription revenues.

It will not be long before cable operators see this opportunity. Broadcasters will be unable to compete with a 24-hour cable television news service, that can also supply more localized splits. In looking toward the future, broadcast station owners often remind themselves that their strength is in local service (mainly news). This is a fragile strength, however, and cable dominance of local service is a real possibility. Once cable exploits its superior capacity for news, we have the potential for one-source television news towns, just as we have one-newspaper towns. Should there be a "Television Station Preservation Act" to sustain television stations?[19] We will discuss this suggestion, seriously, below.

Fewer sports events

As U.S. cable increases its penetration, the medium becomes a preferred market for sports. The channel capacity of cable permits extensive national network coverage of sports not possible in broadcast network television where most sports events do not have enough mass appeal for prime time.

Cable is also a local, or regional, sports medium featuring home teams. Traditionally, broadcast television has served the purpose of generating public interest in sports teams, cable at penetration levels of about 70 percent, cable can also achieve this purpose. The cable operator could realize advertising revenues nearly equal to broadcasting (assuming that the broadcast only households, presumably low income, are not valued very highly by advertisers), and supplement the advertising revenues, by subscription revenues from the added value of the games, reflected in monthly cable rates. As basic cable penetration increases, broadcasting will be a less desirable medium for the sports franchise. The team owners will not be able to effectively sell their television rights to cable systems if many games are on broadcast channels. Whether or not cable becomes the only source for the big events such as the World Series, Superbowl and the Olympic games, may be determined by political as well as economic factors. But the bread and butter sports events could eventually belong to cable at the expense of the broadcast-only consumer.

THE FUTURE FOR CABLE SUBSCRIBERS

Consumer costs

Once cable penetration reaches 70 percent or better, cable will have little effective competition. Broadcast television will be such a relatively weak option in that it will serve only those who have little value for television, have no need for specialized cable services, are unable to pay cable prices, or are so set in their viewing ways that they are unwilling to change. Videocassette rental is an option, but cannot supply the topical material (e.g., news, sports) that is important to television viewers. To the extent that subscribers in the future view cable as a necessity, the cable operator will be in a position to charge monopoly prices. At present, cable prices may be regulated by franchising authorities only in those communities with fewer than three unduplicated broadcast stations; the Federal Communications Commission's definition of "no effective competition."[20] The cable industry will still face some risk of "churn" (downgrading or disconnecting cable services) among marginal users of television, but this becomes less a deterrent to price increases as the broadcast product loses attractiveness and fewer broadcast stations are available. Furthermore, with each succeeding year cable gains in the proportion of subscribing households which have never known television _without_ cable.

As the cable industry completes its shift to addressable technology over the next few years, pay-per-view will become a larger factor in cable pricing. Motion pictures may be released to pay-per-view cable ahead of the home video stores making this programming very attractive along with sports and special events. Pay-per-view services will increase the price of obtaining the most elite level of cable service, perhaps siphoning off some of the programming from lower tiers.

The cable subscriber is paying for an expensive physical distribution system and a certain amount of bureaucratic waste in a multi-level, multiple system operation ownership structure with local, regional and national administrations. During the next several years of concentration (assuming that we are now only in the middle years of this period), cable systems will be acquired and traded at very high capital cost. Many cable subscribers, with the expansion of multiple system operators, will be subsidizing a part of the acquisition program. Subscribers in franchises that are being acquired help to shoulder the tremendously increased debt burden of the new owner.

Consumers with small independent operators have a special problem. Almost all of the cable networks discriminate, to a greater or lesser degree against these small operators.[21] The programmers allow multiple system operators (MSOs) to aggregate subscribers to a network across all systems carrying the network thereby qualifying for vastly reduced program fees. These fees, for the bigger operators exercising their considerable market power are negotiable. The discounts appear to greatly exceed the minor savings in bookkeeping and administration. The higher programming expenses for independent cable systems and small multiple system operators are typically passed on to consumers. Incidentally, since the large MSOs with deep discounts on programming can operate at a higher profit margin, the transfers from independents to MSOs, discussed immediately above, are encouraged.

In summary, television subscription costs have gone from a few dollars to an average of almost $25 per month per cable household in just a few years. With rate deregulation, increasing programming costs, additional services, improved technology, improved consumer acceptance, limited effective competition, and new operator debt burdens, these monthly charges could continue their dramatic rate of increase. Increased consumer costs for cable can be expected to significantly redistribute income from consumers to distributors and producers as this occurs.

Programming

Vertical integration in the cable industry (producers and distributors of programming and cable operators) has probably been essential to the development of the subscription television system dominance described here. Due to lack of "product," the operating branch of the industry had to invest in programming. The best kind of investment, to avoid the details of program decision-making yet still influence overall programming strategy, was to buy into cable networks. Now most cable networks have cable multiple system operators as board members. These operators make the networks in which they have a financial interest "corporate must carries." That is, all cable systems in the corporation that have the channel capacity, must carry the cable network. These MSO-owned networks may displace other contenders for scarce channels in limited-capacity systems, despite consumer interests that might dictate other programming choices.

A further problem for cable subscribers is the growing power in programming development vested in a few multiple system operators. These operators are contacted with proposals for new cable network services. If they sign on in advance of the launch with sufficient subscribers, success is almost assured. If one or two of the largest operators rejects the concept or chooses to wait and see, the new network may never launch or fail shortly after launch. It is difficult to determine whether viable programming concepts or networks are denied to consumers because of program biases and the financial interests of large multiple system operators, but there certainly are potential "program type inefficiencies" connected with catering to the particular biases of these companies. Program type inefficiencies occur whenever cable MSOs value viewers/subscribers differently than viewers/subscribers value programs. To be economically efficient here, a system needs to provide the "correct" mix of programs with respect to type variation, quantity and quality.

As cable becomes more significant in programming and program delivery, and a single source of programming for an ample majority of households, these issues are of greater concern.

Diversity

If the subscription television services wrest a part or all of the first run mass appeal programming from broadcasting as anticipated in this scenario, it is doubtful that this kind of programming will be much expanded within cable. There are some natural limits on the quantity of such programming. Cost is a major factor. Glitzy, mass appeal programs require expensive production and talent. The high cost means that the resources cannot be stretched too far. At some point, it is no longer practical to pursue a segment of the mass audiences, but more profitable to seek a separate niche.[22]

If the growth of subscription television only shifts first run mass appeal programming from broadcast television to cable, not substantially increasing the quantity of mass appeal programming, the primary benefit derived from the growth of subscription television will be the "niche," or specialized program services, spawned by the system. The niche services broaden the whole definition of television and make it much easier for the consumer to adapt television to individual needs. If these specialty services, in adequate numbers to address multiple interests within an individual and across many different individuals, are the principal benefit of subscription services, then, problems of vertical integration and concentration in the industry could have a major impact on program type efficiency. MSO control of program sources and networks could result in an attempt to limit these services artificially. For example, John Sie, senior vice president, TCI, the largest U.S. multiple system operator, is quoted as saying: "Advertisers don't like to deal with 1.0s or 0.5s (low audience ratings). Now we can't get a 10 if we keep adding those fragmented channels, so at TCI we're studying what consumers think are good and bad services, whether they watch it or not. We should really reinvest our money into improving the quality and promote the product we have, so that we can have a robust next phase of growth, which is advertising."[23]

The <u>value</u> of a channel, in terms of its significance to the subscriber, becomes very important here if the specialty networks that fragment the audience are to survive in the cable spectrum of services. Basic cable service, combining a number of channels at a single price, requires cable operators to find some means of gauging the relative importance of each network to subscribers. This assessment combines the direct revenues attributable to the service (e.g., local advertising revenues) and indirect revenues (e.g., the importance of the service in terms of the demand for that overall cable service) and subtracts the direct costs (e.g., monthly per subscriber fee paid by the cable operator to receive the cable network). The direct revenues and direct costs are easily obtained. The indirect revenues representing the demand for the service are much more difficult to ascertain. The demand may be estimated by the size of the audience for a channel but this does not take into account subscriber intensity of demand for various program services. This presents a problem. Under a system where 20 or more channels may make up the basic service at one price, there is a danger that the channels that are heavily used by a relatively small number of subscribers or only briefly used regularly by a great many subscribers, may be undervalued by the operator. If only a few multiple system operators are making the decisions on which services survive, the probability of a mistake is quite high. It is also possible that large MSOs, with great power in determining the survival of programming services, such as TCI, will abandon some of the niche services despite high consumer demand, to further their advertising interests. This is an unfortunate aspect of a system where consumers cannot adequately indicate the strength of their program type interests. It has always been a problem in commercial broadcasting and carries over to advertiser-supported subscription television.

Local programming

As cable gains penetration it strengthens its position against local broadcasters. We have already mentioned the latent potential for cable news. Marginal broadcasters, in the absence of must carry rules, may have to pay for access to cable systems, a cost that would further weaken their ability to sustain high cost programming. If local broadcasters lose audience and scale back local programming, cable operators may opt not to pick up the slack. This is likely in smaller television markets where broadcast stations would be weakest and local programming most costly in relation to local program revenues. The cable operators might be unwilling to assume the burden.

Service

Cable systems now have a strong incentive to provide good customer service. The industry firmly believes that efficient and improving customer service is the most effective retention marketing tool. However, as cable becomes more popular and valued, more necessary to consumers, "churn" will be reduced. In an environment where customer retention is secure, customer service would be less important. Customers could face a decline in the quality of service (e.g., more difficult telephone access, delayed repairs, slow response to orders, etc.)

CABLE'S ROLE IN THE ADVERTISING MARKETPLACE

Cable could grow to dominate the national and local television advertising marketplace. The upscale audiences coupled with the targeting opportunities give cable an advantage. With higher penetration of most television markets cable will be included in the syndicated audience measurements, contributing to the cost of these audience measurements. Advertisers and advertising agencies will come to terms with the complexity of creating advertising for cable and buying time in a multichannel medium with thousands of individual systems. Buying across mass appeal cable channels of the future can give cable the same reach as broadcast television networks (with the exception of lower income, non-cable households which may actually be considered waste for some advertisers).

Cable may also compete very favorably with radio. Many specialized cable networks are similar to special format radio stations in demographic/psychographic targeting with the additional advantage of better geographic targeting. Many specialized cable networks are similar to special format radio stations. Cable "background" services (e.g., MTV, VH-1, CNN, CNN Headline, Weather Channel, shopping channels) are competitive with radio in the home.

The huge inventory of cable television advertising spots and programs for sponsorship gives cable a potential pricing advantage over any other advertising medium. Cable systems could engage in predatory pricing of advertising time, subsidized by subscription revenues, over a long period of time.

Local shopping channels, or shopping information services, were they to develop, could encroach on local newspaper advertising.

The trend toward concentration in cable ownership and clustering adds to the market power of cable MSOs and enhances the opportunity for anti-competitive advertising practices. For example, local cable operators and interconnects prefer to sell advertising "run of schedule" across all available networks, if possible. Although the policy may defy the logic of many buyers, in a seller's market, the cable industry may be able to make it stick.

Thus, cable has the long-term potential of weakening other media, not only through capturing their audiences in the many ways discussed above, but also through exercising market power in the advertising portion of the market.

PUBLIC POLICY IMPLICATIONS FOR BROADCAST-ONLY CONSUMERS

Under the scenario for the development of the television industry in the U.S. we have described, public policy must be concerned about the minority of households with access only to broadcasting and with developing policies capable of preserving their broadcast service.

Policy makers (i.e., The Federal Communications Commission or the Congress) may have to protect broadcasting by changing some of its established rules. For example, the FCC has already expressed its concern for broadcasting's technical problems with high definition (or advanced) television.[24] Additionally, it has reestablished syndicated exclusivity to give broadcasters the opportunity to hold exclusive programming rights in a market. The Federal Communications Commission is also investigating the policy of requiring cable operators to negotiate program rights (retransmissions consent) for importing distant non-network broadcast signals instead of paying an arbitrary blanket fee under a compulsory license through the Copyright Royalty Tribunal. Broadcast rules, originally designed to keep broadcasters (and broadcast networks) in check in another era, may be relaxed (limits on financial interest in programming and syndication, prohibition of networks representing affiliates in advertising sales, prohibition on same-market broadcast ownership of cable systems, etc.).

Public broadcasting could also play a major role for households without cable in the future. The needs or interests of the "upscale" cable subscribers are already being served by other programming sources such as Arts and Entertainment, Disney, Bravo, The Learning Channel, HBO, Showtime, C-SPAN, etc. as well as PBS. Therefore, public broadcasters' viewing share among cable subscribers is declining.[25] Cable subscribers have too many choices and too many close substitutes for public broadcasting. But, in the future the noncable households could be even more dependent on public broadcasting because there will be fewer broadcast stations. Therefore, public television could play a significant role for noncable households if it redirects its efforts toward serving noncable television audiences. Will public television do so? One might expect public broadcasting to have even more difficulty in adapting to the new realities of the marketplace than commercial broadcasters who sense the market more directly. As a consequence, policy makers will need to be particularly creative in developing policies capable of helping public television survive and fill a different role.

PUBLIC POLICY IMPLICATIONS FOR CABLE CONSUMERS

The over-riding concern here is how much regulation will be required to prevent cable operators from exercising their market power with respect to cable subscribers, advertisers, programmers, and competitors. Specific concerns include: the FCC's definition of what constitutes "effective competition" for cable such that rate regulation is permitted; the extent to which cable multiple system operators will be allowed to vertically integrate with respect to programming; the extent to which cable MSOs will be allowed to horizontally integrate both nationally and locally (i.e., through clustering); the extent to which long-term direct competition between cable systems is feasible (i.e., overbuilds); and the extent to which commercial use channels or carefully limited must carry rules might be used to preserve local television broadcast service for both noncable and cable consumers.

Effective competition and rate regulation

When cable achieves 70 percent penetration, and above, it can be argued that it no longer faces "effective competition." In such a circumstance, the FCC's current definition of "effective competition" (which is based on the number of broadcast stations available in a market) is inadequate. Clearly, cable systems with 70 percent or more penetration in a market do not face effective competition regardless of the number of over-the-air television stations present.

Whether one utilizes a cable penetration level to define effective competition, it is clear that policy makers will need to greatly refine their measurement of effective competition. Failure to do so will leave consumers exposed to unregulated pricing by cable operators with very significant market power who could charge monopoly prices unchecked by either market forces or governmental regulation.

Vertical integration in programming

The decision by cable multiple system operators to vertically integrate into the programming area has pluses and minuses from the consumer perspective. On the one hand, it appears to have increased the quantity and quality of programming available to consumers in the short run. On the other hand, it has increased incentives for cable operators to make incorrect and inefficient program carriage decisions. Additionally, in the long run, such vertical integration will lead to increased cable operator market power with respect to programmers , advertisers and competitors.

Because of the obvious consumer benefits that result from cable operator investment in additional programming, policy makers will need to develop narrowly focused regulations capable of preventing or controlling potential cable operator abuses in this area without stifling the robust development which has taken place over the past few years.

Horizontal integration

Aggressive cable system acquisition by large MSOs has raised the fear that they are becoming too powerful. Concerns here are focused on both the national and individual local markets.

National market concentration. Increased national market concentration could have the following implications: (1) Individual system revenues which should be re-invested to improve the local cable system may be diverted to company headquarters for use in acquisition. (2) As cable MSOs get larger nationally, their market power increases with respect to consumers, programmers, advertisers and competitors. And, (3) the increased debt burden often associated with large scale acquisitions may take place at the expense of more productive forms of investment (form the consumer perspective) such as programming, improved service, modernization of cable plant, etc.

Comprehensive limits on national cable concentration would have to come from the U.S. federal government. Although the Federal Communications Commission has twice declined to limit concentration in the cable industry,[26] and has not yet acted on a recent petition, the federal government is now under pressure to consider concentration. There is a precedent in the limits on concentration in broadcast television station ownership to 12 stations and with a potential audience of less than 25 percent of the U. S. households.[27] The cable industry is anticipating eventual limits. Lesser operators wince every time TCI, the biggest multiple system operator, makes an additional acquisition. TCI, itself, has recognized the threat and has divided itself into a number of geographic clusters that can become independent units if the U.S. Justice Department or Congress so orders.

Local market concentration: clustering. One of the traditional defenses against monopoly power in cable distribution has been to divide a community into several cable districts and to award separate franchises to different companies for each district. The franchisees would not compete directly for subscribers, but at least there is a side-by-side comparison of performance and price. The city of Chicago actually makes a public rating of each franchisee on several criteria. The same situation occurs informally in a metropolitan area where several communities have awarded franchises to several different companies. The present effort toward clustering cable systems, that is, combining all or most franchises in a television market under one operator through trades or acquisition, defeats the potential for comparison.

Under these circumstances, the value of side-by-side comparison against the benefits of clustering must be studied. Historically, are the different systems within a market actually different at the start? Do they lead each other to higher levels of service and lower prices as a result of consumer and government comparisons and pressures? Or, are there advantages to clustering, such as the development of local news programming and efficiencies in management, that result in improved service and lower prices? If there is a net loss to the television market as a result of clustering, operators might be willing to give up the concept and find other ways of pursuing some of the goals of clustering such as advertising and programming interconnects and marketing co-operatives. If not, franchising authorities could consider denying the transfer applications or exercising the buyback provision contained in most franchises.

Overbuilds

There are a few places in the United States where two cable companies pass the same households ("overbuild") and compete directly for the subscribers' business. Some communities see franchising of competing systems as a solution to service and price problems that may arise from exclusive franchises. It can be argued that it is economically inefficient to duplicate cable headends and distribution plants.[28] On the other hand, Touche Ross, the accounting firm, studying the circumstances in Sacramento, CA and Denver, CO show combined capital and operating costs of two firms serving the same subscribers to be only 23 to 28 percent greater than a single firm serving the same area.[29] Two other studies, acknowledge that it is possible for two systems to compete in the same area, but that the competition would be very weak.[30]

In the future, as cable increases penetration and also revenue per household, the prospects for a second, competing, service are better. Some argue that entrepreneurs should make the decision about whether or not overbuilds are practical, not public officials.[31] There is also the argument, recently given credibility by the Supreme Court, that the granting of exclusive franchises, if overbuilds are physically practical, could be a violation of the First Amendment rights (freedom of speech and press) of franchise applicants.[32]

Franchising authorities grant <u>de facto</u> exclusive franchises because cable has been presumed to be a natural monopoly. Furthermore, an exclusive franchise justifies regulation. The assumption that consumer welfare and community interest is best served by limited regulation of exclusive franchisees as opposed to competition has had little empirical test. But, consumers do not have much to lose if the test is permitted particularly in the absence of rate regulation.

The National Telecommunications and Information Administration suggests allowing limited telephone company same-market competition with cable as a supplier of distribution facilities.[33] Other proposals have gone as far as to suggest that telephone companies should be permitted to supply video service along with voice. This could have the same effect as permitting overbuilds. The local telephone company would have many advantages over potential competitors including: (1) a maintenance the advantage of a maintenance and billing system along with other economies already in place, (2) public utility regulation which provides them with a guaranteed rate of return. Although there are many issues surrounding same-market telephone company entry into video services, telephone companies are one of the most likely candidates to provide competition to cable.

It must be noted, however, that the competitors among multichannel distribution systems would be drawing on the same pool of mass appeal program creators. An entirely new set of makers of programs will not emerge. If anything, program costs and eventually consumer prices might increase as competitors bid up the price of scarce program material.

<u>Commercial Use Channels</u>

The Cable Act of 1984 built in a safety valve against monopoly abuses of cable operators. An operator with 36 or more activated channels is required to make a portion of these channels available for commercial use. Other entrepreneurs could lease these channels to improve on or add to services provided by a franchisee. The cable operator, under this provision, is permitted to set the price, terms and conditions of such a lease, "to assure that such use will not adversely affect the operation, financial condition or market development of the cable system," although the price, terms and conditions may not be "unreasonable" or inconsistent with the goal of making the "widest possible diversity of information sources available to the public."[34]

At this point the cable industry has had little experience with commercial use channels. It would probably be inefficient for another party to establish one or even several channels independent of the cable operator, with separate marketing and billing. However, if the service were unique and considered to be an added value for the cable subscriber, the operator might supply the marketing and billing services to the lessee. For instance, a broadcast television station might lease a channel to extend its news service to 24-hours. Such an arrangement could be beneficial to both the cable system and the broadcaster. The broadcaster is already staffed and equipped for newsgathering, and by such an arrangement, would foreclose on the possibility that the cable operator would enter into the local news field in competition with the broadcaster, as discussed earlier. The cable operator avoids the heavy capital, operating and promotional expenses in establishing a separate local news unit. The entire community may benefit, as this plan for a commercial use channel might serve to keep broadcast news alive for those not subscribing to cable.

Presumably the franchising authority would encourage, perhaps even promote such a commercial use proposal. The courts would look on the proposal as consistent with the Cable Act, and would not permit a cable operator to block it with prohibitory pricing or terms.

Must carry rules

Another possible method of preserving some television broadcast channels is to require cable operators to carry at least some local television stations. Although the constitutionality of must carry rules is suspect, under a dominant subscription television system, policy makers may well decide that limited rules might have to be imposed in the balance First Amendment rights against the public interest in keeping a broadcast service viable.

Advertising

As cable gets stronger in the advertising industry, it will be appropriate for the Justice Department to monitor multichannel advertising sales practices, so that buyers are not forced into combination purchases that may not suit their purposes and unfairly discriminate against other media advertising sales. Limits on cable concentration will help to serve this purpose by controlling the ability of cable operators to sell large packages at discounted prices against other media.

CONCLUSION

The principal economic base for television is changing from an advertiser-supported system to a subscription-advertising system. Our scenario for the future anticipates a permanent tilt in the playing field toward the multichannel subscription services dominated by a concentrated cable industry. Minor adjustments or corrections would not help broadcasting or the consumer at this point. The main issues then become: (1) assuring that some broadcast outlets survive cable concentration for the benefit of a minority of households not able to become cable subscribers and (2) protecting the cable subscribers as consumers of a service from the negative impacts of a near-monopoly control of television by cable.

It is valuable for the various elements of the television industry to acknowledge this change, for consumers to know what is happening and for public policy makers to begin to address some of the implications of the new system. We hope this article contributes to a new perspective on the television industry and a response to the research imperatives implied by its evolution.

1. Robert Wright, "Text of Wright Speech," Multichannel News, August 24, 1987, p. 40; Jeannine Aversa, "Tisch Sees Tough Times Ahead for Broadcast Nets," Multichannel News, April 6, 1987, p. 9; Andrew Grossman, "Pierce Sees Broadcast Nets Airing More Low-Cost Shows," Multichannel News, May 4, 1987, p. 9.

2. "1988 Report on Television," A.C. Nielsen Company, p. 6.

3. Ibid., p. 3.

4. Roger G. Noll, Merton J. Peck, and John J. McGowan, Economic Aspects of Television Regulation, The Brookings Institution, 1973, p. 32.

5. "Consumers' Cable Tab for '86: $10.5 billion," Multichannel News, February 9, 1987, p. 10B; and "Cable Stats," Cablevision, March 2, 1987, p. 64.

6. "Facts and Figures," Multichannel News, October 10, 1988, p. 54.

7. Cable TV Facts 1988, CableTelevision Advertising Bureau. Note: Cable is still well below its fair share of television advertising revenues. Cable advertising revenues were $1.080 billion in 1987. All television advertising revenues were $23.64 billion. ("Vernonis, Suhler & Associates, Five Year Forecast," Broadcasting, July 4, 1988, p. 48.) If advertiser-supported cable-only television's share of audience for all television households (whether or not they have cable) is 13 percent, then the cable advertising revenues pegged at the same level as broadcast television revenues, should be $3.073 billion (.13 x $23.64). (Cable TV Facts 1988, p. 6.)

8. In the first five quarters after cable rate deregulation in the U.S., premium channels HBO, Showtime and Disney decreased rates by $.47, $.54 and $.85 per month as basic rates were increasing. The penetration of these three channels increased during that time. Sources: "Cable System Retail Pricing Comparison," Multichannel News, April 6, 1987, p. 35; "Cable System Retail Pricing Comparison," Multichannel News, August 10, 1987, p. 34; "Pay Channels' Spurt," Channels, April 1987, p. 64.

9. About 15 percent of the U.S. television households, which are in areas of sufficient housing density to be practical for cable to serve, are not yet passed by cable. Nearly 80 percent are now passed, about 5 percent are in low density population areas. Source: "Cable Stats," Cablevision, March 14, 1988, p. 74.

10. Cable penetration of homes passed is about 60 percent. ("Cable Stats," Cablevision, February 15, 1988, p. 90.) This could theoretically be increased to 100 percent.

11. "Facts & Figures," Multichannel News, January 9, 1989, p. 28.

12. Source: Paul Kagan Associates, Inc. in Robert Marich, "Thinking Big at Think Entertainment," Cable World, December 5 1988. Networks included are: A&E, BET, CBN, CNN/HN, Discovery

Channel, ESPN, FNN, Lifetime, MTV, Nashville Network, Nickelodeon, TBS, Tempo, USA Network, VH-1, Weather Channel.

13. Interview with William Grimes, President, ESPN, Cablevision, March 14, 1988, p. 24.

14. Kay Koplovitz quoted in "Jones Mulls Dropping USA Network, Multichannel News, August 29, 1988, p. 3.

15. Between 1987 and 1988 nine of the top ten cable networks increased the average prime time household audience by substantial percentages (e.g., 61 percent for The Nashville network, 31 percent for ESPN, 49 percent for USA, 52 percent for Lifetime). Source: Steve Behrens, "User-Friendly, at Last," Channels, July/August, 1988, p. 28.

16. Lee B. Becker, Sharon Dunwoody, and Sheizaf Rafaeli, "Cable's Impact on Use of Other News Media," Journal of Broadcasting, Spring 1983, pp. 112-140.

17. David B. Hill and James A.Dyer, "Extent of Diversion to Newscasts from Distant Stations by Cable Viewers," Journalism Quarterly, Winter 1981, pp 552-555.

18. A. C. Nielsen network newscast audiences 1981 to 1987. Findings in a partially completed study by one of the authors.

19. The "Newspaper Preservation Act" in the U.S. permits competing newspapers in danger of failure to combine business and production operations.

20. Implementation of the Cable Act, 58 R.R.2d 1, 1985.

21. Anita Wallgren, Project Manager, "Video Program Distribution and Cable Television: Current Policy Issues and Recommendations," National Telecommunications and Information Administration Report 88-233, June 1988, pp. 80-81.

22. Bruce M. Owen, Jack H. Beebe and Willard G. Manning, Jr., Television Economics, Lexington Books, 1974.

23. TCI Looking at a 'Less is More' Channel Strategy," Broadcasting, October 31, 1988, p. 40.

24. The FCC has held spectrum space in reserve for broadcasting in the event that advanced television requires additional bandwidth.

25. "Cable TV: A Status Report," Nielsen Television Index, Network Information Services, May 1988.

26. Notice of Proposed Rulemaking and Notice of Inquiry, Docket No. 18397, 15 F.C.C.2d 417 (1968) and Notice of Proposed Rulemaking and Inquiry, Docket No. 18891, 23 F.C.C.2d 833 (1970)

27. Multiple Ownership--Seven Stations Rule, 56 R.R.2d 859 (1984).

28. R. C. Johnson and R. T. Blau, "Single Versus Multiple-System Cable Television," Journal of Broadcasting, Summer 1974, pp. 323-346.

29. Touche Ross, "Financial and Economic Analysis of the Cable Television Permit Policy of the City and County of Denver," January 20, 1984.

30. E. M. Noam, "Economies of Scale in Cable Television: A Multiproduct Analysis," (in E. M. Noam , ed., Video Media Competition: Regulation, Economics and Technology, Columbia University Press, 1985.) and B. M. Owen and P. R. Greenhalgh, "Competitive Policy Consideration in Cable Television Franchising," (in Options for Cable Legislation, Hearings on H.R. 4103, 4229, and 4299 Before the House Subcommittee on Telecommunications, Consumer Protection and Finance of the Committee on Energy and Commerce, 98th Congress, 1st Session, Washington, D.C., U. S. Government Printing Office, 1983, pp. 70-117.)

31. Thomas W. Hazlett, "The Policy of Exclusive Franchising in Cable Television," Journal of Broadcasting and Electronic Media, Winter 1987, pp. 1-20.

32. Preferred Communications v. City of Los Angeles, 754 F.2d 1396 (9th Cir. 1985), aff'd, 106 S.Ct. 2034 (1986).

33. Anita Wallgren, Project Manager, "Video Program Distribution and Cable Television: Current Policy Issues and Recommendations," National Telecommunications and Information Administration, June 1988.

34. Section 611, Cable Communications Policy Act of 1984.