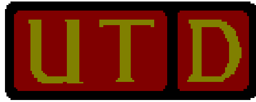

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DATE: September 28, 2007

TO: Jonathan Levy, Deputy Chief Economist,
Federal Communications Commission

FROM: Robert Kieschnick, Associate Professor and the Finance and Managerial Economics Area Coordinator, University of Texas at Dallas

SUBJECT: Review of the Attachment J: "The Declining Financial Position of Television Stations in Medium and Small Markets, 2006" by Theresa J. Ottina.

I have reviewed the report entitled, "The Declining Financial Position of Television Stations in Medium and Small Markets, 2006," by Theresa J. Ottina. While I think that the report provides interesting information, for which the author should be commended, I do not see that the report provides sufficient information to reach its conclusion on page 10: "As this study demonstrates, a relaxation of the television duopoly rule to permit common ownership of two stations in smaller markets would provide needed financial relief for these struggling stations, thereby increasing the strength of local television." For example, no where in the report does the author provide evidence that a station would fail without being operated in a duopoly. Unfortunately, this is just one example of the issues unaddressed by the report that needed to be addressed before it can argue that its conclusion is supported by its evidence.

More generally, I have a number of concerns with the data reported and the statements made about the reported data. I list them below in the order that they are encountered in the report.

1. The report begins by noting on page 2 that the data were derived from the NAB/BCFM Television Financial Survey for 1997, 2001, and 2003. While the author notes the response rates on page 2, nowhere in the report does the author indicate that this was taken into account in deriving the mean estimates. Thus the self-selection error in the reported estimates is not addressed and so the reported estimates are of questionable value.

2. The author notes on page 3 that the data for the cash flow and pre-tax profit line items were only used for markets in which the highest and lowest rated affiliated station participated in the survey. Why the author imposed this filter is not explain, nor is there any discussion of the biases that such a filter might introduce into the reported estimates.

3. On page 3, the author talks about Table 1. The report says: "The table below displays the number of markets included in each market-size grouping." However, the top line of the table states: "Number of Stations Included." to describe the entries in each year column. So, which is it: number of stations or number of markets?

4. Tables 2, 3, 4, 5, and 6 reported the same information but for different market segments (e.g., 51-75, etc.). Consequently all these tables share common problems.

4.1 Each table has columns for the "cash flows" of high rated stations and low-rated stations. On page 4, footnote 2, the report defines "cash flow as net revenues minus total expenses." Then on this same page in footnote 3, the author defines "pre-tax profits" as "cash flow minus depreciation & amortization & interest." If the author is following the standard accrual model, then total expenses include "depreciation & amortization & interest" and the author is double counting. While I doubt that this is true. I think the report's lack of clarity in what it means and how "cash flow" is measured raises questions about just what the data represent and why they are relevant. While one might conjecture that the author was talking about earnings before interest, taxes, depreciation and amortization, I can think of several alternative definitions of cash flow used in the financial community and so the author's definition needs to be clarified before its usefulness can accessed.

4.2 The discussion in the report suggests that the reported data reveal something important about the financial welfare of the reporting television stations. While an accountant might find the data relevant to revealing something about the financial welfare of the reporting television stations, an economist, or financial analyst, or investor would find the data inadequate for this purpose. Let me illustrate with a simple example.

Suppose that we have two TV stations with cash flows as set out below and defined as earnings before interest and taxes. If the operating capital of the two TV stations differs as below, then Station A despite its lower cash flow represents a better investment for its investors than Station B. If the cost of capital of the two stations differs, then the differential could be greater or lesser than shown.

TV Station	A	B
Cash Flow	1,000,000	10,000,000
Net Operating Profit After Taxes		
(40% tax rate)	600,000	6,000,000
Operating capital	3,000,000	60,000,000
ROIC	20.00%	10.00%
Cost of capital	15%	15%

The point of the above example is that the financial health of a station, or a group of stations, from an investor's point of view cannot be ascertained from the evidence reported in this study.

4.3 Each of the above referenced tables reports the average “network compensation for all affiliate stations” and the average “news expense all affiliate stations.” According to the report’s stated definition of “cash flows” these revenues and expenses are accounted for in the cash flows numbers and so the rationale for breaking these items out is unclear. Further, and more importantly, the patterns shown for these averages do not match the patterns for the cash flows in a number of the market segments, which raise a number of questions.

For example, on page 4, the report says: “Declining network compensation coupled with increasing news expenses adds to the tenuous financial situation of these small market stations.” Thus, the author appears to suggest that the drop in average network compensation over time means that stations are worst off. However, one cannot draw such a conclusion based upon the reported evidence. For example, if the networks allocated more ad time to the local affiliate for its use at the same time they cut their network compensation then some affiliates might be better off depending on what they can charge for their local ad time. Such a conjecture would be consistent with the fact that the pattern of cash flows for a number of market segments does not match the pattern for network compensation or news expense for these same market segments. Regardless, the fact that these patterns are not the same in different markets suggests that drawing conclusions about the financial health of stations based upon these components is not appropriate.