An Analysis of Various CRTC Proposals Presented in BNOC 2014-190

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Introduction

Wall Communications Inc. was asked by the Canadian Media Production Association (CMPA) to examine various proposals made by the CRTC in its *Let's Talk TV* proceeding (BNOC 2014-190). In particular, we were asked to examine how broadcasters – acting as rationale economic agents – would likely respond to certain proposals put forward by the CRTC.

The Report examines three proposals put forward by the CRTC: removing simultaneous substitution rules, removing exhibition rules, and opening up entry for non-Canadian specialty services. We first set out a description of the general economic behavior

The examination of each proposal begins with background information taken from the BN and then proceeds to analyze the implications of the proposal.

1. Exhibition

1.1 Background Statements BNOC 2014-190

62. The production and presentation of compelling programming is key to the success of the Canadian broadcasting system.

77. To ensure the presence of compelling Canadian programs on multiple platforms in the future, the Commission is prepared to consider various incentives and other measures, such as:

- Reducing or eliminating exhibition requirements for Canadian programs other than local programming.

Q33. What form should incentives take? Would eliminating certain requirements, for example, exhibition requirements, be an effective and appropriate incentive for producing Canadian programming or programming of certain types?

1.2 Analysis and Discussion

Exhibition requirements have been a long-standing regulatory tool to ensure that Canadian produced programs were available to viewers, especially in prime time. This tool has worked in a complimentary fashion to the incentives to produce Canadian programming – ensuring that Canadian content is not only produced but is also readily available to Canadian viewers.

Certain types of programming (e.g. drama) have also benefited in the past from time credits to further incent their exhibition in prime time.

OTA private TV broadcasters are required to air at least 50% Canadian content during the 6 p.m. to midnight period. Other broadcasters, such as Specialty Channels, have exhibition requirements set specific to the character of their service.

When examining the OTA prime time period of 6 to midnight (a six hour period), a requirement of at least 50% Canadian content implies a minimum of 3 hours of Canadian produced programming. In reality, broadcasters rarely go beyond three hours of Canadian programming in prime time.

Global currently airs Entertainment Tonight Canada from 7:30 p.m. to 8 p.m. on weekdays. Rookie Blue, Global's flag-ship drama, airs once a week from 10 until 11 p.m. Other Canadian programs make up the balance.

CTV airs a variety of one hour Canadian drama series on five nights in the week, including The Listener and Motive at either 9 p.m. or 10 p.m. They also program "etalk" from 7 p.m. to 7:30 p.m. on week days.

In short, the 3 hour average daily exhibition requirement for OTA broadcasters is typically met with 2 hours of news and an hour of other Canadian programming.

If broadcasters were no longer required to adhere to exhibition rules, prevailing economic considerations would likely induce a reduction in the amount of Canadian programming in prime time. Put simply, since comparable quality but less-costly non-Canadian content is available, it would be substituted for Canadian content as a matter of economic prudence.

This would be the case even if Canadian programming expenditure levels were retained. Again, as a matter of economics, a broadcaster would compare the net benefit from placing a US program in prime time versus a Canadian program. An illustrative example is provided below.

Assume the rights for US Program X can be purchased for $350,000. The license fee (or cost to the broadcaster) for Canadian Program Y is $450,000. Moreover, Program X would attract 20% more viewers than Program Y. It is therefore possible that advertising revenues might increase from the substitution.

Assuming there is no change in advertising revenue, it is still economically preferable to replace Canadian Program Y with US Program X since in our example there would be a net gain of $100,000 to the broadcaster. As noted, this is still the case even if minimum Canadian program expenditure requirements are retained. If advertising revenues increase due to exhibiting more US programming in prime time, the economic case for replacing Canadian programming with US programming in prime time is made more compelling.

While the illustrative example uses hypothetical numbers, the cost differential between Canadian and US programs is acknowledged throughout the industry. Moreover, the marketing of US programs is supported by massive celebrity actor exposure in magazines, newspapers and television shows. These efforts translate into higher awareness of US programs relative to Canadian programs.

The consequences of dropping exhibition requirements could be exacerbated by the programming expenditure rules for networks. Network group rules permit a broadcaster to shift its expenditure requirements among its programming undertakings (e.g. OTA operations and its specialty and pay channels). At the extreme, it could be more profitable for a broadcaster to aggregate its Canadian programming into a small number of viewing windows (for example, on a few specialty channels) while exploiting its best viewing window (e.g. the OTA network feed) with more US programming to maximize advertising revenue.

We would note that the predicted broadcaster behavior flows from the fact that prime time network airtime has the most potential viewers. Virtually all BDU subscribers receive local (or some type of) OTA signals whereas specialty channels have a more limited potential audience. And of course, prime time is the time when most viewership takes place. Rationale economic behavior would lead broadcasters to exploit the prime time network window, absent any other rules. This would best be achieved by replacing Canadian programs in prime time with less costly US programs.

2. Simultaneous Substitution

2.1 Background Statements from BNOC 2014-190

56. When broadcasters buy programs from Canadian and U.S. producers or networks, they pay to have exclusive broadcast rights in certain markets. Simultaneous substitution (SS) assists television stations in maintaining advertising revenues from these programs. Specifically, television stations use simultaneous substitution to maximize the audiences for their programs, which enables them to charge a higher advertising rate. Replacing the U.S. feed with

the Canadian one also ensures that advertising dollars remain in the Canadian market.

57. Simultaneous substitution was envisioned as a mechanism that would not be disruptive to viewers, that is, the program substituted is the same on both signals and broadcast simultaneously. However, errors made in performing substitutions and other problems as well as special events, such as the Super Bowl, have made it an irritant to consumers and a frequent source of complaints. In 2013, for example, the Commission received 458 complaints regarding simultaneous substitution, the majority of which related to the English-language market. Of these complaints, 20% were related to Super Bowl commercials, as viewers would have preferred to see the U.S. commercials instead of the Canadian ones. The rest pertained to improperly done substitution, especially during live sports events that run into overtime. Some participants in Phases 1 and 2 suggested that this practice be restricted or banned outright.

58. Another criticism of simultaneous substitution rules is that they have had the unintended consequence of tying the broadcast schedules of Canadian programming services to those of U.S. broadcasters. To take advantage of simultaneous substitution, Canadian broadcasters must organize their schedules to match those of U.S. networks. This restricts their ability to schedule and promote Canadian programs to Canadian audiences effectively, especially in prime time.

59. Further, the actual value of simultaneous substitution may be relatively small. Although the value of simultaneous substitution has previously been estimated at approximately $200 million annually, there are no up-to-date estimates of its value to Canadian broadcasters. This calls into question the efficiency and policy rationale for simultaneous substitution.

60. In light of the above, the Commission requests comments on whether simultaneous substitution remains an appropriate mechanism to enable local stations to maximize audiences and advertising revenues.

2.2 Analysis and Discussion

The CRTC has put forward the notion that simultaneous substitution hinders Canadian broadcasters since it locks them into airing a program at the same time (simultaneously) as the US airing. They suggest the possibility that Canadian programs could be moved to more favorable time slots – perhaps with a further possibility of an increase in the amount of Canadian programs shown in prime time.

Removing the simultaneous substitution requirements would mean that programs aired by Canadian broadcasters that are also received by viewers from a US originated signal would not be replaced by the Canadian broadcasters signal. In other words, a Canadian signal (with Canadian advertisements) and a US signal (with US advertisements) would both be available to Canadian viewers.

Canadian broadcasters purchase and air US programs for two reasons: 1) it is typically cheaper to buy the rights for a US program than to produce or purchase a comparable Canadian program; and 2) US programming is highly attractive to Canadian viewers and can in many cases attract larger audiences than a comparably priced (or even higher priced) Canadian program. The economics therefore suggest that Canadian broadcasters will continue to purchase US programs (with or without simultaneous substitution).

As a first-order consequence, removing SS would lead to lower advertising revenues for Canadian broadcasters since the reach of Canadian advertisements is reduced.

How is a Canadian broadcaster likely to behave? Are they likely to move a US-produced program to a different time slot and replace it with a Canadian produced program? We conclude that is unlikely.

In order to protect the investment it has made in the US program, a Canadian broadcaster is compelled to air the purchased US program at the same time as the US signal is airing it. If the Canadian broadcaster shows it at a later time, then much of the Canadian audience will already have watched the "first window" US feed – and they won't be watching the later Canadian feed. The Canadian broadcaster would therefore garner lower viewership and forego advertising revenues by shifting the program.

In order for a Canadian broadcaster to have an economic incentive to replace the US program with a Canadian program in a given time slot, the Canadian program would have to attract a larger audience than the US program at that time <u>and</u> the concomitant additional advertising revenues earned by the Canadian program would have to be sufficient to offset the drop in advertising revenues (that would have been earned by airing the US program) which were caused by moving to a later time slot. Moreover, we are assuming the costs of the Canadian program are at least as low as the cost of purchasing the US program – an assumption that rarely holds true.

Even though the Canadian broadcaster would suffer a loss of advertising revenue if simultaneous substitution were removed, they would likely suffer a greater loss if they didn't air the program at the same time as the US airing. Therefore, to minimize economic damage, Canadian broadcasters are likely to continue airing programs at the same time as the US feed, implying that there is little scope for scheduling more Canadian programs in prime time.

It could be argued that moving Canadian-produced programs to more favorable program slots would lead to improved popularity over time for those programs – and therefore to improved economics at some point in the future. However, that “potential” benefit for broadcasters in the future must be weighed against “real” higher acquisition costs and possibly lower advertising revenues today. There does not appear to be any strong economic rationale to suggest broadcasters would replace US-produced programs (which are established and relatively risk-free commodities supported by massive cross-platform international marketing) with higher-cost Canadian programs.

3. Allowing More Foreign Entry

3.1 Background Statements from BNOC 2014-190

52. One possible approach would be to authorize all non-Canadian services for distribution in Canada, except where it can be demonstrated that distributing a particular non-Canadian service would have an undue negative impact on the Canadian television system. For example, a non-Canadian programming service would be approved for distribution in Canada unless it holds exclusive program rights that would otherwise be available in Canada or if the non-Canadian service is an important source of programming for a Canadian service. As with the current approach, the Commission would continue to consider these applications on a case-by-case basis and would rely on evidence filed to demonstrate that authorizing a particular non-Canadian service for distribution in Canada would have an undue negative impact on the Canadian television system.

3.2 Analysis and Discussion

In order to project how broadcasters would respond to this proposal, we will first examine the current state in the market and the most likely scenarios for additional non-Canadian entry. Canadian specialty channels that partner with US (or other foreign) broadcasters typically rely on the foreign partner for a portion of their programming.

By taking an ownership position in a Canadian specialty, the foreign broadcaster is remunerated in two ways: first through the sale of programming rights to the Canadian channel and second through a sharing of net income of the Canadian channel. If no ownership rules were in place, it is likely that the US broadcaster would enter the Canadian market with their own channel - thereby minimizing costs, maximizing revenues and not having to share profits.

The Commission has suggested that they would not allow foreign entry if the entrant holds exclusive rights or is an important source of programming to a

Canadian channel. It is unclear how this "test" would be put into practice however. It would seem that the CRTC is suggesting that the onus would be on a Canadian channel to "demonstrate" the negative consequences of a given potential entrant. It is our view that since the terms of agreements change over time, it would be very difficult to know a priori whether a potential entrant could at some point begin to increasing exploit program rights that they either own or can somehow control. It would be even more difficult for an opponent to "demonstrate" future negative economic harm, let alone current economic harm.

Nor is it clear what metrics would be used to gauge the level of "undue negative impact". Every commercial transaction involving consumers and two or more competitive suppliers typically leaves some parties better off and some parties worse off. Attempting to measure a monetary level of benefit and harm arising from potential entrants is both complicated and ultimately speculative.

At the very least, opening up foreign entry shifts the balance of negotiating power to foreign broadcasters that own program rights used in Canada. Whether that leads to higher prices paid by Canadian channels or to outright dissolution of Canadian/non-Canadian partnerships in specialty channels is an open question[1].

Canadian broadcasters, and specialty channel broadcasters in particular, would need to assess if they are better off paying higher prices for those program rights or if they should switch to other programs to reduce costs. In either event, they are likely to be worse off economically.

[1] Numerous partial measures could be taken that would make demonstrating undue economic harm difficult. For example, ESPN could use their rights to some secondary sports to start up a specific channel in that sport rather than allow TSN to use that programming. Other major sports rights arrangements would remain intact. Would that be undue economic impact?