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EXHIBIT 1

TO

COMMENTS OF THE COALITION TO PRESERVE

THE FINANCIAL INTEREST AND SYNDICATION RULE

RECEIVED

MAY 3 0 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

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

ATTACHMENT 5
to the Reply Comments of the
Coalition to Preserve the Financial
Interest and Syndication Rule

DECLARATION OF
DR. FREDERICK R. WARREN-BOULTON
February 16, 1993

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DECLARATION OF FREDERICK R. WARREN-BOULTON

I, Frederick R. Warren-Boulton, declare:

BACKGROUND

1. I am currently a principal of MiCRA: Microeconomic Consulting & Research Associates, Inc., specializing in antitrust and regulatory matters. I hold a Master of Public Affairs and M.A. and Ph.D degrees in Economics from Princeton University.

2. From 1983 to 1989, I served as the chief economist for the Antitrust Division of the U.S. Department of Justice, first as Director of its Economic Policy Office and then as Deputy Assistant Attorney General for Economic Analysis. At the Division, I supervised the economic analysis of all mergers, price-fixing and monopolization cases. My responsibilities also included supervising and contributing to filings before the Federal Communications Commission and other state and federal agencies, as well as contributing to the economic analysis of general policy issues, as reflected in the 1984 Merger Guidelines and the Vertical Restraint Guidelines.

3. My publications include papers assessing the causes and effects of various kinds of vertical restraints and papers that consider appropriate public policy towards mergers. A complete description of my background and papers can be found in my Curriculum Vita, a copy of which I have attached to this Declaration (Attachment A).

PURPOSE AND SUMMARY OF CONCLUSIONS

4. The purpose of this declaration is to respond to the comments filed by the television networks with the FCC on February 1, 1993 concerning the Commission's financial interest and syndication rules (hereafter, "FISR"). In their comments, the networks argue that the Commission erred in concluding that they have the ability and incentive, absent the FISR, to "extract" profits from program producers. Next, they argue, in the alternative, that the Commission erred in concluding that the FISR would inhibit their ability to "extract" profits from producers. Finally, the networks argue that the effect of the FISR is perverse -- that instead of promoting diversity by preventing "extraction," the rules harm program producers by limiting their ability to obtain lower-cost financing from the networks.

5. Based on my study of this industry, including the evidence presented to the Commission in this proceeding, I have reached the following conclusions:

- The networks have market power in the market for the purchase of syndicable programming -- i.e., programming of potential off-network quality.
- The original FISR inhibited the networks' ability to exercise their market power so as to "extract" revenues from program producers through first-degree price discrimination.
- As did the original FISR, a requirement that negotiations for back-end rights take place only after a network has committed to air and scheduled a program would inhibit the network's ability to "extract" profits through price discrimination.

- By inhibiting the networks' ability to engage in "extraction" through price discrimination, the FISR increases the expected returns from engaging in program production, encourages entry, and results in a larger number of producers in equilibrium.
- The networks are not uniquely efficient financiers of program production. On the contrary, the networks are probably the least efficient financiers of network programming.

SUMMARY OF ANALYSIS

6. The FISR affects the ability of the networks to exercise market power in the market for syndicable programming, in which the suppliers are program producers and the only effective purchasers are the three networks and Fox. Syndicable programming is entertainment programming of potential off-network quality -- *i.e.*, programming where the value of the back-end rights, at the time the network rights are first negotiated, are a significant share of the total value of the program. With the exception of the entry of Fox as a fledgling fourth network, there is no evidence that economic conditions or the power of the networks in this market have changed significantly since the FISR was adopted.

A. The Market for the Purchase of Syndicable Programming

7. The networks argue that they do not have market power because they are not the only effective purchasers in the market for syndicable programming. If they attempted to pay prices for syndicable programming that are below the prices they would pay in a competitive market, the networks contend,

the producers would sell their programs (or services) to other program purchasers -- i.e., cable networks or syndicators of first-run programming (firms that sell first-run programs directly to local television stations) -- and would do so in such volumes that the networks would be forced to raise their prices back to the competitive level. In fact, however, syndicable programming is of far less value to cable networks and to syndicators of first-run programming than it is to the networks. Consequently, the networks have monopsony power in the purchase of syndicable programming and neither cable nor syndicators of first-run programming prevents (indeed, they may not even constrain) the exercise of such power by the networks.

8. The networks argue that they could not exercise market power in the purchase of syndicable programming in the absence of the FISR because they could not force producers to accept -- over the long run -- prices for program rights that consistently result in the producers losing money. Moreover, they argue, even if they could exercise market power in this way, it would not be in their interest to drive their suppliers out of business. But this argument fundamentally misapprehends both the heterogeneous nature of syndicable programming and the way in which the networks would exercise their market power in the purchase of such programming. In a competitive market, all but the "marginal" producers would receive more than their production costs. Absent the FISR, the networks would be able to use their market power more effectively, since they would be better able to determine the lowest price the producer would be

willing to accept for his program and then offer the producer an amount closer to that minimum value -- i.e., to engage in what economists term "first-degree price discrimination." Through this conduct, as the Commission found, the networks will be able to "extract" revenues from program producers.

9. Prices for the network exhibition rights to syndicable programs are negotiated between the producer and the network on a program-by-program basis. In each such negotiation, the goal of the network is to set the price paid for the rights to that program as close as possible to the producer's "reservation price," the lowest price acceptable to the producer. In addition to the network exhibition rights, the producer holds -- and can sell -- a set of other, so-called "back-end" rights, including the right to sell the program in domestic syndication. Thus, to achieve its goal, the network must set a price for the network exhibition rights that will extract from the producer the difference (if any) between the combined value of network and back-end rights and the producer's production costs (where costs include a normal return on his investment).

10. Under the original FISR, the network could acquire only the network rights to a program. To achieve its goal of paying the lowest price acceptable to the producer, the network therefore had to try to set the price for those rights as close as possible to the producer's reservation price for those rights alone. In negotiating for the sale of just the network rights to a program, the producer's reservation price

will equal the difference between the producer's production costs and the present value to the producer of the revenues the producer expects to receive from the sale of the back-end rights. Given that the producer's estimate of the latter amount is both subjective and highly uncertain, the network's estimate of the producer's estimate must be even more uncertain. This uncertainty on the part of the network as to the producer's reservation price is critical to the producer if he is to retain as much as possible of the economic rents he would receive in a competitive market: since the producer's only alternative to selling his program to the network is to abandon the project entirely, his only negotiating asset is that the network cannot be certain just how low it can set the license fee for the network rights before the producer will walk away from the program. The original FISR, therefore, inhibited the networks' ability to extract production profits through price discrimination by making it very difficult for a network to estimate accurately a producer's reservation price.

11. Absent the FISR, the network could easily set a price for the network and back-end rights combined that was just above the producer's reservation price for both sets of rights, since the producer's reservation price for both sets of rights combined is equal to his cost of production. The network could offer simply to pay the producer an amount equal to the network's estimate of the costs of production anticipated by the producer in exchange for the network and back-end rights. Since such costs can be predicted relatively

accurately by the network, this would leave the producer with little room to maneuver in bargaining with the network. Moreover, even if the network cannot accurately estimate future costs, or even if the producer refuses to accept that estimate, the network can simply offer to compensate the producer for his actual production costs -- i.e., offer him a cost-plus contract. Given that the producer can negotiate with only that one network, it is hardly surprising that the producers expect that, if the networks are permitted to purchase both sets of rights, the networks will be able to extract almost completely any excess of the value of a program over the cost of production from the producers.

12. In principle, however, the networks' ability to engage in price discrimination could still be significantly inhibited if the networks were allowed to acquire back-end rights only in a truly separate negotiation process -- i.e., a process in which the network could not require the producer to accept a price for the back-end rights equal to his cost of production, minus the previously agreed-upon network fee, as a condition for appearing on the network.

13. Simply introducing a waiting period between negotiations could be insufficient to ensure truly separate negotiations. The problem is that, in the negotiations over the back-end rights, the network would now know with relative certainty the producer's reservation price for those rights (i.e., the producer's cost of production, minus the previously agreed-upon network fee) and could force the producer to accept

its offer. An effective separate negotiation safeguard requires that negotiations over back-end rights be delayed until the relative negotiating positions are more balanced. If the negotiation for back-end rights are delayed until the network has committed to air and has scheduled a program, the network will then have incurred large sunk costs in the program, and now both network and producer will have something to lose from a stalemate. In these circumstances, the network would likely pay more than the producer's reservation price for the back-end rights even though, having already acquired the network rights, the network knows with certainty the reservation price for the back-end rights. Until the network has scheduled a program, therefore, the producer knows that if he rejects the network's offer for his back-end rights in favor of a better bid from some third party, or even in favor of retaining those rights himself, the network can refuse to air the program. For the network, this is a "repeat game", where it can be profitable in the long run to cancel a few potentially profitable programs in order to establish a reputation for cancelling programs where the producer rejects its offer for the back-end rights.

14. The networks argue that their ability to extract profits from producers in this manner is simply a matter of "bargaining power," and therefore should be of no concern to the Commission. This is incorrect. If the market for the purchase of syndicable programs were competitive, a network could not systematically pay producers no more than their

reservation prices because other program purchasers would bid those prices back up to the competitive level.

15. If the FISR is eliminated or replaced by a rule that would not be effective in inhibiting first-degree price discrimination, the result will be a reduction in the number and heterogeneity of producers. First-degree price discrimination by networks reduces the expected return to new entrants in program production, and thus acts as a deterrent or barrier to entry, reducing the rate of entry and the equilibrium level of producers.

B. The FISR's Effect on Efficient Program Financing

16. The networks have also argued that there are certain efficiencies that would be uniquely achievable by them if (and only if) they were allowed to purchase back-end rights from producers and to sell off-network programming directly to independent stations. They further contend that their entry into these activities would enhance competition and thus benefit both producers and independent television stations. None of the empirical support for these asserted efficiencies survives even a cursory economic analysis. See Attachment B. Indeed, because they own the network exhibition rights in programs, the eventual profits from which are likely to be highly correlated with the eventual value of the back-end rights, the networks are in the worst position to diversify away the risks associated with holding back-end rights, and are

thus probably the least efficient source of financing for those rights.

17. In addition, there appear to be several efficiencies that flow uniquely from producers' retention of a significant share of their back-end rights, as one might expect from the fact that, even before the adoption of the original FISR in 1970, the networks found it profitable to allow the producers to retain a significant share of their back-end rights. Retention of at least some of the back-end rights gives the producer a stake in the success of the network run and thus rewards the producer for actions that increase the value of the network rights, while also providing the network with a hostage against opportunistic or "unreasonable" behavior by a producer who might otherwise be tempted to try to renegotiate an agreement for a successful program. From the network's point of view, the benefit to the network from such efficiencies would need to be balanced against the reduction in the network's ability to extract all the economic rents from the producer that occurs because of the network's uncertainty as to the value that the producer places on those rights. Relative to the value of the entire package of network and back-end rights, however, those economic rents are far greater today than they were in 1970, and thus the share of the back-end rights that the networks are likely to leave with the producer absent the FISR are likely to be far lower.

18. A detailed economic analysis of the efficiency effect of network versus producer ownership of back-end rights

is contained in F.R. Warren-Boulton and J.R. Woodbury, Economic Analysis and Policy Implications of the Financial Interest and Syndication Rule (January 24, 1991), which has been previously submitted to the Commission and is part of the record in this proceeding. The most convincing evidence that the efficiencies the networks claim will result from modification of the decrees are mere slights-of-hand, however, is also the simplest: that the purported beneficiaries of network entry have vigorously opposed such entry. Contrary to the Seventh Circuit's assertion in Schurz, the opposition from program producers has been long-standing and unanimous across all sizes and types of such producers, ranging from the studios to the smallest producers and even to potential and new entrants into program production. Those with the most to gain or lose from modification of the decrees clearly understand that they would suffer significant economic harm if the networks again had the unfettered ability to acquire back-end rights in syndicable programs.

19. The Commission's recent proceedings have provided us with yet another independent test of the efficiency versus market power hypotheses, one that shows that even the networks do not believe their own efficiency story. The Department of Commerce proposed allowing the networks to bid on and own back-end rights, conditional upon a waiting period between acquisition of the network rights and network bidding for the back-end rights that would be just long enough to force the network to negotiate separately for each set of rights. This

proposal was intended to permit all of the efficiencies that the networks asserted would follow from network ownership or financing of back-end rights, while still inhibiting any network, acting individually once the producer is "locked-in" to that network, from "extracting" much of the value of those rights. In perhaps the best test yet of the networks' true assessment of the relative strength of the efficiency effects versus the market power effects of the FISR, the networks vigorously opposed this proposal.

20. The networks' claim that producers would be forced to sell their back-end rights to others during the waiting period is meritless if the networks' efficiency claims are true. After all, if the networks are more efficient sources of financing and bid competitively, they will pay more for the back-end rights. A producer could simply wait until the waiting period expired and sell his rights to the network.

21. The networks' assertion that many producers, as a practical matter, must sell their rights before the fall schedule is announced is accurate only if the networks impose such a condition on them (as they currently do). Under the Department of Commerce's proposal, the networks could waive this condition if they felt it interfered with their ability to bid for back-end rights. Moreover, if necessary, third parties could finance the producer's continued holding of those rights until the waiting period had expired, or the producer could simply sell those rights to brokers or other third parties who

could then resell them to the network or to any other potential buyer.

22. If the waiting period were too long for the asserted efficiencies from network ownership to be attained, the net price received by producers would fall and producers could be expected to seek a reduction in the waiting period. It is in the producers' interest to have a Rule with a waiting period and other conditions that would maximize the value of producers' back-end rights. Here, the producers supported a Rule that would permit the networks to negotiate for back-end rights only after a network has committed to air and has scheduled a program.

I. THE FISR'S EFFECT ON NETWORKS' EXERCISE OF MONOPSONY POWER IN THE MARKET FOR SYNDICABLE PROGRAMMING

23. This section addresses four questions. First, is there a separate "market" for syndicable programming in which increased quantities or qualities are available only at higher prices? Second, who are the participants on the buying side of this market? Third, how does the FISR inhibit the ability of the networks to exert unilateral (and/or cooperative) monopsony power in this market? Fourth, can a separate negotiation process inhibit the ability of the networks to exert unilateral (and/or cooperative) monopsony power in this market?

A. The Market for Syndicable Programming

24. In the context of the FISR, the relevant question is whether elimination of the Commission's rules will enable the networks to depress the prices paid for syndicable programming (i.e., the sum of the prices paid for the two components of syndicable programming: the network exhibition rights and the back-end rights) below current levels. The best available methodology for making such a prediction is that contained in the Department of Justice and Federal Trade Commission's Merger Guidelines, which have been applied by the federal antitrust agencies, the courts, regulatory agencies and others in analyzing market power issues, including mergers, monopolization and a wide range of regulatory issues. Using the Merger Guidelines' methodology, the available evidence confirms that there is a separate market for the purchase of syndicable programming.

25. For ease of exposition, the Merger Guidelines discuss market power issues in terms of the market for the sale of a product. As the Guidelines note, however, the same analysis applies to markets for the purchase of products, where the concern is monopsony (instead of monopoly) power. The Merger Guidelines define a market (with the appropriate term for the monopsony case added in parentheses) as the smallest and most narrowly-defined product or group of products such that the reduction in purchases (sales) by consumers (producers) of the "product" in response to a small but significant -- about 5% -- price increase (decrease), would not

make such a price increase (decrease) unprofitable to a hypothetical monopolist (monopsonist) of the "product." To quote (again, with the appropriate term for the monopsony case added in parentheses):

> A market is defined as a product or group of products and a geographic area in which it is produced or sold such that a hypothetical profit-maximizing firm, not subject to price regulation, that was the only present and future producer or seller (consumer or buyer) of those products in that area likely would impose at least a "small but significant and nontransitory" increase (decrease) in price, assuming the terms of sale of all other products are held constant. <u>A relevant market is a group of products and a geographic area that is no bigger than is necessary to satisfy this test</u>.

(Merger Guidelines at Section 1.0. The concept in this last sentence is referred to as the "smallest market" principle.)1/

1/ In the context of a merger, the relevant question is whether the merger is likely to increase (decrease) prices above (below) the current level. The market is defined in terms of a merger to monopoly (monopsony) -- would a merger of all the firms supplying (buying) that product into a "hypothetical monopolist (monopsonist)" result in a 5% price increase (decrease)? But the government would not, of course, tolerate a merger to monopoly (monopsony) in such a market. The Guidelines continue:

> The "small but significant and non-transitory" increase (decrease) in price is employed solely as a methodological tool for the analysis of mergers: it is not a tolerance level for price increases (decreases).

Indeed, the Guidelines express serious concern with mergers that increase concentration to the point where it could be expected, absent any efficiencies from the merger, to result in a price increase (decrease) on the order of one-tenth of one percent. <u>See</u> F.R. Warren-Boulton, "A Commentary on the 1992 U.S. Merger Guidelines," <u>International Merger Law</u> (June 1992) and G.J. Werden, "Market Delineation Under the Merger Guidelines," U.S. Department of Justice, Economic Analysis
(Footnote 1 Continued)

26. Using the Merger Guidelines' approach to market definition, syndicable programming is a separate market. Syndicable programming is defined as entertainment series programming of potential off-network quality -- i.e., programming where the value of the back-end rights, at the time that the network rights are first negotiated, are a significant share of the total value of the program. Since the value of those back-end rights to the producer must be greater than or equal to the deficit that the producer is willing to assume (i.e., the production costs minus the network license fee), syndicable programming includes at least all programming classes where some producers routinely accept large deficits.

27. The value of back-end rights at the time that the network rights are negotiated, and thus the maximum tolerable deficits, differ greatly across and within programming classes. For certain kinds of programming, such as game shows and nightly news programs, the back-end rights are virtually worthless and deficits therefore non-existent. These programs are not syndicable. Indeed, in practice, half-hour network

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(Footnote 1 Continued)
Group Discussion Paper (January 1992).

As discussed in the text, it seems abundantly clear that syndicable programming satisfies -- by a wide margin -- the requirement for designation as a separate market. Moreover, the size of the price effect anticipated by all parties from elimination of the FISR is far greater than the price effect that the government would find "tolerable" in a merger context; even putting aside the economic evidence, common sense tells us that if this were not true, this battle would not have been fought so bitterly and at such expense over the past twenty years.

entertainment series currently account for the bulk of syndicable programming appearing on television stations. Within that class, the value of the back-end rights varies greatly.

28. The networks have argued that for a network to have monopsony power over the supply price of entertainment programming, its purchases must represent a large share of the market for the "creative inputs," such as actors, directors, writers, producers, costume designers, scenic artists, special-effects personnel, etc. According to the networks, these "creative inputs" shift among theatrical feature films, the professional theater, and television programs regularly. The networks are correct when they point out that syndicable programming accounts for only a small share of the total employment of these inputs. The problem with the networks' argument is that these are not the monopsonized inputs.

29. Syndicability is a unique attribute of some programs, an intangible asset quite distinct from actors, directors, film or other inputs into the production of these programs. It is this intangible asset -- the creative concept and its development for network television -- that the FISR inhibits the networks from monopsonizing, not the supply of actors or video tape or other inputs purchased by producers. Such inputs may be available in infinitely elastic supply to producers of syndicable programming, but this does not imply that syndicable programming is available in infinitely elastic supply.

30. A close analogy would be an isolated coal mine that is captive to a single railroad and valueless absent railroad transportation. That coal mine could account for a minute share of the nation's total coal miners, dynamite, drilling equipment and any other input into the production of coal, but no one would argue that this would imply that the owners of this coal mine need not be concerned about being monopsonized by the railroad. What the railroad is monopsonizing is the reserves of coal in the ground, which are valueless without access to low cost (i.e., railroad) transportation to a market. Substitute the idea behind an entertainment program for coal reserves, network for railroad, actors for miners, cable for other higher-cost forms of transportation such as trucks, and you have the market for programming. Now suppose that a gold seam is discovered that wanders erratically through the coal seam, so that gold becomes a valuable, though uncertain byproduct of mining coal in this mine. If the railroad knows of this, it would increase the rates it charges per ton of coal transported from that mine by an amount equal to the expected value of the gold per ton of coal mined, even if the railroad would never be needed to transport the gold. Substitute syndication rights for gold, and network rights for coal, and you have the market for syndicable programming.

31. The networks, former Chairman Sikes and the Seventh Circuit are thus wrong when they suggest that the networks cannot exercise market power in the purchase of

syndicable programming because other forms of entertainment programming exist. The supply of syndicable programming (like the supply of coal and gold from a captive mine that produces both products) is a distinct and separate product that is not available in infinitely elastic supply: one cannot produce any amount of syndicable programming simply by packaging together ten actors, one director, etc. Indeed, to establish that the supply curve of syndicable programming is upward sloping -- and hence monopsonizable -- it is sufficient to point out that the value of back-end rights, and the deficits incurred by producers, vary enormously even within classes of programming, and in any event by far more than the 5% generally used under the Merger Guidelines' methodology as the criterion for market definition.

B. The Networks' Market Power in the Market for Syndicable Programming

32. The networks contend that they have no ability to exercise market power in the purchase of syndicable programming because a program producer can turn to other program distributors -- e.g., cable networks, first-run syndicators -- if he or she is dissatisfied with the network's offer. If the value of back-end rights is, in fact, the same whether a program is purchased by a broadcast network, a first-run syndicator, or a cable programming service, then network access is not essential to a program's syndicability; from the producer's perspective, networks, first-run syndicators and cable networks would all be equivalent participants as