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*Phoenix Center Policy Paper Number 47:*

*An Economic Framework for Retransmission Consent*

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### *An Economic Framework for Retransmission Consent*

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*Abstract:* With the rising cost of broadcast programming and the high-profile of “blackouts,” Retransmission Consent has earned a place at the forefront of the modern communications policy debate. To provide a framework under which to evaluate the issue, we present in this PAPER an economic theory of Retransmission Consent. Taking into account the social contract between the government and broadcasters to serve the “public interest” (e.g., provide “local” programming and a “diversity of voices” to as many Americans as possible), we show that the “market” outcome for the license fee under the Retransmission Consent paradigm may not be socially efficient. Broadcast regulation creates a type of positive information externality, and private transactions do not typically account for externalities, meaning the market price for the retransmission fee is theoretically “too high,” both relative to the socially-optimal price and the market price of an otherwise-equivalent cable network. This “spread,” which we do not quantify, is a consequence of a disharmony between the historical and continuing policy of the broadcast social contract and the “market” approach embodied in the Retransmission Consent regime. In light of our findings, we review some of the policy proposals to modify Retransmission Consent. We find that because it is public policy that has caused the conflict, proposals to move to a less-regulated broadcasting market may be sensible, but it remains to be seen whether or not such legislative fixes sufficiently address the efficiency issue revealed by our theoretical model.

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**I. Introduction**

According to television lore, the first cable television system was constructed in 1948 by Robert Tarlton, a part-time television salesman hoping to increase his business by using army surplus wires to improve the poor reception of over-the-air signals in the valley town of Lansford, Pennsylvania.<sup>1</sup> Even though retransmitting broadcast television signals was the primary product of the early cable system—a role that expanded the broadcasters’ audience and thus broadcaster profits—the amicable relationship between the two industries was

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<sup>1</sup> M. Phillips, *CATV: A HISTORY OF COMMUNITY ANTENNA TELEVISION* (1972).

short-lived.<sup>2</sup> When cable systems began importing distant signals to increase the variety of programming, local broadcasters felt threatened by the service, since more channels might dilute the broadcasters' audiences.<sup>3</sup> In the late 1950's, the broadcast industry enlisted the Federal Communications Commission ("FCC") to regulate the cable industry in order to protect the economic viability, and thus widespread availability, of local broadcast signals and the public good such signals provide.<sup>4</sup> The agency's first formal rules, set in 1965, included mandatory carriage (i.e., "Must Carry"), restrictions on distant signal importation, and non-duplication of programming—rules which FCC Chairman Dean Burch (1969-1974) described as "protectionism for over-the-air broadcasting."<sup>5</sup> Beginning with the grant of spectrum to television broadcasters, the social contract between the government and the broadcast television industry has continued unabated. For many, the social significance of broadcast programming remains relevant in the modern economy, and households continue to rely heavily on broadcast stations for local news and programming.

From the early days of cable television, the laws and courts permitted cable system operators to retransmit local broadcast signals with neither the permission of—nor payment to—the broadcasters.<sup>6</sup> Advertising revenues

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<sup>2</sup> K. Webb, *THE ECONOMICS OF CABLE TELEVISION* (1983).

<sup>3</sup> S. Besen, *The Economics of the Cable Television "Consensus"*, 17 *JOURNAL OF LAW AND ECONOMICS* 39-51 (1974); R. Garay, *CABLE TELEVISION: A REFERENCE GUIDE TO INFORMATION* (1988), at p. 106; G. Shapiro, *Up the Hill and Down: Perspectives on Federal Regulation*, *THE CABLE/BROADBAND COMMUNICATIONS BOOK: VOLUME 1* (1977). D. Boudreaux and R. Ekelund Jr., *Cable Reregulation: The Triumph of Private Over Public Interest*, 44 *ALABAMA LAW REVIEW* 355-391 (1993).

<sup>4</sup> *In The Matter Of Amendment Of Subpart L, Part 11, To Adopt Rules And Regulations To Govern The Grant Of Authorizations In The Business Radio Service For Microwave Stations To Relay Television Signals To Community Antenna Systems*, 38 F.C.C. 683, *FIRST REPORT AND ORDER* (1965) at ¶ 69 (hereinafter "*First Report and Order*") ("CATV competition can have a substantial negative effect upon station audience and revenues. . .").

<sup>5</sup> Quoted in Besen, *supra n. 3*, at p. 41. FCC Commissioner Nicholas Johnson (1966-1973) described the agency's treatment of cable television as follows: "in future years, when students of law or government wish to study the decision making process at its worst, when they look for examples of industry domination by government, when they look for Presidential interference in the operation of an agency responsible to Congress, they will look to the FCC handling of the never-ending saga of cable television as a classic case study." E. Krasnow and L. Longley, *THE POLITICS OF BROADCAST REGULATION* (1973) at p. 8.

<sup>6</sup> In 1976, Congress passed the Copyright Act which required cable companies to pay royalties under a statutory compulsory license for the retransmission of any broadcast

(Footnote Continued. . .)

supported broadcast stations. Section 325 of the Cable Television Consumer Protection and Competition Act of 1992 (hereinafter “1992 Cable Act”) altered this arrangement with its Retransmission Consent mandate, which required cable systems to negotiate with a broadcaster to obtain its consent prior to retransmitting its signal and, in return for that consent, permitted the broadcaster to request compensation from the cable system.<sup>7</sup>

For more than a decade after the passage of the 1992 Cable Act, retransmission consent had little discernible effect on consumers or the video industry. Today, however, retransmission fees are on the rise, and some analysts now expect U.S. TV station owners’ retransmission fees—which equaled about \$2 billion in 2012—to reach \$7.6 billion by 2019.<sup>8</sup> Retransmission consent income is a boon to broadcasters but a cost to MVPDs. Consequently, broadcasters and the video distributors are increasingly at loggerheads over Retransmission Consent.<sup>9</sup> The rising incidence and high-profile of failed negotiations for consent and the rising cost of broadcast programming—coupled no less with the historical embrace of regulatory intervention in the broadcasting industry—have earned Retransmission Consent a place at the forefront of the modern communications policy debate.

A great deal of ink has been spilt over Retransmission Consent, but as of yet the debate has lacked an underlying economic framework with which to evaluate the reasonableness of either the current rules, proposed modifications to

programming sent over the broadcast signal. See 17 U.S.C. §§ 101, 111; 17 U.S.C. §§ 119, 122 (for satellite carriers).

<sup>7</sup> 47 U.S.C. § 325.

<sup>8</sup> See Table 1, *infra*; SNL Kagan Releases Updated Industry Retransmission Fee Projections, FIERCE CABLE (November 22, 2013) (available at: <http://www.fiercecable.com/press-releases/snl-kagan-releases-updated-industry-retransmission-fee-projections>).

<sup>9</sup> See, e.g., B. Stelter, *Next Up on Cable TV, Higher Bill for Consumers*, NEW YORK TIMES (January 3, 2010) (available at: <http://www.nytimes.com/2010/01/04/business/media/04cable.html?hp&r=0>); J. Baumgartner, *CBS Blocks TWC Broadband Subs From Accessing Full Episodes Online*, MULTICHANNEL NEWS (August 4, 2013) (available at: <http://www.multichannel.com/index.php?q=distribution/cbs-blocks-twc-broadband-subs-accessing-full-episodes-online/144786>). Interestingly, in an effort to mitigate consumer backlash from higher programming fees, some MVPDs are adding a specific “Broadcast TV Fee” as a line item on their customers’ bills. See M. Farrell, *Comcast to Introduce \$1.50 Broadcast TV Fee - MSO Says Charge Will Offset Portion of Retrans Cost Increases*, MULTICHANNEL NEWS (November 22, 2013) (available at: <http://www.multichannel.com/cable-operators/comcast-introduce-150-broadcast-tv-fee/146867>).

those rules, or the varied positions of stakeholders. As such, in this PAPER, we present a policy-relevant economic theory of Retransmission Consent (the first, to our knowledge). Our analysis is theoretical and thus abstract, but provides a policy-relevant insight, the value of which we leave to the reader to decide. Our approach is straightforward. We view broadcasters as profit-maximizing firms supplying a unique collection of television programs (e.g., sitcoms, reality shows, sporting events) as well as content that serves a significant public purpose (i.e., localism), the latter of which forms the basis for the social contract between the government and the broadcast television industry (discussed *infra*). In our model, the broadcasters receive revenues from a mix of advertising and license fees, the latter of which are paid by Multichannel Video Programming Distributors or “MVPDs” and thus such fees are a cost to the video provider. Our focus is on the determination of the retransmission license fee and its relation to the welfare-maximizing price and the price of non-broadcast video programming channels (i.e., cable networks).

Our examination of Retransmission Consent exposes the fundamental difference between broadcast stations and non-broadcast cable networks. While the profit-maximizing choices of the broadcast and non-broadcast programmers are identical in form, the welfare implications of the pricing decisions are not the same. This difference arises from the presence of a social contract between the government and broadcasters—but not cable channels—to serve the “public interest” (e.g., provide “local” programming and a “diversity of voices” to as many Americans as possible)—a contract that has provided broadcasters with favorable legislative and regulatory treatment over the years. This social contract embeds a positive information externality in the local broadcast signal, driving a wedge between socially- and privately-optimal prices. More plainly, embedded in U.S. communications law is a clear preference for the widespread “consumption” of broadcast programming due to its socially-valuable nature, whether it is provided over-the-air or over MVPD networks.<sup>10</sup> Yet, with Retransmission Consent, Congress also embraced a market approach to the license fee for broadcast signals, intending broadcasters to engage MVPDs in arm’s-length negotiations over retransmission fees. While the income from such fees may help fund public interest programming, the consent negotiations may

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<sup>10</sup> See *In the Matter of Amendment of the Commission’s Rules Related to Retransmission Consent*, FCC 11-31, 24 FCC Rcd 2718, NOTICE OF PROPOSED RULEMAKING (rel. March 3, 2011) (hereinafter “2011 NPRM”) at ¶ 16 (“recognizing the consumer harm caused by retransmission consent negotiation impasses and near impasses, the Commission seeks comment on certain proposals to modify the rules governing retransmission consent.”).

in some instances lead to higher retransmission fees (and thus high MVPD prices) and in some instances fail altogether, thereby reducing the availability and “consumption” of the broadcast signal over MVPD networks. There is plainly a disharmony between a policy of promoting the widespread availability of socially-valuable broadcast programming and then leaving the choice on availability to private negotiations. As with most regulatory interventions, it appears that the video industry on the regulatory slippery slope—the social contract and Retransmission Consent appear at odds, and now public policy is being called upon to solve what some believe to be a significant problem. Since, in our view, it is public policy that has caused the conflict, proposals to move to a less-regulated broadcasting market—such as the Next Generation Television Marketplace Act<sup>11</sup>—are viewed as sensible, but it remains to be seen whether or not such legislative fixes sufficiently address the efficiency issue revealed by our theoretical model.

In light of our findings, we evaluate several of the proposed policy modifications to the retransmission regime. For example, some argue that the Commission should enforce the concept of “good faith” negotiations to reduce the incidence of broadcast signal blackouts over MVPD networks. Others want the FCC to modify its decades-old Must Carry and distant signal importation rules. Some proposed solutions, if not most of them, require legislative action, and bills are being drafted, some adding regulations while others remove them. At the extreme, some argue that Congress could scrap the entire broadcast regulatory regime altogether, auctioning off the broadcast spectrum to the highest bidder.<sup>12</sup> Our conceptual framework may be used to evaluate most if not all of these proposals.

To begin, in Section II we provide a brief history of the 1992 Cable Act’s Retransmission Consent regulations. In Section III we present our theory of Retransmission Consent. Policy options are discussed in Section IV, with conclusions provided in the final section.

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<sup>11</sup> Text of the bill (H.R. 3720) is available at: <http://www.gpo.gov/fdsys/pkg/BILLS-113hr3720ih/pdf/BILLS-113hr3720ih.pdf>.

<sup>12</sup> An option discussed most forcefully in T. Hazlett, *If A TV Station Broadcasts In The Forest: An Essay On 21st Century Video Distribution*, study commissioned by the American Television Alliance (2011) (available at: <http://www.americantelevisionalliance.org/wp-content/uploads/2011/05/TV-Future-TWH-5-19-111.pdf>).

## II. Broadcast Regulation: Must Carry, Retransmission Consent, and Copyright

Like the media business, broadcast legislation and regulation is complex, and payments among industry participants are governed by both communications and copyright laws. In order to provide the reader with some clarity, we present a highly-simplified description of each regime below.

### A. *Must Carry*

Since the beginnings of the FCC's regulation of cable television, cable operators were required to retransmit the signals of local broadcasters, and limited in their ability to retransmit distant signals.<sup>13</sup> Both regulations were aimed at protecting the broadcast industry from the consequences of an increasingly successful cable television industry that was diluting broadcast audiences. Such rules are part of the broadcasters' social contract, where in return for protection from cable television, the broadcasters would continue to provide "localism" and other government-preferred types of content and services. In Section 614 the 1992 Cable Act,<sup>14</sup> Congress—fearing that the "economic viability of free local broadcast television and its ability to originate quality local programming [was being] seriously jeopardized"<sup>15</sup> by cable television—codified these Must Carry obligations,<sup>16</sup> concluding:

[The] Federal Government has a substantial interest in having cable systems carry the signals of local commercial television stations because the carriage of such signals is necessary to serve the goals contained in section 307(b) of the Communications Act of 1934 of providing a fair, efficient, and equitable distribution of broadcast services.<sup>17</sup>

Must Carry is rich in its implications. First, Congress believed that the broadcast signal includes information that is vital to society; so vital, in fact, that the law requires the signals to be carried irrespective of the wishes of and First

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<sup>13</sup> See, e.g., *First Report and Order*, *supra* n. 4.

<sup>14</sup> 47 U.S.C. § 534.

<sup>15</sup> *Id.*

<sup>16</sup> 1992 Cable Act Preamble Section 2(a)(16), 47 U.S.C. § 521 nt.

<sup>17</sup> *Id.*, Section 2(a)(9).



Amendment rights of the MVPD.<sup>18</sup> Furthermore, Must Carry rules require that such signals appear in the most basic tier of such packages so that *all* subscribers get the signals. (Satellite carriers operate under a different “carry one, carry all” standard.)<sup>19</sup>

Second, Must Carry implies that Congress views broadcast signals as an essential component of any multichannel video distribution service—i.e., *over-the-air transmission is not enough*. As noted above, the Preamble to the 1992 Cable Act concludes the “Federal Government has a substantial interest in having cable systems carry the signals of local commercial television stations,”<sup>20</sup> going so far as to state that,

Consumers who subscribe to cable television often do so to obtain local broadcast signals which they otherwise would not be able to receive, or to obtain improved signals. Most subscribers to cable television systems do not or cannot maintain antennas to receive broadcast television services, do not have input selector switches to convert from a cable to antenna reception system, or cannot otherwise receive broadcast television services.<sup>21</sup>

Thus, Must Carry rules reflect a key component of the social contract—Congress and the FCC want the broadcast signals to be widely available both over-the-air and over MVPD networks since such signals are believed to embed a social good (i.e., an information externality).

#### B. *Retransmission Consent*

The 1992 Cable Act also brought us Retransmission Consent regime. While the Must Carry obligations had been around for over four decades, prior to 1992 cable television systems were not required to either obtain consent or to compensate broadcasters when retransmitting their signals. Section 325 of the 1992 Cable Act fundamentally changed the relationship between broadcasters

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<sup>18</sup> See, e.g., *Turner Broadcasting v. FCC*, 520 U.S. 180 (1997), where the Supreme Court determined that the breach of the First Amendment rights of cable operators could be supported on public interest grounds.

<sup>19</sup> 47 U.S.C. 338(a)(1). The “carry one, carry all” standard requires a satellite provider to carry all locations stations in a market if it carries one local station.

<sup>20</sup> 1992 Cable Act Preamble Section 2(a)(9), 47 U.S.C. § 521 nt.

<sup>21</sup> 1992 Cable Act Preamble Section 2(a)(17), 47 U.S.C. § 521 nt.

and cable systems. The current Retransmission Consent regulations can be summarized as follows:<sup>22</sup>

Pursuant to the statutory provisions, television broadcasters elect every three years whether to proceed under the mandatory carriage (“Must Carry”) requirements of Sections 338 and 614 of the Communications Act, or the Retransmission Consent requirements of Section 325 of the Communications Act. There are important differences between the Retransmission Consent and Must Carry regimes.

On the one hand, a broadcaster electing “Must Carry” status is guaranteed carriage on MVPD systems in its market, and the MVPD is generally prohibited from accepting or requesting compensation for carriage. (This rule is obviously a meaningful and one-sided departure from a free market transaction.) As an alternative to seeking mandatory carriage, a broadcaster may elect carriage under the Retransmission Consent rules, which allow for negotiations with cable operators and other MVPDs for carriage. A broadcaster electing Retransmission Consent may accept or request compensation for carriage in Retransmission Consent negotiations. Under Section 325(b)(1)(A) of the Act, if a broadcaster electing Retransmission Consent and an MVPD are unable to reach an agreement, or do not agree to the extension of an existing agreement prior to its expiration, then the MVPD may not retransmit the broadcasting station’s signal because the signal cannot be carried without the broadcast station’s consent.<sup>23</sup> If a deal cannot be reached with the MVPD, the broadcast station can invoke Must Carry at the next three-year term.

### C. Copyright

Fees paid by MVPDs to retransmit broadcast signals fall into two categories based on whether the broadcast signal is a local signal (serving the same market

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<sup>22</sup> For an in-depth analysis of the legislative history of Must Carry and retransmission, we recommend C. Lubinsky, *Reconsidering Retransmission Consent: An Examination of the Retransmission Consent Provision (47 U.S.C. § 325(b)) of the 1992 Cable Act*, 48 FEDERAL COMMUNICATIONS L. J. 99 (1996).

<sup>23</sup> See 2011 NPRM, *supra* n. 10 at ¶¶ 4-7. The FCC has vigorously enforced its Retransmission Consent rules. Indeed, the agency recently proposed the largest fine in history (\$2.25 million) when it found that an MVPD had retransmitted a broadcaster’s signal without prior consent. *In the Matter of TV Max, Inc. and Broadband Ventures Six, LLC d/b/a Wavevision, Thomas M. Balun, Eric Meltzer, and Richard Gomez, et al.* FCC 13-86, 28 FCC Rcd 9470, NOTICE OF APPARENT LIABILITY FOR FORFEITURE AND ORDER (rel. June 25, 2013).

as the MVPD) or a distant signal that is not available (broadly) to viewers over the air. Retransmission Consent fees are *not* intended to be a direct payment for copyrighted programming sent over the broadcast signal. Retransmission Consent, governed by Section 325 of the Communications Act,<sup>24</sup> is a negotiated payment by the MVPD to the local broadcaster for the right (consent) to retransmit the broadcast signal and embeds no specific payment under Copyright Law.<sup>25</sup> Customers of cable systems not within the over-the-air footprint of broadcast station typically receive distant broadcast signals in their place, normally from the most proximate broadcast stations. MVPDs are not required to obtain consent to retransmit distant signals. Instead, such retransmissions are covered (eponymously) by the Copyright Act of 1976, which establishes a mandatory statutory compulsory license for *distant signal retransmissions*. The regulated fees paid by MVPDs for distant signals are collected by the Copyright Office for later dispensation to creators of content.<sup>26</sup>

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<sup>24</sup> See 47 U.S.C. § 325.

<sup>25</sup> As the retransmission fight intensifies, much attention is being paid to the Second Circuit's recent decision in *WNET v. Aereo*, 712 F.3d 676 (2<sup>nd</sup> Cir.), *rehearing en banc denied*, 722 F.3d 500 (2013) and *Petition for Certiorari Filed* (October 11, 2013)(No. 13-461). There, the Second Circuit ruled that Aereo's service—whereby through a series of individual antennas and remote hard-drives Aereo allows its subscribers to record and view over-the-air broadcast programming via the Internet on various devices—acts like a cloud-based digital video recorder (“DVR”) and, as such, did not constitute a “public performance” under the “Transmit Clause” contained in Section 101 of the Copyright Act. (17 U.S.C. § 101). Yet, often ignored in this discussion are two other recent district court rulings—one from the the Central District of California; the other from the District of Columbia—granting preliminary injunction against a similar services on the grounds that such a service does, in fact, constitute a “public performance” under Section 101. See *Fox Television Stations, Inc., et al. v. Barrydriller Content Systems, PLC, et al.*, 915 F. Supp. 2<sup>nd</sup> 1138 (C.D. Cal. 2012), *appeal docketed sub nom., Fox Television Stations, Inc. v. Aereokiller, LLC*, No. 13-55156 (9<sup>th</sup> Cir. filed Jan. 25, 2013); *Fox Television Stations v. FilmOn X*, \_\_ F. Supp. \_\_ (D.D.C. Sept. 5, 2013). Whether the Ninth and DC Circuits respectively uphold the District Courts and, if so, whether the Supreme Court will eventually settle the potential split between the Circuits, only time will tell. Regardless, it is important to recognize that none of the cases directly addressed the issue of retransmission rights under Section 325 of the Communications Act (presumably because the defendants were not MVPDs), but only whether the defendants were subject to the Copyright Act. For this reason, these cases add little insight to the issue we seek to explore in this PAPER. See also L. Spiwak, *The Curious Cases of Aereo, BarryDriller and FilmOn X*, @LAWANDECONOMICS (October 3, 2013) (available at: <http://phoenix-center.org/blog/archives/1495>).

<sup>26</sup> See, e.g., 17 U.S.C. § 111 (statutory license for secondary transmissions by cable systems); 17 U.S.C. § 119 (statutory license for certain secondary transmissions made by satellite to distant television programming viewers); 17 U.S.C. § 122 (secondary transmission of local television programming by satellite). This regime is administered by the Copyright office in the Library of Congress. See <http://www.copyright.gov/licensing>. For a review of the license, see F. Cate, *Cable Television and the Compulsory Copyright License*, 42 FED. COMM. L. J. 191 (1990). *Fox Television Stations*

(Footnote Continued. . .)

Section 325 did not affect the rules governing distant signals: Section 325(b)(6), which specifically states that: “Nothing in this section shall be construed as modifying the compulsory copyright license established in section 111 of title 17 or as affecting existing or future video programming licensing agreements between broadcasting stations and video programmers.”<sup>27</sup>

Over the years, the compulsory license has come under harsh criticism for purportedly creating distortions in the market.<sup>28</sup> In 2011 the Register of Copyrights recommended – over broadcaster and some MVPD objections<sup>29</sup> – that Congress sunset the compulsory license as “an artificial construct created in an earlier era.”<sup>30</sup> The existing relationship between copyright and communications law for the multichannel video industry appears in flux.

### III. The Rise in Retransmission Consent Disputes

When the 1992 Cable Act was first passed, most broadcasters elected carriage under the Must Carry rules in the early years following enactment of the new regime. As the market evolved and broadcasters started to take advantage of the retransmission regime, in-kind compensation rather than cash was the norm (e.g., carriage of affiliated cable networks, advertising time, and so forth).<sup>31</sup>

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*v. Barrydriller Content Systems*, *supra* n. 26, 915 F. Supp. at 1146 (citations omitted). Satellite providers pay content owners under the compulsory license of Section 119 of the Copyright Act.

<sup>27</sup> See 47 U.S.C. § 325(b)(6).

<sup>28</sup> See, e.g., Cate, *supra* n. 27; A. Thierer, *Toward a True Free Market in Television Programming*, FORBES (Feb. 19, 2012) (available at: <http://www.forbes.com/sites/adamthierer/2012/02/19/toward-a-true-free-market-in-television-programming>) (“Compulsory licensing is the original sin of video marketplace regulation.”)

<sup>29</sup> United States Copyright Office – Register of the Copyrights, *Satellite Television Extension and Localism Act § 302 Report* (August 29, 2011) at p. 39 (According to comments filed by the NAB, “eliminating the statutory licenses permitting local carriage of stations could impair the ability of broadcasters to reach all households within their local markets, and ‘unacceptably damage the continuing effectiveness of our unique American system of free local broadcasting’ and the ‘premise and promise of localism upon which it is founded.’”) (available at: <http://www.copyright.gov/reports/section302-report.pdf>).

<sup>30</sup> *Id.* at iii.

<sup>31</sup> C.B. Goldfarb, *Retransmission Consent and Other Federal Rules Affecting Programmer-Distributor Negotiations: Issues for Congress*, CRS Report for Congress, Library of Congress (July 9, 2007) (available at: <https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&cad=rja&ved=0CDMQFjAB&url=http%3A%2F%2Fresearch.policyarchive.org%2F19204.pdf&ei=cGCvUjBC6bN2QXM9o>)

(Footnote Continued. . . .)

Today, broadcasters are increasingly seeking and receiving monetary compensation (in addition to other concessions) from MVPDs in exchange for consent to the retransmission of their signals.<sup>32</sup> According to the FCC's *Information Needs Report*, "Broadcasters are demanding and getting higher payments for their programming from cable companies in the form of 'retransmission' fees."<sup>33</sup> These higher payments are driven, in large part, by the high popularity of broadcast station programming (and, some argue, in part by regulation) and the transition from a zero-price regime.

**Table 1. Local Broadcast TV Revenues and Blackouts<sup>34</sup>**

Year	Advertising Revenues (\$ Bil)	Retransmission Fees (\$ Bil)	Local TV Blackouts
2004	22.4	...	...
2005	21.0	...	...
2006	22.8	...	...
2007	21.5	0.324	...
2008	20.3	0.471	...
2009	15.8	0.705	...
2010	19.4	1.034	12
2011	17.9	1.445	51
2012	19.7 <sup>e</sup>	1.906 <sup>e</sup>	91
2013	19.1 <sup>e</sup>	2.366 <sup>e</sup>	80 <sup>y</sup>
2014	20.3 <sup>e</sup>	2.845 <sup>e</sup>	...
2015	19.9 <sup>e</sup>	3.282 <sup>e</sup>	...

e. Estimate/Forecast. y. As of August 2013.

Table 1 summarizes the recent trends and forecasts in advertising and retransmission fee revenues for local broadcast stations (including, but not limited, network affiliates). With the exception of a downturn during the 2008 recession, advertising revenues for broadcast television hover around \$20 billion

[HYCQ&usg=AFQjCNH7eAYfxjqidwf9\\_E6Opusc9KZgA&sig2=gebQOIos10RB2mCF4CAyNg&bv m=bv.57967247,d.b2l](http://www.fcc.gov/infoneedsreport)).

<sup>32</sup> 2011 NPRM, *supra* n. 10 at ¶ 2.

<sup>33</sup> Steven Waldman and the Working Group on Information Needs of Communities, THE INFORMATION NEEDS OF COMMUNITIES, Federal Communications Commission (July 2011) (available at: [www.fcc.gov/infoneedsreport](http://www.fcc.gov/infoneedsreport)) (hereinafter "*Information Needs Report*") at p. 76.

<sup>34</sup> Revenue figures from STATE OF THE MEDIA 2013, Pew Research Center (2013) (available at: <http://stateofthemediamedia.org/2013/local-tv-audience-declines-as-revenue-bounces-back>); Blackout data from the American Television Alliance (available at: <http://www.americantelevisionalliance.org/wp-content/uploads/2013/09/ATVA-intro-packet2.pdf>).

annually. Retransmission fees were below \$1 billion prior to 2010, but estimates indicate such fees doubled between 2010 and 2012, and are expected to increase another 70% between 2012 and 2015. One forecast puts retransmission fees at \$7.6 Billion by 2019.<sup>35</sup>

In the final column of Table 1 is a count of local broadcast blackouts from retransmission disputes. As would be expected, the number of disputes leading to blackouts has increased with rising retransmission fees. So why do we see a rise in retransmission disputes? There are likely many explanations, but perhaps all go back to the basic economic principle that demand curves slope downward so that as price rises fewer MVPDs are willing to pay the fee.<sup>36</sup> As shown in Table 2, blackouts are more common as retransmission fee income rises. Also in Table 2 we see that that retransmission fees did not amount to much in the early years after the signing of the 1992 Cable Act; it took eighteen years before retransmission fees totaled one-billion dollars.

An interesting question is why fees have risen so significantly in recent years? First, without question, broadcast *network* programming (in particular prime-time programming and sporting events) is extremely popular. The top twenty-five programs on the broadcast networks often attract over twice the viewership as the top programs on cable networks.<sup>37</sup> A significant number American consumers enjoy and view broadcasters' network programming and, as such, broadcasters merit appropriate compensation for producing and delivering such programming.<sup>38</sup>

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<sup>35</sup> *Supra* n. 8.

<sup>36</sup> Higher costs reduce profits. See J. Tirole, *THE THEORY OF INDUSTRIAL ORGANIZATION* (1995), at pp. 66-7. Since both parties presumably benefit from retransmission, it is probably that blackouts are part of a negotiation strategy more than they are a long-term outcome of a negotiation.

<sup>37</sup> See, e.g., A. Kondolojy, *Cable Top 25: 'Monday Night Football' Tops Cable Viewership for the Week Ending December 15, 2013*, ZAP2IT (December 17, 2013)(available at: <http://tvbythenumbers.zap2it.com/2013/12/17/cable-top-25-monday-night-football-tops-cable-viewership-for-the-week-ending-december-15-2013/223182>) and A. Kondolojy, *TV Ratings Broadcast Top 25: "Sunday Night Football" Tops Week 12 With Adults 18-49, "NCIS" Leads Total Viewers*, ZAP2IT (December 17, 2013) (available at: <http://tvbythenumbers.zap2it.com/2013/12/17/tv-ratings-broadcast-top-25-sunday-night-football-tops-week-12-with-adults-18-49-ncis-leads-total-viewers/223116>).

<sup>38</sup> See, e.g., H. Lewis, *Les Moonves Calls Time Warner Cable Letter "A Well-Wrought Distraction"*, *THE HOLLYWOOD REPORTER* (August 6, 2013) (According to CBS President Les Moonves, "CBS is the most popular programmer in the world. \*\*\* Why can't [an MVPD] see your way clear to honestly

(Footnote Continued. . . .)

According to some analysts, another key contributing factor to rising retransmission prices is the recent and rapid rise of MVPD competition, a change in industry structure that improves the bargaining position of broadcasters (and cable networks as well) in retransmission negotiations. As the FCC recently recognized:

In 1992, the only option for many local broadcast television stations seeking to reach MVPD customers in a particular Designated Market Area (“DMA”) was a single local cable provider. Today, in contrast, many consumers have additional options for receiving programming, including two national direct broadcast satellite (“DBS”) providers, telephone providers that offer video programming in some areas, and, to a degree, the Internet. One result of such changes in the marketplace is that disputes over retransmission consent have become more contentious and more public, and we recently have seen a rise in negotiation impasses that have affected millions of consumers.<sup>39</sup>

So, while the increase in competition among video providers brings benefits to consumers, it also increases the bargaining power of the content providers, which could, in turn, increase end-user prices. In a competitive distribution market, content is king.

The fragmentation of the MVPD market is well documented. At the time the 1992 Cable Act was passed, it was widely acknowledged that operators possessed “a local monopoly over cable households” and, therefore, cable operators could “thus exercise control over most (if not all) of the television programming that is channeled into the subscriber's home [and] can thus silence the voice of competing speakers with a mere flick of the switch.”<sup>40</sup> Over twenty

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paying for what your customers value most?” (available at: <http://www.hollywoodreporter.com/news/les-moonves-calls-time-warner-600213>).

<sup>39</sup> 2011 NPRM, *supra* n. 10 at ¶ 2; *see also* Information Needs Report, *supra* n. 33 at p. 299 (“Changes in the marketplace have led to disputes over retransmission consent becoming more contentious and more public, and we have recently seen a rise in negotiation impasses that have affected millions of consumers.”)

<sup>40</sup> *Turner Broadcasting System, Inc., v. FCC*, *supra* n. 18, 520 U.S. at 197; *see also* 1992 Cable Act Preamble Section 2(a)(2), 47 U.S.C. §521 nt. (“For a variety of reasons, including local franchising requirements and the extraordinary expense of constructing more than one cable television system to serve a particular geographic area, most cable television subscribers have no opportunity to select between competing cable systems. Without the presence of another multichannel video

(Footnote Continued. . .)

years later, however, the MVPD market has radically changed. According to the FCC's just-released *Fifteenth Report* on the assessment of competition in the market for the delivery of video programming, not only do nearly 131 million (approximately 99%) of American homes have access to three MVPDs (one terrestrial cable and two satellite providers), but that an amazing 46.8 million homes (approximately 35.3%) have access to four MVPDs (two terrestrial and two satellite).<sup>41</sup> Indeed, as the Commission wryly states in the *Fifteenth Report*, "since the Commission's first report on the status of competition in 1995, almost no subscriber has fewer MVPD choices and most subscribers have more MVPD choices."<sup>42</sup>

A change in relative bargaining power has predictable effects on the outcomes of negotiations. The influence of MVPD competition on the retransmission negotiations is explained in a 2009 paper by Michael Katz, Jonathan Orszag, and Theresa Sullivan.<sup>43</sup> In this discussion, the authors consider a hypothetical and abstract negotiation between an MVPD and a broadcast station owner regarding the retransmission of the broadcaster's signal. Retransmission increases the audience size of the broadcaster and the demand for the MVPD's service, so both parties have something to gain from a deal. The negotiation is, in effect, about how to share these gains between the two parties. The argument shows that the ability of the broadcaster to play the MVPDs off one another, each fearing a loss of subscribers to the other without retransmission, permits the broadcaster to extract more in retransmission fees. (Notably, the same argument applies to cable channels.)<sup>44</sup>

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programming distributor, a cable system faces no local competition. The result is undue market power for the cable operator as compared to that of consumers and video programmers.")

<sup>41</sup> *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, FIFTEENTH REPORT, FCC 13-99, 28 FCC Rcd 10496 (rel. July 22, 2013) at ¶ 36 and Table 2 (hereinafter "*Fifteenth Cable Report*").

<sup>42</sup> *Id.* at ¶ 37.

<sup>43</sup> M. L. Katz, J. Orszag, and T. Sullivan, *An Economic Analysis of Consumer Harm from the Current Retransmission Consent Regime*, Study Commissioned by the National Cable & Telecommunications Association, DirecTV, and Dish Network (November 12, 2009) (available at: [http://97.74.209.146/downloads/analysis\\_consumer\\_harm.pdf](http://97.74.209.146/downloads/analysis_consumer_harm.pdf)).

<sup>44</sup> Under some conditions, an asymmetry in bargaining power has no welfare implications, implying no gain from interventions directed at altering bargaining power. See T.R. Beard, G.S. Ford and L.J. Spiwak, *Market Definition and the Economic Effects of Special Access Price Regulation*, PHOENIX CENTER POLICY PAPER No. 37 (October 2009) (available at: <http://www.phoenix-center.org/pcpp/PCPP37Final.pdf>).



The evidence seems to support the theory. In the recent high-profile transmission dispute between Time Warner and CBS, for example, Time Warner's Chief Executive Rob Marcus stated that "[t]he issues that were at stake in this negotiation had such significant implications and long-term implications that we felt like we were left with no choice." Indeed, it was later claimed by Time Warner that it lost 100,000 to 150,000 subscribers directly as a result of the black out.<sup>45</sup> In contrast, CBS Chief Executive Leslie Moonves observed the impasse "didn't hurt us one iota financially."<sup>46</sup> In a negotiation, patience enhances bargaining power: "[a] key principle [] is that a player's bargaining power is higher the less impatient she is relative to the other negotiator. ... Indeed, patience confers bargaining power."<sup>47</sup> The relative bargaining power consequences of increased competition in the MVPD market appear plain—MVPD competition improves the bargaining power of the broadcaster. The same logic applies to cable networks as well, which explains, in part, the general rise in programming costs in the MVPD market.<sup>48</sup>

#### IV. Economic Model of Retransmission Consent

Our intent is to craft an informed and policy-relevant economic framework that permits the assessment of Retransmission Consent, the rules governing it, and the proposal to change it. No model can capture all the intricacies of such a complex issue, and economic models are by necessity abstractions. But we believe our model offers a meaningful contribution to the debate. As we see it, the arguments in the Retransmission Consent dispute mostly point to a scenario where one set of regulations (Must Carry, distant signal rules, the compulsory Copyright license, and so forth) potentially give birth to another set of

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<sup>45</sup> J. Pepitone, *Time Warner Cable Lost 300,000 Subscribers Amid CBS Blackout*, CNN MONEY (October 31, 2013) (available at: <http://money.cnn.com/2013/10/31/technology/time-warner-cable-cbs/>).

<sup>46</sup> S. Ramachandran, *Time Warner Cable Says It Lost Customers in Blackout*, WALL STREET JOURNAL (September 11, 2013) (available at: <http://online.wsj.com/article/SB10001424127887323595004579069534186893544.html>).

<sup>47</sup> A. Muthoo, *The Economics of Bargaining*, in KNOWLEDGE FOR SUSTAINABLE DEVELOPMENT: AN INSIGHT INTO THE ENCYCLOPEDIA OF LIFE SUPPORT SYSTEMS, UNESCO and EOLSS: EOLSS Publishers Co. Ltd. (2002).

<sup>48</sup> Naturally, the buyer side of the market will seek ways to level out the bargaining power, perhaps through consolidation. See, e.g., T. Spangler, *Cable Show: Rising TV Programming Costs Could Spur Cable Consolidation*, VARIETY (June 10, 2013) (available at: <http://variety.com/2013/biz/news/cable-show-rising-tv-programming-costs-could-spur-cable-consolidation-1200494965/>).

regulations (which in turn we suspect have children of its own in the future). It is commonly argued that regulation should not even be considered in the absence of a demonstrable market failure.<sup>49</sup> We provide such a demonstration here, and that, we believe, is our contribution. This failure, however, is a consequence of regulatory intervention (as they commonly are). Thus, the remedial options include reducing regulation to attenuate or eliminate the market failure, adding regulation to address it, or, of course, doing nothing. All three options have been proposed in various forms.

There are a number of significant institutional features that must jointly be considered in our modeling effort, if only by approximation. By far, though, the most significant feature of the broadcasting model is that broadcasters have entered into a social contract with the government (as an agent of the people) to serve the “public interest,” and this contract differentiates broadcasters from non-broadcast cable networks (which have no social obligation). Additionally, Retransmission Consent makes the broadcast model more like the cable network model by permitting revenues from both advertising and license fees. We account for both features in our model. Prior to detailing our economic model, we provide a brief description of the social contract, and how its form influences the incentives of the broadcasters.

#### A. Broadcasters and the “Social Contract”

The presence of a social contract is an important element in our economic model, and is critical to the insights provided by the analysis. At its core, the social contract involves broadcasters providing society with “public interest”

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<sup>49</sup> See, e.g., Statement of The Honorable Robert M. McDowell, *Improving FCC Process*, Before the Subcommittee on Communications and Technology Committee on Energy & Commerce United States House of Representatives (July 11, 2013) at p. 4 (“Regulators should be wary of issuing ex ante regulations in the absence of evidence of market failure.”) (available at: <http://democrats.energycommerce.house.gov/sites/default/files/documents/Testimony-McDowell-CT-Improving-FCC-Process-2013-7-11.pdf>); Testimony of Randolph J. May, *Evolution of Wired Communications Networks*, Before the Subcommittee on Communications and Technology Committee on Energy and Commerce, U.S. House of Representatives (October 23, 2013) at p. 1 (“FCC’s future regulatory activity should be tied closely to findings of demonstrable market failure and actual consumer harm”) (available at: [http://www.freestatefoundation.org/images/Testimony\\_of\\_Randolph\\_May\\_-\\_Evolution\\_of\\_Wired\\_Communications\\_Networks\\_-\\_October\\_23,\\_2013.pdf](http://www.freestatefoundation.org/images/Testimony_of_Randolph_May_-_Evolution_of_Wired_Communications_Networks_-_October_23,_2013.pdf)).

programming in return for regulatory and legislative preferences.<sup>50</sup> As the Supreme Court has repeatedly recognized, “[a] licensed broadcaster is granted the free and exclusive use of a limited and valuable part of the public domain; when he accepts that franchise it is burdened by enforceable public obligations.”<sup>51</sup>

For nearly eight decades, the concept of “localism”—along with “competition” and “diversity of voices”—has been a core pillar of U.S. broadcasting “public interest” policy priorities.<sup>52</sup> The arrangement is explicit and continuing. While the relationship was formalized in the Communications Act of 1934 and aggressively enforced in the early regulation of cable television, the general sentiment of broadcast protectionism remains. For example, Section 2(a)(10) of the preamble of the 1992 Cable Act states that a “primary objective and benefit of our Nation’s system of regulation of television broadcasting is the local origination of programming. There is a *substantial governmental interest* in ensuring its continuation.”<sup>53</sup> And Section (2)(a)(11) of the preamble states that “Broadcast television stations continue to be an important source of local news and public affairs programming and other local broadcast services critical to an *informed electorate*.”<sup>54</sup> FCC Chairman Michael Powell (2001-2005) observed,

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<sup>50</sup> For a non-exclusive list of various “public interest” obligations to which broadcasters are subject, see Benton Foundation, *The Public Interest Standard in Television Broadcasting* (available at: [http://benton.org/initiatives/obligations/charting\\_the\\_digital\\_broadcasting\\_future/sec2](http://benton.org/initiatives/obligations/charting_the_digital_broadcasting_future/sec2)).

<sup>51</sup> *FCC v. Fox Television Stations, Inc.*, 129 S.Ct. 1800, 1806 (2009), citing *CBS, Inc. v. FCC*, 453 U.S. 367, 395 (1981) (Emphasis supplied).

<sup>52</sup> See, e.g., Communications Act Section 307(b), 47 U.S.C. §307(b) (“...the Commission shall make such distribution of licenses, frequencies, hours of operation, and of power among the several states and communities as to provide a faire, efficient and equitable distribution of radio service to each of the same”); *NBC v. United States*, 319 U.S. 190, 216 (1943) (“an important element of public interest and convenience affecting the issue of a license is the ability of the licensee to render the best practicable service to the community reached by [its] broadcasts”); *In the matter of 2002 Biennial Regulatory Review – Review of the Commission’s Broadcast Ownership Rules and Other Rules Adopted Pursuant to Section 202 of the Telecommunications Act of 1996*, FCC 02-249, 17 FCC Rcd 18503, NOTICE OF PROPOSED RULEMAKING (rel. Sept. 23, 2002) at ¶69 (citing, Cable Television Consumer Protection and Competition Act of 1992, Conference Report Congressional Findings and Policy Section 2(10), Pub. L. 102-385, §§ 2(a) (10), October 5, 1992, 106 Stat. 1460 (“[a] primary objective and benefit of our nation’s system of regulation of broadcast television is the local origination of programming.”)); *In the Matter of Promoting Diversification of Ownership In the Broadcasting Services*, FCC 07-217, 23 FCC Rcd 3489, REPORT AND ORDER AND THIRD FURTHER NOTICE OF PROPOSED RULEMAKING (rel. March 5, 2008).

<sup>53</sup> 1992 Cable Act Preamble Section 2(a)(10), 47 U.S.C § 521 nt. (Emphasis supplied).

<sup>54</sup> *Id.* at Section 2(a)(11). (Emphasis supplied).

“[f]ostering localism is one of this Commission’s core missions .... [T]he public still looks first to the broadcast industry to serve its localism needs.”<sup>55</sup> (Presumably, if the FCC must foster localism, then the belief is that market cannot be counted on to provide it.) Even the *National Broadband Plan* of 2010 observes, “as a universally available, free over-the-air medium, television broadcasting has long been required to fulfill certain public interest and technical requirements.”<sup>56</sup> Table 2 shows that the broadcasters continue to be a dominant source of news for the American public.<sup>57</sup>

**Table 2. Primary Source of News (Adults 18+)**

Source	News Share	Local News Share
Broadcast Television	37.4%	49.7%
Cable News Channels	10.2%	3.6%
Radio	6.0%	6.5%
Newspapers	10.1%	2.4%
Internet	17.2%	17.1%
Public TV	7.2%	6.7%
Mobile	1.6%	6.3%
No Primary Source	10.4%	7.7%

Source: TV Basics, tvb.org (June 2012).

The broadcast community acknowledges the social contract. The National Association of Broadcasters (“NAB”) has stated the issue plainly:

Broadcasters’ use of the spectrum is unique. Broadcasters differ from all other spectrum users because of their “contract” with the

<sup>55</sup> *In re Broadcast Localism*, FCC 04-129, 19 FCC Rcd 12425, NOTICE OF INQUIRY (rel. July 1, 2004), Concurring Statement of Chairman Michael Powell (“Fostering localism is one of this Commission’s core missions.... That said, even as audiences continue to fragment across an increasingly diverse and competitive media marketplace, and at a time in which they have access to more local content than at any time in our nation’s history, the public still looks first to the broadcast industry to serve its localism needs.”).

<sup>56</sup> CONNECTING AMERICA: THE NATIONAL BROADBAND PLAN, Federal Communications Commission (March 16, 2010) (available at: [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-296935A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-296935A1.pdf)) (hereinafter the *National Broadband Plan*) at p. 89.

<sup>57</sup> *TV Basic*, TVB.org (Updated June 2012) at pp. 25-6 (available at: [http://www.tvb.org/media/file/TV\\_Basics.pdf](http://www.tvb.org/media/file/TV_Basics.pdf)).

government to provide public interest programming free to the American public.<sup>58</sup>

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From the very beginning, broadcast licenses have been awarded as part of a “contract” between government and broadcaster. *In exchange for use of part of the spectrum, broadcasters have agreed to provide programming which is in “the public convenience and necessity.”*<sup>59</sup>

The FCC recently re-affirmed the relevance of the social contract, stating the needs to be some *quid pro quo* for the granting of the broadcast license in exchange for providing “significant treatment of community issues” as part of that bargain. As the FCC’s recent *Information Needs Report* concludes,

In return for this exclusive government license, incumbent broadcasters offered to provide public service. These later became known as the broadcasters “public interest obligations.” The trade of public airwaves for public interest obligations was the “social contract” between broadcasters and the public. ... [T]he spectrum belongs to the public, and the public lent it to broadcasters. In that sense, taxpayers (through their governmental representatives) have every right to demand certain behavior—the *quo* that was supposed to be part of the original *quid pro quo*.<sup>60</sup>

Quite literally, the FCC’s Working Group confirmed the presence of the “social contract” and *quid pro quo* between society and the broadcasters. While the *Information Needs Report* found that the “public interest obligation” system is “broken” and not working as effectively as it should, it confirmed the

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<sup>58</sup> *Epitaph for a Killer Tax*, National Association of Broadcasters (August 1990) (available at: <http://digitalcollections.library.cmu.edu/awweb/awarchive?type=file&item=667529>) at 1.

<sup>59</sup> *Id.* at p. 2 (emphasis in original).

<sup>60</sup> *Information Needs Report*, *supra* n. 33 at 293-4; see also *The Decline of Broadcasters’ Public Interest Obligations*, New America Foundation (March 29, 2004) (available at: [http://www.newamerica.net/files/nafmigration/archive/Pub\\_File\\_1518\\_1.pdf](http://www.newamerica.net/files/nafmigration/archive/Pub_File_1518_1.pdf)).

broadcasters' obligation to promote localism remains very much in force as part of the larger social contract.<sup>61</sup>

### B. *Theoretical Analysis*

In what follows, we will view a broadcaster as the sole seller of a unique collection of valuable programming to an MVPD.<sup>62</sup> The content consists of a bundle of both privately-valued and publicly-valued (e.g., localism) programming. For convenience, we model the broadcaster as a monopolist (which it is over its unique content), though we make no specific claims about the degree of market power.<sup>63</sup> The broadcaster earns revenues from advertising and license fees, and charges the cable company  $P_b$  per subscriber. The MVPD buys the broadcaster's signal and then bundles the broadcast content with other video programming. Because the MVPD has other costs and may have some pricing flexibility, it adds a mark-up (labeled  $\Delta$ ) to the price of the broadcast signal. We assume that the increasing availability of content from other MVPDs (e.g., cable television, satellite television, telephone company television, over-the-top content) results in a market constrained mark-up,  $\Delta$ . In other words, market conditions at the retail stage, along with provider cost structure, impose the mark-up on an MVPD's services. The precise determination of the mark-up  $\Delta$ , though an interesting question, is not our focus in this model. Our analysis is not dependent on the precise levels of these mark-ups, and our conclusions are largely unaffected by assumptions about MVPD market conditions. Hence, potential subscribers are just assumed to face a MVPD service price of  $P = P_b + \Delta$ .

Among the critical aspects of the retransmission pricing problem is the supposed "public good" component in local programming. Whenever a customer "consumes" appropriate local content, a public value is created reflecting the community effects envisioned, and aggressively protected and

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<sup>61</sup> *Information Needs Report*, *supra* n. 33 at p. 295.

<sup>62</sup> We will not provide any formal analysis of the "bargaining" process which is supposed to characterize the retransmission market. We assume there is a positive economic gain to having the local broadcaster's signal retransmitted, and it is in all parties' interests generally to see this happen. Rather, the source of disagreement is entirely one of *how* the gains created are to be shared among the parties. In this light, the failure to reach agreements should probably be seen as a part of an extended strategic plan, aimed at pressuring the MVPDs into later concessions.

<sup>63</sup> The availability of other forms of programming may increase the own-price elasticity of demand for the broadcast signal, but the broadcaster is the sole purveyor of the network's programming. See, e.g., D. Carlton and J. Perloff, *MODERN INDUSTRIAL ORGANIZATION* (2000), at Ch. 7 ("Product Differentiation and Monopolistic Competition").

encouraged, by Congress and the FCC.<sup>64</sup> We have some latitude, however, in specifying the nature of this public value, and one can imagine a number of reasonable specifications. Borrowing from the 1992 Cable Act, where Congress concluded that “[b]roadcast television stations continue to be an important source of local news and public affairs programming and other local broadcast services critical to an informed electorate,”<sup>65</sup> the most natural specification of public value is just to assume that this value is directly proportional to the number of viewers receiving the desirable local content. Thus, we will assume that the public value is proportional to the number of subscribers, and we could term these consumers as the “informed electorate.” Let  $\theta$  measure the (constant) public value of the local content *per subscriber*. This implies that there is a positive social benefit created by the expansion of local content viewership to create an “informed electorate.”

The private valuation (maximum private willingness to pay) for the bundled content is the relevant demand constraint on the broadcaster (and the MVPD). For simplicity, we take this value to be given by the simple linear demand curve:

$$Q = A - P. \quad (1)$$

Here,  $Q$  is quantity,  $P$  is cable service price, and  $A$  represents the size of market demand. In this model, all “consumption” of the television signals occurs over an MVPD network. Of course, broadcast signals are also available over the air to many households, and this is a point we return to later.

As noted above, an important source of revenue to both broadcasters and cable operators arises from advertising. These revenues, of course, affect the pricing calculus for the retransmitted signal. Since these revenues are paid per subscriber, they act as a sort of subsidy to production.<sup>66</sup> A critical aspect of the welfare analysis of signal pricing involves the treatment of these revenues in welfare calculations, which is not an easy matter. Economists have long argued over the proper way to incorporate advertising into consumer welfare

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<sup>64</sup> See 1992 Cable Act Preamble Section 2(a)(9), *supra* n. 20 and text.

<sup>65</sup> 1992 Cable Act Preamble Section 2(a)(11), 47 U.S.C. § 521 nt.

<sup>66</sup> Broadcasters (and cable networks) face a two-sided pricing problem. See, e.g., J. Rochet and J. Tirole, *Platform Competition in Two-Sided Markets*, 1 JOURNAL OF THE EUROPEAN ECONOMIC ASSOCIATION 990-1029 (2004); S. Anderson and S. Coate, *Market Provision of Broadcasting: A Welfare Analysis*, 72 REVIEW OF ECONOMIC STUDIES 47-972 (2005).

calculations.<sup>67</sup> A key lesson from this literature is that the *social* value of advertising may not equal its *private* value. Fortunately, our main point can be made without entering too deeply into these debates. We proceed, therefore, under the assumption that the private values of advertising (i.e. advertising payments) provide a reasonable approximation to their social value.<sup>68</sup> By doing so, we ensure that our results do not depend on any assumption that inefficiencies in the advertising market itself influence our findings. Further, since we must remain relatively agnostic regarding the size of the social benefit of local content, we cannot seek after conclusions which depend critically on the sizes of unknown parameters. We return to this issue below.

### 1. Profit Maximizing Prices

Let the advertising revenue generated per subscriber for the broadcaster (denoted by subscript  $b$ ) and the MVPD (denoted by subscript  $d$ ) be given by  $a_b$  and  $a_d$ , respectively. Similarly, let  $c_b$  and  $c_d$  denote the marginal costs of each. As discussed later, there is no explicit accounting in the model for the regulatory protections (e.g., subsidies, etc.) received by broadcasters (because they are not, in their current forms, relevant to the pricing decision).<sup>69</sup> The broadcaster and cable profits are given by:

$$\pi_b = (P_b + a_b - c_b)Q; \quad (2)$$

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<sup>67</sup> The important early analysis of Dixit and Norman (1978) spawned a large literature. See, e.g., A. Dixit and V. Norman, *Advertising and Welfare*, 9 BELL JOURNAL OF ECONOMICS 1-17 (1978); C. Shapiro, *Advertising and Welfare: Comment*, 11 BELL JOURNAL OF ECONOMICS 749-75 (1980); L. Nichols, *Advertising and Economic Welfare*, 75 AMERICAN ECONOMIC REVIEW 213-218 (1985); V. Tremblay and C. Tremblay, *Advertising, Price, and Welfare: Evidence from the U.S. Brewing Industry*, 62 SOUTHERN ECONOMIC JOURNAL 367-381 (1995); K. Brown and P. Alexander, *Market Structure, Viewer Welfare, and Advertising Rates in Local Broadcast Television Markets*, 86 ECONOMIC LETTERS 331-337 (2005).

<sup>68</sup> This would be true, for example, if one takes the message advertising market to be highly competitive and further assumes that regulations on advertising result in the proper incentives to advertisers.

<sup>69</sup> Somewhat ironically, the forms of the regulatory protections granted to broadcasters are not particularly effective in encouraging broadcasters to increase their output under the current business model. For example, broadcasters receive blocks of spectrum which do not vary in size or value in response to marginal changes in the numbers of viewers receiving local content. Unlike advertising revenues—which vary directly (other things constant) with audience size—the spectrum grant is unresponsive to changes in the numbers of viewers, and thus does nothing to encourage output expansion. Broadcasters, in their pricing and negotiation with MVPDs, have no incentive to lower prices due to their subsidized spectrum holdings or other regulator preferences.



$$\pi_d = (\Delta + a_d - c_d)Q. \quad (3)$$

Absent any regulation to constrain the signal retransmission price ( $P_b$ ), the broadcaster would choose  $P_b$  by solving the following problem:

$$\max_{P_b} (P_b + a_b - c_b)(A - P_b - \Delta). \quad (4)$$

This results in the profit maximizing price and quantity of subscribers:

$$P_b^m = \frac{(A + c_b - \Delta - a_b)}{2}; \quad (5)$$

$$Q^m = \frac{(A - \Delta + a_b - c_b)}{2}. \quad (6)$$

The unconstrained price and quantity given above are very conventional, albeit with the addition of factors representing the downstream MVPD mark-up ( $\Delta$ ), and the per customer flows to the broadcaster from advertising income ( $a_b$ ). Broadcaster costs reduce sales and raise prices, while the downstream mark-up has a negative effect on both. Higher advertising revenues act like a subsidy on the license fee, lowering price and increasing quantity. Critically, neither price nor quantity are a function of  $\theta$ . This is expected, since  $\theta$  is a type of positive information externality—a real value received by society but not monetized by the broadcaster.

## 2. Welfare Maximizing Prices

Having found the privately-optimal behavior of the broadcaster, we can turn to the welfare analysis itself. We take the relevant social welfare to be composed of the sum of: broadcaster profits  $\pi_b$ , MVPD profits  $\pi_d$ , the consumer surplus of MVPD service subscribers, and the information externality represented by the presence of local content in the retransmitted signal ( $\theta$ ). In the case at hand, the consumer surplus is particularly simple a consequence of the linear form of the demand equation for cable service. In particular, since  $P = A - Q$ , consumer surplus at output  $Q$  is just  $\frac{1}{2}Q^2$ . Thus, total welfare is:

$$W = \pi_b + \pi_d + 0.5Q^2 + \theta Q. \quad (7)$$

In the above expression, the social value per customer receiving the local content signal is represented by the parameter  $\theta$  (an externality). In accord with our earlier discussion, the total social value is just proportional to  $Q$ .

Given our expression for welfare, we next examine the question of whether the unregulated pricing of broadcast signals is likely to result in good social outcomes. To do this, we examine how welfare  $W$  varies with changes in the price charged for the broadcast signal  $P_b$ . The social welfare maximizing price for retransmission would solve:

$$\max_{P_b} W, \quad (8)$$

which yields the price,

$$P_b^w = (c_b + c_d) - (\Delta + a_b + a_d + \theta). \quad (9)$$

The expression above shows conceptually how the socially best price depends on firm costs, advertising earnings, the markup downstream, and the social value of local content. Conceptually, this optimal price has two components. First, for the usual reasons, prices should equal marginal costs which, in this case, are  $(c_b + c_d)$ . However, the peculiarities of this market necessitate some adjustments from this simple conclusion. In particular, the downstream mark-up ( $\Delta$ ), the advertising revenue rates  $(a_b + a_d)$ , and the social benefit  $\theta$  of the activities related to the social contract, all act to reduce this optimal price. In principle, it is possible that the signal be “free” if, for example, there is sufficient advertising benefit from it. This is in fact a simple description of the over-the-air broadcasting model of the past (and present for some). Less obviously, given the mark-up being applied downstream ( $\Delta$ ), the broadcaster should introduce countervailing pricing (i.e., a lower price) in an effort to eliminate the quantity reduction from the markup.<sup>70</sup> Most significantly, the existence of a public benefit component ( $\theta$ ) argues for a lower optimal price. If the benefit is large enough, then the proper price (license fee) could be zero, but our analysis does not imply a positive price for retransmission is (in itself) problematic. At this time, we offer no evidence on the magnitude of  $\theta$ , and only point to its presence.

How, though, do privately optimal prices/quantities of the broadcaster compare to the socially optimal ones? The answer to this question depends on the values of some of the parameters involved, a result of the advertising “subsidy” that exists in broadcasting. However, it is possible to make some reasonable assumptions and arrive at a plausible answer. First, we note that we

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<sup>70</sup> Or, as  $\Delta$  falls in response to rising competition in the distribution market, the welfare-maximizing license fee rises.

can plausibly assume that  $A - \Delta > c_b$ . This assumption implies that the maximum value of the multichannel video service ( $A$ ) exceeds the marginal cost of multichannel video service ( $\Delta + c_b$ ). Second, we will assume that  $\Delta + a_d > c_d$ . This condition, like the first, makes a claim about the economic viability of the MVPD service itself. If the MVPD, who earns mark-up  $\Delta$  from selling his service and ad revenues of  $a_d$  per account, cannot by these means earn a positive margin on service, then it is hard to explain the existence of this industry.

Given these two conditions, we immediately obtain our first result: the market (monopoly) price for the broadcast signal is above the welfare maximizing price ( $P_b^w < P_b^m$ ). This is shown by simple inspection of the price expressions. We can conclude, unsurprisingly, that the broadcaster will generally “overprice” its signal based most importantly but not exclusively on its failure to internalize the positive information externality ( $\theta$ ). To the extent the spread in prices relates to  $\theta$ , the overpricing of the signal is a type of market failure (based on the presence of a positive externality).

### 3. *Broadcaster vs. Cable Network Pricing*

Under Retransmission Consent, the broadcaster is able to earn revenues both from advertising and license fees, so Retransmission Consent results in an environment in which broadcasters behave in much the same manner as purely commercial cable networks. Indeed, the forms of Equations (5) and (6) would be the same for both a broadcaster and a non-broadcaster cable network.<sup>71</sup> In both cases, the retransmission fees are set without reference to  $\theta$ , the social benefit per account from local signal retransmission (the cable network does not operate under a social contract).<sup>72</sup> This is to be expected, as both sorts of organizations are for-profit firms.

The welfare-maximizing price for the cable network (subscript  $n$ ) is

$$P_n^w = (c_b + c_d) - (\Delta + a_b + a_d), \quad (10)$$

which differs from Equation (9) only by the exclusion of the  $\theta$  term on the right-hand side. Note first that under the same arguments as above, the license fee charged by the (monopoly) cable network may also be above the welfare

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<sup>71</sup> Of course, the unique circumstances of each type of video programming network will lead to different prices and quantities in practice.

<sup>72</sup> There is no necessity to assume anything about this benefit except that it is non-negative.

maximizing price. But, the welfare-maximizing price for the cable network is higher than that of the broadcaster, since  $\theta$  is positive. Since the prices charged by the broadcaster and the cable network are identical (Eq. 5), the cable network's price is closer to the welfare-maximizing level than is the broadcaster's price.

Assuming all common parameters are equal across broadcast and cable networks, we have the difference between the broadcast and cable network welfare-maximizing price is,

$$P_b^w - P_n^w = -\theta. \quad (11)$$

Equation (11) shows that the license charged by broadcasters are not subject to the same welfare considerations as the license fees charged by cable networks—the broadcasters offer a public service as part of the social contract (measured by  $\theta$ ).

Notably, Equation (11) assumes a broadcaster and cable channel that are identical. This equivalence is an assumption for expositional purposes and not realistic. In fulfilling the localism obligations, the broadcaster will incur costs, and these costs are legitimately recovered in both advertising and license fees. Our theory does not legitimize and is not intended to encourage simplistic comparisons of prices between broadcasters and cable networks, it simply points to the fact that the welfare calculus differs across the two. Specifically, the obligation and presence of socially valuable programming in the broadcaster's signal creates a type of externality and, as usual, the presence of an externality leads to a market failure.

We show here, contrary to some arguments, that there is a profound difference between a broadcaster and a pure cable network such as Discovery, Food Network, AMC, and the like.<sup>73</sup> Specifically, whatever the social merits of their signal content, public policy towards cable networks does not incorporate any assumption that these firms are operating under a social contract, or that there is a compelling government interest (i.e., information externality) in the

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<sup>73</sup> See, e.g., J.A. Eisenach, *The Economics of Retransmission Consent*, EMPIRIS LLC (March 2009) at p. 13 ("Broadcast content is part of the larger market for television programming. Thus, broadcast networks compete directly with cable networks for viewing time and advertising dollars in local television markets. The evidence demonstrates that the market for television programming is highly competitive, with low levels of concentration and rapid entry.") (available at: <http://www.nab.org/documents/resources/050809EconofRetransConsentEmpiris.pdf>).

Food Network being retransmitted over MVPD networks. Fundamentally, broadcasters are different from cable networks, and the market negotiations valid for the latter need not produce efficient outcomes for the former.

### *C. Summary of Policy Implications*

The implications of our analysis are straightforward. Embedded, by design, in the broadcast signal is a social good in the form of localism, diversity, or whatever one wishes to call it, and this social good contributes to an informed electorate. Consequently, Congress has explicitly determined that there is a substantial government interest in having such signals available both over-the-air and over MVPDs networks. This social good is a type of externality, and as such is ignored in the choice of prices set by the broadcaster. As is standard, the “market” price for broadcast retransmission is “too high,” and too high (at least) by the value of the externality.

While some contend that the market for Retransmission Consent is efficient, it is plainly not. In fact, nearly since the industry’s inception, broadcasting has never been free of government intervention motivated to encourage outcomes the market presumably would fail to provide. The broadcast industry has faced onerous ownership limits, thereby and explicitly precluding the market from driving efficient equilibrium industry structure. The broadcast industry’s voice was constrained by the Fairness Doctrine. And, to ensure the maximum dissemination of this social good, MVPDs are subject to Must Carry regulations, a clear violation of free market principles. The list goes on. At the core of broadcast regulation is the goal to provide a form of information externality within the signal of the broadcaster. Therein lays the problem, and the source of a market failure.

Another policy-relevant consideration is that broadcast signals are available over the air to many, but by no means all, households. As such, the broadcasters claim that there really no such thing as a blackout, since the signal remains available (both over-the-air and possibly on a different MVPD network). In the context of our model, if a consumer ends an MVPD subscription yet still views broadcast signals over the air, then the information externality is still consumed and nothing is lost. We must agree that the over-the-air signal may attenuate the social-welfare implications of the social contract, but it does not eliminate them. As we noted in detail above, Congress was clear that there is a substantial government interest in the retransmission of commercial broadcast signals over MVPD networks, and that many households cannot, will not, or do not obtain over-the-air broadcast signals for a variety of reasons. In fact, Must Carry

regulation seems a clear indication that the over-the-air signal is not a good substitute for MVPD retransmission.

That said, demonstrating a market failure and doing something about it are two very different things. Whether or not the externality is large or small is an empirical question, and whether or not there exists a policy that offers a cost-effective remedy is debatable. In the next section, we consider, within the context of our model's findings, some of the proposed remedies to the Retransmission Consent "problem." We do not endorse any of the proposals, nor do we endorse any particular action at all; our interest is academic. Nor is our theoretical framework the only one available, so consistency (or not) with our approach is not necessarily *the* limiting factor.

## V. Policy Options for Mitigating Retransmission Consent Disputes

There have been a slew of suggestions aimed at altering the Retransmission Consent rules with the intent to realign bargaining power, mitigate retransmission disputes, and avoid blackouts. There have also been proposals to more radically change the regulatory treatment of broadcasters, such as Professor Tom Hazlett's argument to end broadcast television altogether.<sup>74</sup> Above, we have provided a conceptual framework with which (some) these proposals can be evaluated. While we do not cover all the proposals, which are quite varied, we do evaluate several commonly proffered approaches—both regulatory and legislative—to dealing with retransmission and broadcast regulation more generally.

### A. Potential Regulatory Solutions

#### 1. More Vigorously Enforce "Good Faith" Negotiations

Under Section 325(b)(1)(A) of the Communications Act, "No cable system or other multichannel video programming distributor shall retransmit the signal of a broadcasting station, or any part thereof, except ... with the express authority of the originating station. . . ." Focusing on the requirement that broadcasters must give express consent under all circumstances, the Commission has taken a hands-off approach in overseeing retransmission negotiations, thus far foregoing mandatory arbitration or mandatory interim carriage while dispute resolutions

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<sup>74</sup> Hazlett, *supra* n. 12.

are pending.<sup>75</sup> That said, Congress amended the 1992 Cable Act to provide the FCC with the authority to ensure that the parties negotiate in “good faith” in Retransmission Consent negotiations.<sup>76</sup>

In 2000, the agency released its first attempt to define “good faith.” After consideration, the agency opted for a two-part test, beginning with the brief, objective list of negotiation standards that follows: First, a broadcaster may not refuse to negotiate with an MVPD regarding Retransmission Consent. Second, a broadcaster must appoint a negotiating representative with authority to bargain on Retransmission Consent issues. Third, a broadcaster must agree to meet at reasonable times and locations and cannot act in a manner that would unduly delay the course of negotiations. Fourth, a broadcaster may not put forth a single, unilateral proposal. Fifth, a broadcaster, in responding to an offer proposed by an MVPD, must provide considered reasons for rejecting any aspects of the MVPD’s offer. Sixth, a broadcaster is prohibited from entering into an agreement with any party conditioned upon denying Retransmission Consent to any MVPD. Finally, a broadcaster must agree to execute a written Retransmission Consent agreement that sets forth the full agreement between the broadcaster and the MVPD.<sup>77</sup> The second part of the good faith test is based on a *totality of the circumstances* standard. Under this standard, an MVPD may present facts to the Commission which, even though they do not allege a violation of the specific standards enumerated above, given the totality of the circumstances constitute a failure to negotiate in good faith.<sup>78</sup>

The Commission’s “good faith” framework did not entirely avoid the high-profile blackouts that draw unwanted negative attention to the industry, the FCC, and Congress. Thus, in 2011, the Commission issued a *Notice of Proposed Rulemaking* where it sought comment on potential ways it could strengthen its

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<sup>75</sup> 2011 NPRM, *supra* n. 10 at ¶¶ 18-19.

<sup>76</sup> See 47 U.S.C. § 325(b)(3)(C)(ii) and (iii), whereby both broadcasters and MVPDs must:

... negotiate in good faith, and it shall not be a failure to negotiate in good faith if the [television broadcast station or MVPD] enters into retransmission consent agreements containing different terms and conditions, including price terms, with different multichannel video programming distributors if such different terms and conditions are based on competitive marketplace considerations. (Emphasis supplied.)

<sup>77</sup> *In re Implementation of the Satellite Home Viewer Improvement Act of 1999, Retransmission Consent Issues: Good Faith Negotiation and Exclusivity*, FCC 00-99, 15 FCC Rcd. 5445, FIRST REPORT AND ORDER (rel. March 16, 2000) (hereinafter “*Good Faith Order*”) at ¶ 6.

<sup>78</sup> *Id.* at ¶ 7.

good faith negotiation standard by establishing new “per se” violations. These ideas included, but were not limited to: (1) making it a *per se* violation for a broadcast station to agree to give a network with which it is affiliated the right to approve a Retransmission Consent agreement with an MVPD or to comply with such an approval provision<sup>79</sup>; (2) making it a *per se* violation for a broadcast station to grant another station or station group the right to negotiate or the power to approve its Retransmission Consent agreement when the stations are not commonly owned<sup>80</sup>; (3) making it a *per se* violation for a Negotiating Entity to refuse to put forth *bona fide* proposals on important issues<sup>81</sup>; (4) making it a *per se* violation for a Negotiating Entity to refuse to agree to non-binding mediation when the parties reach an impasse within 30 days of the expiration of their Retransmission Consent agreement<sup>82</sup>; (5) a re-examination of what standards the agency should consider in determining whether a Negotiating Entity has acted in a manner that “unreasonably” delays Retransmission Consent negotiations<sup>83</sup>; and (6) whether it is a *per se* violation if a broadcaster requires, as a condition of Retransmission Consent, that an MVPD not carry an out-of-market “significantly viewed” (“SV”) station.<sup>84</sup>

The Commission also requested comment on ways it could better implement revising the “totality of the circumstances” standard for determining “whether actions in the negotiating process are taken in good faith, in an effort to improve the standard’s utility and to better serve innocent consumers.”<sup>85</sup> In this regard, the Commission concluded in its *Good Faith Order* that “competitive market considerations” includes activity that would “hinder significantly or foreclose MVPD competition.”<sup>86</sup> Since the agency has already recognized that “broadband deployment and video entry are ‘inextricably linked’...,” in that “broadband deployment is not profitable without the ability to compete with the bundled

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<sup>79</sup> 2011 NPRM, *supra* n. 10 at ¶ 22.

<sup>80</sup> *Id.* at ¶ 23.

<sup>81</sup> *Id.* at ¶ 24.

<sup>82</sup> *Id.* at ¶ 25.

<sup>83</sup> *Id.* at ¶ 26.

<sup>84</sup> *Id.* at ¶ 27.

<sup>85</sup> *Id.* at ¶ 31.

<sup>86</sup> *Good Faith Order*, *supra* n. 77, at ¶ 58.



services that cable companies provide,”<sup>87</sup> the agency itself appears to have made the argument for revising the good faith standard.

A detailed assessment of all the various pieces of the Commission’s existing good faith policies and those proposed in its *NPRM* are well beyond the scope of this PAPER. What does our analysis say about a “good faith” policy? Above, we have demonstrated that the social contract appends a type of externality to broadcast programming, but, as usual, profit-maximizing firms ignore this externality. Thus, if one conceptual underpinning of “good faith” was a full accounting of this externality in price setting, then some types of reform could be justified by our theory of Retransmission Consent. Central to the social contract is the government’s substantial interest in having local commercial broadcast stations retransmitted over MVPD networks, so policies that encourage a smoother negotiation and help avoid impasses and blackouts are supported.

Whether or not the outright regulation of the terms and conditions of retransmission is within the authority of the FCC is hotly debated. The Commission has concluded, at least to date, that it lacks much authority in this regard. Others challenge the Commission’s interpretation of the statute limiting its authority.<sup>88</sup> As a general matter, price regulation is not the agency’s strong suit, as its bungled efforts in payphone compensation, cable television prices, and other efforts reveal. Retransmission agreements are not simple one-price rate cards, but very complex contracts with multiple prices covering multiple services, some of which are options. As such, we suspect benchmarking would be difficult. Complexity and rapid change do not bode well for price regulation. Nevertheless, our theory focuses on price, and we conclude the broadcaster’s chosen price is the wrong one. So, we recognize that our analysis may be used to support some fairly direct and potent regulatory interventions. Whether this

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<sup>87</sup> *In re Implementation of Section 621(A)(1) of the Cable Communications Policy Act of 1984 as Amended by the Cable Television Consumer Protection and Competition Act of 1992*, FCC 06-180, 22 FCC Rcd. 5101, REPORT AND ORDER AND FURTHER NOTICE OF PROPOSED RULEMAKING (rel. March 5, 2007) at ¶ 51, citing G.S. Ford, T.M. Koutsky and L.J. Spiwak, *The Impact of Video Service Regulation on the Construction of Broadband Networks to Low-Income Households*, PHOENIX CENTER POLICY PAPER NO. 23 (September 2005) (available at: <http://www.phoenix-center.org/pcpp/PCPP23Final.pdf>); see also *In re Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, FCC 06-11, 21 FCC Rcd. 2503, TWELFTH REPORT (rel. March 3, 2006) at ¶ 146 at n. 536, again citing PHOENIX CENTER POLICY PAPER NO. 23, *id.*

<sup>88</sup> See, e.g., December 11, 2013 *ex parte* filing of Public Knowledge, DISH Network, New America Foundation *et al.* in MB Docket No. 10-71 (available at: <http://apps.fcc.gov/ecfs/document/view?id=7520961540>).

departure from efficiency justifies the burden of outright price regulation is a decision that is made above our pay grade. We observe, however, that the FCC has of recent revealed itself to be unafraid of playing a role in price setting.<sup>89</sup> We hope it does not come to that. Unfortunately, regulation begets more regulation, as our analysis reveals.

## 2. *Allow MVPDs to Import Distant Signals*

Another significant proposal to equalize the bargaining positions between MVPDs and broadcasters is to have the FCC repeal its decades-old rules concerning network non-duplication and syndicated programming exclusivity so that a MVPD can import distant signals as a potential substitute for local programming. While not a perfect substitute for local programming, revising these rules arguably would allow the MVPD's customers access to highly-desired network and sports programming. However, given that the retransmission of distant signals is also governed by contracts between the networks and affiliates, it is unclear how much help repeal of the exclusivity rules will actually provide. As the Commission itself recognized in 2005,

Whether or not these rules remain in place, cable operators' ability to retransmit duplicative distant broadcast signals is governed in the first instance by the contract rights negotiated between broadcasters and their programming suppliers. If networks and syndicators have entered into contracts with broadcasters that limit broadcasters' exclusivity such that a duplicative distant signal could be imported by an MVPD without blacking out the duplicative programming, the Commission's rules would not prevent that result. Conversely, where exclusivity contracts exist, repeal of the Commission's rules would not necessarily be

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<sup>89</sup> See, e.g., L. Spiwak, *Data Roaming, Spectrum Auctions, and the Widening of the Broadband Credibility Gap*, @LAWANDECONOMICS (January 31, 2012) (available at: <http://phoenix-center.org/blog/archives/291>); G. Ford, *FCC Rules Block Broadband Price Cuts*, @LAWANDECONOMICS (May 13, 2013) (available at: <http://phoenix-center.org/blog/archives/1389>); G. Ford, *When in Doubt, Regulate*, @LAWANDECONOMICS (June 6, 2012) (available at: <http://phoenix-center.org/blog/archives/603>).

sufficient to enable the retransmission of duplicative programming.<sup>90</sup>

Notwithstanding the above, the Commission's 2011 NPRM asked for comment about whether "eliminating the Commission's non-duplication and syndicated exclusivity rules, *without abrogating any private contractual provisions*, would have a beneficial impact on retransmission negotiations."<sup>91</sup> We tend to think not, at least as long as the network is permitted to govern such retransmission under contract. Absent retransmission of distant signals under a *compulsory* license, which are not governed by contractual provisions between network and affiliates, altering the distant signal importation regulations is unlikely to have much effect on Retransmission Consent negotiations and the outcomes of those negotiations. Implementation of a signal importation remedy will require legislative action.

In the context of our model, we note that the social contract relates not to sitcoms and national sports programming but to the localism and diversity elements of the broadcast signal. To the extent distant signal importation is used, therefore, our model suggests that its social value is only in altering the bargaining power of the local broadcaster so that a retransmission deal is eventually reached between the MVPD and the local (not distant) broadcaster. Distant signals are not a viable substitute for local signals under the social contract—such signals are a bargaining tool aimed largely at weakening the potent threat and consumer harm of a blackout.

## B. Potential Legislative Solutions

### 1. Legislatively Modify "Good Faith Negotiations" Requirements

Since the FCC appears concerned about its authority to intervene under the "good faith" standard, some have called for Congress to enhance the "good faith" authority of the agency. For example, Congress could amend the Retransmission Consent provisions of the Communications Act to provide that if a Retransmission Consent agreement between a broadcaster and MVPD reaches an impasse, the FCC may authorize interim carriage of the station by the MVPD

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<sup>90</sup> RETRANSMISSION CONSENT AND EXCLUSIVITY RULES: REPORT TO CONGRESS PURSUANT TO SECTION 208 OF THE SATELLITE HOME VIEWER EXTENSION AND REAUTHORIZATION ACT OF 2004 (September 8, 2005) at ¶ 49.

<sup>91</sup> 2011 NPRM, *supra* n. 10 at ¶ 44 (emphasis supplied).

pending the conclusion of a new agreement.<sup>92</sup> This solution would continue to satisfy Congress' substantial interest in having local commercial broadcast stations appear in MVPD channel packages. Broadcasters argue, however, that such a change would weaken their bargaining power too much, thereby conflicting with Congress' intent expressed in Section 325 (Retransmission Consent). (This spat is just one more manifestation of the disharmony inherent in modern broadcast policy.)

Our model does not shed too much light on this issue, since we do not directly model the role of bargaining power in our model. We do note that under the social contract, retransmission is explicitly preferred since it is a source of a positive externality (a "substantial government interest"). Also, our model suggests that the broadcasters' perception of pricing is a bit askew. Together, these points could provide support for a deeper investigation into legislative changes, though we make no specific proposals since we have no evidence on the size of information externality or the cost and benefits of specific proposals.

## 2. *Eliminate Basic Tier Requirements*

As another option, some have called for Congress could eliminate the requirement that broadcast signals electing for Retransmission Consent be placed in the cable system's "basic tier."<sup>93</sup> The basic tier would then consist only of "Must Carry" broadcast signals and PEG channels, and consumers could choose more directly whether or not to pay the retransmission fees of the broadcasters. Such a policy could reduce the impact of high and rising retransmission fees, since under existing law the retransmission fees raise the price of MVPD subscriptions for all subscribers. Given the high viewership of broadcast television on MVPD systems, it's not clear this remedy would have much of an effect on retransmission negotiations.

In light of our theory, we believe that this approach is, in effect, abandoning a core element of social contract. The social contract holds that broadcast signals should be ubiquitously available for free or at very low prices both over-the-air

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<sup>92</sup> See, e.g., the Video CHOICE Act co-sponsored by Representative Anna Eshoo and Representative Zoe Lofgren (available at: [http://eshoo.house.gov/uploads/CBO\\_227\\_xml.pdf](http://eshoo.house.gov/uploads/CBO_227_xml.pdf)). While some argue that legislation would be required for the Commission to mandate interim carriage, others believe the existing statute permits such rules.

<sup>93</sup> J. Eggerton, *Rep. Eshoo Proposes Retransmission Bill: Draft Bill Would Let FCC Grant Interim Carriage Of Station In Retrans Impasse*, MULTICHANNEL NEWS (September 9, 2013)(available at: <http://www.multichannel.com/policy/rep-eshoo-proposes-retransmission-bill/145361>).

and over MVPD networks, a goal that is somewhat ignored in this policy. Still, we see some logic in the proposal, since it could be high prices for some broadcast signals that lead consumers to abandon the MVPD service, potentially losing the social content of other, lower-fee local broadcasters remaining in the basic tier. It's an interesting idea, though we do not suspect it will change negotiations much. Today, many MVPD's are already placing a separate line item on consumer bills for broadcast retransmission fees, and the popularity of the programming encourages MVPDs to place the content in the basic tier. At some price, however, tiering broadcast stations may be a profitable solution, or meaningful threat, for MVPDs.

### 3. Mandate a "Cable" Network Model

Retransmission Consent is one part of a complex set of rules governing the relationship between broadcasters and MVPDs. Some of the rules, like Must Carry and distant signal importation rules, are alleged to alter the bargaining power of the broadcasters and are, thus, partly responsible for bargaining impasses. Some have called for the elimination of all such regulations, along with the compulsory Copyright license regime, thus permitting the negotiation for the carriage of commercial broadcast stations to "take place in the same deregulated environment for carriage for non-broadcast channels such as Discovery, Food Network, and AMC."<sup>94</sup> This approach has garnered some support.<sup>95</sup>

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<sup>94</sup> See, *Scalise, DeMint Introduce Legislation to Deregulate Television Market*, Press Release, Office of Congressman Steve Scalise (December 16, 2011) (available at: <http://scalise.house.gov/press-release/scalise-demint-introduce-legislation-deregulate-television-market>).

<sup>95</sup> See, e.g., S. Donohue, *Republican Lawmakers Introduce Bill To Reform Retransmission Consent, Fierce Cable* (December 19, 2011) (<http://www.fiercecable.com/story/republican-lawmakers-introduce-bill-reform-retransmission-consent/2011-12-19>); *DIRECTV Applauds Introduction of Video Deregulation Bill*, DIRECTV Press Release (December 16, 2011) (available at: <http://dtv.client.shareholder.com/releasedetail.cfm?ReleaseID=634027>); Testimony of James Campbell, Vice President of Regulatory and Legislative Affairs, Midwest Region, CenturyLink, Inc. before the House Energy and Commerce Committee, hearing on Innovation Versus Regulation in the Video Marketplace (September 11, 2013) at p. 9 (available at: <http://docs.house.gov/meetings/IF/IF16/20130911/101284/HHRG-113-IF16-Wstate-CampbellJ-20130911.pdf>); *ACA Commends Media Reform Bill Unveiled By Sen. DeMint, Rep. Scalise*, American Cable Association Press Release (December 16, 2011) (available at: <http://www.americancable.org/node/3304>); Thierer, *supra* n. 28; J. Gattuso, *Adjusting the Picture: Television Regulation for the 21st Century*, Heritage Foundation (November 6, 2012) (available at: <http://www.heritage.org/research/reports/2012/11/adjusting-the-picture-television-regulation>).

(Footnote Continued. . . .)

Since the market failure we identify is a consequence of existing regulations, wiping the slate clean of all of those regulations (Must Carry, Retransmission Consent, and the compulsory Copyright licenses) certainly could prove fruitful. Yet, however beneficial a “clean slate” approach may be, it is important to see the forest for the trees—i.e., we must remember that root of the market failure continues to lie with the social contract created by the substantial government interest in having local commercial broadcast signals carried over the MVPD networks. It is the “localism” and “diversity” that drives the market failure, and as long as these concepts are relevant and promoted by law and regulation, the “market” price is arguably not the right price for the broadcast signal.<sup>96</sup> If broadcasters are permitted to reduce their obligations for localism, thereby shrinking the unique social value of the programming, then pricing may then be sensibly left to the market.

The migration from regulatory forces to market forces is nearly always desirable, but for there to be a true “market solution” to Retransmission Consent (or broadcast television generally), Congress must eliminate, or meaningfully reduce the scope of, the social contract, including the various protectionist and support mechanism given to the broadcast industry. In this regard, some argue that the nature of the industry’s access to spectrum is one target for reform. The FCC’s *Information Needs Report* made the point clear:

A true free market would operate more akin to the spectrum management system applied to newer technologies like mobile. That spectrum is auctioned off to the highest bidder, with proceeds going to taxpayers. Broadcast licenses initially were given, for free, to various companies. Over the years, other companies have purchased them, but the taxpayers have not seen

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[for-the-21st-century](#)); R. Radia, *A Free Market Defense of Retransmission Consent*, OPENMARKET.ORG (April 11, 2012) (available at: <http://www.openmarket.org/2012/04/11/a-free-market-defense-of-retransmission-consent>); R.J. May, *A Truly Free Market TV Marketplace*, Free State Foundation (March 30, 2012) (available at: <http://freestatefoundation.blogspot.com/2012/03/truly-free-market-tv-marketplace.html>).

<sup>96</sup> Interestingly, Representative Scalise appears to concede our point about the social contract when he reintroduced his bill in the 113<sup>th</sup> Congress. As he states in his press release, “[b]roadcast television is a unique and important platform” and provides “[v]aluable local affiliate programming, strongly demanded by consumers including myself...” See *Scalise Reintroduces Legislation to Modernize Television Laws*, Press Release, Office of Congressman Steve Scalise (December 12, 2013) (available at: <http://scalise.house.gov/press-release/scalise-reintroduces-legislation-modernize-television-laws>).

any of that money. Moreover, broadcasters do not pay any ongoing rent to use the spectrum—another practice that free-market-oriented economists have recommended as a means to instill market principles. Finally, there is little opportunity for a competitive company to challenge licensure rights of an incumbent broadcaster.<sup>97</sup>

For this reason, the agency's Working Group recommended, *inter alia*, that:

... if a station has little interest in serving its community, there are now better uses for the scarce spectrum. It could be sold to another station or ... stations could put the spectrum into an incentive auction, where it could be purchased by a wireless company to help make wireless high-speed Internet access more available. The station would get part of the proceeds and media system would benefit from greater availability of high-speed Internet.<sup>98</sup>

Even with the upcoming incentive auction, we expect the increased scrutiny of the broadcast industry's use of its spectrum. If the social obligations of broadcasters are curtailed, then the pressure to surrender spectrum will only rise. Migration to a more market-based broadcasting model may, then, sink the broadcasting model altogether. Perhaps an end to the social contract is best, but that is obviously a decision Congress must make.

## VI. Conclusion

The rising cost of broadcast programming and the high-profile of broadcast station blackouts have earned Retransmission Consent a place at the forefront of the modern communications policy debate. Both the FCC and Congress are actively pursuing strategies to alter the consent regime. In this PAPER, we

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<sup>97</sup> *Information Needs Report*, *supra* n. 33 at p. 293. Interestingly, should the Supreme Court rule in the defendant's favor in the *Aereo* case, *supra* n. 25, several network executives have publicly suggested that they may abandon the free broadcast model and convert their business into a cable-type subscription service. See D. Cohen, *News Corp. Threatens to Make Fox Cable-Only Amid Aereo Dispute*, VARIETY (April 8, 2013) (available at: <http://variety.com/2013/digital/news/chase-carey-threatens-to-yank-fox-from-broadcast-tv-over-aereo-1200334235>); E. Gardner, *Univision Says Aereo Could Force It to Go "Pay-Only"*, THE HOLLYWOOD REPORTER (April 8, 2013) (available at: <http://www.hollywoodreporter.com/news/univision-says-aereo-could-force-434888>).

<sup>98</sup> *Id.* at p. 295.

provide an economic theory of Retransmission Consent, which focuses on the social contract between the government and broadcasters to serve the “public interest” (e.g., provide “local” programming and a “diversity of voices”). For eighty years, communications law and policy has supported and protected a broadcast television industry in return for public interest programming that creates an “informed electorate.” This social contract embeds a positive information externality in the broadcast signal, and since private transactions do not typically account for externalities, we find that the market price for the retransmission fee is theoretically “too high,” both relative to the socially-optimal price and the market price of an otherwise-equivalent cable network. This market failure is a direct consequence of regulatory intervention. Solutions, then, must involve either removing the regulation responsible for the failure, or addressing the market failure itself. Both extremes have been proposed in various forms, but today, the direction of policy is yet to be determined.