The Economics of the Network-Affiliate Relationship: Reply

By Stanley M. Besen and Ronald Soligo*

Daniel Graham and John Vernon’s (G-V) comment on our paper raises four points: 1) that we have erred in the construction of the curve marginal to our “supply” of time schedule; 2) that we have mistakenly identified the area under the supply curve as the return which a network affiliate would have received had it remained an independent station; 3) that if the network regards the marginal cost of supplying a program to an additional affiliate as zero that this will lead to an oversupply of programming; and 4) that when our analysis is extended to permit variations in the distribution of advertising time between the network and the affiliate that one of our conclusions, that the ban on option time permits the affiliate to earn above normal profits, is vitiated.

We are grateful to G-V for pointing out the technical slip in the construction of the curve marginal to the supply schedule and for indicating the inaccuracy in our description of area under the supply curve. We would point out only that while our description was inaccurate, our analysis was correct.

G-V’s third point is not correct. They are clearly right that the network must determine whether it should produce a program at all. And, clearly, for the network to be willing to do so the sum of the returns it gets from each of the stations that carry the program (the network share of advertising revenue minus the payment to the affiliate) must exceed the cost of carrying the program. But, contrary to their claim, the network need not have “overinvested in programming” even “... if the marginal revenue product to the network of the last hour cleared by a representative affiliate (and thus by all affiliates) is ... zero...” (p. 1034).

To see why this is so it is necessary only to recognize that the array of programs according to the sharing ratio which will induce the affiliate to accept programs can and in general will be different for different stations. The relative attractiveness of a given network program and its nonnetwork programming alternatives is likely to differ from market to market because, for example, audiences tastes differ. If these differences exist, the return to the network from the carriage of the marginal program by each affiliate can be zero while all programs in the network schedule are profitable. A program which is marginal for one station will be inframarginal for others and there will be contributions to network profits from the carriage of the program by all stations for which the program is inframarginal.

G-V’s analysis of this point is misleading in one important respect. It is generally not possible to write down an equation such as their profit-maximizing equation since it is not possible to know on the basis of data from a single station alone what share of the cost of a program it should bear if the network is to maximize its profits. For the case cited in G-V’s footnote 4 in which all affiliates are identical, equal apportionment of cost gives the correct answer, but in general it will not be possible to employ this procedure.

While G-V are correct that the network must earn positive profits on each program, their attempt to take production costs into account at the time of establishing the terms of the affiliation contract runs the risk that the network will not produce a program which would increase its profits. The approach that we suggest, that the network first decide what its payment will be to each affiliate if a program is produced and then decide whether the program should be produced at all, always yields the correct answer.

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while the proposed G-V procedure does not. As for point 4), G-V are correct that the network can, by reducing the proportion of advertising time during which an affiliate can sell advertising, shift the supply curve of programming upward, thus increasing network profits while leaving the amount of programming accepted unchanged. This represents an interesting extension of our model. We would, however, raise two points concerning it. First, the policy requires that the networks increase the proportion of network advertising revenue $p$ paid to affiliates to get them to clear the entire network schedule.\(^1\) But, as we pointed out in our paper (p. 264), there seems to exist an informal upper bound on $p$ which is designed to make it possible for nonnetwork program suppliers to have access to the time of network affiliates. If the increase in $p$ required by the reduction in station advertising time would cause it to exceed this limit, it may still prove impossible for the network to get all of a station’s quasi rents. Second, since presumably one of the objectives of the ban on option time was to increase station profits, the Federal Communications Commission might not be terribly receptive to changes in network behavior which offset the effects of the ban, especially when the objective of the change is likely to be transparent. The basic thrust of G-V’s point 4) deserves emphasis, however. When the regulated firm has many degrees of freedom, it will often be able to partially or totally frustrate the efforts of the regulators.

\(^1\) Network profits increase, nevertheless, because the total amount of network advertising revenue increases.

REFERENCES
