Regulation of TV Group Owners in Canada: Addressing the Potential for "Gaming" of the Broadcasting System

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Introduction

This is a critical time for the over-the-air (OTA) TV broadcasters in English Canada. Faced with declining revenues and profits, they have been granted one year renewals by the CRTC. But they will also be called to a hearing starting on September 29, 2009, to discuss the policies that should apply for their long-term renewals to come next year.

The public notice for that hearing is to be issued in early July. But the Commission has already indicated in a preliminary way how it wants to proceed. In recent speeches in Banff and before the Heritage Committee, the Commission Chair has identified seven areas where the Commission expects to implement structural reform.

The first is the concept of using a group-based approach to licence renewals. The second is to focus the OTA services on what are considered "core elements", i.e. local news, local programming and Canadian programs of national interest. The third concept is to link local programming obligations to the size of the market. Fourth, introducing revenue support for OTA services through various means. Fifth, requiring firm commitments from OTA broadcasters on local news, local programming and programs of national interest. Sixth, requiring restraint on foreign programming and/or commitments toward Canadian program spending. And finally, seventh, finding an acceptable approach for the transition from analog to digital television.

This is an ambitious agenda for the fall hearing and the Commission will undoubtedly give more guidance as to what it wants to discuss in its notice of consultation and hearing expected in July.

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This morning I'm not going to weigh in on the whole agenda. We also have a panel coming up next on the crisis facing over-the-air television broadcasting.

Instead I propose to discuss some fundamental accounting issues that will arise if the Commission intends to follow through on its agenda. In particular, I'm going to address how the Commission should proceed if it wants to have meaningful requirements on Canadian programming that are not undermined by accounting loopholes or so-called "gaming" of the system.

This is not a theoretical exercise. In Canada, we have had a long history of private licensees interpreting CRTC rules in a way to minimize their adverse effect. And this is entirely understandable.

Some of these accounting strategies have already been identified and struck down by the Commission in various decisions, rendered after the strategies came to its attention. But others will need to be addressed if we want to have a system with clear obligations and regulatory integrity.

Allocation of Program Costs

In discussing this, I'm going to focus primarily on program costs and their allocation. I'm not going to address the allocation of other expenses – such as shared operating costs or management fees. These too can be manipulated to undermine the effect of regulation, but that would warrant a separate discussion.

In looking at program costs, I also want to set aside the issue of timing. You can account for programming costs on a cash basis or on an amortization basis. Both approaches can be defended and, as long as a broadcaster applies the approach consistently, this is not an area that should give rise to concern.

There are also two problems that don't need to be discussed in detail because the Commission has already addressed them a number of years ago. Those problems relate to double counting and recoupment.

Double counting occurs when a group owner purchases the rights to broadcast a program on two or more platforms, but claims the entire purchase price for both services. Related to this is the recoupment problem. For instance, if a particular station buys national rights to a program and then recoups some of this cost by selling off local rights to various other stations across the country, that first station might claim the whole national licence fee as its expenditure, while the other stations also count their portion of the cost towards their expenditures. The first station gets partial recoupment, and the expenditure is in effect double counted.

A similar recoupment problem occurs when a licensee claims an expenditure was made even though within a certain period of time, it was recouped. An obvious example is a loan. That is not an expenditure and shouldn't count as an expenditure unless it is never repaid.

These kinds of abuses – double counting and recoupment – are not theoretical matters. They famously occurred in Canada in the early 1990's until the Commission learned about them and addressed the issues in Public Notice CRTC 1993-93.

In my discussion today, I'm not going to dwell on these problems because I think they are adequately addressed in that public notice.

However, there are two other issues that do need to be addressed. One is the misallocation problem. The second is the misattribution problem.

The problem of misallocation relates to the allocation of the price of a program between two services. In Public Notice 1993-93, the Commission left this entirely to the judgment of the broadcaster as long as there was no double counting.

However, this gives rise to a problem when the two services are regulated differently. Suppose a group owner purchases a priority program which can run on both an OTA service and a specialty service. But only the specialty service has a CPE requirement. Then the owner will allocate as much of the licence fee as possible to the specialty service, not the OTA service. But the OTA service will still count the program towards its priority program scheduling requirement. The asymmetry in CRTC regulation creates an incentive for misallocation. And this kind of misallocation has been happening over the last few years.

Now some people might say, you will need to regulate how you make such an allocation. But that is very difficult in practice. There is legitimate room for a number of allocation approaches and there is no accounting standard for allocation that is fixed in stone. There is a lot of room for subjectivity here.

However, there is a simple solution and I'll come to that in a minute.

The second kind of accounting loophole that can undermine the regulatory system is the misattribution problem.

This is the problem that occurs when a station claims to have expended money on a program but in fact that money was expended by someone else and misattributed to the station. Another variant is when a station overspends on a program but the overspending drops into the pockets of its subsidiary.

The classic example of the first type of misattribution is the CRTC "licence fee top-up" policy which currently allows private broadcasters to claim some of the CTF expenditures – now the Canada Media Fund -- as if they had spent the money themselves.

I have long criticized this policy. It flies in the face of transparency and it distorts the system. Dollars contributed by BDUs should add to program funding, not subtract from it. The system is also highly discriminatory since it counts a dollar spent by one licensee as having greater weight than the same dollar spent by another. I would hope that the Commission will review this policy as part of its proceeding next year and it would be the right time to do so, since the pay and specialty licences will be before it as well as the OTA licences. So any necessary adjustments to CPE levels to address this can easily be made.

The other kind of misattribution problems occurs when there is self-dealing. Suppose the Commission requires a proportion of original hours to be licensed from independent producers, but allows a portion to be produced in-house or through subsidiary companies. There is then an

incentive for the service to pay its own company a higher licence fee than it would to an independent producer for a comparable program. The higher licence fee counts towards the service's CPE requirement but also drops to its subsidiary's bottom line.

What to Do?

Now, having identified these problems, how can the CRTC address them?

Let's start with how one might address the U.S. overspending problem. Over the last five years, as we all know, the private English language OTA groups massively increased their US program spending. It rose from 27% to 40% of revenue. This seems to fly in the face of s. 3(1)(f) of the *Broadcasting Act*, and the CRTC Chair suggested applying a 1 to 1 ratio for foreign and Canadian spending. However, the OTA services avoided having such a rule for the coming year. But the issue has not gone away. As the CRTC Chair stated to the Standing Committee last month,

> "To live up to the objectives of the *Broadcasting Act*, some sort of restraint or attenuation is required. It remains to be determined whether this should by achieved by way of ratio, minimum Canadian expenditure requirements or a percentage of revenues obtained. But some sort of restraint mechanism appears necessary and desirable."

Putting a cap on the U.S. spending, or establishing a 1 to 1 ratio with Canadian program spending, raises difficult allocation issues. The reason is that even if you impose a cap on US spending for an OTA licence, the group owner might be able to allocate some of those costs to a platform that has no cap on U.S. spending. So unless you put a cap on U.S. program spending across the board, it won't work. And apart from accounting issues, putting a cap on U.S. spending also creates trade irritants.

To me, the better solution is simply to put a floor on the Canadian program spending by the OTA licensees.

Over the last five years, each of the English private OTA licensees spent between 25% and 27% of their ad revenue on Canadian programming. Last year, for example, the number for CTV was 25.5%, CanWest was 26.6% and Rogers was 26.8%. Given that history, 26% might be an appropriate level for a floor over the next seven years. And as I have said, to be fair and non-discriminatory, this needs to be real money spent by the group owner and not include licence fee top up.

The Commission might also find it appropriate to include an expectation in its decision that the U.S. spending will decline to more reasonable levels. But its key concern under the Act needs to be the Canadian program spending. Putting a CPE requirement on OTA ensures that the US overspending does not adversely affect Canadian program spending.

There is a second benefit to putting a CPE requirement on the OTA licensees. By doing so, the Commission removes any regulatory incentives to misallocate Canadian spending between services owned by the group, since all the services will have their own CPE requirement and double counting is prohibited. With symmetrical regulation, you eliminate any regulatory incentive for misallocation.

So, for example, if CTV buys a comedy show like "Corner Gas" and runs it both on its OTA network and on the Comedy Channel, it can allocate the price any way it likes between the two services, but only the portion so allocated counts towards the CPE applicable to Comedy and the portion allocated to CTV counts towards the CPE applicable to CTV.

By having a CPE floor set for each of the services owned by a group owner, the CRTC largely eliminates any regulatory incentive to misallocate Canadian program spending as between OTA and the commonly owned specialty services. And the second advantage is that putting a CPE floor on OTA probably obviates the need to put a cap on U.S. program spending.

Supporting Programs of National Interest

That brings me to the most difficult problem, the support of programs of national interest that otherwise would not be produced. In his speech to the Heritage committee, the CRTC Chair said that "in exchange for the above-mentioned harmonization of obligations and negotiated funding, it will be necessary for OTA broadcasters to provide firm commitments regarding local news, local programming and programs of national interest."

Apart from news or sports, most programs of national interest would qualify as priority programs. And the most difficult to finance of these priority programs is Canadian drama.

So if we're going to talk about programs of national interest, Canadian drama is where the rubber hits the road. Given its cost and its risk, it is clear that OTA broadcasters will not commission drama unless there is a requirement to do so. Left to their own devices, and even if they had a CPE requirement, the OTA licensees would have major incentives to spend it all on Canadian news and sports, not on drama. Or they would go with cheaper Canadian content like magazine shows.

So what do you do about Canadian drama or other programs of national interest that would not otherwise be produced? One answer is to single out the program category and seek commitments for so many new original hours per year. This was the system back in the late 1990s, when CTV and Global were each required to commission about 2 ½ original hours of drama per week. But this too is problematic. Given their different revenue base, the group owners would not be able to commit to the same output levels. In addition, there would be an incentive to go with cheaper drama – *Train 48*, anyone?

In looking at this problem more closely, I think the solution lies in looking at all the broadcast services owned by the group. Remember, when an OTA group owner commissions Canadian drama, the licence fee typically covers runs on all their group-owned services, both OTA and specialty. And the beauty of well-done drama is that it does have shelf life and can be offered on many platforms.

All of which suggests a more innovative approach. That would be to impose a spending requirement for the program category under threat, like Canadian drama, but one that applies not to any particular service, but to all the services owned or controlled by the group owner. Let me explain how it might work.

A few years ago, when the late Charles Dalfen was Chair, the CRTC suggested that an appropriate target for Canadian drama spending by the OTA licensees should be 6% of revenue, not including licence fee top up or transfer benefits. But the target was never met and in fact Canadian drama spending by the OTA services went down not up. Interestingly, however, Canadian drama spending by the pay and specialty services has continued to rise, driven by the CPE requirements on the drama-oriented services.

To my mind, there is an innovative solution to the Canadian drama problem that also addresses the accounting problems I have mentioned. What you could do is to set a drama expenditure condition for the group owner. You would start by finding out how much the specialty services owned by the group owner spent last year on Canadian drama, as a percentage of revenue, net of licence fee top-up. To this you would add a certain percentage of the group owner's OTA revenues. The CRTC established 6% as an appropriate OTA target, but this might be adjusted to take account of the recession, or phased in over time. Whatever the number, the aggregate amount would be converted into an overall percentage of the group revenues.

You then do the necessary arithmetic and apply a licence condition, namely, that the group owner spend no less than the required percentage of overall group revenues on Canadian drama in the coming year.

Of course there would be an expectation that the big-ticket drama will show up on the OTA stations as well as on the specialty services. But in my view there is probably no need to regulate this. The broadcaster would have every incentive to put big-ticket Canadian drama on whichever platform or platforms deliver the biggest audience.

Nor would there be any requirement as to how the program cost is allocated between services. What is spent would count towards the CPE of any service chosen by the broadcaster, as long as there was no double counting. The key is to ensure that the total required amount is spent. Of course there would be flexibility in terms of under or over spending in any particular year.

I can see five advantages for this approach.

1. It does not dictate the number of hours, or the cost per hour. It gives the group owner complete flexibility in regard to the kind of drama to be financed. The licensee can opt for a larger volume of cheaper drama. Or it can elect to support a smaller number of higher-cost dramas, even Canadian feature films, which have long been under-supported by our OTA sector. The licensee can make the "quality vs. quantity" trade-off, but in the end it must still spend the dollar amount required.

2. The amount required to be spent is based on a percentage of the previous year's overall revenue, so it automatically adjusts upwards or downwards if ad or subscription revenue changes.

3. The CRTC does not have to concern itself with how the cost is allocated between the services, as long as no double counting occurs.

4. This approach takes advantage of the massive consolidation of ownership that has taken place in the last few years. Despite the decline in OTA revenue, the group owners each have

profitable specialty services under their wing. This approach enlists their support to fund under-represented Canadian programming.

5. And finally, the most critical benefit. With a drama expenditure requirement, the focus for the licensee will turn away from the accountant's question, "how can I get away with spending less?" and towards the programmer's question, "since I have to spend the money anyway, *which Canadian drama will get me more viewers?*" This is a profound change in attitude but it will only come if there is an expenditure requirement for drama.

There is one last accounting problem that needs to be addressed in order to protect the position of independent producers. Currently the CRTC has an expectation that at least 75% of the priority programming broadcast in the year by CTV or CanWest Global be produced by independent production companies. But this does not distinguish between originals or reruns and does not prevent misattribution of program cost.

The solution is simple: have the 75% rule apply to both hours and value, instead of hours alone. In other words, if you have a drama expenditure requirement applicable to the group, simply say that at least 75% of the hours and 75% of the expenditure must be on independently produced drama. That addresses any misallocation of cost caused by self-dealing.

When I began this presentation, I mentioned that the Commission may implement a number of regulatory measures but unless the measures are carefully worded or thought through, they may be undermined or even rendered ineffective by various accounting strategies.

However, the advent of group owner licensing also gives the Commission an opportunity to address its regulatory agenda with some innovative approaches. If carefully thought through, these can forestall to a large extent any gaming of the system.

Thank you.