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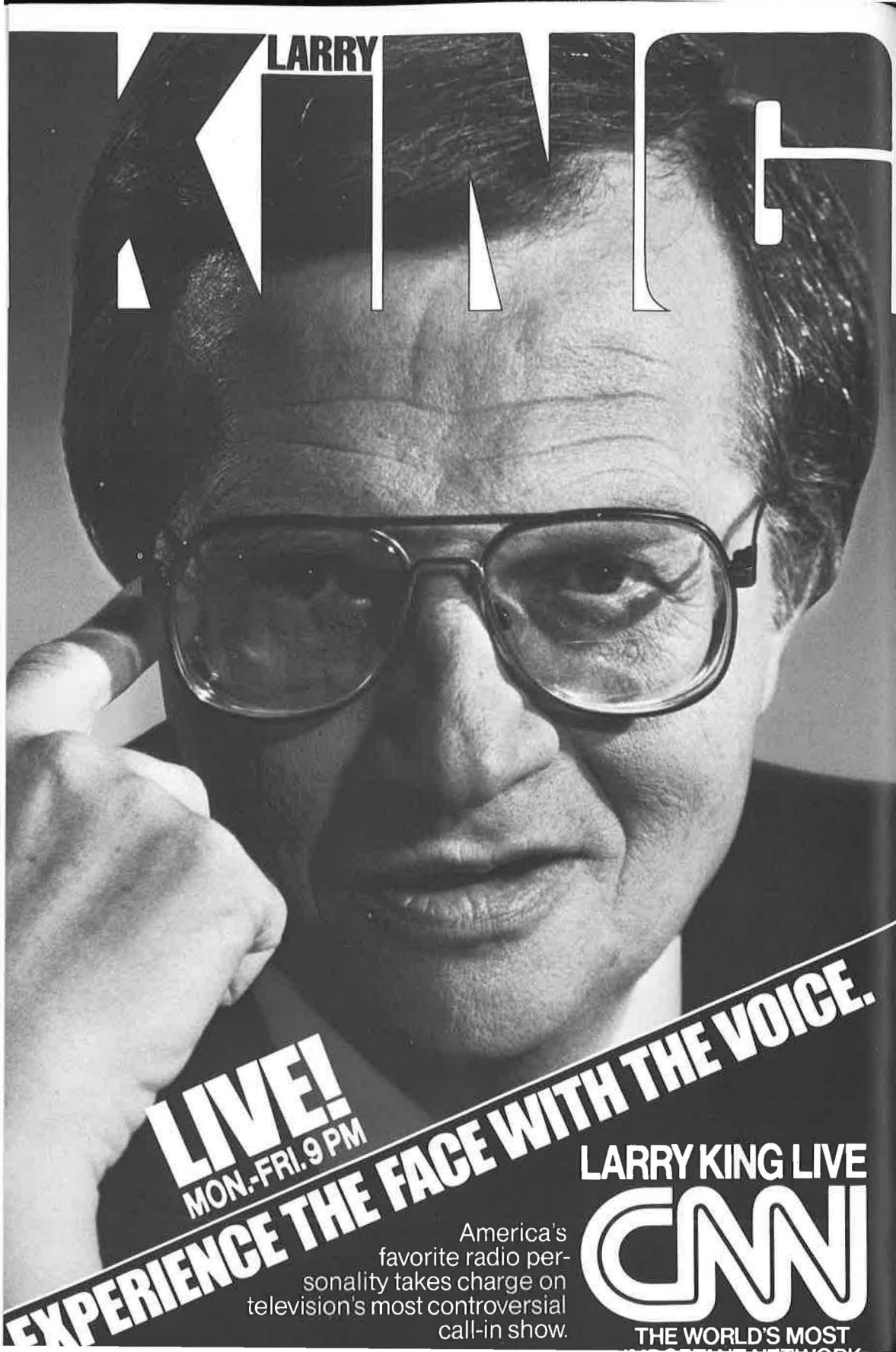


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LIFE WITHOUT "MUST CARRY": A PRELIMINARY ANALYSIS

BY MICHAEL BOTEIN

Introduction

The District of Columbia Circuit Court of Appeals sent shockwaves through legal and policymaking establishments in July 1985 when it held in the *Quincy Cable* case that the Federal Communications Commission's "must carry" cable television rules violated the free speech provisions of the First Amendment.

In June of 1986, the Supreme Court of the United States refused to review *Quincy*. The whole controversy thus fell back into the collective lap of the Congress, the Commission, and the various interest groups. Although the FCC initially exhibited an inclination not to adopt any must carry rules, it quickly came under significant Congressional pressure to take some action. The FCC responded in August 1986 by adopting new must carry regulations—of perhaps questionable constitutional validity—which essentially require cable operators to carry a limited number of "local" television stations.

Despite all of the *sturm und drang* about must carry, none of the industry or governmental interests has bothered to undertake any real analysis—at least publicly—of the rules' abolition. This article reports the results of a preliminary analysis of *Quincy's* economic impact.

At the outset, it may be useful to review briefly the reasons for the legal and policymaking communities' failure to anticipate the possibility and effect of *Quincy*. Lawyers and policymakers may have underestimated the vitality of the constitutional challenge to the must carry rules, because the requirements were viewed as just part of the age-old battle between broadcasters and cable operators—a traditional form of economic guerilla warfare. Since economic protectionism generally creates less concern than first amendment limitations, the must carry issue received relatively little consideration.

One reason for the failure to examine *Quincy's* impact may be the rather murky nature of the D.C. Circuit's opinion. Without undertaking an analysis of the decision—as others already have done very well—it seems fair to characterize it as having either a literal or a pragmatic meaning. Taking the court at its word, it applied the traditional "substantial government interest" test, and found that the rules flunked it. This interpretation would lead to the conclusion that virtually any form of must carry rule is unconstitutional.

On the other hand, the court went out of its way to emphasize the extent to which it had based its decision on the FCC's two-decade failure to produce any empirical justification for the rules. Judge Wright explicitly criticized the Commission for the "blun-

derbuss approach of the rules," which "indiscriminately sweep into their protective ambit each and every broadcaster. . . . Indeed, the final section of the opinion reads like a traditional review of administrative agency action, rather than a decision of constitutional dimensions; it places a heavy emphasis on the FCC's lack of empirical data, and invites the Commission to do what it should have done two decades ago—namely, to make a record as to the need for the must carry rules.

Whether or not the D.C. Circuit ultimately approves it, the pragmatic view seems to have been adopted by both industry interests and regulatory authorities. None of the private or public sector players has suggested that all must carry rules are unconstitutional. The operating assumption behind the NCTA/NAB/CATA/TOC/INTV "Joint Industry Agreement" filed with the FCC is that at least some form of must carry rules is constitutionally permissible.

The Joint Industry Agreement resulted in the new must carry rules. A brief description may be useful. Although the new regulations exempt cable television systems with less than 21 channels, they require operators with 21 to 27 channels to use up to 7 channels for "local" stations, and systems with more than 27 channels to use up to 25% of their capacity. Cable systems have complete discretion in choosing which local stations to carry, except that they must offer at least one or two noncommercial stations depending on their channel capacity (one for systems with less than 54 channels, two for systems with more). The rules also require operators to offer subscribers free "A/B" switches, to switch from cable to conventional receiving antennae.

Despite the D.C. Circuit's emphasis on proving the need for any must carry rule, neither the industry groups nor

the Commission seem to have taken even a first step towards creating the type of rulemaking record which Judge Wright apparently contemplated in *Quincy*. This dearth of information is surprising—especially in a legal and political context which seems to require it. It thus seemed useful to undertake a rough cut at analyzing the economic effects of abolishing the must carry rules. This analysis is highly tentative in nature, and is suggestive rather than definitive. Nevertheless, it may be useful in terms of encouraging more refined research.

At the outset, some conclusions appear to be intuitively obvious. Abolition of the rules would impact different broadcasters in disparate ways. At the one extreme, stations with what Dr. Rolla E. Park terms high "attractiveness indices"—primarily network affiliates and strong "superstation"-type independents—presumably would continue to be carried by cable operators, because of their appeal to subscribers. (Indeed, were it not for the "compulsory copyright" provisions of the Copyright Act, they might have enough leverage to demand compensation from cable operators.)

At the other extreme, cable systems would be quick to drop unattractive stations—such as UHF public broadcasters—unless the systems already have substantial excess channel capacity. The fact that only a few cable operators have dropped stations probably is a result of the cable industry's explicit decision not to create any confrontations at this point; indeed, the cable trade associations apparently have advised their members against dropping signals.

Similarly, different cable operators would benefit from abolition of the must carry rules in disparate ways. At the one extreme, a "saturated" system with no vacant channels would be able to add a—or perhaps even a first—pay channel, thus creating a new revenue flow equal to a large part of its traditional "basic" service. At the other

extreme, an "unsaturated" system with extra channels would benefit very little from the rules' abolition, because the rules did not prevent it from adding program services in the past. (A system might have excess channels either because it had high bandwidth or because it had few must carry signals in its market.) Since activation of a channel involves capital costs of approximately \$6,000 and annual operating costs of less than \$1,000, an unsaturated system presumably would have no reason to delete any station with even a small number of viewers.

The more difficult question, of course, is how abolition of the rules would impact upon broadcasters and cable operators which do not fall at either one of these extremes. This analysis thus attempted to generate data as to the impact of the rules' abolition in terms of the following criteria:

1. Decreased revenues to broadcasters from non-carriage;
2. Increased revenues to cable operators from availability of additional channels; and
3. Comparative losses and gains for broadcasters and cable operators.

As is obvious from the following summary and tables, the existing data are fragmentary at best. It is relatively easy to generate rough estimates as to a broadcaster's loss in advertising revenue from non-carriage, or as to a cable operator's gain in subscription revenues from addition of a new channel. The existing data do not help predict, however, either (1) a broadcaster's losses in an entire television market (as opposed to on a given cable system) or (2) a cable operator's incentives in adding new services.

Despite these caveats, this initial analysis may be useful. If nothing else, it indicates that abolition of the rules creates widely varying effects from station to station and system to system. As discussed in the Conclusion, this has implications for policymaking.

Summary of Data

A. Impact on Broadcasters of Abolishing Must Carry Rules

The study first attempted to estimate the economic value of must carry status—and thus of loss of that status—to broadcasters. The analysis used a mix of nine cable systems, which had varying characteristics in terms of number of subscribers, channel capacity, and market size. (As will be seen, the latter two characteristics are relevant primarily in the later consideration of the value of an additional channel to cable operators.)

The study started from the assumption that a cable system would be most likely to drop the weakest local station—i.e., the station with the smallest share. As would be expected, this invariably was a UHF independent station. Using conventional industry assumptions as to cost per thousand viewers (CPM), number of commercial minutes per hour, and total number of hours per day on the air, it was possible to arrive at the value of each station's carriage on the system in question. The analysis then applied Dr. Rolla E. Park's assumption of a forty to fifty percent (that is, an average of forty-five percent) increase in audience through cable carriage, to estimate the increased advertising revenue attributable to cable carriage—or, once again, the amount of revenue decrease through loss of carriage.

The study estimated the value of decreased audience size through non-carriage, by using conventional industry statistics—i.e., a six dollar CPM, a twenty hour broadcast day, and an average of ten commercial minutes per hour. (The results are set forth in Table I of the Appendix.)

The dollars lost through non-carriage naturally varied from one situation to another, depending upon the size of the cable system. The larger the system, of course, the greater the eco-

nomic impact upon the broadcast station. For example, the total annual loss for a broadcast station carried on a 962 subscriber system was \$1,679.00; on a 38,500 subscriber system, \$75,883.50; and on a 93,500 subscriber, \$184,288.50. (Once again, these figures are on a system-by-system, rather than market-wide basis; a total of these amounts for a given market naturally would be substantially higher.)

The size of the potential lost revenues is no surprise, of course, given Park's estimate of increased viewership through cable carriage. The more significant consideration is that these figures reflect the maximum amount which a commercial broadcaster could pay for carriage in a free market environment.

This in turn raises two questions. First, while commercial broadcasters may be willing to pay up to these amounts for carriage, public stations may not be able to, unless they can translate a larger audience directly into increased viewer contributions. This presumably would depend largely upon the cable subscribers' demographics. Moreover, officials at public stations probably would have a difficult time convincing their superiors that it was necessary to buy an audience for fundraising.

Second, and more important, it is worthwhile to compare these figures with estimates of cable operators' gains through the availability of an additional channel. To the extent that a cable operator consistently can realize more revenue by adding a new service than by receiving payments from a broadcaster, it presumably would have no incentive—and a broadcaster no ability—to negotiate any type of compensated carriage.

B. Impact on Cable Operators of Abolishing Must Carry Rules

In order to compare the impact of the rules' abolition on cable operators with that on broadcasters, the study next attempted to estimate an opera-

tor's potential gain from adding a new service. As indicated in the Introduction, this aspect of the analysis is speculative, since it involves second-guessing cable operators' marketing decisions—a particularly difficult task since cable operators disagree as to the most profitable mix of services.

Nevertheless, it seemed fair to posit that any operator would choose the most lucrative class of service to replace a must carry signal. The study thus assumed that, depending upon its existing channel line-up, a cable operator would choose a pay cable channel (such as HBO or Showtime), with a monthly net revenue of roughly \$4.50 per subscriber. (For large MSOs with significant bargaining power, of course, the net revenue figure may be much higher—as much as \$7.00 or \$8.00 per month.)

The analysis also relied upon general industry "folklore" in assuming that the penetration of an additional pay signal would be 100 percent on a 12-channel system and 50 percent on a 21 to 35-channel system. These figures may be somewhat optimistic. While they appear to be in line for relatively new urban and suburban builds, they probably are somewhat high for older, rural operations. (The results are set forth in Table II of the Appendix.)

Perhaps the most striking observation was the often tremendous disparity between broadcasters' losses and cable operators' gains through abolition of the must carry rules. Returning briefly to the illustrations in Section II(A) above, where a broadcaster's annual loss was \$1,679.00, the cable operator's gain was \$25,974.00; if the loss were \$75,883.50, the gain was \$1,039,500.00; and if the loss were \$184,288.50, the gain was \$2,524,500.00. (Comparative figures for all nine cable systems are set forth in Table III of the Appendix.)

This disparity was not, however, universal. As would be expected, the high-capacity systems already carried

a full complement of pay signals and thus presumably had little to gain by freeing up additional channels; this naturally was most pronounced for systems with vacant channels (other than channels unusable for engineering reasons), since by definition these systems could have added channels even under the old must carry regime.

Realistically, high-capacity systems with no vacant channels might realize a small gain by replacing unattractive broadcast stations with satellite programming; since these systems already carried all of the major satellite networks, however, they could add just relatively unattractive services—a move which presumably would add little revenue beyond the 3 to 5 cents per subscriber per month paid by some of these services.

In most situations, abolition of the must carry rules thus helps cable operators more than it hurts broadcasters. This result naturally has several implications. First, it may demonstrate that must carry rules are economically inefficient, since their absence creates more value than their presence. Second, channel capacity is highly determinative of the rules' impact; systems with vacant channels derive no benefit from abolition of the rules. Third, if a cable operator knows—as is the case in some of the situations above—that it invariably will gain more by adding a new service than by being compensated by a broadcaster, it has no incentive to deal with the broadcaster.

Conclusion

As indicated in the Introduction, this analysis is tentative, and needs considerably more refinement before any firm conclusions can be drawn from it. Nevertheless, it suggests some conclusions of relevance to the on-going policy debate over must carry requirements.

Most importantly, and not unexpectedly, losses to most independent

broadcasters and gains to most cable operators from abolition of the rules are asymmetrical. (Once again, of course, these observations do not apply to "superstation"-style independent stations with large audiences.) Although independent broadcasters' decreases in revenues are quite predictable and consistent, cable operators' increases in revenues vary from system to system.

The key factor, of course, is a system's current number of vacant channels and of income-producing signals; if elimination of the must carry rules does not make a new channel available to an operator, or if an operator already has a full complement of profitable signals, it has little or no opportunity to increase its revenues. Conversely, if a system can add a very profitable channel by dropping a signal, its gain is far more substantial than the station's loss.

This asymmetrical relationship between losses and gains has several effects. Many broadcasters may be unable to buy carriage, because the operators' increased revenues exceed the value of cable carriage to the broadcasters. Conversely, unsaturated systems—generally the new, urban operations—may have enough vacant channels that they incur no disadvantage by continuing to carry all local signals, unless one of them actively offends their subscribers; the marginal cost of activating a vacant channel is low enough that any station can afford it. This is not to suggest that total channel capacity is the key determinant; the number of vacant channels has the primary effect. For example, under the old must carry rules a thirty-six channel system in New York City would have had twenty non-local channels, while a 36-channel system in Kalamazoo, Michigan would have thirty-five.

In a free market environment, the relationship between broadcasters and cable operators thus would vary markedly—not just on a market-by-market,

but also on a system-by-system basis. This has some obvious implications in terms of the transactions costs which might be involved in negotiations for carriage between broadcasters and cable operators.

More significantly, this suggests that any attempt to promulgate uniform must carry rules—as in the past—will not reflect the actual economic relationship between broadcasters and cable operators. Basing carriage rights on a system's capacity alone does not reflect the value of an additional channel to a system, except perhaps in the case of extremely high-capacity systems. Moreover, use of a channel capacity standard obviously invites a cable operator to deactivate channels in order to free itself from must carry requirements.

For example, under the FCC's new rules, an operator of a twenty-one channel system would be required to carry up to seven signals, thus giving it fourteen channels for non-local programming. By simply deactivating one channel, the system could remove itself from all must carry obligations, and thus have twenty channels free for non-local programming.

It thus seems fair to question whether the new rules are truly responsive to the underlying relationships between broadcasters and cable operators, in their emphasis on channel capacity as a trigger for must carry obligations. As discussed above, there is no necessary relation between a system's number of channels and its ability to increase its profitability. The FCC's approach seems to satisfy neither Judge Wright's criticism that "... the Commission's promise to 'get the facts' remains unfulfilled," nor his suggestion that "the Commission must make some effort to move beyond the amorphous in defining the interest served by the must-carry rules."

A more appropriate—and perhaps legally stronger—approach might be to base a system's must carry obligations upon guaranteeing a mini-

mum number of channels available for non-local programming. A system would have the right to carry a certain number of channels, defined in terms of an economically viable program package under existing industry custom and usage. (To a certain extent, of course, this harks back to the Commission's initial approach to distant signal carriage in 1972.)

The size of this package naturally would vary with a system's channel capacity; after all, the greater an operator's investment, the greater is its expected return. Instead of basing a system's obligations on its capacity—regardless of how many channels actually were available for non-local programming—this approach would take into consideration differing numbers of local signals. It thus would insure that an operator could offer an economically viable service, regardless of the number of local signals in its market. (The size of an appropriate minimum program package for systems with different channel capacities naturally would need to be established through data on industry practices—thus creating the type of record which Judge Wright appears to have contemplated.) This type of approach would prevent variations from market to market and system to system, thus allowing systems with similar capacities to carry the same number of non-local channels.

Future policymaking on the must carry issue thus must take into account two factors: (1) the asymmetrical relationship between broadcasters' losses and cable operators' gains as a result of non-carriage; and (2) the variation in values of each additional channel to cable operators. The FCC's traditional blunderbuss type of approach will serve neither the public interest nor Judge Wright's requirements. ■

The author is Professor of Law, New York Law School. He wishes to thank Ms. Ann Bingley and Ms. Beth Goldstein for helping to compile the data tables in the Appendix.

APPENDIX

TABLE I
Impact of Non-carriage on Broadcasters' Revenues

	Mason City, Iowa	Campbell, Missouri	Poughkeepsie, N.Y.
Number of Cable Channels	12	20	12
Number of Cable Subscribers	962	758	12,312
Total Households in Franchise Area	4,751	2,156	58,400
Market Share of Least Attractive Station ^a	1%	1%	1%
Number of Cable Households Viewing Station	9.6	7.6	123.1
Value of Share (\$) ^b	\$11.52	\$9.12	\$147.72
Increased Daily Value of Share ^c	\$4.60	\$4.10	\$66.47

TOTAL ANNUAL INCREASED VALUE	\$1,679.00	\$1,496.50	\$24,215.55
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	Stockton, Calif.	San Rafael, Calif.	Stamford, Conn.
Number of Cable Channels	24	30	54
Number of Cable Subscribers	38,500	51,000	39,300
Total Households in Franchise Area	134,000	71,606	113,680
Market Share of Least Attractive Station ^a	1%	1%	1%
Number of Cable Households Viewing Station	385	510	393
Value of Share (\$) ^b	\$462.00	\$612.00	\$471.60
Increased Daily Value of Share ^c	\$207.90	\$275.40	\$212.22

TOTAL ANNUAL INCREASED VALUE	\$75,883.50	\$100,521.00	\$77,460.30
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a. Derived from *Television/Radio Age*, February, 1986, at A-3.

b. Assumes that the average independent station airs ten commercial minutes per hour, twenty hours per day. Source: Frazier, Gross & Kadlec, Washington, D.C.

c. See R.E. Park, *Audience Diversion Due to Cable Television* (1978).

TABLE I cont.

	Upper Manhattan, N.Y.	San Francisco, Calif.	Dallas, Texas
Number of Cable Channels	26	35	80
Number of Cable Subscribers	93,500	71,308	93,500
Total Households in Franchise Area	315,656	315,179	400,000
Market Share of Least Attractive Station ^a	1%	1%	1%
Number of Cable Households Viewing Station	935	713	935
Value of Share (\$) ^b	\$1,122.00	\$855.60	\$1,122.00
Increased Daily Value of Share ^c	\$504.90	\$385.02	\$504.90
TOTAL ANNUAL VALUE	\$184,288.50	\$140,537.30	\$184,288.50

a. Derived from *Television/Radio Age*, February, 1986, at A-3.

b. Assumes that the average independent station airs ten commercial minutes per hour, twenty hours per day. Source: Frazier, Gross & Kadlec, Washington, D.C.

c. See R.E. Park, *Audience Diversion Due to Cable Television* (1978).

TABLE II
Effect of Additional Channels on Cable Operators' Revenues

	Mason City, Iowa	Campbell, Missouri	Poughkeepsie, N.Y.
Number of Cable Channels	12	20	12
Number of Cable Subscribers	962	758	12,312
Number of Unused Channels	0	0	0
Best Possible Replacement	pay channel ^a	pay channel ^a	pay channel ^a
Value of Best Replacement (Monthly)	\$2,164.50	\$1,705.50	\$27,702.00
TOTAL ANNUAL VALUE	\$25,974.00	\$20,466.00	\$332,424.00

a. Assumes that twelve to twenty-one channel systems will average almost 100% pay penetration, and that higher capacity systems will reach roughly 50% penetration, at an average gross revenue of \$4.50 per subscriber.

b. Assumes that systems with vacant channels will not add signals, since they did not do so when must carry rules were in effect.

TABLE II cont.

	Stockton, Calif.	San Rafael, Calif.	Stamford, Conn.
Number of Cable Channels	24	30	54
Number of Cable Subscribers	38,500	51,000	39,300
Number of Unused Channels	0	3	0
Best Possible Replacement	pay channel ^a	none ^b	pay channel ^a
Value of Best Replacement (Monthly)	\$86,625.00	0	\$39,300.00
TOTAL ANNUAL VALUE	\$1,039,500.00	0	\$471,600.00

	Upper Manhattan, N.Y.	San Francisco, Calif.	Dallas, Texas
Number of Cable Channels	26	35	80
Number of Cable Subscribers	93,500	71,308	93,500
Number of Unused Channels	0	0	7
Best Possible Replacement	pay channel ^a	pay channel ^a	none ^b
Value of Best Replacement (Monthly)	\$210,375.00	\$160,443.00	0
TOTAL ANNUAL VALUE	\$2,524,500.00	\$1,925,316.00	0

a. Assumes that twelve to twenty-one channel systems will average almost 100% pay penetration, and that higher capacity systems will reach roughly 50% penetration, at an average gross revenue of \$4.50 per subscriber.

b. Assumes that systems with vacant channels will not add signals, since they did not do so when must carry rules were in effect.

TABLE III
Comparison of Losses and Gains

	Broadcasters' Losses	Cable Operators' Gains
Mason City	\$ 1,679.00	\$ 25,974.00
Campbell	\$ 1,496.50	\$ 20,466.00
Poughkeepsie	\$ 24,251.55	\$ 332,424.00
Stockton	\$ 75,883.50	\$1,039,500.00
San Rafael	\$100,521.00	0
Stamford	\$ 77,460.30	\$ 471,606.00
Manhattan	\$184,288.50	\$2,524,500.00
San Francisco	\$140,532.30	\$1,925,316.00
Dallas	\$184,288.50	0