

Level of the BBC licence fee from April 2007
A review of the current BBC funding and licence fee proposals¹

Government is currently considering the level of the BBC licence fee with a view to taking a decision in 2006 on the settlement from 2007. The BBC has published its own proposals for further significant real rises in the level of the licence fee over a seven year period from April 2007.

The BBC proposes steeper real increases in the licence fee, coming over and above the rises delivered via the current settlement and, indeed, every year since 1998. The BBC has provided very little information to support the case for these further increases in its published documentation, despite claims of increased transparency.

This document seeks to analyse the BBC's pitch in as far as is possible based on the publicly available information.² Government, which it is to be hoped has been provided with considerably more information by the BBC, should be able to take such analysis much further.

A settlement on the lines proposed by the BBC would have implications well beyond the Corporation. The BBC's commercial competitors would be impacted in at least three ways: Firstly, the BBC's services already enjoy much higher budgets than their commercial competitors across television and radio. Extending the BBC's lead further would be likely to impact on those commercial services' ability to compete and, therefore, on their commercial revenues. Second, the BBC's increased investment in programming would be likely to drive inflation of programming costs for all broadcasters and in a commercial market where otherwise a measure of deflation might be expected. Finally super-funding would encourage and allow the BBC to enter new markets with public funding underpinning "free" provision, thus undermining emerging commercial models.

These threats are likely to impact in particular on the BBC's commercial public service competitors, ITV1, Channel 4 and five. Such channels are in direct competition with the BBC on all platforms and need a critical audience mass to sustain their commercial appeal to advertisers. Such channels provide higher levels of originated UK programming and therefore are particularly impacted by rights inflation fuelled by the BBC, in a way that applies less to subscription digital channels reliant of non-originated programming and premium sports rights. These channels also have a particular need to grow their revenues in new markets in order to sustain public service obligations whose continued provision might otherwise be under threat. If those markets are distorted by the entry of an over-funded BBC, an avenue for adapting commercial PSB for the digital world could be cut off. The settlement for the licence fee proposed by the BBC would make a bad situation worse in terms of the long-terms prospects of commercial public service broadcasting in the UK.

The analysis in this document would indicate that – even on its own terms and before looking at this wider impact – the case for any real increases in the licence fee beyond the current settlement period has not been made. Indeed, there would seem to be a strong case for a settlement which holds or reduces the level of the licence fee in real terms.

¹ A confidential version of this report was submitted to DCMS in late 2005, before further relevant information – notably the PKF report – was published. ITV believes that PKF's work provides further substantial support for the analysis and conclusions set out here.

² *Delivering Public Value: The Future Funding of the BBC; Delivering Public Value: supporting Information; Charter Review Briefing: The Future Funding of the BBC*, BBC, October 2005

The current settlement

The BBC’s proposals are pitched in terms of the additional income the BBC will require over and above that provided for by the current licence fee settlement. Major areas of cost – such as DTT build out, quality content, digital services, and regional – are conceived of entirely in terms of implying incremental costs on top of a cost base for existing operations largely taken as a given. The increased level of the licence fee that will be reached by the start of the Charter period is also taken as the baseline for the coming settlement.

It is not altogether surprising that the BBC should want the terms of the current settlement to be re-examined as a new settlement is discussed. The current licence fee settlement itself has provided the BBC with seven years of income growth rising on average at **double** the annual rate of inflation.

To an extent, real income rises were an intended consequence of the current settlement, which provided for annual RPI+1.5% rises in the licence fee for a full seven years. However there can be little doubt that – as it has turned out - that settlement has been considerably more generous than was either intended by Government or, indeed, requested by the BBC.

Two factors lie behind this unanticipated growth in the BBC’s income. Firstly, the BBC’s real income has increased further and faster than the headline rises to the licence fee suggest because of household growth. Second, the income of the BBC’s commercial competitors has grown more slowly than anticipated and, in some instances, has reduced in real terms. In both absolute and relative terms, the BBC’s real revenues and spending power have surged ahead over the last several years. Further detail on each of these two factors is set out below:

Growth in the BBC’s licence fee income

The current licence fee settlement provided for the licence fee to increase by 1.5% above inflation for seven years. The increases in the current settlement came on top of significant real rises in the licence fee in 1998 and 1999. The per annum increases through to the end of the current settlement are set out below.

Real increases in BBC licence fee, 1998-2006

Year (from April)	1998	1999	2000	2001	2002	2003	2004	2005	2006
Real licence fee increase	3.0%	0.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%

Source: BBC Annual Reports, DCMS

To the end of the current licence fee period therefore the **level** of the licence fee will have risen by 15% in real terms. In current prices, the level of the licence fee has increased by well over a third since 1997.

But the BBC’s licence fee income has risen much further and faster than the headline licence fee. The number of homes paying the licence fee has been increasing very steadily, largely due to demographic changes. Since 1998, the number of homes paying the full licence fee has risen by an average of 2% each year, more than twice the level of increase anticipated by the Davies Panel (of 0.85% per annum.) As a result, around 15% more homes are paying the full licence fee today than were before the licence fee started its real growth path in 1998.

Number of UK homes paying full licence fee, 1998-2004

Year (from April)	1998	1999	2000	2001	2002	2003	2004
Full licence fee paying homes	21.9m	22.4m	22.8m	23.5m	23.8m	24.2m	24.4m
Additional homes	0.6m	0.5m	0.4m	0.7m	0.3m	0.4m	0.2m
% increase in homes	2.8%	2.3%	1.8%	3.1%	1.3%	1.7%	0.8%

Source: BBC Annual Reports

On average then the BBC's total licence fee income has risen in real terms by an average of around 3.5% per year since 1999. In nominal terms, the BBC's total licence fee income has risen by an average in excess of **6% per year** over the same period. As a result of a steady increase in the number of homes paying a steadily increasing licence fee, the BBC's total licence fee income has grown **by 50% over the last seven years**.

It is not clear that it was the intention of Government to increase the BBC's licence fee income to this extent. Announcing the settlement, the Secretary of State claimed that he was "not going to allow the BBC the massive injection of funds that it has sought from the licence fee – an increase reaching more than £700 million a year by 2006." He further claimed that Government would be "providing for an increase in licence fee funding that will raise on average around £200 million per year between now and 2006."³

In actual fact, the increase in BBC funding over the licence period has been greater than the "massive injection of funds" sought by the BBC which Government said that it rejected. Over the licence period, the BBC's licence fee income is on course to rise by nearly £1 billion. In 1999, the BBC's licence fee income was around £2.3 billion. This year, the BBC's licence fee income should comfortably exceed £3 billion. By 2006 – even on the assumption of no further household growth from the 2004 level – BBC licence fee income could be expected to reach around £3.2 billion. If the current pace of household growth is continued, BBC licence fee income could be expected to be around £3.3 billion.

At this level, the increase provided for by the current settlement would exceed the £200 million per annum indicated by Government by some margin. An average of £200 million per annum would equate to around £1.4 billion cumulative additional income over the course of the settlement (compared to the BBC's licence fee income in the year prior to the settlement). In fact, the BBC's additional income over the course of the settlement can be expected to exceed its pre-settlement income by **£3.5 billion or £500 million for every year of the settlement**.

The current settlement has provided for increases in the BBC's licence fee income far greater than that intended by Government and, indeed, above the "massive injection of funds" sought by the BBC itself. As the present Director General has put it, the BBC has been bathing in a "jacuzzi of cash" over the course of the current settlement.⁴

³ *Statement to House of Commons by Chris Smith*, 21 February 2000

⁴ Mark Thompson, then Chief Executive of Channel 4, quoted in *Broadcast*, 2003

BBC licence fee income vs commercial revenues

There can be no doubt therefore that the **absolute** level of BBC public funding has grown very dramatically in real terms since 1998. Equally, since the start of the current settlement in 2000 in particular, the BBC's position **relative** to its commercial competitors has improved even further. As the BBC has benefited from an era of unprecedented public funding growth, so the BBC's competitors - in particular the commercial public service broadcasters - have had to fight for revenue and share in an increasingly competitive market context.

The current BBC licence fee settlement was agreed at a high point in the growth of commercial television revenues in early 2000. In the context of the internet bubble and an advertising boom that had not yet ended, the BBC was able to play up the threat of licence fee income accounting for an ever smaller proportion of UK television revenues.

The Davies Report, for example, projected forward growth in commercial TV revenues as high as 7% per annum in real terms (nearly 10% nominal growth) with even its more modest "long-term growth" extrapolation still at 4.5% real growth (around 7% nominal growth). On the basis of these figures, Davies was concerned that the BBC licence fee as a proportion of total TV revenues was on course to fall from around 31% in 1998 to as low as 20% by 2008.⁵

The current settlement certainly ensured that there would be no such reduction in the BBC licence fee as a proportion of the market. Calculated on the same basis as the Davies Panel, the BBC licence fee income as a proportion of TV revenues has barely fallen at all since 1998, standing at 29.4% in 2004. From 1993 to 1998, the BBC licence fee income as a proportion of TV revenues fell from 42% to 31% or more than 2 points per annum. In the years since 1998, the BBC has lost less **than three tenths of a point** in share per annum.⁶ The long-term trend of the BBC – like every other established broadcaster – losing some revenue share as new entrants enter the market has effectively been halted.

The BBC's own figures – perhaps inadvertently – make the same point. The BBC is presented as accounting for 23% of media industry revenues in 2002/3 falling to 20% in 2012/13, on the basis of the proposed BBC settlement for 2007-13.⁷ However these figures are massively distorted by the inclusion of internet advertising revenues, already accounting for 20% of total media industry revenues. It is not clear why internet advertising is relevant to the BBC's income needs. Such advertising includes significant amounts of search engine listing fees and classified revenues diverted from local and national press. Furthermore even the BBC does not claim that the BBC expenditure on internet services needs somehow to be proportionate to the volume of internet advertising (which already represents over 20% of commercial revenues, but well under 10% of BBC spend). Stripping out internet advertising from the BBC's own figures would see the BBC still actually holding its share of the broadcasting revenues at around 27-28% of total right through to 2013.

The relative boost to the BBC's revenues under the current settlement is even more stark when the BBC income is compared to that of its main commercially funded competitors.

⁵ *The Future Funding of the BBC: Report of the Independent Review Panel*, July 2003

⁶ Figures to 1998 from Davies Report; figures from 1998 extrapolated from *The Communications Market Review*, Ofcom 2004 / 2005 and BBC Annual Reports

⁷ *Delivering Public Value: Supporting Information*

BBC licence fee analysis

In 1998, the BBC's total licence fee income was around £250 million more than the advertising income of the UK's largest commercial network ITV1. By 2004, the BBC's licence fee income lead over ITV1 had *quintupled* with the BBC's enjoying a massive £1,250 million income lead over its nearest competitor.

In 1998, ITV1 and Channel 4 had a combined income *lead* over the BBC licence fee of over £300 million. By 2004, the BBC's licence fee income was significantly greater than the combined advertising income of ITV1, Channel 4, five, GMTV, S4C and *all* their associated digital channels.

The BBC's licence fee income is growing at such a rate that it is closing fast on the advertising income of all UK commercial channels combined – including *all* the terrestrial and digital channels on *all* platforms. Since 2000, the BBC's licence fee income has been growing in real terms by an average 3.5% per annum, while total UK television advertising revenues have reduced by nearly 6% in real terms.

BBC licence fee, ITV1 advertising revenues and total TV advertising revenues 1998-2004

Year	1998	1999	2000	2001	2002	2003	2004
ITV1 advertising revenues	1765	1875	1967	1703	1685	1629	1672
Total UK TV ad revenues	2861	3099	3327	3008	3144	3173	3392
BBC licence fee income	2010	2286	2371	2533	2659	2798	2940

Source: BBC Annual Reports, Zenith Optimedia

Between 2005 and 2010, the major advertising industry forecaster, Zenith predicts total UK television advertising revenues across all channels growing on average by less than 2% in real terms per annum. The limited growth in the market, Zenith predict, will be focused on digital channels, rather than the established commercial public service broadcasters. On these projections, given the current rate of household growth, the BBC would be able to extend its income lead over its main commercial rivals *on a static licence fee*. Indeed, the BBC's revenues would be on course to overtake the total UK television advertising market within the next funding period. A single publicly-funded broadcaster would thus enjoy revenues outstripping those of *hundreds* of channels and services, including several rival commercial PSBs and at least one FTSE 100 company.

The BBC’s proposals

There can be no doubt then that the BBC has been super-funded under the current settlement, with growth in both its absolute revenues and its income relative to its competitors far outstripping the predictions that were the basis for that deal. The current settlement therefore should already have built in significant financial slack for a responsibly managed BBC over the coming years.

The justification offered for the BBC receiving a further real income boost on top of a licence fee deal of unprecedented generosity is sketchy in the extreme. The BBC sets out a list of uncosted items under a number of vaguely defined areas and puts a big price tag next to each heading. There is no admission of areas where the BBC could be expected to reduce its costs, under these or other headings. As is becoming the norm in BBC funding pitches, efficiency savings past and future, are cited as evidence in favour of further licence fee increases, rather than – as perhaps might be expected – demonstrating that the same BBC income could go further without such increases.

The BBC’s broad figures – and there is little more to this list and these figures in the public domain – are set out below:

Additional requirements	
Digital infrastructure	£0.7 billion
Quality content	£1.6 billion
Base cost increases	£1.4 billion
Digital services	£1.2 billion
Local relevance	£0.6 billion
Switchco/spectrum	£0.5 billion
Total	£6.0 billion
<i>Less</i>	
Efficiency gains	£2.6 billion
Improved collection	£0.2 billion
Household growth	£0.7 billion
Commercial dividends	£0.4 billion
Total	£3.9 billion
“Funding gap”	£2.1 billion

The following pages set out comments on each of the elements of this claim. As far as possible publicly available information is used. The clear message is that the BBC’s proposals systematically overstate the Corporation’s prospective costs and understate the impact of self-help measures.

Cost increases

Digital infrastructure

The BBC claims “direct additional cumulative costs” with respect to digital infrastructure over the period of £700 million. It is not clear what such costs are cumulative with respect to and how they are calculated. For example, nearly half this cost - £338 million – is set against DTT build out. Digital switchover will involve significant transitional transmission costs as a new DTT network is built. However the BBC’s estimate – equivalent to an additional £50 million per annum - seems very high. Moreover no mention is made of savings in analogue transmission and existing digital terrestrial network which will kick in from the start of switchover in 2008 and may, in the case of the BBC, rise to a peak in excess of £50 million per annum, offsetting the DTT costs entirely by switchover. Beyond switchover, the BBC will be spending **less** on terrestrial transmission than it does today.

It is far from clear therefore how the BBC has turned a long-term transmission saving into a short-term significant cost. It may be that the BBC – for the purposes of its funding pitch - has effectively front-loaded the new DTT transmission costs within the funding period, rather than the longer period of the new Charter or the DTT multiplex licence terms. With a capital intensive project such as the DTT build out, it makes sense for annual payments to be smoothed over a longer term period. The BBC should be encouraged to enter into a long term DTT contract to avoid the costs of establishing the new DTT network being borne entirely by licence fee payers over the first few years of the next Charter period.

The BBC has cited £43 million as a cost of setting up a free digital satellite platform. It is not clear what calculations lie behind this £43 million figure.

Taking into account these factors, a more realistic estimate of the net costs **genuinely incremental to current BBC expenditure** associated with digital infrastructure would be around half the level proposed by the BBC.

Quality content

The BBC requests a further £1.6 billion of public money to support improvements in terms of “quality content” on the BBC services.

It is worth being clear that, although it proposes to deliver content in new ways, the BBC does not plan any further significant additions to its range of television and radio channels and services over the coming years. It has stated that no further television channel or national radio service launches are expected. The £1.6 billion is therefore broadly to be spent on programming for the existing suite of BBC services (albeit delivered also via other means). More “quality content” is required therefore **not** to fill new services, but to improve quality of content on existing services.

It is important to be clear also that this element of the funding claim does not relate to increases in the cost of providing the same level of quality – that is provided for under the separate £1.4 billion claim for “super-inflation”. More investment in “quality content” is **not** required because such content is becoming more expensive.

The implication of the BBC’s claim in this area can only be that the BBC does not believe that its current output represents sufficiently “quality content”. The BBC

would seem to believe that it needs to invest more than it is doing today in real terms to increase the quality of its output to acceptable levels.

This itself represents a telling admission of failure by the BBC: on the back of a funding settlement which has produced unprecedented real increases in BBC income and in a relatively suppressed commercial context, the BBC is effectively conceding that it still has not delivered content of sufficient quality across its services. This is not the sort of admission that would naturally lead to the conclusion that further, steeper increases in the level of the licence fee are justified.

Furthermore the claim that BBC services are somehow under-funded would seem to be straightforwardly contradicted by the facts. Across BBC television and radio its services are far more generously funded by any other direct commercial competitors. For example, excluding transmission costs and overheads, news and regional programming, BBC1 spent over £870 million last year. The equivalent figure for ITV1 would be at least 10% lower. (This represents a relatively recent role reversal: for most of ITV's history, its budget considerably outstripped that of BBC1.) The gap between the budgets of the BBC's digital and radio services and their commercial rivals is even wider. BBC3, for example, has a programme budget several times that of E4 or ITV2, both of which perform more strongly in audience terms. Radio 4 alone has a budget of over £70 million per annum.

The BBC seems very aware of the presentational difficulties of its revenues and spending running so far ahead of its commercial rivals. It has repeatedly restated and adjusted the presentation of its own spending figures with the effect of making such comparisons more difficult or misleading. For example, the 2002 BBC1 budget was cited as £962 million in the 2002 annual report, before being restated as £731 million a year on. Over £300 million of "programme related costs", including news costs, have been stripped out of channel budgets thus reducing the apparent level of expenditure. On the previous accounting basis, BBC1's budget could be expected to be well above £1 billion already.

At the headline level, therefore, the "quality content" charge seems at best unjustified and, at worst, to signal a worrying failure by the BBC to deliver on its past promises. The only detail the BBC gives to sustain its claim is that the additional investment would: reduce the level of repeats in the BBC schedules; and allow a shift investment from low cost to high cost genres. Both these claims are worth examining,

With respect to repeats, the Chairman recently claimed the BBC would ban repeats on BBC1. However both Chairman and Director General have since backtracked on this claim. Repeats across the BBC's suite of channels are actually increasing. This is to be expected as children's channels includes high volumes of repeat material and digital channels include both "catch-up" and previewed material. Even repeats on the established BBC channels have a role and may be popular with viewers. It is also worth noting that, although its programme budget is considerably below that of BBC1, ITV1 has consistently delivered a schedule featuring fewer repeats and more originated programming than BBC1.

The impact on cost of replacing repeats with originated programming are also overstated by the BBC. It cites the costs of replacing a BBC1 repeat at a cost of £25,000 per hour with a drama at nearly £500,000 per hour. Drama is of course the most expensive network genre, costing more than twice as much as any other originated BBC genre according to the latest annual report. The average cost per originated hour of BBC1 programming is under £175,000 per hour, around a third of the replacement figure cited by the BBC.

Furthermore the vast majority of repeated programming on the BBC appears off BBC1, which actually has a 10% peak limit for repeat programming. On BBC2 the average cost per originated hour is under £100,000. The average cost per originated hour across *all* BBC channels is well below that level. The average cost of replacing a repeat with an originated programme is therefore likely to be below one fifth of the cost of replacing it with an originated drama suggested by the BBC.

Even on BBC1, most BBC repeats are shown in slots where replacement with high-cost drama would represent a complete waste of public money. It would be reckless to the point of irresponsibility to replace a daytime repeat with a £500,000 per hour drama. Even in peak viewing time, repeats are focused on slots where their replacement with highest cost programming would make no sense. Repeats are often slotted against successful programming on other channels or over the low viewing summer months where the “available audience” is low. Even if the BBC had limitless resources, there would be better ways of investing its funding than replacing repeats with drama on BBC1 or any other channel.

Outside drama, there is a wide range of costs for originated productions. Original daytime programming, which tends to be low cost and delivered in long runs, may not be significantly more expensive than repeat programming on a per hour basis. Programming in the classic public service genres – religion, adult education, arts etc – also tends to be relatively low budget. Religious programming, for example, costs around £100,000 per hour. Music and arts programming costs even less for the BBC digital channels. News and weather costs around £40,000 per hour on analogue channels and £4,000 for digital channels. By contrast, the most expensive genres include those at or beyond the PSB fringes: entertainment programming, for example, costs around £200,000 per hour. It is not clear overall therefore why the BBC expects to shift spend towards the highest cost production genres from lower cost genres. Indeed insofar as the BBC claims to be increasing its PSB focus in the new Charter period, it is not clear why this should lead to an *increase* in its per hour programme investment, rather than a *fall*.

An additional £1.6 billion would purchase an additional 9,000 hours of originated BBC1 programming and more than twice that volume of hours across all BBC channels. This would equate to 1,300 hours of BBC1 programming per year or over 2,500 across the BBC channels. The existing 10% limit on peak repeats on BBC1 means that there less than half an hour of repeated programming on BBC1 in peak every evening. The additional investment in “quality content” would fund the replacement of this programming with originated content *more than seven times over*. Alternatively the BBC funding proposal would allow it to remove every single hour of repeated programming on BBC1 in peak viewing time and still have sufficient funding to produce an additional 2,000 hours of original programming each year outside BBC1 peak viewing time for its existing suite of channels. The BBC would produce well over 10% more originated programmes for the same suite of channels broadcasting for the same volume of hours in the day.

This is to assume that the BBC spreads this massive additional investment equally across the years in the funding period. If, as may be more likely, its investment increased each year with its licence income, the increase in its programme investment over the period and its resultant originated output would be even more extreme. On steady investment increases each year of the period, the BBC’s programme investment in the final year of the settlement could be expected to grow by around £400 million versus the pre-settlement level because of this £1.6 billion

additional “quality content” injection. This would equate to around 2,300 hours of additional replacement BBC1 content and more than 4,500 hours across the BBC.

These figures further assume that the existing programme budgets of the BBC channels represent good value for the public’s money. There is a strong argument that already the BBC has been able to outbid the market in terms of its spend per genre to an unreasonable degree. For example, the BBC claims to spend £500,000 per hour on drama, while Ofcom has estimated an average across the PSBs (including the BBC) of under £150,000 for all time and still below £300,000 per hour in peak. In other genres examined by Ofcom, the BBC is similarly at or well beyond the market average in terms of its spend.

Base cost increases

The BBC does not clarify what it meant by this £1.4 billion demand other than to state that it refers to “superinflation in broadcast costs to be funded by future BBC self-help”.

Although deliberately vague, the broadcast costs the BBC is referring can only be interpreted as applying to the BBC’s programming costs. There are no grounds for expecting superinflation in, for example, transmission, continuity, property, planning or other broadcasting related costs.

However it is not clear how the BBC can predict such super-inflation in programming costs given its own arguments for the maintenance of the licence fee and increased investment in quality content, which rest on predicted disinvestment in UK programming outside the BBC.

For example the £1.6 billion additional claim for further investment in “quality content” is justified in terms of the commercial pressure on the BBC’s competitors to “narrow” their offering. In its green paper response to Government, the BBC predicts that future growth in commercial broadcasting revenues will be skewed to subscription and pay per view, rather than advertising. The BBC notes that subscription channels invest only 3% of their revenues in new UK content.⁸ It is this threat to investment in UK content by the commercial sector that the BBC offers to justify the continuing intervention of the licence fee and its potential future growth.

But if the growth of commercial revenues is to be skewed to parts of the market which will not reinvest in UK content and away from those broadcasters which have traditionally invested in UK content, it is very unclear what will drive the “superinflation in broadcast costs” that the BBC refers to. One might expect superinflation in the cost of premium subscription rights, for example to sport or US movies, but not UK content rights. If, as the BBC implies, the main commercial investors in such content – ITV1 and Channel 4 – will *lose share* in a declining market, it is not clear how they will at the same time be able to *increase* their investment in programming and thus fuel inflation for the BBC. The BBC cannot have it both ways: either there will be super-inflation of costs in UK broadcasting fuelled by thriving competition in the supply of UK programming or there will not be such competition and no consequent super-inflation.

Furthermore, insofar as there **has** been superinflation in rights costs over the last few years, the BBC needs to be honest about what has caused that. It has not been

⁸ *Review of the BBC’s Charter, BBC Response, May 2005, pages 9-10*

growth in the commercial market – advertising revenues are well down in real terms versus 2000. Subscription channels have flourished, but as the BBC has noted, their investment in UK content remains low. The cause of superinflation in UK programming costs has been the BBC's own real income growth.

Superinflation in broadcasting threatens to become a self-fulfilling prophecy by the BBC: inflation-busting rises in the licence fee themselves cause the superinflation that the BBC uses to justify those same rises.

Digital services

The BBC states that it requires an additional £1.2 billion to develop further digital services making more of the BBC's content available on demand. This is despite the fact that the BBC has claimed that no major new service launches, in terms of additional channels and radio services, are planned.

The new digital services cited under this heading include: MyBBCPlayer, "navigation", search and recommendation tools; the BBC Creative Archive; Action Network; Music for All; and Sport Action. None of these initiatives are costed in the publicly available information.

It is unclear whether any of these proposals have been subject to the "public value" test and the new service approvals process. Indeed, by including such draft services in the BBC's pitch for licence fee increases, the BBC Governors would seem to be prejudging the outcome of any such tests in the future.

If the application of the public value test is not to be a foregone conclusion, Government needs to think long and hard before signing off the funding for initiatives which themselves have not yet been approved. Indeed, it could be argued that additional funding should not be provided for such services up front as the public value is more likely to represent a genuine test if the BBC is required to assess the public value of each new service relative to existing uses of public money, rather than in a context where those funds have already been committed.

The MyBBCPlayer, navigation proposals and BBC creative archive project in particular merit a much fuller new service assessment before their funding is signed off. These represent precisely the kinds of areas where publicly funded encroachment is likely to foreclose potentially exciting commercial opportunities. For example, broadband downloading of television content could represent a growth market for broadcasters and content providers, including the commercial public service broadcasters looking to supplement reducing advertising revenues. If the BBC is permitted and funded to wade into that market with content funded by the licence fee, but provided free at the point of use, that commercial market may well be smothered at birth. Consumers may simply refuse to pay for TV content, given that the BBC provides it "free" of charge. The creative archive project could create similar difficulties for providers of commercial archive services. The navigation proposals involve broader issues of why the BBC should seek to replicate already existing – and often freely provided – services using public money.

A number of the examples cited (notably Action Network, Music for All and Sport Action) would seem like exactly the kind of worthwhile initiative that the BBC has in the past been able to fund from its core, existing licence fee income. As these initiatives come on stream, there will doubtless be other BBC initiatives which will have run their course and demand less funding. For example, Music for All and

Sport Action would seem very close to the BBC Talent initiative launched several years ago and comfortably funded out of existing BBC resources. Other such past initiatives would include: webwise, Fighting Fat, Fighting Fit; Computers Don't Bite; Count Me In; the University for Industry partnership; and countless others. As such initiatives fade away, funding is thus freed up out of existing BBC resources to support replacement initiatives. The additional funding required for such initiatives should therefore be marginal.

Local relevance

The BBC claims that it will seek to improve its record in terms of regional services and production outside London. It claims that this will cost an additional £600 million over the period.

It is absolutely right that the BBC seeks to correct its long-standing bias to London and the South East, both in terms of regional services and production. However it cannot be right that the BBC should use its record of persistent failure on this front as grounds for further claim on licence fee payers. Furthermore it is not clear why correcting the BBC's London bias should result in the BBC spending **more** public money, rather than helping it achieve overdue reductions in cost.

The current BBC licence fee settlement was explicitly signed off on the basis of the priority given to "devolution in national and regional broadcasting".⁹ The BBC has expanded and increased its investment in national and regional services, spending more than £350 million on such services across television and radio last year. Again comparisons over the period are hampered by the BBC's restatement of past costs. Reported regional costs for 2002, for example, fell by over £100 million between 2002 and 2003 because of such an adjustment. However, taking such adjustments into account, the BBC's nations and regions spend has already grown by at least one third.¹⁰

Factoring back in programming related costs, the BBC's spend on national and regional television services may already have reached twice the level of ITV1. This is a slightly surprising statistic, given that ITV has **more** regional services than BBC television; has a significantly **higher** volume of regional news output per service; and, for the English regions in particular, around **300%** more hours of regional non-news programming output per region. It is not obvious therefore that the BBC's national and regional services are being starved of necessary investment.

With respect to network production from the nations and regions, the BBC's claim that this represents a net cost to the Corporation should also be treated with some scepticism. There is no reason why producing programming outside London should be more expensive than production inside the capital. Indeed, the reverse may well be the case. Every consequent investment in "building new studios and offices" for example, should be offset by the freeing up of more expensive studios and offices in the South East. The BBC seems to be tabling every conceivable additional cost, whilst omitting every associated cost saving.

Nor is there any reason to assume that a significant shift of network production from London to the regions should imply a massive **transitional** cost. As a comparison, ITV1 has been required by the regulator to increase its regional production from 33%

⁹ Chris Smith statement

¹⁰ *BBC Annual Reports and Supporting Information*

of originated programming to 50%. This would take ITV even further ahead of the BBC in terms of regional production and would represent a more significant change in terms of the impact on the production for the network than is being promised by the BBC. ITV is being required to achieve this transition within three years. No significant financial allowance is being made for the “costs” of this transition, which will be met by ITV from its existing revenues.

It is not clear therefore why over the settlement period proposed by the BBC the shift of regional emphasis should imply **any** significant additional costs to the Corporation and licence fee payers.

Switchco/spectrum

The BBC claims £500 million in order to meet its commitments to Switchco and towards possible spectrum payments.

The BBC expects to pay £200 million to Switchco (Digital UK) to market the digital switchover process. Whilst a significant sum, this should be put in perspective, representing less than 1% of the BBC’s licence fee income over the period. It is therefore misleading of the BBC to position its claim for increased funding as justified in order to allow the BBC to “drive and shape the next phase of the digital world”. Less than one tenth of the claimed increase in funding relates to driving digital.

There are two potential areas for spectrum charging: analogue; and DTT spectrum. Although theoretically possible, it seems unlikely that fresh analogue spectrum charges will be introduced ahead of digital switchover. Ofcom has stated that it is likely only to introduce such charges in the event of a delay to switchover and, even then, only if that delay was a consequence of the action of the relevant broadcaster(s). At worst then, the BBC would only ever be liable to pay a few months of such tax from the switchover target date (the end of 2012) through to the end of their proposed settlement period (April 2014). In net present value terms, an analogue spectrum tax can be disregarded for this settlement.

There is separately the possibility that DTT spectrum charges could be introduced for the second multiplex licence terms. For those multiplex licences which started transmission in 1998, this could run from 2010. However the BBC’s first multiplex is not licensed on the same basis as other multiplex licences. It is not clear that the introduction of a percentage of multiplex revenue requirement would be a simple task for this multiplex. If it could be applied, it would run for a maximum of 3.5 years of the relevant period (from late 2010 to early 2014). The second BBC multiplex runs on a later licence term and could not be subject to percentage of multiplex revenue payments until 2014, outside the period in question.

Insofar as the BBC’s proposals make any sense therefore they would seem to suggest a per multiplex per annum payment of around £100 million. This figure would be well above any reasonable industry expectations for DTT multiplex payments.

It is, in any case, not altogether clear that it makes sense to impose spectrum taxes on public service broadcasters who already “pay” for their spectrum via their PSB obligations. But it is worth being clear that the purpose of the introduction of any spectrum payments for analogue or DTT would be to ensure the optimisation of a scarce public resource. Even non-commercial users of spectrum, it is argued, should face incentives to its efficient use. However, by pitching for the maximum possible

spectrum tax to be paid for out of licence fee payers pockets, the BBC would simply replace one possible waste of public resource (spectrum) with another (excess public funding). Were the BBC to extract the fullest possible spectrum tax from the public and then reduce their actual spectrum payments by their efficient use of spectrum, the result would be a BBC in receipt of more public money than it requires.

From this perspective, any spectrum tax will only serve its purpose and be consistent with an efficient BBC if set at a level which incentivises the BBC to act with maximum spectrum efficiency in order to secure the right level of effective funding, rather than to exceed it. On this argument the allowance for spectrum charging in the licence fee settlement would quite deliberately be set at well below 100%.

In the light of these considerations, the total additional cost of the BBC's digital switchover support and spectrum payments might reasonably be capped at half the claimed figure or – if spectrum tax is to be disregarded entirely – at £200 million.

“Self help” revenue increases

Improved collection

The BBC claims improved collection will generate £200 million of additional revenues over the funding period. This seems a remarkably unambitious total, equivalent to a per annum improvement of less than £10 million or one third of one percent of licence fee income.

The BBC flatters itself in terms of its improvements in reducing the costs of evasion and collection by presenting these as percentages of the BBC's income, which itself is growing by 3.5% in real terms every year.¹¹ On the BBC's figures as long as the costs of evasion and collection were not growing by more than 6% per annum, the costs relative to total income could be shown continuing to fall. What has driven down these relative costs over recent years has been the growth in licence fee income, not any significant efficiency gains on this front by the BBC.

Were the BBC to commit to a £15 million per annum reduction in the costs of evasion and collection over the next licence period – less than one half of one percent of licence fee revenue - this would translate into cumulative additional revenues over the period of around £400 million, twice the level proposed by the BBC. This conservative adjustment would reduce the headline licence fee increase by around 0.2%.

Efficiency gains

The BBC claims that “self-help” will include improved efficiency gains over the period of the funding settlement by putting itself “back on the long-term VFM track established in the 1990s”.¹²

However, once again, the BBC's presentation of these figures seems wilfully misleading. The return to a 3.3% annual efficiency improvement average depends on the inclusion of two years of higher than average efficiency improvement outside the funding period in question (2005/6 and 2006/7). Excluding these two years, the BBC's average efficiency improvement for the funding period would actually be below the 2000-07 average. The BBC is actually promising to go **backwards** in terms of its efficiency gains, rather than **forward**.

Although the BBC figures are not wholly transparent, it would appear that the 2007-14 average efficiency improvement would actually be around 2.5% on the BBC's projections. Simply lifting this more relevant target to 3.3% over the settlement period would reduce the BBC's funding requirement by around 0.8% a year, over a third of the increase sought.

Capturing household growth

The BBC targets £700 million of additional income from “capturing household growth” over the settlement period, bizarrely described elsewhere as a form of “self-help”.

¹¹ *Delivering Public Value: Supporting Information*, table 1.4

¹² *Charter Review Briefing and Delivering Public Value: Supporting Information*, table 4.3

Since 2000, the number of households paying the full licence fee has grown by an average of more than 400,000 homes per year. Over a seven year period, the cumulative impact of any year on year rises in household growth on the BBC's total licence fee income is significant. Were the recent trend to be continued, on a static licence fee, the BBC could expect to earn an additional £1.5 billion from household growth over the 2007-14 period, twice the level projected by the BBC.

The BBC's own figure of £700 million would seem to correspond to a 100,000 home increase per annum over the period. ITV is not aware of any year in recent BBC history when the number of licence fee paying homes has increased by such a small amount.

A relatively uncontroversial assumption that the recent rate of household and licence fee payer growth will be maintained over the next few years would reduce the BBC's headline increase in licence fee by a further 0.8% per annum or even more. To ensure that there is no "double count" with the impact on household growth yielded by reduced evasion, a 0.5% reduction in the headline licence fee claim would represent a very conservative assumption.

Commercial dividends

The BBC claims that commercial dividends will account for £400 million of its additional funding requirement over the 2007-14 period. This would amount to a per annum increase in commercial dividends of around £15 million over the period.

Over the period of 2000-07, the BBC claims that additional cumulative commercial revenues will have contributed £600 million to its self-help target. The BBC would therefore appear to be forecasting that it will only be able to achieve additional commercial dividends reduced by 33% compared to the current period. As that growth will start from a considerably higher base compared to 2000, the growth rate in commercial contribution could be expected to represent an *even lower proportion* of the 2000-07 run rate.

Were the BBC tasked with achieving the same level of additional commercial contribution in 2007-14 as it claims for 2000-07, its total funding requirement would be reduced by £200 million and the licence fee increase by 0.2%. If the expectation was that the current rate of growth would be sustained over the 2007-14 period, the total funding requirement could come down much further.

Conclusion

The BBC is coming to the end of the 2000 funding settlement in rude financial health. Its licence fee revenues have been boosted in real terms by the unanticipated pace of household growth and the challenging market faced by the BBC's main competitors over the period.

Looking to the next funding period, the analysis in this paper would strongly suggest that the BBC's funding needs over the 2007-14 period are significantly overstated in the BBC's licence fee proposals. The true level of "additional costs" may be just 10% of the BBC's figures. Furthermore the scope for "self-help" (including household growth) is systematically underplayed by the BBC. More realistic – but not particularly aggressive - assumptions on self-help would lift the associated revenue benefits to the BBC by around 50% over the funding period.

The "funding gap" used by the BBC to justify further licence fee increases is therefore an illusion. Self-help measures and natural increases in its spending power will more than offset any increased funding needs. Taking a more realistic approach to both funding and self-help would suggest that the BBC licence fee may now be held or even reduced significantly in real terms without fear of preventing the BBC discharging its vital PSB role. On the figures summarised above, ***even on a static real licence fee***, the BBC would be on course to reap a very significant funding surplus over the funding period.

Clearly all such future projections are subject to caveats, in particular in the current uncertain market. However this is no argument for systematically erring on the side of generosity to the BBC, given the costs that this will imply to licence fee payers and to the BBC's commercial competitors. Furthermore, insofar as such uncertainty is real, it argues for a shorter funding period. Locking down BBC funding for seven years in such a fluid environment would seem particularly unwise. Government should be looking at a settlement extending for no longer than five years. There is no need for the current funding to extend beyond the point of switchover given that Government has made clear that licence fee funding will continue for the ten years of the next Charter and therefore to 2017. The level of the licence fee beyond 2012 should be determined closer to that date, rather than more than five years ahead of time.