

The NHL Lockout



BEM 106 Final Paper

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Background

Executive Summary

On February 16, 2005, National Hockey League Commissioner Gary Bettman announced that due to the inability of the league owners and its players' union, the NHLPA, to agree on a new collective bargaining agreement, the 2004-05 NHL season will be cancelled, the first time in major American professional sports history that a league has had an entire season wiped out due to a labor dispute, and the first time since 1919 that the league's coveted Stanley Cup trophy will not be awarded. Our project will design a strategy that will help the league overcome this dispute and return with a product that is financially successful as well as exciting and entertaining for hockey fans.

The NHL

The National Hockey League began play in 1917, though it has its roots in the Amateur Hockey Association, formed in Canada 30 years earlier. Before long, the NHL established itself as the premier hockey league in North America, and began adding expansion teams to its Original Six (Montreal, Toronto, Boston, New York, Detroit, and Chicago) in 1967. Currently, there are 30 teams, six of which are in Canada, the rest in the United States. Though the NHL was always considered one of the four major American sports leagues, along with the NFL, NBA, and Major League Baseball, hockey has always trailed the other three sports in popularity. This is partly due to the fact that while baseball, basketball, and football have wide-ranging appeal, hockey has more of a niche audience, with most of its fans concentrated in Canada and the northern United States. Here, the cold climate helps to foster an interest in ice hockey and winter sports in general. Hockey is also unique in that it caters more to its diehard fans than to the general public. For example, hockey is the only sport in which players are permitted to fight each other during a game. While hardcore fans argue that fighting is both an entertaining and necessary element of the game, the more casual watchers are often appalled by it. Recent attempts by Commissioner Bettman to reduce violence in the NHL and make the sport more family-friendly have not been successful, as they have not only failed to draw new viewers, but through softening the game they have also alienated loyal

NHL fans. Due to this and a variety of other reasons, hockey has waned in popularity in recent years. Television networks, noticing the poor ratings of televised hockey, have decreased the number of games shown to the point where hockey has become almost irrelevant. The lack of exposure merely compounds the problem. Thus, when the news of the lockout came, the general reaction was a mix of acceptance and indifference. People either already knew that this was coming, or they simply didn't care.

The 2004-05 Lockout

The NHL experienced its first lockout before the 1994-95 season, though the dispute was eventually settled and a collective bargaining agreement was reached that lasted to the 1998-99 season (later extended to 2003-04), and a reduced schedule of games was played. During the 2003-04 season, there was constant speculation that the league and the players were too far apart on key issues and that another lockout was probable. Negotiations between the two sides on a new CBA began shortly after the season ended, but they soon stalled. The lockout officially began September 16, 2004, the day the 2004-05 season was scheduled to begin. When the league-imposed deadline of February 16, 2005 came, and no agreement had yet been reached, despite a number of last-ditch efforts by both parties, the entire season was cancelled. Now, talks have all but stopped, and a large number of former NHL players have gone overseas to play for European leagues, or in upstart leagues in North America, such as the new World Hockey Association. While both sides remain optimistic that play will be resumed for the 2005-06 season, neither is willing to give in to the other's demands, and the NHL has already discussed the possibility of using replacement players.

Issues of the Lockout: Cost Certainty and Salary Cap

The NHL's team owners argue that the salaries earned by its players are too high for the revenues that the league is receiving. The NHL spends more of its revenue (76%) on player salaries, than football (64%), baseball (63%), and basketball (58%).¹ The league also claims that its clubs collectively lost \$273 million during the 2002-03 season and \$1.5 billion over the course of the CBA², which took effect before the 1994-95 season, though these figures are disputed by the players. However, even if this were the case, it

is clear to any hockey fan that the NHL trails far behind the NFL, NBA, and MLB in popularity. As an example, we can examine the NHL's television contracts with ESPN and NBC, which are 1-year deals, with the ESPN contract paying \$60 million, and the NBC contract guaranteeing the league no money, only a share of profits.³ To put this in perspective, the NFL's new contracts with FOX and CBS are for a combined \$8 billion over 6 years.⁴ This clearly shows that televised hockey is in low demand, especially when compared to the other sports. The current financial situation has caused Commissioner Bettman to promote a concept that he calls "cost certainty," the idea that player salaries should be directly tied to revenues, so that no matter how poorly the NHL is doing, it will remain profitable.⁵ To realize this, the league owners have proposed a salary cap, a maximum allowed payroll for every team directly based on league revenue. This has been implemented to great success in the NFL and NBA. Other than the cost certainty aspect, a salary cap would also serve to balance the talent level over all teams, making play more competitive and increasing the overall quality of the product. The NHL players, however, stated that they will never accept any sort of salary cap, and that player compensation should be based on their market value, and have proposed a revenue sharing scheme that they claim would provide many of the competitive benefits of a salary cap¹. While proposed solutions have come from both sides and a variety of third-party sources, the league and its players still seem far apart and unlikely to reach any sort of agreement.

Five Forces Analysis

New Entrants

New entrants into this industry are other hockey leagues. However, with further examination we can see there are a number of entry barriers that reduce the threat of these entrants. The current lockout was caused by financial problems less related to the NHL specifically than to the unpopularity of hockey in general. It is likely that any new league will have the same problems attracting fans as the NHL did. Furthermore, there are extremely high operating costs associated with running a professional sports club, such as

acquiring and maintaining a stadium, advertising, and of course player salaries. While a former NHL player may choose to play in a new league for a low salary temporarily, it would most likely be on the assumption that he would, at some point, be able to return to the NHL and resume making a much higher salary there. This means that any new hockey league would be viable only as a short-term operation. Furthermore, if the new league attempted to stay in business even after the NHL returned, the competition between these two leagues for star players would dilute the talent and reduce the overall quality of play, while at the same time raising player salaries, which would be disastrous for both leagues. The failure of the two proposed new leagues started during the lockout, the World Hockey Association and the Original Stars Hockey League, to play more than a few exhibition games⁶ demonstrates that there are great entry barriers to any prospective new hockey league.

Buyer Bargaining Power

The NHL gains revenue from gate receipts, television contracts, and merchandise sales. All three are directly tied to fan interest and support of the league. Furthermore, the demand for hockey is relatively elastic. While the league has a small base of diehard fans, the majority of its audience is fairly indifferent, as evidenced by the general lack of public outcry during the lockout, especially when compared to that seen during the 1994 baseball strike. The NHL's revenue is completely dependent on fan interest, and because its base of loyal fans is relatively small compared to its casual viewers, it must cater to the needs of these fans. Individual fans can have very little bargaining power, but the NHL must nonetheless be receptive to the wishes of its fans as a whole. For this reason, major television networks have a fair amount of bargaining power. The NHL is dependent on the networks to increase the sport's exposure, and the networks in turn demand a product that appeals to both audiences and advertisers.

Supplier Bargaining Power

The NHL's product is hockey, and the quality and entertainment value of the games is directly tied to the talent level of the players. However, the players have little bargaining power because they really have few alternatives to playing in the NHL. While

many players have already gone to play in Europe during the lockout, they are receiving far less compensation than they would have from the NHL, and most likely will return to playing in the NHL when the lockout is resolved. In addition, the players do not have the option of playing in other North American leagues, as discussed in the topic of new entrants. Most hockey players have few good alternatives to playing in the NHL, so they have little bargaining power. Although they have little individual bargaining power, they increase their collective power through the players' union. The NHL needs talented players if it is to maintain and grow its fan base. Since the best players in the world were already playing for the NHL, there is no comparable player pool from which the NHL can draw replacement players. Therefore, the players' union as an entity has a decent amount of bargaining power.

Rivalry

Because of the entry barriers, the NHL has been and will always be the only major professional hockey league in North America, and foreign leagues don't compete with the NHL for the same audience. The NBA, NFL, and MLB offer a completely different product than the NHL, so they cannot be considered rivals. Thus the effect of rivalry on the NHL is minimal if not completely non-existent.

Substitutes

Other sports can be considered substitutes for NHL hockey. Because the majority of the NHL's teams and fans are in the United States, where hockey is far less appreciated than in Canada, most fans see sports like basketball and football as an alternative to hockey, rather than as a separate product. With far smaller revenues than other sports, the NHL spends relatively little on advertising, and because of its unpopularity, few networks are willing to broadcast its games nationally, so the NHL receives far less exposure than the other leagues. This lack of accessibility is only more reason for a fan to substitute another sport for hockey.

Complements

Any hockey-related product such as sticks, jerseys, or hockey video games and movies is a complement to NHL. Moreover, school and amateur leagues are also an important complement to the NHL. Professional hockey is popular in Canada because it is integrated into the culture through children who play hockey at a young age and are exposed to hockey far more often than American children. Therefore, anything that can foster an interest in hockey in general could be thought of as a complement to the NHL.

Strategy

Increase Fan Base Through Revenue Sharing

The current problems with the NHL can be attributed to a weak and uneven fan base. Forbes Magazine reported that in 2003-04, the NHL lost roughly \$124 million.⁷ Though this number is less than half of the number that the NHL owners reported, it is still substantial. The teams with the largest player expenditures received the greatest share of the revenue although this did not necessarily lead to a profit. Because a player's salary is directly correlated with his ability to perform, teams that bring in more revenue are able to afford a higher payroll and thereby attract more high-priced talents than smaller teams. A team with a more talented roster is able to win more games and thus make more money, leaving smaller teams unable to compete. Teams compete for elite players because name recognition will draw fans, and their ability will help improve the team, which further increases fan interest, leading to more revenue. However, this competition is not beneficial to the league as a whole. Teams with large number of high-salaried superstars tend to dominate their opponents, making play predictable and unexciting, which leads to fan disinterest.⁸

The interest of fans in a sports league are, as predicted by game theory, correlated with the talent in the league and as well as outcome uncertainty of the game.⁹ Because the NHL can attract elite talent from around the world, it is evident that the NHL's current problems stem from a lack of competitive balance. Dr. Eberhard Feess, an economist from the University of Aachen, and Dr. Gerd Muehlheusser, from the

University of Bern, propose revenue sharing as a solution to create competitive balance in any sports league. The objective of revenue sharing is to increase revenue by equalizing the teams' ability to sign players, which should be interpreted as a means to increase social welfare, since ultimately, the desire for competitive balance stems from the preference of fans for uncertainty in the outcome of the game.¹⁰ Without revenue sharing, strong clubs hire too many talents, thereby not taking into account the effect of its behavior on its rivals. By implementing revenue sharing, the clubs are forced to cooperate, evening out the distribution of talent for the good of the league.

To make the game exciting for fans, there must be parity in the league, and teams should have equal chances to be successful. Therefore, we need a system of revenue sharing, which distributes all revenue the league receives evenly among all teams. This will allow struggling small teams with low payrolls to offer high salaries to star players without crippling the franchise, and level the playing field for these teams. Revenue sharing will make the NHL's product far more interesting and exciting for its fans, and will increase the overall revenue brought in by the league.

Increase League Involvement in the Community

It is currently hypothesized that the Russian Super League is the premier hockey league in the world. During the lockout, many former NHL players went overseas to play for the league.¹¹ The ability of Russian teams to turn a profit, while the NHL was unable to do so with the same players, is due to the huge number of hockey fans in Russia, which itself can be directly attributed to the synergies of hockey with Russian society. Because of its cold climate, Russian youth grows up playing hockey, as opposed to American children, who mostly play baseball or basketball. While it is unreasonable for anyone to expect that the United States will ever embrace hockey like Russia has, for the NHL to be successful, it must take steps to integrate hockey into American society. The following three facts demonstrate that fan interest in NHL hockey is affected by the synergies that the league bolsters:

- Expansion teams such as Nashville, Phoenix, Florida, and Atlanta, which have few regional developmental hockey programs, suffer losses, showing a trend of lower gate revenue as well as miscellaneous revenue.

- Minnesota and Columbus, despite being the two most recent expansion teams, show a positive operating balance, mostly due to their high involvement in community hockey programs.
- All but one team that reported a positive operating income had miscellaneous revenue exceeding gate revenue as a source of income. This leads to a conclusion that ticket sales alone are not enough for teams to make a profit, and other means of revenue are necessary.

Cities in the southern United States such as Tampa Bay, Nashville, Phoenix, Florida, and Atlanta had not had any hockey exposure until the NHL placed expansion teams there. Those teams have yet to attract a large fan base or become financially successful. To increase fan base in communities where involvement in hockey is limited, we must increase hockey's exposure to those communities. The NHL should follow the example of the Russian Super League and Canadian minor leagues of how to attract fans from an early age. To increase hockey involvement, the NHL must pursue the following strategies:

- Establish youth hockey training, and make NHL players available to people through these programs
- Encourage the public to use training rinks through the promotion of hockey programs in schools and colleges
- Lobby the government to create incentives for schools to start hockey programs
- Make hockey more appealing to minorities by funding hockey programs in minority communities

These actions are long term initiatives that will bolster the popularity of hockey nationwide. Only once these actions are implemented can the NHL build up synergies with American society that are comparable to those of the three other major sports. In addition, like the other major sports, the NHL needs to use the media to increase its exposure. Currently, however, national broadcasting companies do not consider hockey to be profitable enough to televise during the regular season, as evidenced by the NHL's television contract with ESPN, which calls for only 40 games to be televised on ESPN2 throughout the entire season, but with increased coverage of the playoffs.³ Broadcasters

refusing to nationally televise hockey prevents new fans from discovering the game. An immediate solution to this problem would be to sell hockey programming at a lower price per broadcast than at which it is already sold, in return for televising games on a regular basis throughout the season, as opposed showing mostly playoff games. Because the NHL's television contracts are already worth so little, this may result in dramatic financial losses in the short term. However, once the NHL's exposure is increased, the fan base will grow larger and demand for hockey will go up. The league could then demand larger television contracts comparable to those of the other sports. These revenues could then supplement gate revenues to help the NHL turn a profit.

Eliminate Clear Losers

Some regions, no matter how much the NHL invests to increase its popularity, will be hard pressed to support hockey teams. One clear example is the Phoenix Coyotes, who were relocated from Winnipeg in 1996 and lost \$21.1 million 2002-03. Teams like this simply do not have the cultural fan base to support a hockey team. The league can only do much to increase the popularity of hockey, because people's preferences cannot be drastically altered, and it is impossible to force the entire country to watch hockey. Phoenix, being in the middle of a desert, simply is not a location that fosters interest in ice hockey. A popular solution to this problem is to move teams north, especially to Canada, where hockey is far more appreciated and revered than in the United States, ironically reversing actions taken by the NHL during the mid-90's which relocated a number of Canadian teams to the American South. However, Canadian cities are much less populated than their American counterparts, and the largest cities in Canada already have NHL teams. No matter how great the fan support is, Canadian teams will not be able to survive financially, even with revenue sharing, as their markets are simply too small. The only remaining solution, therefore, is to eliminate poor performing teams. Though Commissioner Bettman has said that contraction is not an option¹², it is necessary, as revenue sharing will not work if it simply spreads around losses. Some teams will never be profitable simply because of the nature of their location, so these teams need to be eliminated. Another effect of contraction is that as the players on the contracted teams are distributed among the remaining teams, the level of talent on those

teams will increase, improving the quality of play and leading to increased revenue. Eliminating poor performing teams will be the only way the NHL can survive, especially considering the slump in fan interest that is bound to follow the conclusion of the lockout.

Conclusion

The NHL lockout was caused by the desire of owners to eliminate financial losses that had come about due to the declining popularity of hockey in America in recent years. While the owners and players bicker over who gets the lion's share of the insubstantial remaining pie, our strategy is more focused on how to increase the size of the pie by making the league profitable again. Revenue sharing will create competitive balance, making games more exciting and fun to watch for fans, while increasing the league's involvement in communities will help to integrate hockey with American society, winning over new fans. At the same time, we recognize that hockey cannot be popular with everyone, and eliminate teams that will never gain a substantial following, which will increase the level of play in existing teams even further, by concentrating the available talent. These measures will hopefully help the NHL return to its former status with a product that is both exciting for the fans and profitable for the league.

Figure 1A

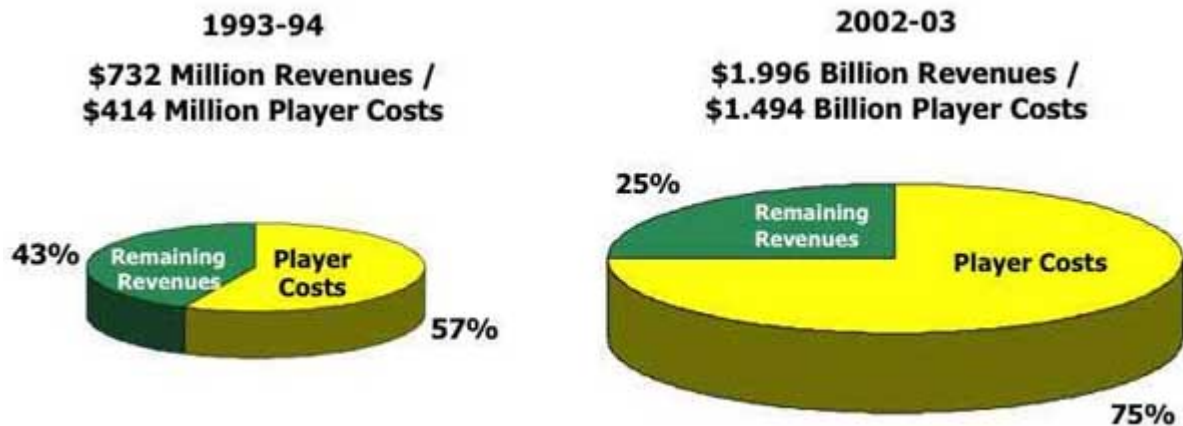
2002-03 League-Wide URO Results
(In Millions Of US Dollars)

	2002-03	%
Combined Revenues	\$1,996	100%
Player Costs	1,494	75%
Other Operating Costs	775	39%
Total Operating Costs	2,269	114%
Operating Loss, excluding depreciation, amortization, interest and taxes	(\$273)	

Source: http://www.nhlcbanews.com/uro_results.html

Figure 1B²

Major League Player Costs as a Percentage of Revenues



Source: http://www.nhlcbanews.com/uro_results.html

Figure 2

Top 10 National Estimated Advertising Expenditures by Sport in 2003*

(in millions)

SPORT	TOTAL	NETWORK	CABLE	SYND.
NFL	\$1,962.5	\$1,707.1	\$123.9	\$131.5
Sports Commentary	\$856.1	\$279.2	\$576.9	\$0.0
NBA	\$588.4	\$288.9	\$299.5	\$0.0
College Basketball	\$586.1	\$502.0	\$84.1	\$0.0
Golf	\$525.0	\$470.8	\$54.2	\$0.0
MLB	\$494.0	\$304.6	\$130.7	\$58.7
College Football	\$436.7	\$334.7	\$102.0	\$0.0
NASCAR	\$387.3	\$305.5	\$81.6	\$0.24
Wrestling	\$167.8	\$105.7	\$17.2	\$44.9
NHL	\$132.5	\$64.0	\$68.5	\$0.0

Source: <http://www.bonham.com/inside/fun.html>

Figure 3

Team by Team Revenue/Expenses for 2002-03 Season (millions of dollars)

Team	Gate Revenue	Other Revenue	Total Revenue	Player Expenses	Other Expenses	Total Costs	Operating Income
Minnesota	\$39	\$40	\$79	\$28	\$30.9	\$58.9	\$20.1
Toronto	\$49	\$56	\$105	\$62	\$29.2	\$91.2	\$13.8
Dallas	\$54	\$56	\$108	\$68	\$34.4	\$102.4	\$5.6
Pittsburgh	\$28	\$29	\$57	\$32	\$20.5	\$52.5	\$4.5
Columbus	\$32	\$34	\$66	\$33	\$29.4	\$62.4	\$3.6
Philadelphia	\$46	\$55	\$101	\$62	\$35.5	\$97.5	\$3.5
Boston	\$36	\$48	\$84	\$43	\$38.2	\$81.2	\$2.8
Los Angeles	\$32	\$46	\$78	\$46	\$30.4	\$76.4	\$1.6
Chicago	\$24	\$50	\$74	\$45	\$28.0	\$73.0	\$1.0
Vancouver	\$55	\$11	\$66	\$38	\$27.3	\$65.3	\$0.7
Edmonton	\$23	\$25	\$48	\$34	\$14.1	\$48.1	-\$0.1
Tampa Bay	\$22	\$43	\$65	\$33	\$32.7	\$65.7	-\$0.7
Atlanta	\$23	\$34	\$57	\$32	\$25.9	\$57.9	-\$0.9
Ottawa	\$24	\$35	\$59	\$35	\$26.0	\$61.0	-\$2.0
Nashville	\$19	\$27	\$46	\$30	\$18.8	\$48.8	-\$2.8
Colorado	\$52	\$36	\$88	\$65	\$26.9	\$91.9	-\$3.9
Buffalo	\$20	\$30	\$50	\$33	\$22.3	\$55.3	-\$5.3
Montreal	\$27	\$44	\$71	\$50	\$26.4	\$76.4	-\$5.4
Calgary	\$19	\$32	\$51	\$37	\$19.8	\$56.8	-\$5.8
NY Rangers	\$42	\$71	\$113	\$79	\$40.9	\$119.9	-\$6.9
San Jose	\$30	\$35	\$65	\$47	\$26.6	\$73.6	-\$8.6
Florida	\$19	\$38	\$57	\$32	\$34.2	\$66.2	-\$9.2
New Jersey	\$45	\$28	\$73	\$58	\$24.4	\$82.4	-\$9.4
Anaheim	\$27	\$32	\$59	\$46	\$23.8	\$69.8	-\$10.8
NY Islanders	\$23	\$33	\$56	\$44	\$22.9	\$66.9	-\$10.9
Carolina	\$20	\$37	\$57	\$40	\$30.0	\$70.0	-\$13.0
Detroit	\$42	\$47	\$89	\$70	\$32.7	\$102.7	-\$13.7
Washington	\$30	\$32	\$62	\$54	\$29.0	\$83.0	-\$21.0
Phoenix	\$20	\$23	\$43	\$45	\$19.1	\$64.1	-\$21.1
St Louis	\$32	\$35	\$67	\$68	\$28.4	\$96.4	-\$29.4
Total	\$965	\$1,129	\$2,094	\$1,389	\$828.7	\$2,217.7	-\$123.7

Source: <http://www.andrewsstarspage.com/8-1-04cba.htm>

¹ <http://www.cbc.ca/sports/indepth/cba/issues/salarycap.html>

² http://www.nhlcbnews.com/uro_results.html

³ http://www.devaskarsports.com/national_hockey_league/nhlbettmantelevisionfailure0504.html

⁴ http://www.findarticles.com/p/articles/mi_m1208/is_52_228/ai_n8702667

⁵ <http://www.andrewsstarspage.com/CBA/12-7cba.htm>

⁶ <http://www.martlet.ca/archives/041125/sports3.html>

⁷ <http://www.andrewsstarspage.com/8-1-04cba.htm>

⁸ Humphreys, B. (2002): "Alternativemeasures of competitive balance in sports leagues," *Journal of Sports Economics*, 3(2), 133—148.

⁹ http://www.econ.ed.ac.uk/papers/js_0011.pdf

¹⁰ <http://www.vwi.unibe.ch/staff/muehlheusser/papers/soccerrev.pdf>

¹¹ <http://www.nhlpa.com/EuropeanInfo/PlayersList.asp>

¹² <http://www.cbc.ca/sports/indepth/cba/features/contraction.html>