Competition vs. Regulation: The Case of the Mass Media

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THE CASE OF THE MASS MEDIA

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INTRODUCTION

At a not so distant time in the past, communications law was FCC law. The compleat practitioner, broker, banker, owner or investor thus could get by with a library that consisted of Senator Dill's treatise on radio regulation, a copy of the Communications Act, and a comparatively thin volume of Commission Regulations.

The last few years have witnessed the development, however, of new media with strange acronyms -- e.g., CATV, MDS, RCC. In addition, both the Commission and the courts have embarked upon what may be a major restructuring of the common carrier and broadcast industries. The Justice Department is trying to bust up the world's largest corporation, of course, and the Commission increasingly has promoted competition with AT&T as to both equipment and services. Local cross ownership of television stations and newspapers has become an issue for the Supreme Court.

At about the same time, the federal government has created its own brand of alphabet soup -- agencies ranging from IRS to OSHA, from FAA to FTC. In order to deal with day-to-day problems, it is necessary to monitor at least a dozen different agencies.

Lawyers and other professionals thus must understand the requirements of both the competitive and regulatory environments. Although this collection of materials will not create instant expertise, it should help to define the issues.
I. TRENDS IN REGULATION OF THE MEDIA

A. Internal Revenue Service: Tax Policy Affecting the Electronic Media

Federal tax law and policy impacts upon the electronic telecommunications media in similar fashion to its effect upon most other business enterprises. While on a day-to-day basis tax planning considerations will not be of vital importance to the operator of a broadcast station or cable system, the sale or transfer of the property will give rise to a number of important planning problems which must be considered.

From the standpoint of the seller, primary attention must be paid to the effects which depreciation recapture will have upon the transaction. Also, where the transaction contemplates the use of a non-competition agreement or a consulting agreement involving the owners of the property, the impact of the inclusion of these regular income items in the sale must be carefully assessed.

With regard to the purchaser, the primary tax planning concern will be the allocation of the purchase price. The acquisition of a typical broadcast property will involve such items as fixed assets and a host of intangibles including network contracts, talent and program rights, film contracts, non-competition and/or consulting agreements, leases, program formats (radio) and advertising contacts. In the case of a cable system, the allocation list will include many of the above items plus CATV subscriber accounts, program supply agreements and CATV franchise authority.

The evaluation of a broadcast property for tax purposes is a complex matter. While the following IRS memorandum should be considered far from the last word on the subject, the analysis does present an insight into the allocation rules which will be applied to every transaction involving the sale or transfer of a broadcast property and for this reason provides most interesting and instructive background for tax planning purposes.
Section 1, PURPOSE

The purpose of this Revenue Procedure is to provide guidelines for the market determination of the fair market values of radio and television broadcasting stations for estate, gift, and income tax purposes. In addition, the Revenue Procedure sets forth factors to be considered in the allocation of a lump-sum purchase price of such stations between depreciable and nondepreciable assets. Further, the Revenue Procedure outlines a procedure for making a detailed market value analysis of the subject station based on market characteristics, network affiliations, competitive factors, and technical facility capabilities.

Sec. 2, BACKGROUND

Commercial broadcasting is a service industry regulated by the Federal Communications Commission (FCC) that provides AM and FM radio and television programs to the public. Broadcasting revenues are derived from sales of air time to local, regional, and national advertisers who pay approximately four billion dollars annually to more than 7,100 stations.

Most broadcasting companies are closely held. The stocks of these companies are not ordinarily publicly traded. Thus, in the absence of stock market quotations, some other method is required to determine the fair market value of the stock of such companies as well as the fair market value of the assets of such companies. There have been relatively large numbers of stations sold, and these sales make the market data, or comparable sales approach, a preferred method of valuation.

Broadcast frequencies are limited in number and their use is closely regulated. Allocation of frequencies and licensing of broadcasting stations, as well as industry regulation, are functions of the FCC. Broadcast frequencies allocated to or suitable for use in substantial markets are, in most cases, licensed to existing stations. Under these conditions the only feasible approach to station ownership is to purchase an existing facility. Prices demanded for existing stations reflect frequency scarcity and a range of market conditions. Market characteristics of major interest are size, growth trends, and competition. The American Research Bureau (ARB) divides the United States into more than 200 television markets, consisting of approximately 62,000,000 TV households. Common measurements of TV market size include total number of households, TV households, weekly and daily circulation. Circulation is measured by the number of households in which a particular station is viewed at least once during the period of one week or within a broadcast day.
Television markets are classified as VHF, UHF, or mixed markets. In mixed markets, circulation and revenues for the VHF stations are usually substantially greater than for UHF stations. Radio markets are most numerous, more competitive, and cover wider population ranges than television markets. Competitive data for most markets are available from FCC and trade publications.

Sec. 3. PROCEDURE FOR DETERMINATION OF FAIR MARKET VALUE

As in other business acquisitions, the primary objective in most broadcast station acquisitions is to obtain rights to future earnings. The magnitude of anticipated future earnings establishes the upper limit on the price a knowledgeable buyer is willing to pay. Future earning potentials of broadcast stations are functions of station management effectiveness, market size and growth rate, competition, technical facilities, network affiliation contracts (for television stations), economic environment, tax, and regulatory trends.

Where markets are served by four or more TV stations, one or more stations operate independently without network affiliation. Independent stations typically incur higher programming costs, command lower time rates and realize smaller market shares than affiliated stations. Thus TV network affiliation usually results in increased earning power and higher market value.

A potential purchaser estimates future earnings by projecting past operating results, modified by the above factors, over future time periods. Past operating results are first analyzed to determine the degree to which present management has realized the market potential of the station. Excessive leasing, salary and depreciation expenses are isolated to permit reconstruction of realistic operating results. Analyses of hundreds of broadcast station sales transactions reveal little correlation between sales price and cash flow or earnings shown on financial statements. The analyses indicate that the best correlation is between sales price and revenues.

Since earnings are derived from revenues, stations with larger revenues usually have a larger profit potential and market value. Maximization of revenues is an objective common to all station managements. Past revenues provide a combined measure of management effectiveness, market size, competition, and relative technical facility coverage capability. Assuming stabilized competition, future earning and revenue improvements for a particular station are functions of market growth and management. Major changes in station management frequently follow acquisition.