

THE BBC'S PROPOSED LICENCE FEE SETTLEMENT

SUBMISSION TO DCMS BY BSKYB – MAY 2006

1. Introduction and summary

The future funding of the BBC is a highly significant issue for all the BBC's stakeholders, and in particular for licence fee-payers, for commercial broadcasters on television and radio, for advertisers, for the UK's creative industries, and for the corporation itself.

It is sometimes argued that, whatever the effect of an increase in the BBC's funding on the commercial sector, everyone else will benefit, including the UK as a nation and as a 'brand'. It is certainly true that the BBC is an internationally-famous broadcaster with a strong reputation for quality programming. However, as noted in this paper, the experience of previous over-generous licence fee settlements is that they tend to encourage waste and inefficiency at the BBC; they stifle innovation and the provision of new services or cause their failure by launching 'me-too' rivals; and – perhaps worst of all – they increase the burden of a regressive tax on sections of the population which increasingly derive little or no benefit from BBC services.

The interests of the licence fee-payer are served above all by a lean and efficient BBC operating in a highly-competitive market. The current BBC proposals damage those aspirations.

The determination of the level of the licence fee has historically been carried out in an opaque manner. Sky welcomes the opportunity given to stakeholders to offer views at an industry seminar on 5 May. We look forward to the publication of written information from the BBC and DCMS in order to inform that discussion process. The release of PKF's Review of BBC Value for Money and Efficiency is a helpful start, but is not a substitute for full public scrutiny of the BBC's proposals and the assumptions that underpin them.

In the meantime, based on the information available to us, we have prepared our own analysis of the BBC bid. The key points we wish to make are as follows:

- There is insufficient detail and rigour in the BBC's proposals as they stand for anyone to feel confident that the expenditure proposed is justified (a concern reinforced by the extensive criticisms made by PKF in its review). Reassurance could be given to stakeholders by inviting the National Audit Office (NAO) to conduct its own analysis.
- The BBC is proposing a huge increase in its expenditure - £6bn over 7 years. This equates to an extra £860m a year – a rise of almost 30% on the total amount it spent in 2005. When analysed correctly, the BBC is effectively requesting an increase in the licence fee equivalent to RPI plus 6.6% per year in order to fund this extra spending, when other public expenditure programmes will be expected to manage with budgets growing below the rate of inflation.
- The overwhelming majority of the population are opposed to the BBC plan for a significant expansion of its services paid for through an increased licence fee. Only 11% agree that "*the BBC should improve its services, increasing the licence fee by more than inflation in order to do so*" (a question originally asked by the Davies panel in 1999), and yet this is exactly what the BBC is proposing to do. If the BBC delivers the efficiency savings it has itself identified (which, according to PKF, understate the true level of savings that could be attained), it could continue to provide its current level of service to viewers and listeners while reducing the licence fee to £120 by 2013 (£94 at 2005 prices).
- Determining the level of the licence fee for seven years is ill-advised when the media landscape is changing at its current frantic pace. A three-year settlement is considered adequate for Whitehall departments and should be applied to the BBC.

- The BBC's plans include an additional £3bn to fund "quality content" and "super-inflation". This will release a flood of public money into the broadcasting market, driving out competition and creating precisely the "super-inflation" it is alleged to counter.
- All proposals for new services or major changes to existing services (including the recently announced "Creative Future" initiatives) must be subject to the approval process set out in the White Paper. If this is to have any real purchase, the money for these enhancements should not be released by the BBC Trust until the proposed service has passed a public value test (including Ofcom's market impact assessment), and there should be a mechanism for returning surplus funds to licence fee-payers where a service fails the test.
- If the BBC is to be made responsible for funding targeted assistance during digital switchover, such money should be ring-fenced so that the BBC cannot redeploy it on other services, but equally so that the quality of BBC services is not compromised if the sum proves to be insufficient.

2. Process

The only material published by the BBC so far – *Delivering Public Value: The Future Funding of the BBC*¹ – is wholly inadequate as a basis for understanding and evaluating the BBC's funding bid, despite the corporation's claim that it represents a new degree of openness in the licence fee debate. In reality it is no more than a superficial wish list of spending demands that is not susceptible to any kind of analysis. The BBC must provide much more detail and supporting evidence if there is to be a meaningful public consultation on its proposals.

When the BBC's funding bid was originally published in October 2005, Michael Grade said *"this bid has been thoroughly and independently scrutinised by the Governors. We commend it to Government as an efficient business plan designed to meet licence payers' expectations at the lowest cost."*². Yet a few months later the BBC admitted to the House of Lords Select Committee on BBC Charter Review that its original estimate for one part of its bid – the proposed move to Manchester – was exaggerated by £200m (33%). This example demonstrates the danger of accepting the BBC's numbers at face value. As the Committee stated in its report, *"our scrutiny of only one part of the BBC's licence fee bid has shown that the BBC's costings were rudimentary and could be significantly reduced.... [the BBC] has admitted that the figure in the bid was based on the easiest calculation possible rather than on a real estimate of how best value could be provided"*³.

The only way to instil public, industry and parliamentary confidence in the process is to subject the BBC's figures to rigorous, independent review. Sky agrees with the Select Committee's recommendation that the NAO should be invited to scrutinise all aspects of the bid and to publish its findings in full.

The appointment of outside consultants - PKF – to look at the BBC's proposals is not a substitute for involvement of the NAO. While we welcome the decision by DCMS to publish PKF's report, it is hard to comment on the analysis without access to the detail of BBC's own funding proposals (the so called "Red-Book") and with so much financial information redacted. However, it is clear that PKF has significant concerns about rigour of the BBC's financial projections and the opacity of their presentation, which only serves to reinforce the need for greater external scrutiny of the bid.

3. Scale of the bid

¹ Published 11.10.2005

² BBC press release 11.10.2005

³ Further issues for BBC Charter Review published 03.032006 (para 14)

The BBC is proposing an enormous increase in its expenditure - £6bn over 7 years. This equates to **an extra £860m a year** – a rise of almost 30% on the total amount it spent in 2005. To put this in context, the proposed increase alone represents twice the annual income of the entire commercial radio sector.

At a time when the BBC is proposing such a huge increase in expenditure, other publicly funded services – including hospitals, local authorities, and the armed services – are being required to deliver improved quality within a tightly constrained, or even shrinking, budget.

The BBC plans to fund its increased spending through a combination of £3.9bn of “self-help” (efficiency savings, commercial dividends etc.) and a £2.1bn increase in the amount raised by the licence fee. It calculates that this would require the level of the licence to rise by RPI plus 2.3% a year (this does not include the additional increase required to fund the targeted assistance scheme for switchover, which could bring the total close to RPI plus 3% a year).

Treating the “self-help” figure properly – as part of the bid – means that the BBC is effectively asking for a licence fee settlement of **RPI plus 6.6% a year**. If the BBC chose simply to maintain services at their current level, it could return “self-help” savings to licence-payers through a reduced licence fee. Based on a simple pro-rata calculation, if an extra £2.1bn requires an RPI plus 2.3% settlement, a £3.9bn saving would enable the licence fee to be reduced by **RPI minus 4.3% a year**. Because the BBC has chosen instead to take these savings and re-employ them on additional programmes and services, the increase in funding requested by the BBC is equivalent to a settlement of RPI plus 6.6% above the current base line.

The starting point for any discussion about the future funding of the BBC should be the amount of money it requires to maintain its existing level of service. Anything above this represents a net increase in the size and scale of the BBC, and should only be contemplated on the back of strong evidence of public support for a higher licence fee and an expanded BBC, and proper safeguards to protect against market distortion. To date, neither the government nor the BBC has made this case.

As discussed above, according to the BBC’s own numbers this base line equates to a settlement of RPI minus 4.3% a year. In practice the reduction in the licence fee ought to be even greater than this. PKF’s analysis suggests that even if the BBC delivers the £3.9bn savings it has already committed to, there would still be considerable scope for further efficiencies. For example, while the BBC claims to have exceeded the “self-help” targets agreed as part of the previous licence fee settlement, in PKF’s assessment it *“has in the event delivered only marginal cash-releasing organisational efficiencies”*⁴. If, as PKF recommends, the BBC is required to achieve more demanding savings going forward, this implies that it could continue to provide its current level of service with a licence fee settlement of **even less than RPI minus 4.3% a year**. Experience from other public sector/privatised organisations suggests that subjecting the BBC to the discipline of an ‘RPI minus’ funding formula is the best way to ensure that it delivers the required level of efficiencies.

Despite the BBC Chairman’s denials, many in the industry and Parliament believe that the BBC’s proposals are simply the opening bid in negotiations with government, and that it does not expect to receive the full RPI plus 2.3% it has requested. The Secretary of State herself confirmed this view when she told the House of Lords Select Committee that she *“certainly expected it [the final settlement] to come in lower”* than the BBC’s initial pitch. The prevailing view seems to be that the BBC will be forced to make do with a much tougher settlement, such as the licence fee simply increasing by RPI each year. It needs to be made clear that an RPI settlement is not “tough”, even a flat licence fee anticipates the BBC spending - according to its own figures - an additional £3.9bn over and above what is needed for its current services.

4. Lack of public support

The level of the licence fee has increased by nearly 50% over the past 10 years, at a time when viewing to BBC television services has declined by 20%. The picture is even more stark when average figures

⁴ Review of the BBC Value for Money and Efficiency Programmes published 26.04.06 (para 1.30)

are disaggregated. 36% of adults now watch less than 5 hours of BBC TV a week, and 13% watch less than 15 consecutive minutes of any BBC channel in a week, yet pay as much as the heaviest viewers of the BBC.

In this context, it is appropriate to question the wisdom and sustainability of the BBC's proposal to increase the level of the licence fee by a further 50% to reach c.£190 by 2013. There is a very real risk that such a reckless approach will fatally undermine public support for the corporation and the licence fee as a method of funding.

The BBC wants the public to pay for a significant expansion of its services through an increased licence fee. But the overwhelming majority of the population are opposed to such a move. Only 11% agree that *"the BBC should improve its services, increasing the licence fee by more than inflation in order to do so"* (a question originally asked by the Davies panel in 1999, when 13% agreed⁵). Three times as many people support the proposition that *"the BBC should cut its services and cut the licence fee"* (30% in 2006 vs. 29% in 1999).

But there is no need even for the BBC to cut its services to help the hard-pressed licence fee-payer. The BBC's own figures show that it can make substantial efficiency savings and maintain services at existing levels. If the £3.9bn "self-help" savings were used to bear down on the level of the licence fee, and an RPI minus 4.3% funding formula was introduced, we calculate that this would allow the cost of a TV licence to fall to £120 in 2013 (£94 in 2005 prices). With more demanding efficiency savings the level could be even lower. The question the public should be asked is whether they would prefer existing BBC services and a licence fee of £120 (or less) or the BBC's own proposal of expanded services and a licence fee of £190. It is revealing that, among the vast amount of consumer research the BBC conducts, it consistently fails to ask this type of question.

5. Duration of settlement

The environment in which the BBC operates is characterised by a rapid pace of change and a high degree of uncertainty about future developments in technology, consumer behaviour and competitor activity. This makes it both inappropriate and unwise for the government to fix the level of the licence fee for many years in advance. The White Paper itself says that *"broadcasting in 2016 will bear little relation to today's media world"*⁶. If it is impossible to predict what the media landscape will look like in 5-10 years time, it is surely impossible to say how much money the BBC will require (and what it should be spending it on) over the same horizon.

The dangers of this approach are illustrated by the BBC's assumptions about the competitive environment (particularly sustained advertising growth) that underpinned 2000 licence fee settlement. The BBC argued that it needed an above inflation settlement, in part, to keep pace with the rapidly growing revenues of its principal competitors in the commercial radio and TV sectors⁷. But shortly after the level of the licence fee was set, and the BBC was guaranteed seven years of rising income, the advertising market entered a severe downturn, from which it has yet to recover fully. According to figures from Zenith Optimedia⁸, UK television and radio advertising expenditure was 6% lower in real terms in 2005 than it was in 2000. Over that period, the BBC's income from the licence fee increased by 14% in real terms. This had the effect of putting the BBC at a significant – and unintended – advantage to its commercial rivals, compounding the distortionary effect it has on the market. Rather than taking the opportunity now to reverse this error and restore a level of equilibrium with the commercial sector, the BBC's proposals would lock in the mistakes of 2000 and then increase the disparity still further through an even larger increase in the level of the licence fee.

⁵ The Future Funding of the BBC published 05.08.1999 (p178). Sky replicated this question in a nationally representative Omnibus survey of 2,000 adults in April 2006.

⁶ A Public Service for All: The BBC in the Digital Age published 14.03.2006 (p5)

⁷ For example the Davies Panel report (p50) compares projected future BBC revenues with a 7% forecast annual growth rate for the commercial TV sector and concludes that *"this substantiates the BBC's concern that...[it] might be unable to maintain its standard-setting role in television programming and play an important role in the development of digital services."*

⁸ UK Television Forecasts September 2005 (p7)

To reduce the risk of this sort of miscalculation being repeated, the next licence fee settlement should be for a maximum of three years. This would provide an opportunity to review the level, and recalibrate if necessary, in 2009/10 in the light of market developments, including the launch of any new BBC services. This timetable would also allow the findings of Ofcom's second quinquennial review of Public Service Broadcasting, scheduled for 2009, to be factored into decisions about the BBC's future funding.

6. Impact on market

Additional expenditure on the scale envisaged by the BBC risks crowding out investment, stifling innovation and reducing diversity in the commercial sector – all contrary to stated government objectives.

While Ofcom's role in conducting market impact assessments (MIAs), as set out in the White Paper, is intended to ensure that these concerns are factored into decisions about new services and significant changes to existing services, the more general inflationary effect of increased BBC spending power must not be ignored.

The BBC is proposing to spend an extra £1.6bn on "quality content" and a further £1.4bn on "super-inflation" in base costs over the next seven years. Very little of this £3bn additional expenditure is likely to be subject to an Ofcom MIA (for example, if it simply forms part of an expanded budget for existing services like BBC One or BBC Online), although it will undoubtedly have a major impact on the market, since increased spending by the BBC has the effect of bidding up costs for other players (content/sports rights, on and off-screen talent etc.). The allocation for "super-inflation" will thus create the very problem it is intended to avert. Although this would no doubt be welcomed by sports rights holders, Hollywood Studios and on-screen talent which will benefit from the BBC's largesse, viewers would not benefit at all. Creating "super-inflation" in broadcasting costs is not an appropriate use of public funds.

7. New services

£2.5bn of the BBC's proposed additional expenditure is earmarked for new services ("digital services" estimated at £1.2bn; "digital infrastructure" at £0.7bn; "new local investment" at £0.6bn) that should be subject to the approval process set out in the White Paper.

However, we are very concerned by the apparent ease with which the BBC thinks it can circumvent this process. The BBC recently announced a series of new initiatives and changes to existing services under the "Creative Future" banner. Notwithstanding the fact that these include plans to develop services competing directly with established commercial operations such as Sky Sports Broadband and MySpace.com, the BBC is reported to believe that these will not need to be subjected to a full public value test (including, critically, a market impact assessment by Ofcom). The government must make it clear to the BBC that no such services can be launched – or expenditure committed – until they have been through the formal approval process set out in the White Paper.

Given the vague - and in some cases bizarre - proposals listed in the BBC's funding pitch (e.g. "BBC buses"), there must be a real possibility that some of these services will not, following a PVT, be approved (if this were not accepted as a real possibility, it would raise fundamental questions about the rigour of the approval process and the independence of the Trust). In this context, we note PKF's scepticism about some of the BBC's proposals, and strongly support its recommendation that the government should *"satisfy themselves that each and every investment is absolutely required to deliver the role of the BBC as set out in the Green Paper"*⁹

It is essential that funding for new services is withheld by the Trust until approval is given to a specific service with a defined budget. This is consistent with the PVT regime which will (according to the BBC governors' proposals published in October 2005) assess whether a proposed new service represents value for money, and the service licence, which will include each service's budget. The money

⁹ Review of the BBC Value for Money and Efficiency Programmes published 26.04.06 (para 1.57)

earmarked for new services that are not (yet) approved must not be available to BBC management to spend in other areas as they see fit. This deficiency in the previous licence fee settlement became apparent when the BBC was given extra funding in 2000 (with no strings attached), but initial proposals for some of its new services were later rejected. For example, BBC3 was not approved finally until September 2002, meaning that the budget originally intended for that service had been available for the BBC to spend elsewhere for two-and-a-half years prior to launch.

At the same time, a mechanism needs to be put in place to return any surplus funds to licence-payers if the proposed new services (for which the funding was intended) are not approved within a given timeframe or are approved with a reduced budget. The most straightforward way to do this may be via a reduced licence fee in future years. It is clearly not acceptable that such money simply drops back into the BBC's general pool of resources for, say, BBC One – that would involve unapproved increases in the funding of such services above what had been deemed adequate in the agreed licence fee settlement.

8. Switchover costs

The RPI plus 2.3% a year increase in the level of the licence fee requested by the BBC does not include the cost of the targeted assistance scheme for digital switchover. While neither the government nor the BBC have yet published any detail on the proposed scale of expenditure, the Secretary of State hinted that it was likely to be between £400m and £800m in total. Based on a conservative estimate of £500m, this would add an extra 0.5% a year to the BBC's licence fee bid, which would result in the cost for individual households rising to nearly £200 in 2013.

Sky agrees with the House of Lords Select Committee that the cost of funding targeted assistance (and other switchover costs) should be met from general taxation and not through the licence fee. However, if it is to be funded by the licence fee, allocated resources must be ring-fenced from other BBC expenditure and independently administered (e.g. by Digital UK).

A clear and transparent mechanism needs to be put in place to deal with what happens if switchover costs turn out to be significantly more, or less, than projected. The BBC must not be allowed to re-deploy any surplus funds elsewhere, but equally it should not be expected to cut its existing services to cover any deficit (which is probably the greater risk).