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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D. C. 20554

In The Matter of	)	
	)	
Evaluation of the Syndication	)	MM Docket No. 90-162
and Financial Interest Rules	)	

Additional Comment of the Staff of
the Bureau of Economics
of the Federal Trade Commission*

March 25, 1991

* This comment represents the views of the staff of the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner. Inquiries regarding this comment should be directed to Bruce H. Kobayashi (202-326-3363) of the FTC's Bureau of Economics.

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I. Introduction

The staff of the Federal Trade Commission (FTC) appreciates this opportunity to respond to the Federal Communication Commission's (FCC) order requesting further comment on the financial interest and syndication ("fin-syn") rules.[2] The FCC is seeking comment on two proposals to modify the fin-syn rules. Our comment addresses certain issues relating to economic efficiency, competition, and the enforcement of the antitrust laws. It does not discuss other policy considerations that may be relevant to the FCC.[3]

The staff previously filed a Comment and a Further Comment in this proceeding. In our Comment, the staff concluded that a compelling economic case did not exist for continuing to impose a *per se* ban on the acquisition of certain ownership rights by television networks, that competition would be

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[2] *See Order Requesting Further Comment*, In the Matter of the Evaluation of the Syndication and Financial Interest Rules, MM Docket No. 90-162, issued March 15, 1991.

[3] This comment is based on positive economic analysis and therefore does not explicitly address normative concerns falling outside the scope of such an analysis. These and other concerns not explicitly addressed in this comment should be considered separately.

better served by removing the restrictions, and that instances of alleged monopolization could be addressed through conventional application of the antitrust laws.[4] These conclusions were largely based upon an analytical assessment of possible anticompetitive problems in the industry and the ability of the fin-syn rules to address them. The staff also found no evidence that the networks behaved anticompetitively prior to the enactment of the rules. Furthermore, the staff found that subsequent changes in the market have made anticompetitive behavior unlikely in the future.

In our Further Comment, staff examined two basic types of compromise solutions that raise competition policy issues: (a) the regulation of the negotiation process between the networks and the producers and (b) the regulation of network ownership of financial interest and syndication rights.[5] Staff argued that regulating the negotiation process is unlikely to affect the ultimate outcome of the negotiations. Thus, compelling reasons were not found to adopt any of the proposed restrictions on the negotiation process. Further, since the regulation of negotiations can potentially increase the costs of bargaining and might cause mutually beneficial transactions to be bypassed, adoption of these regulations may reduce efficiency. With respect to the regulation of network ownership rights, the staff suggested that conventional antitrust enforcement be used instead of specific regulatory limits. Thus, compelling reasons also were not found to adopt regulations that would prohibit or limit network ownership of syndication rights.

FTC staff have reviewed the FCC's latest proposals to reevaluate the

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[4] *See Comment of the Staff of the Bureau of Economics of the Federal Trade Commission,* In the Matter of the Syndication and Financial Interest Rules, MM Docket No. 90-162, September 5, 1990 [hereafter Comment].

[5] *See Further Comment of the Staff of the Bureau of Economics of the Federal Trade Commission,* In the Matter of the Syndication and Financial Interest Rules, MM Docket No. 90-162, December 21, 1990 [hereafter Further Comment].

Commission's Financial Interest and Syndication Rules. Our evaluation suggests that "Proposal Two" [hereafter Proposal II], which would substantially eliminate the rules over a four year period and would make a presumption for repeal of the rules at the end of this period, is largely consistent with the position FTC staff have taken throughout these proceedings. Given that we have not seen any evidence since these comments were written to change our conclusions, we believe that adoption of Proposal II would most likely benefit consumers by encouraging competition in the marketplace.

Proposal I adopts many of the compromise options contained in the FCC's Further Notice of Proposed Rulemaking,[6] and contains several new options. As noted in our Further Comment, "compromise may lead to a result that is less desirable than either complete elimination or complete retention of the rules." We believe that Proposal I represents the kind of compromise that might leave consumers worse off than if complete elimination or complete retention of the rules were chosen.

Given the time limitations, and the fact that a detailed restatement of the position we articulated earlier in this matter would not be useful, we limit this comment to an examination of the sections of Proposal I that were not specifically addressed in our earlier comments, and to a discussion of ways in which this debate might be resolved empirically.

[6] *See Further Notice of Proposed Rulemaking* In the Matter of the Evaluation of the Syndication and Financial Interest Rules, MM Docket No. 90-162, issued October 22, 1990.

II. The Order for Further Comment: Proposal I

A. An Overview of Proposal I

Proposal I has several major elements. It would allow network acquisition of financial interests in prime time programming only if the network licensing term is limited to two years or less.[7] It also would allow the networks to syndicate in-house productions.[8] However, in-house productions would be limited. First, in-house programs would be defined to include only foreign co-productions or programs wholly owned and controlled by the networks.[9] Second, the percentage of a network's prime time schedule composed of that network's in-house productions would be capped at 40%[10] The proposal also would place anti-warehousing and anti-favoritism restrictions on network ownership of syndication rights.[11] In addition, domestic network syndication of first-run programming would be prohibited.[12] Finally, Proposal I would require that the networks collect and report specified data to the FCC.[13] All of

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[7] See the FCC's order, *supra* note 2, Proposal I, Section 2A.

[8] *Id.*, Proposal I, Section 3.

[9] *Id.*, Proposal I, Section 3A.

[10] *Id.*, Proposal I, Section 3B.

[11] *Id.*, Proposal I, Section 3C. Proposal II also contains anti-warehousing and anti-favoritism regulations that would apply during the four-year phase out period. See Proposal II, Section 2. However, the regulations contained in Proposal II are not as strict as those contained in Proposal I. For example, the anti-warehousing regulation contained in Proposal II would force a network owned program to be made available within five years of the commencement of the network run (Proposal I would require availability within four years). And instead of strict percentage caps on network owned programs sold to affiliates and network owned stations, Proposal II would require that non-affiliates be offered these programs on terms no less favorable than those offered to the affiliated and network owned stations.

[12] *Id.*, Proposal I, Section 5.

[13] *Id.*, Proposal I, Section 3C(3). Reporting requirements are also contained in Proposal II. See Proposal II, Section 4.

the restrictions and rules would apply to "networks" defined as entities "providing 14 or more hours per week of prime time entertainment on a regular basis to interconnected affiliates that reach, in aggregate, at least 75 percent of television households nationwide."[14] These restrictions and rules are discussed individually below.

B. Limits on option periods to two years.

Proposal I would allow networks to purchase passive financial interests in non-network produced programs if and only if the option clauses are limited to two years or less.[15] That is, this option envisions a *quid pro quo* arrangement under which a network can purchase financial interests only if it agrees to give the producer a shorter option period.[16] This *quid pro quo* arrangement seems to be designed to enhance the program producer's bargaining position. As we and many others have noted before, a rule that limits a particular clause, yet leaves the source of any network power unchanged, is unlikely to change markedly the bargaining outcome.[17] The same analysis we applied to bargaining under the fin-syn rules applies to bargaining under imposed limits on option periods.[18] Any increased profits accruing to the producers from increased leverage after

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[14] *Id.*, Proposal I, Section 6, 7. Fox currently has 12 hours (four nights) of prime time programming per week, so the definition would not currently apply to them. However, the rules would apply to Fox if they expanded their network schedule to five or more nights.

[15] An option clause gives the acquiring network the exclusive right to purchase, at a pre-specified price, a series for a specific number of years. *See*, see Besen, Krattenmaker, Metzger, and Woodbury, *Misregulating Television: Network Dominance and the FCC*, Chicago: University of Chicago Press (1984), p. 104.

[16] Limits on length of option clauses are not a part of the current fin-syn rules. Limits on option clauses to no more than four years were imposed as part of the Department of Justice consent decrees, and will expire in 1995. *See, e.g.*, 5 Trade Reg. Rep. CCH at 50,766 (1980) [ABC Decree]. Thus, acceptance of the two year option would cut in half the allowable length of the option clauses.

[17] *See, e.g.*, Further Comment, supra note 5.

[18] For an explicit analysis of this point, see Besen *et al.*, *supra* note 15, p. 138.

the second season will be rationally anticipated by the networks and reflected in lower network fees.

Nor is it clear that this *quid pro quo* arrangement will help to promote competition or efficiency. We have said in our earlier comments that the major pro-competitive economic function of allowing the networks to own financial interests and syndication rights is to help align, contractually, the risks and rewards that flow from program specific investments.[19] To the extent the fin-syn rules reduce the networks' ability to capture competitive returns from program specific investments, network financing of such investments may be inefficiently reduced. Relaxing the prohibition on network ownership of financial interests can reduce this misalignment. However, it is not clear that the two-year option will be used much in practice. A network can, under the proposed rule, always choose to keep the *status quo* of having a four year option period and no financial interests, and there is some indication that any gains from holding a financial interest would not be worth the risk of losing a show to another network after only two years.[20] If this is the standard case, then this particular proposal for reform of the rules will be little used, have little practical effect, and result in few efficiency gains.

In addition, it is not clear that substantial efficiency gains will be realized even if the networks choose to accept a shorter option period in exchange for financial interests. Because option clauses and financial interests serve a similar economic function, (i.e., they both allow the parties to a contract to align the risks and rewards from up-front investments), a limit on the length

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[19] See Comment, supra note 4, pp 12-17. See also Besen *et al.*, *supra* note 15, p. 137.

[20] David Gerber, the CEO of MGM/UA Television, noted that the two year option limit is "unheard of...I don't think that the networks are going to try to do a partnership with anybody if they take a chance of losing a show after two years." See Kneale, "Networks Get FCC Reprieve on Rerun Rules," *Wall Street Journal*, (March 14, 1991): B1.

of the option period may create the same type of inefficiency as the existing rules create.[21] Thus, although permitting a network to obtain financial interests may lead to efficiency gains, tying this to a permissible option period that is shorter than the parties would otherwise select may simply re-create many of the inefficiencies that resulted from the rules.

C. Restrictions on network syndication of first-run programming.

Proposal I would prohibit network participation in the domestic syndication of first-run programming. The current fin-syn debate has concentrated on the potential exercise of market power by networks in the market for "newly-produced off-network" programs.[22] Consequently, we can identify no competition policy basis for restricting the syndication of first-run programming by a network. The record contains no claims or evidence that the networks, individually or collectively, could exercise market power in the sale of first-run syndicated programming. Further, our analysis suggests that such a prohibition would likely be anticompetitive rather than procompetitive.

We argued in our Comment that it is unlikely that the networks would be able to exercise market power in an antitrust market defined as all off-network programs. Market power concerns are even less compelling when the antitrust market is defined to be "first-run" syndicated programs because these programs do not appear on the network prior to being syndicated. While some proponents of keeping the current fin-syn rules have hypothesized that the networks will attempt to use their control over access to the network to restrict the supply of "off-network" syndicated programming,[23] such access is not

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[21] *See, e.g.*, Besen *et al.*, *supra* note 15, pp. 104-105 and pp. 137-139.

[22] For a discussion of this, see Comment, *supra* note 4, pp. 28-36.

[23] Some proponents of retaining the current rules suggest that the networks may monopolize the market for newer off-network syndicated programs by conditioning a producer's access to the network on the (*de facto*) transfer of rerun rights from the producer to the network. These rights could be explicit transfers of syndication or control rights, or implicit transfers via incentive

required for first-run programs sold to downstream purchasers (independent television stations and cable networks). Thus, the networks do not appear to possess the ability to restrict the supply of these programs, and the entry of the networks into first run programming would not pose a direct threat to downstream purchasers of first-run syndicated programming.

The entry of the networks into first-run programming also would not appear to threaten competition in upstream production of first-run syndicated programming. The fact that certain competitors might be harmed by some action (in this case, entry by the networks) does not imply the action is anticompetitive. Entry of competitors is likely to increase, not decrease, competition in this, as in any other, market, and a rule that serves as a barrier to entry is likely to protect competitors only at the expense of competition.[24]

D. Direct FCC Regulation of Programming

Proposal I contains limits on in-house production, and anti-favoritism and anti-warehousing safeguards. All three of these issues were discussed explicitly in the staff's Further Comment. We suggested that such regulations would be unnecessary, ineffective, and counterproductive.[25] In lieu of restating

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mechanisms. For a critique of these arguments, see Comment, *supra* note 4, pp. 22-35.

[24] *See* Demsetz, "Barriers to Entry," *American Economic Review* 72 (March 1982): 47-56. The FCC has expressed concern that expanded network in-house production might eviscerate the Prime Time Access Rule (PTAR). *See Further Notice of Proposed Rulemaking, supra* note 6, Section VIII. However, a blanket prohibition of network participation in the domestic syndication of first-run programs would not be an appropriate response to this concern. This concern might be remedied by extending the prohibitions of the PTAR to include network-produced in-house programming, and Proposal I already contains such a remedy. This remedy would ensure that the programs seen in the access period are produced by others than the networks. However, as pointed out in our earlier comments, this will not necessarily result in either a different or higher quality set of programs. The networks will still have complete choice over which programs they will broadcast, so that changing who produces a program does not imply that what is broadcast will be substantially changed. See Further Comment, *supra* note 5, p. 19.

[25] *See* Further Comment, *supra* note 5, pp. 19-24.

these arguments, we will comment on several issues that were not covered explicitly in our earlier comments.

First, Proposal I contains a rule that creates a presumption of "favoritism" when a network sells a show to more than 40% of its affiliate and owned and operated television stations. Although such a rule would effectively prevent a network from selling a particular show to more than 40% of its affiliates and O&O's, it is not clear that such a rule would benefit consumers or that the rule would increase efficiency. A network "favors" its affiliates by supplying them with network programming and news presumably because to do so is efficient. Many of the same efficiencies from owning a national, interconnected, and full-time system of program distribution would seem readily to apply to the sale of "off-network" as well as "network" programming. Preventing the networks from selling a show to more than 40% of its affiliates may prevent the network from taking advantage of these efficiencies.[26]

Second, the strict (narrow) definition of "in-house programming" which includes only those shows co-produced with foreign firms and shows wholly owned and controlled by the networks may perpetuate the effect of the existing rules. For example, domestic partnership deals between independent producers and the networks would not be classified as in-house productions, and would be subject to the rules as contemplated in Proposal I. Under these circumstances, further network financing of an independent producer's deficits would occur only if the independent producer either sells all ownership rights to the network or convinces the network to take a two rather than a four year option. Neither option is likely to be an attractive contract.[27]

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[26] *See* Besen *et al.*, *supra* note 15, pp. 132-133, and p. 155, Comment, *supra* note 4, pp. 21-22, and Further Comment, *supra* note 5, p. 20-21.

[27] According to the Wall Street Journal, the chief operating officer of MTM enterprises said that the FCC plan would all but eliminate any chances of negotiating partnership deals with the networks to get better financing to produce series, forcing independent producers to deal only with Hollywood's

Third, the FCC might examine the effects of this rule on the Fox network and other program producers considering entering as a broadcast network. The most effective (but not the only) way in which to diminish any broadcast network's market power would be to induce other broadcast networks to be formed. It would seem to be counterproductive to put in place a rule which might force a recent entrant such as Fox to cut back its plans for expanding its network schedule beyond four nights per week. It would seem equally counterproductive to force Fox to divest either its network or its syndication business. The observation of either outcome would send a negative signal to any other program producers who might consider starting their own networks.[28] That is, the signal received by a program producer considering integrating into network broadcasting might be that it either has to stay small (and not be considered a network under the FCC rules) or be subject to forced divestiture of its syndication business.[29]

Finally, the positions of the parties have, quite correctly, been a focal point during this debate. As we cautioned in our earlier comments, these positions must be evaluated carefully. For example, the hypothesis that program producers should support repeal of the rules if repeal would increase efficiency does not necessarily hold once the networks' position as a purchaser and as a potential alternative to the output supplied by the program producers is taken

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major studios. See Kneale, supra note 20. See also the statement of David Gerber, CEO of MGM/UA, supra note 20.

[28] Broadcasting Magazine has reported that MCA and Paramount have considered setting up a network. *See* "Making the Fifth: MCA and Paramount Talk Network," *Broadcasting* (October 23, 1990): p. 35.

[29] The rules would not apply to Fox if it maintains its current four-night (12 hour) per week schedule. In addition, the rules have a grandfather clause, which would not force Fox to divest ownership of programs it currently owns. However, neither the grandfather clause nor the fact that the rules under Proposal I would not apply currently to Fox will prevent the rules from inefficiently deterring the future actions of Fox or other potential entrants.

into account.[30] However, the fact that Proposal I has been criticized by independent producers in addition to the networks raises serious questions about the compromise contained in Proposal I, and raises the possibility that the regulations contained in it may be worse than either complete retention or complete repeal of the rules.

E. Reporting Requirements

Both Proposal I and Proposal II require the networks to collect data and file reports with the FCC. Requiring the collection of data could prove useful in resolving the underlying policy debate empirically, and so might be an efficient requirement provided it is not overly burdensome.

The economic analyses presented during this debate point to several potentially informative empirical projects. As pointed out in our earlier comments, much of the discussion about the networks' ability to act as monopolists in the sale of syndicated programs revolves around whether an antitrust market for newly-produced off-network programs exists. For reasons explained before, we think it unlikely.[31] Since the existence of such a market is a necessary (but not sufficient) condition for the exercise of network monopoly power, the absence of empirical support for such a narrow market would weaken further any basis for retaining the rules.

Analysis of this question would generally require estimation of a

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[30] *See* Comment, *supra* note 4, pp. 21-22 and p. 14, fn. 28. The general principle put forth by those who support retention of the fin-syn rules is that a firm owning a large broadcast medium cannot also freely own the programs broadcast over it. We note that this argument would apply equally to the relationship between a large cable multi-system operator and a large media company owning pay program services broadcast on these systems, and that efficiency is unlikely to be served by a *per se* rule interfering with broadcast networks' ownership of the programs they broadcast and is equally unlikely to be served by *per se* rules that prevent companies owning pay program services from owning and operating cable systems.

[31] *See, e.g.,* Comment, *supra* note 4, pp. 23-27.

"residual demand curve" facing the firms in the market.[32] Unfortunately, such a study would require more than network participation in the reporting process. Among other things, the project would require collection of a representative set of contracts (including terms and prices from syndicators) for both off-network and first-run syndicated program sales, as well as data on costs of distribution and production of these shows.

We also note that the reporting requirements will be especially important if Proposal II is adopted. The substantial elimination of the rules over a four year period would result in a greater opportunity to examine empirically network behavior in light of the various theories (e.g., warehousing, favoritism) put forth by those favoring the rules.[33] Such information would provide a sound basis for the FCC decision either to relax substantially or to re-impose the Rules. This opportunity would not be available if Proposal I, which substantially perpetuates the effects of the current rules, is adopted.

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[32] *See, e.g.*, Baker and Bresnahan, "Estimating the Demand Curve Facing a Single Firm," *Journal of Industrial Economics* 33 (1985): 427, and Scheffman and Spiller, "Geographic Market Definition Under the U. S. Department of Justice Guidelines," *Journal of Law & Economics* 30 (April 1987): 123-148.

[33] Empirical studies of the networks' behavior prior to adoption of the rules do not support the imposition or continuation of the rules. *See, e.g.*, Crandall, "The Economic Effect of Television-Network Program 'Ownership'," *Journal of Law & Economics* 14 (October 1971): 385-412; and "FCC Regulation, Monopsony, and Network Television Program Costs," *Bell Journal of Economics and Management Science* 3 (Autumn 1972): 483-508. *See* also Woodbury, Besen, and Fournier, "The Determinants of Network Television Program Prices: Implicit Contracts, Regulation, and Bargaining Power," *Bell Journal of Economics* 14 (Autumn 1983): 351-365.

III. Conclusion

FTC staff continues to believe that the best course is to eliminate the fin-syn rules. We believe that Proposal II substantially achieves this goal. We also continue to believe that Proposal I represents the kind of compromise that might leave consumers worse off than if either complete elimination or complete retention of the current rules were chosen.