Broadcasters' woes could spell trouble for free TV

December 29 2009, By ANDREW VANACORE , AP Business Writer

In this advertisement released by Time Warner Cable, a warning that FOX has threatened to pull the plug on Time Warner Cable customers at midnight, New Year's Eve, unless the cable company gives in to demands for massive price increases.(AP Photo/Time Warner Cable)

(AP) -- For more than 60 years, TV stations have broadcast news, sports and entertainment for free and made their money by showing commercials. That might not work much longer.

The business model is unraveling at ABC, CBS, NBC and Fox and the local stations that carry the networks' programming. Cable TV and the Web have fractured the audience for free TV and siphoned its ad dollars. The recession has squeezed advertising further, forcing broadcasters to accelerate their push for new revenue to pay for programming.

That will play out in living rooms across the country. The changes could mean higher cable or satellite TV bills, as the networks and local stations squeeze more fees from pay-TV providers such as Comcast and DirecTV for the right to show broadcast TV channels in their lineups. The networks might even ditch free broadcast signals in the next few years. Instead, they could operate as cable channels - a move that could spell the end of free TV as Americans have known it since the 1940s.

"Good programing is expensive," Rupert Murdoch, whose News Corp. owns Fox, told a shareholder meeting this fall. "It can no longer be supported solely by advertising revenues."

Fox is pursuing its strategy in public, warning that its broadcasts - including college football bowl games - could go dark Friday for subscribers of Time Warner Cable, unless the pay-TV operator gives Fox higher fees. For its part, Time Warner Cable is asking customers whether it should "roll over" or "get tough" in negotiations.

The future of free TV also could be altered as the biggest pay-TV provider, Comcast Corp., prepares to take control of NBC. Comcast has not signaled plans to end NBC's free broadcasts. But Jeff Zucker, who runs NBC and its sister cable channels such as CNBC and Bravo, told investors this month that "the cable model is just superior to the broadcast model."

The traditional broadcast model works like this: CBS, NBC, ABC and Fox distribute shows through a network of local stations. The networks own a few stations in big markets, but most are "affiliates," owned by separate companies.

Traditionally the networks paid affiliates to broadcast their shows, though those fees have dwindled to near nothing as local stations have seen their audience shrink. What hasn't changed is where the money mainly comes from: advertising.

Cable channels make most of their money by charging pay-TV providers a monthly fee per subscriber for their programing. On average, the pay-TV providers pay about 26 cents for each channel they carry, according to research firm SNL Kagan. A channel as highly rated as ESPN can get close to $4, while some, such as MTV2, go for just a few pennies.

With both advertising and fees, ESPN has seen its revenue grow to $6.3 billion this year from $1.8 billion a decade ago, according to SNL Kagan estimates. It has been able to bid for premium events that networks had traditionally aired, such as football games. Cable channels also have been able to fund high-quality shows, such as AMC's "Mad Men," rather than recycling movies and TV series.

That, plus a growing number of channels, has given cable a bigger share of the ad pie. In 1998, cable channels drew roughly $9.1 billion, or 24 percent of total TV ad spending, according to the Television Bureau of Advertising. By 2008, they were getting $21.6 billion, or 39 percent.

Having two revenue streams - advertising and fees from pay-TV providers - has insulated cable channels from the recession. In contrast, over-the-air stations have been forced to cut staff, and at least two broadcast groups sought bankruptcy protection this year.

Fox illustrates the trend: Its broadcast operations reported a 54 percent drop in operating income for the quarter that ended in September. Its cable channels, which include Fox News and FX, grew their operating income 41 percent.

Analyst Tom Love of ZenithOptimedia said he expects the big networks will end the year with a 9 percent drop in ad revenue, followed by an 8 percent drop in 2010 and zero growth in 2011.

A small chunk of the ad revenue is being recouped online, where the networks sell episodes for a few dollars each or run ads alongside shows on sites such as Hulu. Media economist Jack Myers projects online video advertising will grow into a $2 billion business by 2012, from just $350 million to $400 million this year.

But that is not significant enough to make up for the lost ad revenue on the airwaves. Advertisers spent $34 billion on broadcast commercials in 2008, down by $2.4 billion from two years earlier, according to the Television Bureau of Advertising.

So rather than wait for the Internet to become a bigger source of income, the networks and local stations are mimicking what cable channels do: They're charging pay-TV companies a monthly fee per subscriber to carry their programming.

Since 1994, the Federal Communications Commission has let networks and their affiliates seek payments for including their programming in the pay-TV lineup. Not everyone demanded payments at first. Instead they relied on the broader audience that cable and satellite gave them to increase what they could charge advertisers.

The big networks also were content to let their broadcast stations essentially be subsidized by higher fees for the cable channels that fell under the same corporate umbrella. A pay-TV company negotiating with the Walt Disney Co., which owns ABC, is likely paying more for the ABC Family channel than it otherwise would, with the extra assumed to help Disney cover its costs for the ABC network broadcasts.

But over time - such contracts generally run about three years - more networks began demanding payments for the stations they own. And affiliates already receiving the fees have bargained for more money.

Some talks have been tense. In 2007, Sinclair Broadcast Group, which operates 32 network-affiliated stations around the country, pulled its signals for nearly a month from Mediacom Communications Corp., which provides cable TV to about 1.3 million subscribers, mainly in small cities.

The American Cable Association says its members - mainly small cable TV providers - have seen their costs for carrying local TV stations more than triple over the past three years. The group's head, Matt Polka, says those fees have gone "straight to consumers' pocketbooks" in the form of higher cable bills.

Gannett Co., for instance, which operates 23 stations, has taken in $56 million in fees from pay-TV operators this year after negotiating a new batch of agreements, up from $18 million in 2008. Dave Lougee, president of Gannett's broadcast arm, defends the fees, saying "broadcasters were late to the game in really starting to go after the fair market value of their signals."

Analysts estimate CBS managed to get as much as 50 cents per subscriber in its most recent talks with pay-TV providers that carry CBS-owned stations. CBS Corp. chief Leslie Moonves said such fees should add "hundreds of millions of dollars to revenues annually."

That could be just the beginning. CBS and Fox are also asking for a portion of the fees that their affiliates get, arguing that the networks' shows are what give local stations the leverage to ask for fees.

Over time, the networks might be able to get even more money by abandoning the affiliate structure and undoing a key element of free TV.

Here's why: Pay-TV providers are paying the networks only for the stations the networks own. That amounts to a little less than a third of the TV audience, which means local affiliates recoup two-thirds of the fees. If a network operated purely as a cable channel and cut the affiliates out, the network could get the fees for the entire pay-TV audience.

If forced to go independent, affiliates would have to air their own programming, including local news and syndicated shows.

Fitch Ratings analyst Jamie Rizzo predicts that at least one of the four broadcast networks "could explore" becoming a cable channel as early as 2011.

Any shift would take years, as the networks untangle complicated affiliate contracts. At an analyst conference last year, CBS's Moonves called the idea an "a very interesting proposition." But he added that it "would really change the universe that we're in."