



Regulatory Impact Assessment: BBC Charter Review

March 2006

REGULATORY IMPACT ASSESSMENT – BBC CHARTER REVIEW

1. TITLE OF PROPOSAL

Changes to policy regarding the BBC's relationship with licence fee payers and the broadcasting market.

2. PURPOSE AND INTENDED EFFECT

The purpose is to provide for the establishment of the BBC by Royal Charter for a further 10 years. This RIA describes changes to the policy regarding the BBC's relationship with licence fee payers and the broadcasting market that are designed to improve accountability, transparency and scrutiny of the BBC's activities, provide greater clarity and certainty for its competitors and open up the BBC's commissioning to wider competition.

3. OBJECTIVES

The BBC has existed as a public policy intervention in the UK broadcasting market for over 80 years with a mission to inform, educate and entertain. It is intended that the BBC will continue to fulfil these purposes but subject to clearly defined remits and robust accountability and transparency.

The latest review of the BBC Royal Charter involves no new regulation of any business, voluntary organisation or charity.

The objectives of the intervention are as follows:

- A strong BBC committed to the highest quality public service programming which is independent of Government and independent of commercial pressures;
- A BBC with a clear purpose; A clear framework of public purposes to set the body of the BBC's activities;
- A genuine sense that the BBC is owned by and accountable to the people who use its services;
- A BBC which has the flexibility to adapt to new technologies and other developments in the media market, after thorough scrutiny and assessment in the public interest.

4. RATIONALE FOR INTERVENTION

The BBC has operated under a Royal Charter since 1927 charged with informing, educating and entertaining the British people. It has formed the cornerstone of the Government's policy for public service broadcasting since that time.

The broadcasting market is changing rapidly. Competition is intense. Digital TV channels are proliferating and people are receiving content through an increasingly wide range of converging media. The BBC is founded on two abiding principles:

- the public expects more from broadcasting than the market itself would willingly provide
- that the public would be best served through the commissioning and broadcasting, free to air, of high quality programmes publicly-funded through a licence fee.

In 1927, the Government gave life to these principles by bringing the British Broadcasting Company into the public sector. Successive Governments have enshrined this principle by maintaining the BBC as a deliberate intervention in the broadcasting market. As a result, the British public benefit from arguably the best television and radio services the world has to offer: and the BBC has taken on an inherent value that transcends arguments of market failure. We believe that the underlying principle is as relevant today as it was in the 1920s and are actively seeking to maintain a strong BBC, independent of Government, as the cornerstone of public service broadcasting in this country.

However, the broadcasting landscape of 2006 is very different to that of 1926. Eighty years ago there were just a handful of fledgling radio services. It was another twenty years before television began to become commonplace. Another decade passed before ITV was launched and UK viewers could benefit from more than one TV channel. And until the late 1980s, access to more than four public service television channels – BBC 1 and 2, ITV and Channel 4 – was rare.

In the last decade or so, the picture has become very different. Most households have access to digital television and radio, through a range of platforms. There are hundreds of TV and radio channels. Developments in new media are changing the way that people use and relate to broadcast content. And there is every sign that the pace of change is only going to increase. We will maintain the BBC's position at the heart of this changing world, by giving it the flexibility to adapt and remain relevant to its audiences.

The Government believes that dynamic, competitive markets in broadcasting and other media also play a vital role in ensuring that consumers are provided with a wide choice of services. It is therefore important to provide safeguards for those with whom the BBC shares the landscape. This makes defining the role of the BBC more clearly than ever before critical.

As stated in the Green Paper *A Strong BBC, independent of Government*, published in March 2004, the existing definition of purposes needs to be refined. The headline mission – to 'inform, educate and entertain' through a wide range of subjects targeted at a wide range of audiences – is essentially unchanged from the original remit given to the BBC in the 1920s. It has given the BBC the freedom to expand and develop its services over the past eighty years. But while it remains valid, it is not by itself sufficient.

Today's media market is much more complex than that of the 1920s. Viewers and listeners now have far more choice, and if they are to continue to pay for the BBC they need to have a much clearer understanding of what they can expect it to provide. The independent panel on Charter Review concluded that the BBC's remit should give it a mandate to 'maintain a powerful presence over a range of content and channels' but that it should also set out the limits of that mandate.

We agree that clarity of purpose is vital. It is not enough to say that everything the BBC does, being funded by the public, must constitute public service broadcasting. Many commercial media companies now provide elements of information, education and entertainment. To retain a distinctive role, the BBC needs to have a more closely defined set of purposes that can be understood by the Corporation, by commercial rivals and by the public.

Nor should the BBC's purposes be defined in terms of the sorts of programmes it is expected to provide. The case for the public funding of the BBC, and for public service broadcasting in general, is based on the benefits it can bring to society. The BBC should be set objectives that reflect those benefits. It should be defined by its goals as a public service – not only by its programming output.

'Inform, educate and entertain' should remain the mission statement of the BBC, but the new Charter should explain more clearly how we expect that mission to be achieved. That is why we have decided to sharpen up the BBC's remit with the introduction of a new set of public purposes for the BBC. They are as follows:

- Sustaining citizenship and civil society
- Promoting education and learning
- Stimulating creativity and cultural excellence
- Representing the UK, its Nations, regions and communities
- Bringing the UK to the world and the world to the UK

And a special purpose:

- Building digital Britain

The new governance arrangements for the BBC will ensure the Corporation will publish, and consult on, public purpose plans so that licence fee payers and the BBC's commercial competitors will have a clear understanding of the nature of, and, more importantly, the limits to, the BBC's role.

5. PROPOSED INTERVENTION

- The BBC's Royal Charter will be renewed for a period of ten years in order to give it the independence, stability and flexibility it needs in a rapidly changing UK broadcasting market.
- The BBC will continue to receive public funding in the form of the licence fee for a further 10 years.
- A new governance structure will be introduced. There will be a clear separation of roles between the BBC Trust – responsible for oversight, and, the Executive

Board which will be responsible for the delivery of the BBC services on a day-to-day basis.

- Clearly defined remits will also be introduced for all of the BBC's services. New, detailed service licences will ensure that each BBC service is defined with a clear, distinctive form and remit, providing clarity for the public and the market on what should and should not be expected from the BBC.
- The Public Value Test, incorporating a Market Impact Assessment, will be introduced to increase transparency and accountability and to ensure that BBC activity is exposed to thorough public scrutiny. Ofcom will be responsible for providing the detailed market impact assessment. However, in doing so, it will operate a methodology agreed with the Trust, and its work will be overseen by a steering group drawn jointly from the Trust and Ofcom. The aim is to ensure that the Trust receives the type of evidence required to carry out the public value test effectively, whilst at the same time providing assurance to those potentially affected that the market impact assessment will be carried out by the organisation best placed to do so using a clear methodology. Each proposal for a new service, or significant change to an existing service will be subjected to a "public value test". Only if the public value outweighs the negative net market impact (if any) will the proposal be given further consideration.
- A new system of programme commissioning will be introduced, allowing independent production companies and other external producers to compete with BBC in-house production for an extra 25% of commissions above the mandatory 25% already reserved for the independent sector. This more open, fair and transparent system will create new opportunities for independent production companies.
- We will introduce new assessment criteria for the BBC's Commercial Services, which is designed to ensure that the BBC can evaluate which commercial activities it should and should not be engaged in.
- There will be an interim review of funding methods, designed to take account of the pace of technological change and the potential risks faced by commercially funded public service broadcasting. A second review will examine the potential for distribution of public funding beyond the BBC.

Overall, the changes to be introduced as a result of the Charter Review process will equip the BBC for the new digital world while ensuring increased transparency and accountability and much greater sensitivity to the wider market.

This regulatory impact assessment provides a detailed analysis of the above changes together with commentary on a number of other related issues – including the method of funding the BBC – which were considered throughout this Charter Review period.

6. CONSULTATION

The review process to date has involved an unprecedented degree of public and industry engagement, involving a wide range of events, consultation, research and focused analysis.

On 11 December 2003 the Government launched a consultation to ask viewers and listeners what they want from the BBC. This was the first time that public have been consulted at such an early stage in the Charter Review process. We published the consultation document Review of the BBC's Royal Charter and accompanying leaflets - distributed through libraries and via a TV listing magazine - inviting the public to submit their views in letter and email form.

The document was also translated for children and young people, and we held four seminars designed in conjunction with the National Children's Bureau, to ensure that they could also have their say; two of which were attended by the Secretary of State.

A dedicated BBC Charter Review telephone line and website were also set up to ensure that all stakeholders, licence fee payers and other interested parties had access to the latest news, publications and a wide range of useful information on the Charter Review process. In total we received nearly 5,500 responses, the majority of which are published on our website, as well as over 26,000 hits to the website.

During March 2004, the Secretary of State and Broadcasting Minister took part in a series of visits across the UK. Each visit included an open public meeting involving interactive voting, and seminars with key members of the local broadcasting industry in partnership with the Royal Television Society. We also visited a variety of media organisations, witnessed some of the BBC's activities in the nations and regions and conducted a series of local visits to broadcasting organisations and public institutions. As part of this a visit was set up to a school in Glasgow who had replied to the consultation and expressed an interest in participating further in the Charter Review process. The school children held a debate on the pros and cons of the BBC in front of the Broadcasting Minister.

We also conducted a major programme of survey research, between late January and early June last year to support and test the consultation, and to make sure we reflected the views of all sections of the population. This encompassed qualitative, deliberative and quantitative survey research. Demographic factors – from age, ethnicity and geographical location, to media consumption behaviour – were taken into account. We published a summary of the consultation and research findings in What You Said about the BBC, in July 2004 to enable everyone who had contributed and people with an interest in the process to get a flavour of the main findings of the consultation and research. The full report and supporting research can be accessed at: http://www.bbccharterreview.org.uk/publications/CR_PUBS/pub_wysabb.html

Further Evidence

A wide range of external evidence was also considered throughout the consultation process, helping to inform our thinking in the Green Paper. This included:

- Ofcom's Review of Public Service Television Broadcasting
- Philip Graf's report on BBC online

- Patrick Barwise's report on BBC new digital TV services
- Tim Gardam's report on BBC new digital radio services

Independent Adviser and Seminars

The Secretary of State appointed an Independent Advisor, Lord Burns, on 18 September 2003, to help provide her with advice on a number of different issues throughout the Charter review process.

She also appointed an Independent Panel on 15 June 2004, to work alongside Lord Burns. The panel members were Sly Bailey, Alan Budd, Howard Davies, Janet Finch, Tim Gardam and Alice Rawsthorn.

Lord Burns and his panel held a series of seminars to debate a number of key issues for Charter review, which were identified through the public consultation and research. The series ran from 20 July to 3 December 2004, and included 13 seminars as follows:

- BBC's Public Purposes
- Funding
- Principles of Governance and Regulation
- BBC Commercial Services
- BBC Television
- Radio
- Representation: Nations, Regions and Communities
- Education and Learning
- International Role
- Informed Citizenship
- Culture
- Sport
- Models of Governance and Regulation

The seminars took place at DCMS (with two exceptions) in front of a small invited audience, including industry experts and representatives, as well as members of the public, who were people that replied to the consultation and were keen to have a further role in the Charter Review process. The programme started on 20 July and concluded on 3 December, following publication of Lord Burns "interim paper" on 1 December. These seminars were broadcast live on the internet via web streams.

The seminars provided the department with a credible evidence base which has provided us with a solid foundation for Charter Review. More directly, the outcome of these seminars played a key role in developing themes for the panel's two advice papers to the Secretary of State. They also played a role in helping to develop themes for the Green Paper.

The panel submitted their final advice to the Secretary of State on 28 January 2005 and this was used to help formulate the options in the Green Paper. The themes the panel considered all arose from and were defined by the public consultation.
Publications

The Independent Panel has published two papers: the first "[Emerging Themes](#)" was published on 1 December 2004 and formed the paper for the final seminar in the

series. It summarises the major themes of the debate to that point. This report can be accessed at:
http://www.bbccharterreview.org.uk/publications/in_pubs/pub_emerging_themes.html

The second was the panel's final advice to the Secretary of State and was published on 28 January 2005. It reflected the outcome of the debates which took place during the series of informed seminars, chaired by Lord Burns. The final report can be accessed at:
http://www.bbccharterreview.org.uk/publications/in_pubs/pub_final_advice.html

Green Paper Consultation

The publication of the Green Paper on 2 March 2005 marked a further phase of consultation. This was advertised through the distribution of over 500,000 leaflets through public libraries and through adverts in the national press. A number of our stakeholders e.g VLV and Media Trust, also advertised the consultation through their networks. A children's version of the Green Paper was also produced which is available on line and was advertised to children and young people through the National Children's Bureau and the Children's Rights Alliance.

The public and the industry and other stakeholders were invited to submit their comments to us either by e-mail or letter or through an online questionnaire on our website. The online questionnaire simplified the policy in the Green Paper and put the consultation questions into a simple yes/ no format in order to make it more accessible to the public. We received around 4,500 responses to this consultation. All of the responses have been published in full on our website, unless confidentiality was requested. Individuals, organisations and interested groups responded by letter, e-mail and online questionnaire with over 4,000 responses coming directly from individual members of the public. Every one was read, analysed and fed into a summary report, which was produced by Ubiquis Reporting – who produced the report of responses to our initial consultation. This report will be published on our website alongside the White Paper.

In addition, we received around 130 responses on behalf of organisations. We have carefully analysed each of these responses. They have helped to inform the policy decisions set out in this White Paper. We have also produced a summary of these responses, which was done in house, and again will be published, on our website alongside the White Paper. To date, the Government's public consultation has resulted in around 10,000 responses from members of the public and the industry; all of which have been used to help develop policy and the majority of which are published in full on the website.

Finally, we have recently commissioned some further qualitative research to test some specific aspects of the Green Paper- principally the idea of the Trust and greater accountability being given to the licence fee payer and the questions about collection and enforcement of the licence fee. The results of this research have fed into the White Paper and the report will be published in full on our website.

7. OPTIONS

7.1 FUNDING

INTRODUCTION

The method of funding the BBC has been the subject of much debate over the years. This Charter Review period has been no different and the debate has been particularly marked about the role of the BBC as we move towards the age of digital television. Through extensive consultation with both industry and the public it was found that, although not perfect, the licence fee remains the best and most widely supported funding model for the BBC. The licence fee will continue for the duration of the next Charter period, and as such, we are not changing the policy with regards to funding the BBC. However, in light of rapid technological change we are putting in place the necessary mechanisms to allow for an interim review of funding. The review will take place as we move towards the completion of digital switchover to establish whether any alternative funding models, particularly for subscription, need to be reconsidered after 2016.

The Government is not proposing to change the policy with regard to the method of funding the BBC. However, in the overall context of Charter Review, it is helpful to detail the options considered in the run-up to the publication of the White Paper, the advantages and disadvantages of each approach, and justification for the chosen policy.

Peacock Report 1986

BBC Licence fee funding has been scrutinised by some of the UK's leading economists stretching back at least to the Nobel Laureate Ronald Coase's work more than fifty five years ago¹.

The Committee on Financing the BBC chaired by the eminent economist Professor Alan Peacock was set up in 1985 to assess the effects of introducing advertising or sponsorship as an alternative for, or supplement to, income received through the licence fee². Peacock argued that British broadcasting should move towards a sophisticated market system based on consumer sovereignty, envisaging a three stage scenario throughout which public service provision would continue.

Peacock saw no good reason for introducing advertising on BBC television. Instead indexation of the TV licence by no more than the general inflation rate (RPI) was suggested in the (then) current stage 1 environment where satellite and cable develop but most viewers and listeners continue to rely on BBC, ITV and Independent radio.

However, in Stage 2 where there is a proliferation of broadcasting systems, channels and payment methods which was thought likely to begin well before the end of the century, Peacock recommended that subscription should replace the licence fee. The BBC would look to subscription and ITV to advertising for mainstream income, but with no bar to either drawing on alternative sources.

¹ Coase, R (1950) *The BBC: A study of Monopoly* London: Bell.

² Peacock, A (Chair) (1986) *Report of the Committee on Financing the BBC*. Cmnd 9824 Home Office London HMSO.

Peacock acknowledged that under such arrangements there would be some erosion of PSB in the narrow sense, and argued that it would be better to take proactive action to make finance available for PSB. The finance of the arts provided a possible model for a Public Service Broadcasting Council to which all channel operators and programme makers could apply for support. Peacock had no objection in principle to taxpayer financing perhaps through a continuing licence fee as a standard approach to funding "public goods".

Eventually, by Peacock's stage 3, an indefinite number of channels would allow full multiplicity of choice leading to a full broadcasting market. However, choice by producers, listeners and viewers in the market place would be supplemented by public finance for public service type broadcasts, not less than, and probably far exceeding, what was spent on current affairs, the arts, serious drama, religious and minority programming on BBC and ITV.

Davies Report 1999

During 1999 Gavyn Davies chaired an Independent Review Panel on the future funding of the BBC³. The DCMS's terms of reference made clear the expectation that the licence fee would remain the principal source of funding for the public services for the Charter period ending 31 December 2006. Davies was invited to consider ways in which funding to support public service output could be extended from other sources and to take a forward look at the possible funding mechanisms, as well as at the BBC's current operations and concessionary licence schemes.

Davies explicitly discussed the funding of PSB in a 'market failure' context where PSB had characteristics associated with a 'public good' i.e. non-excludability and non-rivalry (zero marginal cost)⁴. Overall Davies suggested a formula which would raise BBC real income by 2 to 2.5% per annum from 2002 to 2006, which combined with efficiency gains and self help would raise real spending by 3.5% per annum.

The Davies Panel recommended a digital licence 'top-up' fee to facilitate the rapid roll out of digital services from the then current 5/100 world - i.e. 5 digital to 100 households analogue. The supplement to be introduced in 2000 would decline in subsequent years and disappear by 2010. Effectively the analogue fee would rise over time to meet the digital fee as digital switchover approached. The principal potential disadvantage to this approach was that the higher licence fee might deter take-up of digital systems.

The Davies Panel preferred the digital option mainly because it better meets the principle that digital users pay for the digital services. However, the Government eventually rejected the idea in favour of an across the board RPI inflation plus 1.5% settlement for the remainder of the Charter period. Thus TV licenced households provide the funding for the BBC, TV, domestic radio and on-line internet services⁵.

³ Davies G (Chair) (1999) The Future Funding of the BBC. Report of the Independent Review Panel Location Luton: DCMS, July.

⁴ For a full discussion see Graham A C (1999) Public Purposes in Broadcasting funding the BBC London University of London Press. Graham A Davies G (1992) Broadcasting, Society and Policy in the Multimedia Age Location : University of Luton Press.

⁵ Interestingly Peacock (1986) suggested the introduction of a car radio licence (of not less than £10 a year). Domestic radio licences had been abandoned as early as 1971.

OPTION 1 – GOVERNMENT FUNDING

Government funding could be considered fairer than the licence fee in that it would be progressive – each individual would in effect only contribute according to his or her income. This would make the BBC an area of Government spending like any other public service. The objections to this arrangement are made on the grounds that the BBC is a public service like no other, and it is feared that direct Government funding might threaten both:

- the BBC's independence – if the Government held the purse strings; and
- its stability and security – were the BBC to be subject to reviews of its funding through the periodic Government Spending Review processes.

These objections appear to be supported by public opinion. The public told us they wanted less scope for Government interference in the running of the BBC and nearly two thirds of them support the licence fee in its current form as the best method of funding.

Ofcom's audience research found there was significant opposition to Government funding – partly because people wanted the Government kept out of television and partly because they saw a distinct difference between the 'luxury' of public service television and the 'right' to other forms of universal public service such as the NHS.

OPTION 2 – ADVERTISING AND SPONSORSHIP

The case for allowing advertising on the BBC is difficult to make. Considerable opposition to the idea of advertising on the BBC was expressed in the course of DCMS public consultation and research. 60% say advertising interferes with the enjoyment of programmes (31% disagree). The lack of advertising is therefore felt to be a distinguishing characteristic of the BBC. Indeed, it was the third most frequent value spontaneously attributed to the BBC by contributors to DCMS quantitative research.

The BBC would attract advertisers if allowed. However, modelling of the advertising market suggests that the effect of such a move would be to push down the price of TV advertising (since the total amount of money spent on advertising would not rise significantly but many more ad 'spots' would become available). It is likely, for example, to reduce significantly the advertising premium currently enjoyed by ITV plc. In addition, total reliance on advertising revenue by the BBC would almost certainly reduce the income of the BBC compared with the amount that can be achieved through the Licence Fee. Moreover, revenues of the existing advertising funded broadcasters (including other public service broadcasters, such as ITV and Channel 4) would also be likely to fall below present levels.⁶

Advertising would also create conflicting incentives for the BBC. For example, the requirement to fulfil public purposes would have to be weighed against the need to generate revenue. As a result, the character of programming might drift towards the middle ground of taste. Ofcom has pointed out that such a conflict of incentives already exists for ITV 1, Channel 4 and Five, and that it will be increasingly difficult to regulate in future as competition for advertising revenue intensifies. Moreover

⁶ PriceWaterhouse Coopers (2004): "Economic Analysis of the TV Advertising Market", December.

52% of those we surveyed said they thought the BBC would lose its independence if it relied on advertising or sponsorship.

The long-term trends in the TV advertising market are anyway uncertain. TV advertising represents a declining proportion of total advertising expenditure. Moreover, new digital technology – particularly Personal Video Recorders (PVRs)⁷ – increasingly allows audiences to skip through advertising breaks. It may be unwise to increase the dependency of public service broadcasting on advertising revenue when the future volume of such revenue is particularly uncertain.

There are probably fewer concerns about allowing the BBC to take sponsorship for, and paid-for product placement within, some programmes.⁸ There would still be some questions to answer, however, about a potential conflict of incentives and the impact of such a move. Although viewers will already have some experience of product placement, on the basis of the Department's extensive consultation and research and the conclusions to be drawn on the "commercialisation" of the BBC, it seems likely that licence fee payers would view the systematic attachment of commercial messages to programmes unfavourably – although DCMS research suggests they would prefer it to advertising. Moreover, sponsorship brings with it a potential threat to editorial independence no matter how subtle or indirect. Finally, and in any case, sponsorship and paid-for product placement alone is never likely to deliver sufficient income to sustain the BBC without some additional source of funding.

OPTION 3 - SUBSCRIPTION

Some of the BBC's own 'willingness to pay' research⁹ suggests that some people are willing to pay significant amounts for access to BBC services – 42% say £20 per month and 19% say £30 per month. If services were put together in differently-priced packages, with premium programmes available at different prices depending, for example, on their newness, exclusivity or popularity, audiences would have more options to choose from and, some argue, that the BBC might attain a sustainable level of funding.

However, much depends on how the willingness to pay questions are asked and the content of information provided. The Mori survey results published with the BBC licence fee bid showed average willingness to pay for "personal value" subscriptions

⁷ A PVR uses hard disk storage technology to record and store programmes and enables viewers to pause and rewind 'live television' broadcasts. Programme recordings can be easily set up using programme listings in electronic programme guides (EPG) *Ofcom, Communications Market 2005 p188*

⁸ Programme sponsorship is estimated at £100 million p.a. and some believe that paid for product placement could grow to a similar level within 5 years of its introduction see *MediaGuardian*, 16th December 2005. *Ofcom's consultation document on product placement (Ofcom, December 2005)* suggests that product placement revenues might reach £100m

⁹ Willingness to pay assessment using contingent valuation methods to value public goods has become an accepted part of the public policy process, beginning initially in environmental areas but more recently extending to the arts and culture. Such methods provide a powerful and versatile tool for measuring non-market economic benefits. See: Mitchell RC and Carson RT (1989) *Using Surveys to Value Public Goods: the Contingent Valuation Method* Washington DC: Resources for the Future. Torrington S and Dollar C (2004) "Measuring the Value Created by the BBC" in Helm D et al *Can the Market Deliver? Funding Public Service Television in the Digital Age* Eastleigh John Libby, pp 60-77 and BBC (2004) *Measuring the Value of the BBC. A report by the BBC and Human Capital* London: BBC, October, set out willingness to pay results for the BBC licence fee.

of only just over £11.00 per month even for two enhanced versions of the BBC offering¹⁰

It is also possible that overall consumers' welfare could increase if consumers are permitted to subscribe for the channels they actively wish to see rather than those they are willing to accept. This would occur if the acceptance of subscription led to an increase in the number of available choices. However, the extent of this increase is currently limited by the availability of spectrum. Nevertheless, the popularity of satellite-based subscription services serves to illustrate the potential for welfare gain from this source.

However, if people could choose not to subscribe then prices might have to rise for those who carried on paying, and some low-income viewers and listeners who did want to subscribe might well be priced out of the market for BBC content. This would lead to a reduction in overall consumer welfare if it seriously reduces the size of the BBC audience. It is not known whether net consumer welfare would increase if the BBC were to become a subscription service.

This funding model raises additional significant issues of principle. The chief argument against subscription is that it would undermine the principle of universal access. The BBC content would no longer be universally available for free at the point of use. Hence, such a funding system would undermine the universality on which the purposes of the BBC rest, unless accompanied by measures to assist access by the low-paid. It can be argued in response that the existing licence fee is anyway a form of 'compulsory subscription'. Services are only 'free' once a bulk licence fee has been paid. Nevertheless, it remains true that if that content were not universally available, its potential benefit to society would be reduced.

Since a subscription service depends upon the strength of individual demands for its revenue stream it cannot take account of the public value it might generate when making its business decisions. Such public value is additional to the value generated for individual users. For this reason, sole reliance on subscriptions by the BBC runs the risk of insufficiently funding the provision of services, which yield significant levels of public value.

While a TV subscription service could function in satellite and cable homes, for most terrestrial viewers (including most digital terrestrial or Freeview homes) it is not presently possible to control access to individual channels. New subscription technology (code-protected cards for 'conditional access') of the sort used in satellite and cable homes would need to be included in most, if not all, digital terrestrial equipment before any subscription system could function for the BBC. Moreover, in mainstream radio, no subscription facility exists, nor is one likely to be widely available for some time.

In addition, it is not clear how platform operators – satellite, cable and, potentially, mobile network providers – might react to any additional regulatory burdens that might be entailed by being required to participate in subscription systems aimed at BBC services. A further issue for consideration at the next review of funding methods (which the Green Paper states should take place towards the end of digital switchover) is the extent to which failure to pay under any future subscription model would entail the loss of all television services, even those not provided by the BBC.

¹⁰ For the two enhanced BBC options of new services and programmes 17-20% proposed to pay £13 or more per month while the averages were £11.01 and £11.08 per month respectively. See Mori (2005) Willingness to pay Mori Report Appendix on Mori research on new services page 11.

OPTION 4 – INDEPENDENT PANEL – “MIXED FUNDING” MODEL

The Independent Panel has suggested that a 'mixed funding' model, combining elements of licence fee, advertising, sponsorship and subscription, may be workable beyond the next ten years. As is detailed above, each of the main alternatives to the licence fee have been considered carefully and each gives rise to serious disadvantages. None of those disadvantages is diluted under a mixed funding model: indeed, it could be argued that a mixed funding model represents the worst of all possible worlds. Because the technology required for subscription is currently unavailable and the infrastructure required could take a number of years to put in place, the only form of mixed funding that would currently be technically viable is a combination of licence fee funding with a commercial revenue stream – advertising, sponsorship or product placement. Licence fee payers would potentially be left with a fee to be paid (albeit potentially reduced), but without their most valued benefit – commercial-free broadcasting. At the same time, the impact on the advertising industry and on commercially-funded broadcasters would be potentially very serious.

Nevertheless we agree that there should be a further review of the practical implications of different funding options during the course of the next Charter and before the completion of digital switchover, so that the necessary planning could be carried out for any change after 2016. One issue for that review to consider should be the feasibility of rolling-out conditional access systems to the point where subscription options were viable in some form.

OPTION 5 AND CHOSEN OPTION – RETENTION OF LICENCE FEE

The licence fee takes the form of a flat-rate tax levied on households with useable TVs. It continues to be the best funding mechanism for the foreseeable future. That conclusion is endorsed by Ofcom and the Culture, Media and Sport Select Committee, as well as by licence fee payers. While some people show interest in the alternatives, in all strands of DCMS consultation there was more support for the licence fee than for any other funding mechanism. Some 63% of those who mentioned funding when responding to the consultation accepted the principle of the licence fee. Many respondents argued that the licence fee provided unparalleled value for money, and one of the most common arguments made in its support was that it binds all households together as equal stakeholders in the BBC.

Audiences want the BBC to remain a universal service. They also value the licence fee because it keeps the BBC at arm's length from Government and has the potential to bring it closer to the public who are footing the bill.

The Licence Fee has the disadvantage that it is weakly regressive with income. (i.e. rich people devote a smaller proportion of their income to it than poor people). Like all flat-rate taxes its burdens are not modulated according to ability to pay. Some account of this fact is taken by the concessions (see below), which are included in the regime. Nevertheless, the adjustments are partial and are, in any case, not designed to ensure that the Licence Fee is related to the ability to pay across all households.

Concessions

The concessions policy will also remain unchanged. Free television licences will remain for people aged 75 or over, as will the 50 per cent discount available to registered blind people. Retired people over 60 and disabled people living in residential homes or qualifying sheltered housing will also remain entitled to a concessionary licence fee. A number of easy payment schemes are available to help other TV licence payers spread the cost of their licence. These, together with the active promotion of online, telephone and direct debit payment methods will help reduce bureaucracy and ease the burden on all licence fee payers - including businesses and organisations requiring a TV licence.

Enforcement

The combined costs of evasion and of collecting and enforcing the licence fee are roughly 11% of licence fee income, or £300 million per year, which is foregone before any money is spent on programmes.

In the context of wider proposals by the Department for Constitutional Affairs for reducing burdens on Magistrates' Courts, we shall be exploring the possibility of streamlining the handling of TV licensing cases by the courts and options for the diversion of offenders from court. The combined aim of these initiatives is to reduce burdens on both the courts and the general public; the impact on businesses, though unlikely to be substantial, should likewise be deregulatory and will be kept under consideration.

7.2 GOVERNANCE

OPTION 1 DO NOTHING

At present, the BBC Board of Governors is a body corporate incorporated under a Royal Charter. There are 12 Governors. Governors are appointed to represent the English regions, Northern Ireland, Scotland and Wales. The Board of Governors is responsible for the provision of programmes, the determination of strategy, appointments of management including the Director General and preparation of the Annual Accounts. The Governors also set the objectives and priorities for BBC services and enforce performance against them. Included in these are guidelines for taste and decency, fair trading and quotas for external commissioning of programmes. Finally, the Governors are the main regulators of the BBC.

Despite this structure having safeguarded the independence of the BBC for nearly 80 years retention of the status quo is rejected for the following reasons:

- Under present structure the respective responsibilities of the Board of Governors and the executive are unclear and little understood. As a result, there is a perception that the BBC does not act fairly.
- There is a danger of conflicts of objectives on the part of the Board of Governors between its role in delivering the BBC's services on the one hand, and scrutinising and assessing its performance on the other

We are moreover concerned that the current arrangements do not provide for sufficient account to be taken of the potential impact of BBC activities on the wider market, raising the risk that the UK broadcasting market is not as competitive, efficient, innovative or productive as it might otherwise be.

Finally, and most important, there is a perception that the existing composition of the BBC Board of Governors does not ensure full accountability of the BBC to the people it serves or to people and organisations affected by it. The public purposes of the BBC are closely related to the lives, beliefs and aspirations of everyone in the UK. In meeting its public purposes the Government believes it is important that the BBC retains the support and trust of the people it serves. Only then will it be possible to ensure that the BBC's operations yield the level of public value that the Government expects. This requirement makes the BBC unusual among public organisations and requires that the BBC be accountable directly to the public and that the Governance system is founded unequivocally in upholding the public interest. This feature is not adequately incorporated into the existing structure.

OPTION 2 – OFCOM

Ofcom already regulates the BBC across much of its activity, both in relation to content and competition. Indeed, the only area of, for example, programme content regulation that is left solely to the existing Governors is that of accuracy and impartiality. However, the Governors are responsible for ensuring the BBC delivers its remit.

Ofcom has built up considerable expertise in, for example, media markets and competition and it is right for its role in this respect to continue (indeed, the new arrangements will strengthen Ofcom's involvement in ex ante regulation of the BBC and market impact assessments). The main issue for consideration is whether Ofcom, in addition to its responsibilities for economic regulation of the communications sector is the organisation best placed to make judgements about where the balance of public interest lies with respect to the BBC.

It could be argued that Ofcom might better insulate the BBC from Government intervention – by providing an intermediary, 'buffering' layer between the two. This option has the advantage of building on Ofcom's expertise in regulating commercial public sector broadcasters. For this reason there is potential for greater consistency of regulation of the broadcasting market so ensuring equality of treatment between the BBC and other public service broadcasters. But others argue that an external Government-appointed regulator such as Ofcom may in fact be more inclined than the Governors to act in a way that it imagines Government would wish.

We do not think Ofcom should be given a role of oversight or scrutiny in relation to the BBC as a whole, for a number of reasons. Given its range of responsibilities across the commercial sector, it may be difficult for Ofcom to devote itself fully to upholding the public interest in BBC services and programmes, in defending the independence of the BBC itself or in satisfying the need for direct accountability to licence fee payers.

It might not be obvious to the licence fee payer how Ofcom was going to resolve any conflict between what was good for the delivery of the BBC's public purposes and what was good for the commercial sector. Significant organisational change would be needed were it to be entrusted with the guardianship of the BBC – Ofcom is not at present responsible for the direct oversight of public spending on the scale represented by the licence fee. Such a change would be likely to lead to greater confusion of responsibilities rather than clarity. We note that Ofcom agrees with this view in its PSB Phase 3 report in stating that "we do not believe that the answer [to improved regulation] is to ask Ofcom to take on governance or accountability

responsibilities for the BBC. That would lead to a further confusion, rather than clarification, of the distinct functions”.

OPTION 3 – “BUILDING PUBLIC VALUE”: BBC’S PROPOSALS FOR A MORE INDEPENDENT GOVERNING BODY, BASED ON THE EXISTING MODEL

Building Public Value proposed that the Governors should remain as trustees of the public interest, but that the following key changes should be implemented in order to:

Underline their independence from Management:

- Establish a separate Governance Unit
- Independently commission external research
- Mobilise specialist broadcasting knowledge from the Governance Unit rather than the Executive

Improve transparency:

- Publish Service Licences and Statements of Programme Policy for every channel and service
- Apply public value tests to new services and any major changes to existing ones

Increase accountability and responsiveness:

- Publish results of public value tests and external research
- Establish communication via the internet between the Governors and licence fee payers
- Strengthen the Advisory Councils
- Appoint a new Head of Complaints reporting directly to the Governors

While this proposal goes some way towards eliminating some of the weaknesses of the present structure it is rejected for a number of reasons. First, this option does not provide a clear separation between the functions of delivery on the one hand and oversight on the other. Second, it also relies on behavioural change to ensure that Governors act independently from management. Fourth, this proposal does not provide sufficient safeguards against the risk of unfair competition in the UK broadcasting market.

OPTION 4 – “OFBEEB”

A newly created ‘Ofbeeb’ could be set up. This would be a wholly separate regulator dedicated to the purpose of maintaining the BBC’s independence and focus on public purposes (OFCOM and OFT would continue as the competition authorities). It

would, therefore, operate in a similar fashion to other agencies, which are responsible for ensuring that public utilities operate in the public interest.

The creation of a separate OfBeeb to represent the public interest, with no control over the distribution of the licence fee, might blur lines of accountability and loosen the direct link between the public and the BBC. In addition, the effective oversight of the BBC at the highest level requires an understanding of, and ability to influence, the culture of the organisation and it is difficult to see how an entirely separate external regulator, with no budgetary controls, could fulfil this role. In addition, an Ofbeeb in this position might risk being captured by the BBC, having no other regulatory client. Finally, while it would be possible for Ofbeeb to set fair competition guidelines it is difficult for such an organisation to enforce them. Hence, it is unlikely that the current risk of unfair competition would be reduced.

OPTION 5 – BBC BOARD PLUS PUBLIC SERVICE BROADCASTING COMMISSION

The Independent Panel proposed the creation of a Public Service Broadcasting Commission to oversee the BBC. Their proposal included a suggestion that the Commission might at some future point be given the power to allocate licence fee funding to broadcasters other than the BBC, as a means of encouraging the BBC to perform better. The proposal is summarised as follows:

BBC Board plus Public Service Broadcasting Commission:

- Through the Charter, the Government and Parliament would determine the overall objectives of public service broadcasting and have responsibility for setting the level of licence fee, the BBC's borrowing limits and any other public funds financing public service broadcasting, following advice from the Public Service Broadcasting Commission (PSBC).
- The BBC would be governed by a unitary board of executive and non-executive directors in line with the recommendations of the combined code on corporate governance. This board would have a non-executive Chair, appointed by Government. It would be responsible for deciding and delivering the BBC's programming output, subject to the oversight of the PSBC, within the allocation of the licence fee and the BBC's borrowing powers. It would have to maintain adequate systems to define and maintain editorial standards, ensure value for money for its funding and to deal with complaints.
- A new Public Service Broadcasting Commission, independent of Government, would be responsible for oversight of public money invested in broadcasting and for recommending to Government the level of the licence fee.
- The Government would give up its powers of prior approval for BBC services TV, radio, ancillary and commercial services and for commissioning reviews of services. However, together with Parliament, Government would be responsible for holding the PSBC to account.
- Ofcom would continue to be responsible for the regulation of competition, economic, spectrum and pan-broadcasting industry issues.

The Panel's proposal would provide for a very clear separation of functions between two different bodies. However, the degree of separation is such that it risks placing

too great a distance between the licence fee payer and the delivery of BBC services. In this sense, we consider the proposal is close to becoming a version of 'OfBeeb'. Lacking a direct relationship with the BBC executive, the Commission might be too weak to effect real change. At the same time, allowing the Government the power to appoint the Chair of the executive would compromise the independence of the BBC. Finally, it is not clear how this proposal will lead to improved accountability of the BBC to the consumers it serves.

The uncertainties surrounding the future development of public service broadcasting are such that the recommendation to establish a Public Service Broadcasting Commission is one that is somewhat ahead of its time and the Government does not propose to adopt it. However, the Government intends to review the issue of the distribution of public funding beyond the BBC towards the end of switchover, and it will be important that the new arrangements maintain the flexibility to accommodate relevant conclusions in due course. In any case, a number of other aspects of the proposal are attractive and consistent with the principles for reform – for example, the strong emphasis on the need for structural separation, and the Government's preferred option reflects them.

OPTION 6 AND PREFERRED OPTION – BBC TRUST

This option involves creating a 'BBC Trust'¹¹ and Executive Board. This body is composed of trustees of the BBC's Royal Charter which embodies the public interest. The Trust reflects the views of licence fee payers and safeguards the independence of the BBC. Members of the Trust would be appointed by the Crown (as the Governors are now). The new Charter will also establish a formally constituted Executive Board responsible for the delivery of all of the BBC's activities and accountable to the Trust for its performance.

The Trust will act as the sovereign body in relation to the BBC and have ultimate responsibility for the licence fee, setting the BBC's priorities within the resources available and ensuring that the executive delivers value for money and financial efficiency. It will be responsible for setting the BBC's performance framework and assessing performance against it approving strategies and high level budgets; and holding the Executive Board to account for delivery. The Trust will have the right to access to all the information it requires in order to carry out its functions.

The Executive Board will contain a significant minority of non-executives, reflecting its level of autonomy on strategic matters. The role of the non-executives on the Executive Board is to support the executive members as "critical friends", by bringing wider perspectives and expertise to their decision-making. The Executive Board will be chaired by the Director General or, at the discretion of the Trust, a non-executive.

There will be a clear structural separation between the functions of the two bodies. In particular, the boundaries of the Trust's involvement in strategic and financial decisions will be clearly set out.

The two boards will be required to work to explicit protocols, detailing the processes for interaction between them, with a view to ensuring clarity, openness and transparency. The Trust will subject decisions to public engagement and objective evidence-based assessment. The presumption will be that its decisions are made public, together with the evidence and other inputs which have informed them.

¹¹ It is important to note that the Trust would not be established under the generally accepted legal definition of the term

Potential risks are that the BBC Trust might not be able to command sufficiently clear access to the information it requires, that BBC Executive may be able to exercise strong influence over members of the BBC Trust and that the boundary between the respective jurisdictions of BBC Trust and Ofcom are unclear. However, these risks will be minimised via the detailed provisions in the Charter and Agreement defining the Trust's role and its relationship with the Executive Board. In addition, to make this option function effectively it would need to be strengthened by specific measures to ensure the Trust takes a wider view across the market.

However, the BBC is unique and requires a unique system of Governance: the BBC Trust is our model of choice. Nevertheless, it is also important to note that the Trust Model is consistent with many of the principles of the Combined Code on Corporate Governance¹². As Sir Derek Higgs, one of the authors of the Code, said in evidence to the Lords Select Committee "To suggest that you can just pick up the combined code and impose it on an NHS Trust Board or the BBC I think is missing the point"¹³.

The Trust Model is therefore the preferred option for a number of reasons. Firstly, the Trust Model provides for clear separation of different responsibilities, to avoid confusion or capture. Second, the Trust is a powerful advocate for the public interest, able to safeguard the BBC's independence, with ultimate power over the licence fee. Third, the clear separation of functions allows for more rigorous and transparent scrutiny of BBC's performance. Fourth, the Trust will be directly accountable to the consumers of BBC services and to Parliament for the performance of the BBC under the Royal Charter. Finally, we believe such a governance model will improve decision making within the Corporation by removing potential conflicts of interest and allow the Corporation, on a daily basis, to function more effectively.

7.3 COMMISSIONING OF CONTENT

OPTION 1 –Do Nothing

The BBC, along with other terrestrial broadcasters, is currently required to source a minimum of 25% of qualifying (i.e. first run, non-news) TV programmes from independent producers. Originally introduced in the 1990 Broadcasting Act, the quota was applied to the BBC, ITV, Channel 4, S4C (and, later, Channel 5), and came into force on 1 January 1993. This quota, which was overseen by the OFT in the case of the BBC and which was applied across BBC1 and BBC 2 together, did much to create a thriving and competitive production industry across the UK. In 2002, the ITC Programme Supply Review recommended continuing with the 25% quota (and continuing to measure it in hours) as well as measuring it against BBC1 and BBC2 separately. The 2003 Communications Act continued with the quota, extending it to all public service channels, as well as making a number of other recommendations around powers to measure by spend, and a role for Ofcom in verification and enforcement. Ofcom estimates that UK channels spent £4.7bn on programming in 2004 and excluding rights, programming spend has increased by 3% per year since 1999¹⁴. The BBC estimates that their 25% quota is currently worth in the region of £250-300M per annum.

¹² The Combined Code on Corporate Governance, Financial Services Authority, July 2003

¹³ House of Lords Minutes of Evidence Taken Before the Select Committee on the BBC Charter Review, 5 July 2005, Dr. Dieter Helm, Sir Derek Higgs and Sir Robert Phillis, Sir John Bourn, Questions 1263-1349. See p. 3.

¹⁴ Review of the Television Production Sector, Ofcom, Jan 2006

The floor of 25% is of advantage to the independent sector. In particular, it provides the sector with a guaranteed level of work from the BBC, and means it can plan its development and operations with some certainty. However, the best way to encourage the development of the independent production sector is if non-BBC producers have open access to the commissioning system.

Option 1 is rejected because it affords insufficient scope for the future development of the independent production sector. Moreover, there is a risk that the 25% may be treated as a limit, which would restrain the potential for competition to provide the best programmes for licence fee payers.

OPTION 2 The Chosen Option– Quotas plus Window of Creative Competition (WOCC)

The Green Paper proposed a system that would satisfy two apparently conflicting desires. On the one hand, the Government believes that the BBC has a responsibility to adopt the most meritocratic commissioning policy possible, and to give the independent sector the chance to compete. On the other, it is clear from our extensive consultation with the broadcasting industry that the BBC requires a critical mass of in-house production that will enable it to continue, not only as a key source of creative excellence, but also its highly valued role in research and training not only for its own employees but also for the sector as a whole.

Quotas can act as somewhat “blunt instruments”. However, the Government believes that they are sometimes necessary to maintain viable competition in some markets. The WOCC combined with the 25% quota addresses both issues by providing for an adequate level of in-house capacity, by guaranteeing the independent production quota, and by freeing up another 25% of airtime for which the BBC will compete with independent producers. The WOCC will therefore provide a means of opening up a wide range of new opportunities for independent TV production companies and others.

The effectiveness with which the WOCC has met its stated objectives will be reviewed regularly by the Trust. We would expect the Trust to show, amongst other things, that the WOCC (ie, the 25% window open to all to bid for):

- Has satisfied the same specific range and diversity requirements that commissions to independent producers have to now;
- Operates openly, fairly and with a degree of transparency that satisfies all involved in bidding; and
- Has delivered diversity of supply.

The WOCC will build on the existing statutory arrangements in relation to independent production and Ofcom will continue to exercise its statutory duties in the way it does now.

This allows the BBC to retain a strong in-house production base in order to sustain wider public service benefits such as research, training and regional production and programming, whilst at the same time opening up at least 50% of commissions to external providers with a strong element of competition for quality. Training, in particular, benefits not only its own employees but also those in the rest of the sector. Consultation with the industry revealed that the BBC remains an extremely valued source of skills, and that it makes a significant contribution to training the

sector through its contributions to organisations such as Skillset and the National Film and Television School. There is no formal commercial equivalent operating on anything like the scale that the BBC provides. To remove or constrain this role runs the risk of adversely affecting the future development of the broadcasting industry as a whole.

Maintaining an in-house capacity has to be balanced against the need to introduce a more equitable system of commissioning – for example, by providing for equal access to commissioning structures and relevant research for both in-house and external producers and ensuring that value for money considerations are conducted on a like-for-like basis.

In the Green Paper, the Government welcomed the BBC's commitment to increasing competition in programme supply and supported the principles behind the idea of a 'window of creative competition'. We are satisfied that, if implemented openly, fairly and transparently, this approach will provide a major stimulus to entrepreneurial companies in the independent sector and wider commercial market. Independent research by Mediatique forecasts that "the WOCC, at the full 50%, would be worth up to £240m in incremental revenues for the independent sector in 2007, and £320m in 2014"¹⁵. However, the extent to which this shift in expenditure will lead to increased innovation in production values, limitation of cost increases or increases in productivity has not been assessed.

7.4 COMPETITION

In recognition of the unique nature of the broadcasting industry, the Communications Act 2003 gave Ofcom powers to regulate competition in the communications market. At the core of the competition issue, is the fact that spectrum is a finite and valuable resource, particularly frequencies in the broadcasting UHF bands, and it is in the UK's economic interest that it is used as efficiently as current technology allows. New technologies may allow either an increase in the number of services or support new services such as high definition television services on terrestrial networks or mobile TV services using DVB-H transmissions to specially adapted mobile phones. However, because each user could impede the use of spectrum by the other users, decisions on new services will depend on international co-ordination (the UHF band is currently restricted to broadcasting use). For the time being at least, terrestrial TV broadcasters in the UK command a share of over 65% of audiences and revenues.

These powers include sector-specific ex ante powers which mean that it can lay down and enforce rules by which licensed broadcasters can enter, and operate in, the broadcasting industry.

The BBC is independent and publicly funded. It provides considerable contributions to culture, social life and citizenship, beyond that which would normally be provided in a purely commercial broadcasting environment. Van Der Wurff provides an overview of national TV markets for commercial (advertising financed) and public general channels across 8 European nations, including the UK, in the 1990s when competition was categorised as "moderate" for most countries. He found that public broadcasting contributed to open market diversity of programme types so public broadcasting as such contributes to provision of minority programmes, the number of public channels not mattering too much. This diversity effect occurs even after

¹⁵ From the Cottage to the City: the evolution of the UK independent production sector. An Independent Report Commissioned by the BBC September 2005 Mediatique

the partial crowding out effect of public provision on commercial advertising funded programming.¹⁶ The BBC is a very influential organisation, with over a 50% share in radio and 35% of television audiences. However, apart from its commercial activities, the BBC is exempt from Ofcom ex ante regulations.

The Government does not believe that Ofcom's open-ended ex ante powers should be extended to the BBC as this would cut across the Trust's over-riding duties. However, if there is evidence of a need for more tightly defined powers, in specific areas, the Government is prepared to consider it.

Option 1 – Do Nothing

The BBC's publicly funded services have never been subject to external ex ante competition regulation by Ofcom. Instead, in relation to competition regulation, the BBC has limited itself with formulating a Fair Trading Commitment to govern the conduct of its commercial services. Nevertheless, public funding of BBC services distorts the broadcasting market. The BBC is subject to general competition law, which is constructed around either agreements which prevent, restrict or distort competition or the concept of misuse of a dominant position. This serves to protect the broadcasting industry from the possible adverse effects of a large publicly funded organisation. However, most potentially problematic conduct of the BBC does not involve agreements regulated under Chapter I of the Competition Act 1998 and in most markets the BBC's share falls below the 40% level which is normally regarded as the minimum required to define a firm as dominant under Chapter II of the Competition Act 1998. Thus, the BBC rarely falls within the core ambit of the Competition Act 1998. It is also true that in general terms, ex-post, competition law may not allow a competition regulator to act quickly enough to prevent anti-competitive behaviour occurring for an extended period of time. Broadcasting is rapidly evolving in new markets. There is an increasing need for extended ex ante powers, beyond the existing Fair Trading Commitment rules, to govern the BBC's commercial activities, so as to both strengthen and protect the broadcasting market as it evolves. Competition Option 1 is rejected because it does not provide scope for ex ante rules on the BBC to govern competition.

Option 2 Set Ex ante Rules for the BBC

Competition law and policy safeguards competition rather than the livelihood of a particular competitor. The fast changing nature of the broadcasting market means that ex-ante powers are sometimes required to address the potential for the rapid development of negative effects on competition or for previous competition problems to recur. In particular, ex ante rules can help avoid the significant and potentially lengthy disruption that occurs in full ex post competition cases; an investigation under the Enterprise Act could take up to 2.5 years. We believe that providing for further ex ante regulation of the BBC's publicly funded, non commercial services could serve to protect and encourage fair competition. During the Charter review process we have received opinion from the BBC Trust and Ofcom on the mechanisms for setting ex ante rules. Two options have been identified to bring this about.

¹⁶ Richard Van Der Wurff(2005): "Competition, Concentration and Diversity in European Television Markets", *Journal of Cultural Economics*, Vol 29, No 4, November, pp 249-275.

Option 2a Ofcom set ex ante rules

Under this model Ofcom, in consultation with the BBC, would have the power to draw up codes for the BBC in defined areas. For example:

- Cross promotion that unduly favours one digital TV or radio platform over others;
- Exclusivity in BBC broadcasting contracts which result in an undue distortion of competition (e.g. excessive hoarding of broadcast "rights");

Before setting *ex ante* competition rules, Ofcom must consider whether it is more appropriate to use Competition Act 1998. Ofcom's decision to have *ex ante* rules cannot be appealed to Competition Appeals Tribunal (CAT), although the content of the rules can.

Ofcom would have an obligation to have regard to the BBC's public purposes in setting codes and guidance (as would CAT).

Ofcom would only consider an appeal after the BBC Trust had reached a view. The Trust could disagree with Ofcom's conclusions, and give its reasons, but the appellant and/or Ofcom could appeal this to the CAT. This may require secondary legislation.

This option would set clear guidelines for BBC activities which are likely to enhance competition in some markets. It would, therefore, probably be supported by many commercial companies. Nevertheless, we reject it for two reasons. First, it would set up a potential confusion over the jurisdictions of Ofcom and BBC Trust. Second, the Trust is designed to be more accountable to UK licence fee payers in its setting of *ex ante* powers than Ofcom, and is the ultimate guardian of the public interest in relation to the BBC.

Option 2b and preferred option: BBC Trust sets ex ante rules

Under this option the BBC Trust draws up and consults on codes for those aspects of the operation of its public services that raise potential competition issues (for example, on cross-promotion and platform neutrality). These codes must "have regard to" Ofcom's codes for commercial broadcasters, and Ofcom must be consulted on the codes.

In order to recognise the important role of Ofcom, the Trust will be required to:

- "Have proper regard to" all recommendations made by Ofcom in setting codes;
- Give reasons for rejecting any Ofcom recommendations; and
- Consider recommendations made by Ofcom outside the consultation period, and also give reasons if not accepting them.

This option runs the risk that other broadcasters will not be prepared to share commercially sensitive information with the Trust, or that its judgements are not respected in wider broadcasting and public arenas because of a perceived lack of

expertise in relation to the wider market. These risks can be minimised by placing appropriate duties on the Trust to consult OFCOM and to maintain confidentiality information provided by third parties.

Nevertheless, we prefer Competition Option 2b. There are two reasons for this view. First, the Trust will be an independent transparent and accountable body and so will be best placed to balance the achievement of the BBC's key public purposes against the effect on competition of BBC activities. Second, BBC Trust will have access to Ofcom's expertise in drafting rules but without the weaknesses involved in Option 2a.

7.5 Commercial Activities

Although over the period of the last Charter the BBC's commercial companies increased in size, a number of these have subsequently been sold. Currently, the BBC has three subsidiary companies, BBC Worldwide, BBC World, and BBC Resources. Their activities include publishing, programme distribution, and production support. Together they have sales in excess of £600 million per annum and generated profits of around £38.5 million.

It might be argued that these activities could be supplied by commercial firms. Hence, there is no need for the BBC to supply such goods and services. It might also be questioned whether the BBC enjoys an unfair advantage in supplying these goods and services because it has the advantage of funding from the Licence Fee. Such arguments assume that the commercial activities are subsidised in the sense that they are not required to earn an appropriate return on capital employed.

However, this argument is rejected. Provided such a return is demanded and achieved then not to engage in these activities will mean that the BBC earns less in return for the contribution of taxpayers than would otherwise be the case. It is tantamount to granting an opportunity to commercial interests at the expense of the BBC brand which is owned by all licence payers in the UK. There is, therefore, widespread support for the idea that the BBC should be encouraged to make money out of its assets. 90% of people surveyed agreed that the BBC should raise money from selling its programmes and other products.

However concerns were raised in a number of areas:

- Alignment of the BBC's commercial activities with its publicly funded services;
- Fairness and transparency;
- How the money should be used – whether it should be spent on better programmes (50% of participants), only used to reduce the licence fee (30%) or both (20%);
- Whether or not the current arrangements deliver the best value for money.

Our view is that the BBC should generate as much income as possible from its commercial activities. However, the commercial services should be kept clearly separated from publicly-funded ones. In particular, there should be no cross-subsidy of the former by the latter, and fair trading commitments must be rigorously and transparently regulated. We also believe that each commercial activity must be

tested to make sure it adds a sufficient rate of return and is in a significant some way related to core public purposes.

Option 1 – No change

At present, approval of the Secretary of State is required for any new commercial services or the sale of the existing ones. Over the last 10 years the size and scope of the BBC's commercial activities grew rapidly. This growth was criticised on the grounds that the BBC was entering markets that had only limited connection to its core purposes.

The BBC's Fair Trading Commitment has proved controversial. It is expressed in general terms and some have argued that the Governors have not upheld it rigorously. Various elements of the competition law are the responsibility of Ofcom, the EU or the OFT. However, if the BBC is to be trusted by its commercial competitors in the wider market then it is important that the framework under which it undertakes commercial ventures be trustworthy and accountable. In this regard, it is noteworthy that some competitors have found it difficult to know to which regulator they should direct their complaints.

Commercial Activities Option 1 is rejected because it affords insufficient levels of transparency and accountability. Moreover, we believe that to continue the Secretary of State approval of new services, would be to perpetuate an unnecessary level of bureaucracy.

Option 2 and preferred option – Implement new framework for commercial services

New commercial services would no longer require the approval of the Secretary of State. Instead, the Trust would assume responsibility for commercial approvals on the same basis as that currently exercised by the Secretary of State.

The BBC Trust will be responsible for ensuring that the BBC's commercial operations comply with four criteria:

- Fit with PSB purposes
- Commercial efficiency – whether the operation in question deliver an appropriate return when compared to the wider market
- BBC Brand protection
- Absence of market distortions

These criteria are a mixture of commercial and public policy imperatives which may not be consistent with each other in all circumstances. For example, brand protection may conceivably interfere with commercial efficiency. Hence, in practice, the Trust might have to trade off these principles one against another. The Board of BBC worldwide will have to be satisfied that all commercial ventures afford a

balance of advantage when measured against these four criteria, and it is envisaged that the judgements that the Board makes will be open to public scrutiny.

This option will allow, in line with the public' view made clear during our consultation, the BBC to continue to generate a commercial income to reduce pressure on the licence fee. At the same time, it will:

- Focus the BBC's commercial activities on those that it is most appropriate to carry out
- That a suitable return will be generated compared to the wider market
- That it will ensure the BBC's trusted brand continues to be used appropriately and fairly
- That it will address some of the principle concerns raised by the BBC's competitors during our consultation phase, and
- The removal of the need for the Secretary of State to approve all new commercial services is an important deregulatory measure.
- **8. COSTS AND BENEFITS**

As the lead public service broadcaster in the UK, the BBC is in a unique position as a strongly branded and publicly trusted communicator. This means that it inevitably and by design has an impact on the rest of the market – that is other broadcasters (public and commercial), production companies, publishers, content providers, platform operators etc.

8.1 Funding

The BBC's public purposes are funded in a variety of ways. In 2004/05, £2,508million was received by way of the licence fee, £432mm was disbursed by the Department of Work and Pensions (DWP) to pay for free licences for the over 75s, and £225million was paid by the Foreign and Commonwealth Office (FCO) to run the World Service. In addition, the BBC earned a net income of £91million from external sources such as commercial activities and subscriptions to World Service.

The costs of the BBC to consumers are the revenues it receives from the public either directly via licence fees, via sales or subscriptions or indirectly via payments from other parts of Government. Our extensive research found that, although not perfect there was widespread support for the licence fee as the method for funding the BBC. The benefits are, however, harder to quantify. This is because many of the services produced by the BBC are supplied at zero price to the consumer or user at the point of use. In such cases, it is necessary to use indirect stated preference methods to arrive at a valuation of output. One such method is to ask a random sample of consumers how much they would be willing to pay to avoid having BBC broadcasts taken away. In a recent exercise¹⁷ commissioned by the BBC it was found that 9% of viewers were willing to pay £480 a year for a licence, 10% £360 pa, 23% £240 pa and 39% £120 pa. If we transposed these proportions to the 25.91 million households in the UK we find that BBC services are worth approximately £5.5 billion pa. to consumers in 2005/6 prices. Nevertheless, subsequent Mori research on "willingness to pay" by subscription for enhanced BBC offerings provided much lower estimates of personal value, averaging only around £11.00 per month, which is roughly in line with the current licence fee¹⁸ (although it is important to note the

¹⁷ Source: Human Capital/Martin Hamblin GfK, A study measuring the value of the BBC, 2004.

¹⁸ Mori (2005) op cit. P.11.

lack of consensus over current willingness to pay methodologies and the impact this has on the confidence that may be placed in the conclusions).

As part of its first quinquennial review of Public Service Television Broadcasting, Ofcom carried out research into the public's willingness to pay for public service broadcasting. One of the main conclusions of the research showed that, once realistic costs are attached, the public tends to want to pay for a slightly lower level of PSB than that provided today, but higher than the level which would exist if only the BBC was funded to produce PSB programming at its current level. This suggests a level of explicit funding of PSB of between £121 and £151 a household¹⁹. However, even with this type of technique it is not possible to quantify all the costs and benefits associated with the various funding options. Of particular note are the benefits of universal provision, a fair stable and independent funding stream and a funding stream which ensures that the public purposes of the BBC are served. Although, these benefits are largely unquantifiable they are believed to be sufficiently significant to outweigh any discrepancy between quantifiable financial costs and benefits.

¹⁹ Ofcom review of public service television broadcasting Phase 2 – Meeting the Digital Challenge September 2004

TABLE 8.1
COSTS AND BENEFITS OF FUNDING OPTIONS
(£ billion at 2005/06 prices; accumulated over next Charter period)

	Tax Funding	Ads and Sponsorship	Subscription	Mixed Funding(1)	Licence Fee
COSTS:					
To consumers			23.7 (2)		29.6(3)
Lower competition	7.7(4)		7.7(4)		7.7(4)
Higher taxes	29.6(3)				
To business		13.4(6)			
Administration					1.5
Evasion					1.5
Funding Review					0.005(5)
TOTAL	37.3	13.4	31.4		40.3
BENEFITS:					
Reduced price of ads		7.7(4)			
Willingness to pay	54.6 (7)	24.6(7)(8)(9)	43.7(2)(7)		54.6(7)
TOTAL	54.7	32.2	43.7		54.6
NET FINANCIAL BENEFITS	+17.3	+18.8	+12.3		+14.3
Universality	+	?	-	?	
Stability	-	-	-	?	
Independence	-	-	-	?	
Fairness	+	+	-	?	
Public Values	?	-	-	?	

+ Improvement or rise compared to Do Nothing Option.
- Deterioration or fall compared to Do Nothing Option.
? Indeterminate outcome compared to Do Nothing Option.

Notes:

1. The precise costs and benefits of the mixed funding model depend upon the mix of funding chosen and cannot be specified ex ante.
2. Assume that BBC consumers are unwilling or unable to pay subscriptions to the extent that existing revenues are cut by 20%.
3. Assume no change in Licence Fee in real terms.
4. Assume that the price of TV advertising in 2005/06 was 20% higher than it would have been in the presence of the BBC in the advertising market.
5. Assume that the Funding Review will cost £5 million.
6. Assume that the BBC is able to capture 35% of the total advertising revenue. This is equivalent to 56% of the Licence Fee collected in 2005/06.
7. Willingness to pay based on Human Capital/Martin Hamblin GfK, op cit.
8. Assumes benefits yielded by BBC are proportionate to revenue available. Hence, 56% of the Licence Fee will only generate 56% of the present willingness to pay.
9. Assume 60% of BBC consumers dislike advertisements to the extent that their willingness to pay is reduced by 25%.

All options yield positive net financial benefits with the advertisement /sponsorship option generating the most, allowing for the estimated impact on advertising prices.

This is principally because of the substantial benefits of public service broadcasting which is widely accessible. However, neither this option nor the tax funding method guarantees the BBC a stable funding stream which is independent of political and commercial interests. Such independence is a core policy objective widely supported by the public. Hence, although the Licence Fee method yields fewer net financial benefits than either the advertisement/sponsorship and the tax funding options it is preferred on a multiple criteria analysis basis. A major potential disadvantage is on equity grounds because it is not related to the ability to pay (although research carried out on behalf of Ofcom as part of its review of public service television broadcasting appeared to indicate some support for a regressive fee, on the grounds that public service broadcasting is not felt by the public to have the same degree of necessity as, for example, health and education services).

8.2 Governance

The creation of a BBC Trust would provide:

- Strengthened accountability to the licence fee payer and greater independence from Government
- A clear separation between the responsibilities for running the BBC's services and responsibilities for strategic oversight in the public interest, allowing much more effective regulation of the management's activities
- Arrangements which would take full account of best practice in corporate governance

In an organisation the size of the BBC small sustained improvements in competitiveness or increments in public value over time will ensure ample justification of the increased costs of governance. It is expected that improved clarity of purpose for the BBC would result from the changes and lead to improved financial performance and efficiency as less crucial or less effective parts of the organisation were rationalised. In addition, it is likely that those elements of its activities which have been identified by the BBC as sources of public value would be likely to be emphasised, and so grow in relative and absolute terms over time.

At present, the costs of governance are only partially identified by the BBC. Under these circumstances the estimated costs of alternative options must clearly be treated with caution. Salaries and pensions costs of Governors and Executive Committee members vary from year to year. Therefore, where data for 2003/4 and 2004/5 are both available we take the mean as the basis of cost estimates. Otherwise, the 2004/5 data are used. We have also assumed that the present cost of supporting the governance structure is the same as on-going Board costs over the Charter period.

The costs of the preferred BBC Trust option have been estimated as follows. On-going Board costs are estimated on the basis of existing board costs but with an increase in membership from 21 to 24. A research budget of £0.5 million is assumed. Support costs are estimated at three times the preferred option board costs. Ofcom costs of £0.5million are assumed and increase at 3% above annual inflation. Finally, capital costs of £50 million are included.

The BBC Trust is broadly comparable (slightly more expensive) than the Ofbeeb and the Board plus Commission alternatives. In option appraisal the focus is on value for money rather than cost minimisation so that incremental benefits can be weighed against higher identified costs. Three benefits of the new structure have been

recognised; namely, increased clarity of purpose, improved accountability and enhanced public value. Unfortunately, none of these benefits can be quantified with any certainty. However, the preferred BBC Trust operating within clear boundaries with Ofcom, sufficiently timely information, and the instruments needed to enforce its policies, is judged to provide the best value for money option

It also appears to be the option most likely to achieve the Government's policy objectives of a strong BBC, independent of Government with greater accountability to licence fee payers and one that is much more sensitive to its position in the market. Although it appears to be marginally more expensive than the alternatives it is likely to yield significantly greater benefits especially as a result of the changes to public accountability it promises. The second best options appear to be the Board plus Commission and extending the jurisdiction of Ofcom to cover the BBC.

The link between governance and productivity and competitiveness is indirect. Productivity growth in broadcasting, as with many other capital intensive industries, is technologically driven. It is, therefore, very important that the BBC Trust provides a stable, clear and coherent basis for capital and technological investment. Moreover, improved Governance may enhance the efficiency with which capital and labour are employed internally. On the other, if the new governance arrangements prevent the BBC from entering growing markets or adopting new production and distribution methods, then productivity growth may be reduced.

On balance, the BBC Trust model offers the best available approach to providing a long-term stable governance structure which combines effective regulation with the clarity and accountability needed to improve economic efficiency and boost public value.

TABLE 8.2
GOVERNANCE OPTIONS
(£ million at 2005/06 prices; accumulated over next Charter period)

	Do Nothing	Ofcom	BBC Proposals	Ofbeeb	Board + Commission	BBC Trust
COSTS:						
Board Costs	67.1(1)	67.1(1)	67.1(1)	67.1(1)	67.1(1)	76.7(2)
Capital	50 (3)	50 (3)	50 (3)	50(3)	50(3)	50 (3)
Advisory Councils			2(4)			
Regulatory Costs		20(5)		20(5)	20(5)	
Reduction in Competition(11)		-	+	?	-	+
Research		5(6)	5(6)	5(6)	5(6)	5(6)
Support	67.1(7)	67.1(7)	80.5(8)	201.2(9)	201.3(9)	230(9)
Ofcom costs	5 (12)	10 (10)	10(10)	10(10)	10(10)	10(10)
TOTAL	189.1	219.1	214.6+	335.3	335.3	371.6+
BENEFITS:						
Clarity of purpose		?	-	-	+	+
Productivity		+	-	+	+	+
Competitiveness		+	-	-	+	+
Public Value		+	+	+	+	+
Accountability		-	+	-	+	+

Effective regulation		+	-	-	+	+
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- + Improvement or rise compared to Do Nothing Option.
 - Deterioration or fall compared to Do Nothing Option.
 ? Indeterminate outcome compared to Do Nothing Option.

Notes:

1. Accumulated costs of BBC Board and Executive over next Charter period based on average of 2003/04 and 2004/05 costs from BBC Annual Report.
2. Assumes increase in Board members from 21 to 24.
3. Assumed costs of building, fit out, equipment and systems.
4. Assumed cost of strengthening Advisory Councils £0.2 million p.a.
5. Assumed cost of regulator or Commission.
6. Assumed budget for research to support governance functions.
7. Board support and administration assumed to be equal to direct Board costs.
8. 20% increase in Board support due to establishment of Governance Unit.
9. Trust support costs assumed to be three times present Board support costs.
10. Ofcom costs are assumed to be £1.0 million in 2005/06.
11. Judgement of whether or not the proposed arrangement is likely to increase (+) or reduce (-) costs due to the impediments it places on, or takes from, competition in supplier markets compared with the Do Nothing Option.
12. Current OFCOM costs assumed to be £0.5m per annum.

8.3 Organisation

The BBC plans to focus its Research and Development and training capability, although the potential savings involved are not identified. Also the BBC aims to raise the proportion of programmes commissioned from independent production houses from the present commitment of 25% of qualifying hours and 25% of programme budget.

TABLE 8.3
ORGANISATION OPTIONS
(£billion at 2005/06 prices; accumulated over next Charter period)

	Do Nothing	WOCC + training
COSTS:		
Training costs		?
Commissioning independents	1.5 (1)	2.2(2)
R&D		?
Operating Costs	24.7	22.8(3)
	26.1	25.0
BENEFITS:		
Increased productivity		?
Lower cost programmes		+
Public Value		+
Greater inventiveness		+

- + Improvement or rise compared to Do Nothing Option.
 - Deterioration or fall compared to Do Nothing Option.
 ? Indeterminate outcome compared to Do Nothing Option.

Notes:

1. Assumes independent producers are awarded 25% of BBC qualifying output.
2. Assumes BBC original commissions are open to independents as follows. Total commission £983.7 million. 40% of these are reserved to BBC. Of the 60% qualifying time an extra 12.5% is awarded to independent companies.
3. Assumes operating costs fall by 7.5% in line with additional independent commissioning

8.4 Competition

It is proposed that the BBC should be subject to a series of ex ante rules to ensure that it does not undermine competition in the markets in which it engages. These rules may take the form of formal Codes of Practice or Statements of Principles.

TABLE 8.4
COMPETITION OPTIONS
(£ million at 2005/06 prices; accumulated over next Charter period)

	No change	Ex ante rules by Ofcom	Ex ante rules by BBC Trust
COSTS:			
Administration		20(1)	20(1)
Market distortion		-	-
BENEFITS:			
Accountability		-	+
Clarity of purpose		?	?

- + Improvement or rise compared to Do Nothing Option.
 - Deterioration or fall compared to Do Nothing Option.
 ? Indeterminate outcome compared to Do Nothing Option.

Note:

1. Costs of drawing up and enforcing ex ante rules assumed to be £2 million p.a.

In principle, the advantages of drafting and enforcing ex ante rules for the behaviour of the BBC in the broadcasting market are clear. Such rules will mean that the expense and delays in ex post competition law will be avoided. Provided they address the main areas in which the BBC reduces competition they should have a positive effect on the competitiveness of broadcasting and other related markets. However, the success depends upon the absence of doubt about the jurisdiction of either the BBC Trust or Ofcom. Moreover the BBC Trust will need to mobilise adequate expertise in drawing up, implementing and monitoring such rules. On balance, the preferred option is to for the BBC Trust to be given sole responsibility to administer the rules and engage the expertise of Ofcom.

8.5 Commercial Activities

A new regime to govern the commercial activities of the BBC is to be introduced. Under it, the Secretary of State will no longer give approval for new services. Instead, a protocol will be established under which approvals will be considered by

the BBC Trust. We have assumed that this new system will cost £5million per annum (at 2005/6 prices). In addition, the commercial activities of the BBC will be reported upon each year. The report will include an assessment of the success of those activities and how far they meet the criteria. We have assumed this reporting will cost an additional £2m per annum (at 2005/06 prices). Finally, on-air trailing of BBC magazines will no longer occur, and there are likely to be restrictions on trailing of other commercial products eg books and DVDs (although the competition concerns that have been raised in connection with non-magazine products are considerably less significant). We have assumed that this will reduce sales by 1% and so will cost the BBC £0.22 per annum in revenue.

TABLE 8.5
COMMERCIAL OPTIONS
(£ million at 2005/06 prices; accumulated over the next Charter period)

	Do nothing	New Framework
COSTS:		
Administration		50(1)
Reporting		20(2)
Reduced Sales		1.6 (3)
TOTAL		71.6
BENEFITS:		
Greater competition		+

- + Improvement or rise compared to Do Nothing Option.
 - Deterioration or fall compared to Do Nothing Option.
 ? Indeterminate outcome compared to Do Nothing Option.

Notes:

1. Assumed costs of administration £5 million p.a.
2. Assumed costs of reporting £2 million p.a.
3. Effect of non-trailing of magazines is 1% of magazine sales.

The general benefit of those measures is to reduce the extent to which the BBC can use its market power to influence market outcomes. While this may, on occasion, mean that competition in particular markets is temporarily, at least, reduced and prices raised in some markets where the BBC no longer competes it is believed that overall the improvements in allocative efficiency will more than outweigh this effect. Unfortunately, it has not proved possible to quantify these effects.

8.6 Race Equality Impact Assessment

An initial assessment has been conducted and it was concluded that no full assessment was needed.

9. SMALL FIRMS IMPACT TEST

Guidance from the Small Business Service suggests that the key stages in assessing the impact of policy on small businesses are:

- (i) An initial sounding of small businesses (or representative bodies) before formal public consultation, to identify the likely impact on the sector.

- (ii) Where the impact appears significant or complex, a more detailed explanation of the issues.
- (iii) Assessing and reflecting representations made by small firms during the consultation in the final RIA, adapting policy to the needs of SMEs.

In fact, as both the Green Paper and the White Paper make clear, there is no proposal for radical change in service delivery, except for the establishment of a Trust to oversee the BBC. Given that there are no significant proposals to alter the operation of the BBC, there can be no grounds for expecting an impact on small and medium sized enterprises. Indeed, under the new arrangements, where changes are proposed to the range of services delivered by the BBC, individual businesses will have a much greater say in the decisions reached by the Trust.

As the Small Firms Impact Test guidance makes clear, all that is required at the RIA Initial Assessment Stage is a paragraph indicating that the impact on small businesses is insignificant. However, the publication of this statement does allow for comments to be raised in the further consultation which will accompany the White Paper.

10. COMPETITION ASSESSMENT

BACKGROUND

The communications and broadcasting sector of the UK economy is highly regulated. As noted earlier, in the case of the broadcasting industry this has arisen because the radio-magnetic spectrum employed by broadcasters although rivalrous or subtractable in the absence of rules governing its use (the use by one broadcaster prevents or impedes its use by another) is not alienable or exclusive (it is available to all who desire to use it).²⁰ Without rules governing its use competitors will seek to compete by impeding the use of spectrum by others and thereby reduce the utility of all consumers. Spectrum is, therefore in essence, a commons.²¹ For this reason, the allocation and use of spectrum is subject to international treaty. International trade of spectrum does not normally occur although there is active international exchange of programmes. Most jurisdictions, including the UK, actively regulate the use of spectrum.

In the UK, the Government's interventions into the broadcasting industry take a variety of forms. They include the Ofcom to oversee the allocation and use of spectrum by commercially-focussed broadcasting companies, the incorporation of the BBC by Royal Charter and its public funding. As a result, entry into, and exit

²⁰ For an introductory discussion of various problems associated with electronic commons and how they may be solved by means of collective and legal agreements see Paul A. David (2003): "The Economic Logic of "Open Science" and the Balance between Private Property Rights and the Public Domain in Scientific Data and Information: A Primer", SIEPR Discussion Paper No 02-30, Stanford Institute for Economic Policy Research, 17th March and Siobhan O'Mahony (2003): "Guarding the Commons: How Community Managed Software Projects Protect Their Work", Harvard Business School.

²¹ To some extent this phenomenon is due to the use of analogue technology by UHF band broadcasters. It is conceivable that the use of digital technology will both ensure considerable spare capacity in spectrum and so make the pirating of spectrum pointless. If so, the spectrum may no longer be a commons.

from, the industry has been for some time, and continues to be, heavily regulated and, hence, significantly impeded.²² Moreover, the choice of product, its price and quality and the nature and geography of the inputs used in its production are, in varying degrees constrained by regulation.²³ Finally, the various markets served by the UK broadcasting industry are kept largely separate by regulation. For all these reasons, competition in UK broadcasting markets is limited.

In addition, the industry is subject to rapid technological change the benefits of which normally accrue disproportionately to large firms. Moreover, firms within the broadcasting industry are subject to significant external and internal economies of scale and scope. There is a tendency for the use of any commons being exploited by firms with economies of scale and scope to become dominated by a few large firms, the operation of which can threaten the very use-value of the commons concerned. The UK broadcasting sector is no exception with broadcasting dominated by a few large concerns the largest of which is the BBC.

The risk of domination by the BBC is enhanced by the fact that the BBC is deliberately kept independent of commercial and political pressures. It is incorporated by Royal Charter which means that it is not subject to the normal commercial disciplines imposed by the money and capital markets. Moreover, it does not have to attract revenue directly from its customers and instead has access to the proceeds of a flat-rate tax levied on television owning households (i.e. the licence fee).²⁴ As a result, the BBC's revenue stream is largely immune to the vagaries of advertising, sponsorship and subscription markets.

Such a significant intervention into broadcasting allows the Government's public purposes for the industry to be widely and consistently served. However, it also brings with it the potential for significant distortion of competition in the various markets in which the BBC operates. For this reason, it is necessary for the Government to limit the activities of the BBC, thereby ensuring that any distortions to competition are minimised subject to the constraint that the public purposes of the BBC are served.

This competition assessment explores the dominance of the BBC, analyses the ways in which the BBC may distort competition and assesses how far the measures proposed in the White Paper could potentially assist in reducing those distortions.²⁵

THE MARKET POSITION OF THE BBC

The regulation of broadcasting means that the various markets that the industry serves are largely separate. In normal circumstances this will greatly assist the

²² Competition Commission (2000): "Carlton Communications Plc and Granada Group Plc and United News and Media Plc: A Report on the three proposed mergers", Cm 4781, July 2000, Appendix 4.2, p192f and Ofcom: "Communications Market 2005", Chapter 4.2.7, pp 217ff.

²³ Ofcom, *ibid*, p 218f.

²⁴ The licence fee is levied annually on each useable TV at a rate determined in negotiation between officials and the BBC. Currently, the rate is £126.50 p.a. per household. However, evasion of the licence fee does occur and the tax is expensive to collect. Together these effects are estimated to amount to £300 million p.a. compared with a total licence fee raised of about £2,300 million p.a.

²⁵ An accurate assessment of how far a particular policy measure may or may not lead to a closer approach to competitive equilibrium in the markets concerned requires a full knowledge of the consumption, production and regulatory reaction functions for the broadcasting market. See R.G. Lipsey and K. Lancaster (1956): "The General Theory of Second Best", *Review of Economic Studies*, Vol 24, December, pp 11-32.

measurement of market dominance. The BBC participates in five markets on behalf of the Government. They are:

- Television broadcasting;
- Radio broadcasting;
- Programme broadcasting;
- Online services; and
- Publishing.

Measurement of the extent to which the BBC dominates these various markets is made difficult for two reasons. First, neither the BBC nor its commercially-focused free to air rivals charges for access to its products. Hence, it is not possible to usefully employ the usual measures of dominance such as concentration ratios or Herfindahl indices based on the sales share. Second, all the above markets are in varying degrees open to international competition and the BBC is itself a significant international broadcaster and programme distributor. For these reasons, we have to resort to relatively anecdotal, imprecise and indirect indications of market dominance.

The BBC is the largest single organisation involved across the five UK markets. It employed some 27,000 people in 2004-05 and has assets of £2.2 billion. The next largest organisations are BSkyB with assets of £2.3 billion and ITV with £1.1 billion. The BBC is the largest TV broadcaster in the UK and its 7 channels gained 36.6% of the total TV audience in 2004. The next largest, ITV, commanded some 24.1% of the audience.²⁶ During the same period, BBC radio commanded on average 53.5% of the total audience. In 2004, the BBC produced £983.7 million worth of original TV commissions or some 33.3% of the industry total compared to 20.5% by the ITV companies.²⁷ Graf (2004) found that the BBC has a significant, if not dominant, presence in Internet surfing, news consumption and online consumption of radio services.²⁸ Only in the publishing market is the BBC one of many participants, although it is conceivable that it may be able to exert some market power in particular sub-sectors of that market.

POSSIBLE DISTORTIONS OF COMPETITION

Many of the BBC's activities have the potential to impact on competition. This is not surprising since the BBC as a whole represents a deliberate intervention in the market for public policy purposes. This is one of the reasons why the BBC is already subject to competition law regulation. A form of ex ante regulation will be introduced. This will be developed by the BBC Trust in consultation with Ofcom. Areas where such regulation might be appropriate include cross promotional activities in television and radio broadcasting which may unduly favour some digital television and radio platforms over others, and the potential distortionary impact of online proprietary distribution technology on downstream content services.

In the following each of the four types of neo-classical "market failures" are discussed. This gives a convenient framework within which to consider the main ways in which the BBC "distorts" the UK communications market. It should be noted that such a framework is confined to the consideration of possible resource

²⁶ Ofcom, op cit, Figure 4.28, p 212.

²⁷ Ofcom, op cit, Figure 4.14, p. 203.

²⁸ Philip Graf: "Independent Review of BBC Online", Department for Culture, Media and Sport, 10th May 2004, pp 35-36.

allocation effects and ignores the older, classical reasons for market intervention,²⁹ which are commonly categorised as merit goods in the neo-classical canon. As noted earlier, the very limited evidence available means the following discussion is primarily in theoretical terms backed up by relatively anecdotal evidence from particular examples in some of the five markets identified.

Modern micro-economics has identified four types of market distortion. They are, as summarised by:

- Monopoly Power;
- Externalities;
- Economies of scale or scope; and
- Uncertainties.

Monopoly Power

The BBC's dominant position is derived from several factors:

- a) The BBC is funded by a licence fee which takes the form of a specific, flat-rate tax on TV households.
- b) Significant but unmeasured economies of scope and scale are available to communications companies.
- c) The BBC is trusted by the general public and is a widely recognised brand.
- d) BBC's own research and development places it at the heart of technological change across the communications sector.

The dominant position means that the BBC can influence the outcomes of a wide variety of communications markets. These markets are highly regulated. This wide influence means that these markets may be more likely to serve public purposes as embodied in the BBC than would otherwise be the case. Dominance can be used to influence market outcomes (i.e. "distort" markets). These may take a variety of forms.

(i) Crowding Out

It has been asserted that the BBC can crowd out commercially based competition. This may take a variety of forms including supplying material at below cost in competition with commercial operators and bidding up the prices paid for bought in materials and staff. Either may result in the BBC expanding as a way of justifying or preserving its future existence. So the BBC may expand beyond the limits that would be determined by purely commercial considerations. It is not clear how important this effect is.

It could be argued that the BBC is encouraging the use of public value material in this way.³⁰ Hence, it sets standards for the whole industry and in some cases makes markets which would not otherwise develop. One example is that it ensures that minorities are heard. In this way, it is enabling much larger audiences to receive

²⁹ The intervention in the broadcasting market which the BBC embodies was first designed when this older classical type of justification for Government intervention was current namely to develop the economy and produce a particular distribution of income or wealth. See A.C. Pigou (1932): "The Economics of Welfare", 4th edn, Macmillan, London

³⁰ See VanDer Wurff, op cit.

material which is directly relevant to them than would be possible under a purely commercial environment.

This crowding out effect may be reduced by requiring the use of independent producers by the BBC. Currently, Ofcom requires public service broadcasters (including the BBC) to source 25% of first run, non-news programmes from independent producers. The White Paper proposes to extend this in the case of the BBC so that a further 25% of such programming will be open to competition from outside the BBC.

This proposal should assist in reducing the crowding out effects in TV broadcasting. Nevertheless, its effectiveness depends upon how openly and fairly the new competition is conducted. It is also proposed to place the Trust under a duty to secure the role of independent production in BBC Radio or BBC Online.

(ii) Predation

A dominant firm can use its position to undermine the viability of potential or actual rivals. This can conceivably happen as follows:

- Cross subsidising services which compete with private sector companies.
- Supplying material at zero price to drive competitors out of business.
- Poaching staff.
- Giving commercial value to sponsors on publicly funded services.

These result in much less competition in the long run than would otherwise be the case. They may significantly reduce investment in the industry in the long run. They also mean the extension of a dominant position across many more markets than would otherwise be the case. For example, when One Word, then operating independently as a commercial spoken word station exited its market it cited free-to-air BBC7 as a factor in its decision. Although the industry throws up many such anecdotes they are rarely accompanied by objective evidence. Moreover, the extent of such behaviour is uncertain.

It could be argued that the BBC is passing on economies of scale and scope of unknown extent to consumers by means of zero price supply. This may be preferable to rent seeking behaviour by BBC staff. Nevertheless, the determination of the distribution of such benefits is normally regarded as a matter for Government policy not corporate preference.

The tendency for predation may be countered by opening up content to independent producers. In addition to the quota mentioned above, there are further plans to develop a WOCC, to further increase competition in programme supply. While the independent production quota would remain at 25%, the WOCC would provide for up to a further 25% of commissions to be opened up to independent production companies, in-house production bidders and others. This would allow independent producers to compete for as much as 50% of qualifying commissions. In addition, the White Paper confirms the separation of public service broadcasting (PSB) and commercial services. It is expected that the proposed changes to BBC governance will assist these tendencies. Nevertheless, much depends on the independence of the BBC Trust and the adequacy of the information systems it commands.

(iii) Innovation

Dominant firms are in a position to design, make and sustain markets and technology which might not otherwise prove viable. In this way, they can determine the pace and direction of innovation. A more pluralist competitive environment might allow the least cost alternative of market structure and technology to emerge. This may not happen in the presence of a dominant firm because:

- Dominant firms have significant economic and financial resources.
- A dominant brand may frighten off potential market entrants.
- A dominant firm can take greater risks than new entrants.

Together these effects may result in the BBC determining the direction and pace of innovation in many of the markets in which it operates, which may lead to distortion of these markets. This is more likely to occur in newly created markets such as the online market. Hence, this may lead to the BBC spending large sums on R&D and in training and nurturing staff while at the same time unfavoured markets and technologies are neither explored nor exploited. This may place the BBC in danger of over-expansion or undermine investment in the industry in the long run and raise costs for all participants.

These risks can be reduced by enforcing a regime which ensures that all resources are charged at full alternative cost (including the full cost of capital) and by the use of market impact assessment. Both are expected to be part of the new governance structure. However, neither fundamentally addresses the dynamic inefficiencies which a dominant firm, like the BBC, may impose on markets in the long run.

(iv) Exclusivity

A dominant firm can impose conditions on the contracts it enters into which can prevent other firms from obtaining the means to compete. Such agreements may fall within the ambit of Chapter 1 of the Competition Act 1998. Ofcom is currently investigating an exclusive contract between Red Bee Media Ltd (a subsidiary of the BBC) and Channel 4. Another example is the European Commission investigation of the contract under which Premier League viewing rights were sold. The BBC enjoys a number of forms of exclusivity:

- Exclusive national use rights over material.
- Prevention of sale to other media companies.
- Hoarding of spectrum for which it does not pay.
- Not allowing access to BBC IPR.

The result of this exclusivity is that entry into markets may be less than would otherwise be the case. However, doubts exist about the extent of this effect. Nevertheless, these contracts are normal in many other markets and the degree to which the BBC's contracts are detrimental to competition is hard to measure. Moreover, banning such arrangements may reduce rents which artists might otherwise be able to earn. In due course it is possible that increased competition from new digitally-based services will reduce the ability of the BBC to conclude such arrangements.

Because of these doubts and because of the unknown extent of the effects of exclusivity no specific policy is proposed in the White Paper to address the issue.

(v) Collusion

Dominant firms can more readily cartelise markets than non-dominant firms. This is because a dominant firm can readily enforce cartel discipline through the carrot of involvement and the stick of exclusion. Collusion may take the form of partnerships or joint ventures involving the dominant firm or its subsidiaries. An example is the digital curriculum and digital news services.

Nevertheless, all commercial organisations engage in such ventures. In most cases, they do not significantly affect the competitiveness of markets but rather, by sharing and spreading risks, make possible new ventures which might not otherwise occur. Such relationships distort competition when they are formed with such an end in mind and when they are used to forestall competition. The BBC has been accused of such practices in the case of the agreement with the FA over the sale of rights to broadcast the FA Cup and over the Red Bee Media Ltd contract with Channel 4.

The changes to BBC governance which will require the performance of a public value test accompanied by market impact assessment should assist in preventing problems arising. In addition, the White Paper proposes that BBC Trust be given ex ante powers to prevent certain types of business practice.

Nevertheless, the collusive effect of joint ventures and partnerships is hard to identify and rarely the openly stated objective of commercial decisions. If the ex ante powers are to be effective in countering collusion the BBC Trust will require access to considerable information and analytical capability.

Externalities or “Spill Over Effects”

The BBC creates externalities which affect third parties not directly involved as market participants. Three types of externality can be identified.

First, the BBC is a major provider of transferable skills through training opportunities for its own staff and for those of other companies and by the export of technical staff.³¹ Insofar as these activities take place at less than full replacement cost they represent a subsidy for the industry and may lead to more investment in technology and high skills than would otherwise be the case. This, in turn, may restrict entry into broadcasting, production and online markets and so raise costs for consumers.

Second, the BBC invests in R&D to the extent that it can often dictate technical standards in production and broadcasting. It may be that such investment acts as a disincentive to R&D by other companies. This, in turn, may reduce the degree to which innovations in the markets in which the BBC participates are driven less by the dynamic interplay of alternative solutions and more by the decisions within the BBC. As a consequence, there is a risk that in those markets affected there is less chance of the least cost alternative emerging as the industry standard.

Third, because it is funded by the licence fee the BBC does not participate in the advertising, sponsorship and subscription markets. This means that competition for advertising, sponsorship and subscriptions is considerably less and revenues for ITV plc and BSkyB higher than it would otherwise be.³² This effect is particularly likely to be evident in the free to air TV broadcasting market. Again, it is possible that

³¹ The BBC is the UK's biggest investor in broadcast training: last year BBC training and development delivered 37,858 training days for 22,000 people both within and outside the BBC, in all a total of 3,814 separate courses – source: Review of the BBC's Royal Charter March 2005.

³² PriceWaterhouseCoopers (2004): “Economic Analysis of the TV Advertising Market: Commissioned by Ofcom”, December.

advertisers and viewers consumers are presented with less attractive choices than would otherwise be the case.

Although it is possible that such effects could be of some significance it is not possible to estimate their size or extent with any degree of accuracy. Moreover, it is not possible to design policies which could be expected to counter directly the external effects that might occur. Nevertheless, the proposed use of the public value test coupled with market impact assessment will assist in reducing any of these effects that might arise from new ventures.

Economies of Scale and Scope

The making and broadcasting of television programmes has exceptionally high fixed costs and very low marginal costs – it costs no more to make a programme available to extra people (within a range of a given transmitter system). This feature means that the lowest cost method of obtaining universal access to public service broadcasting is to employ a single organisation to supply it. Provided the public purposes of that organisation are safeguarded then the advantages of scale and scope can be passed on to consumers.

However, if these safeguards are not present, there are risks that rent-seeking behaviour will divert the resources saved away from consumers and towards staff or other vested interests. Moreover, economies of scale may make it difficult for new firms to enter the broadcasting market and therefore results in a highly “concentrated” industry – a high percentage of total programming output is accounted for by a few providers.³³

The extent of these effects in the case of the BBC are not known.

Uncertainty

The BBC is said to create uncertainty for private companies because of its ability to compete vigorously in markets and to quickly create new services unlike commercial PSBs. This arises because:

- Commercial PSBs require lengthy Ofcom clearance for new services;
- The BBC can deploy large resources to change market structure;
- The BBC brand is very strong; and
- The plans of the BBC are not well known in advance and rumours about BBC activity may be sufficient to preclude competitors from entering a market.

The normal investment process may be disturbed as a result. This could lead to biasing investment against those types involving large sunk costs and towards those with high variable costs. It may also lead to shorter pieces of content. This may in turn affect the structure of the BBC as it tries to compete with commercial offerings.

Graf (2004) found that if the threat of the BBC causes potential competitors to withdraw from the online market this did not necessarily constitute a lessening of competition. Far more significant, in his view, is the genuine risk that the BBC may deter investment from potential competitors which could change the nature of the

³³ Davies G (Chair) (1999) The Future Funding of the BBC - Report of the Independent Review Panel, DCMS

market especially if this deterrence is due to the unique features of BBC Online. Graf concluded, that, although the risk existed, there was no evidence that a reduction in competition had occurred.³⁴

No policy initiatives are proposed to directly avert this kind of risk. Nevertheless, the introduction of public value tests accompanied by market impact analysis could assist in reducing this type of risk in the future.

11. ENFORCEMENT, SANCTIONS AND MONITORING

A new BBC Charter and Agreement will include a commitment to fair trading across the full range of the Corporations services, both public and commercial. This will include compliance with the competition law and the four criteria for commercial services. The Trust will be required to ensure that the BBC's policies are published for consultation, including with Ofcom, and subject to regular review. The new arrangements will be underpinned by robust mechanisms for dealing with complaints. The scope for Ex ante regulations will be extended to the BBC. The Trust will have responsibility for enforcing the codes. The Charter and Agreement will require the Trust to formulate and consult on codes governing all aspects of public service operations giving rise to potential competition issues. Strong partnership working between the BBC Trust and other regulators and external sources of expertise will be essential. The Trust will develop a Memorandum of Understanding with Ofcom, setting out how they will work together.

12. IMPLEMENTATION AND DELIVERY PLAN

The changes set out in the White Paper and in this RIA will be delivered via the Charter and Agreement.

13. POST-IMPLEMENTATION REVIEW

It is proposed to conduct a review of the practical implications of the different funding options, particularly subscriptions, during the course of the next Charter, before the end of digital switchover, so that the necessary planning could be carried out for any change after 2016. In addition, it is planned to reconsider whether there is a case for the wider use of public funding, including licence fee money, to fund public service broadcasting beyond the BBC. Finally, BBC Trust will be required to review both the performance of the WOCC and the performance of the BBC's commercial services on a regular basis.

14. RECOMMENDATION

We recommend the policy in the White Paper.

³⁴ Graf (2004), op cit, Chapter 5.

15. DECLARATION

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs

Signed

A handwritten signature in black ink, appearing to read 'JP', written over a large, faint, light-colored circular watermark or background mark.

James Purnell
Minister for Creative Industries and Tourism