

CONFIDENTIAL



11 February 2011

Jeremy Hunt
Secretary of State
DCMS
2-4 Cockspur Street
London
SW1Y 5DH

Colette Bowe
Chairman

Ed Richards
Chief Executive



Dear Jeremy,

News Corporation/BSkyB proposed merger: advice on proposed undertakings in lieu

We are writing today as requested to advise you in relation to News Corporation's proposed undertakings in lieu ("the proposed UILs"). We are aware that the OFT is also writing to you today with their advice on whether the proposed UILs would be practically and financially viable and effective in the short to medium and long term, in relation to which we have, as requested, assisted in light of our sectoral expertise.

You asked Ofcom to advise you, in accordance with section 106B of the Enterprise Act 2002, on the extent to which we think the proposed UILs address the potential impact on media plurality identified in Ofcom's report on the proposed merger between News Corporation and BSkyB dated 31 December 2010.

We focused on Sky news and current affairs services ("Sky News"), which we saw as essential to plurality. Our concern, in sum, was that the proposed transaction would result in Sky ceasing to be a distinct media enterprise from News Corporation, which would result in an increase in News Corporation's ability to influence public opinion (through Sky News), as measured by share of news and current affairs consumption by a UK-wide cross media audience. Taken in combination, this indicated a change in the concentration of media ownership which would be likely to affect sufficient plurality.¹

¹ Paragraphs 5.46 and 5.52 of the report.

The proposed UILs²

1. The proposed UILs, in essence, provide for Sky News to be spun off into a new company ("Newco") owned 39.14% by the News Corporation/Sky merged entity. The other shareholdings in Newco and its governance arrangements would reflect those of Sky today. Assets used only by Sky News would be transferred to Newco, while arrangements would be made to allow Newco the continued use of other shared assets, in particular the Sky brand. The News Corporation/Sky merged entity would enter into a carriage agreement with Newco for the continued supply of the Sky News channel over News Corporation/Sky's capacity for 10 years and thereby provide Newco with a revenue stream.
2. This would essentially replicate the current shareholding and governance arrangements of Sky. But the nature of Newco and its relationship with News Corporation would not be the same as that between Sky and News Corporation today and is indeed fundamentally different.
3. We have had two weeks in which to report to the Secretary of State. In the time available, we have put in writing to News Corporation our views on their proposed UILs, we have met with them to discuss these and have received today in writing from News Corporation amendments that it is willing to offer to its proposed UILs. The following assessment sets out our views of News Corporation's proposed UILs taking account of its further proposals to us.

Assessment

4. We have seen a draft of the OFT's report to you in relation to the financial and practical viability of the proposed UILs. In relation to the matters addressed by the OFT on financial and practical viability, we have no concerns over and above those set out by it. We note that the issues raised by the OFT are relevant to our plurality concerns and would need to be satisfactorily addressed in any final UILs.
5. We see the proposed UILs as a significant step by News Corporation towards addressing the potential impact on plurality we identified in our report. We take this view mainly because the combination of the carriage agreement and the brand licensing agreement make explicit the value that News Corporation and Sky place on Sky News and represent a significant commitment to the continuation of the Sky News operations for a period of 10 years. In addition, the Newco business plan appears to provide reasonable certainty over the viability of the spun-off entity against future market risks.

² See attachment to letter from Jeremy Hunt to Ofcom dated 27 January 2011.

6. However, whilst the proposed undertakings reproduce the shareholding and governance structure of Sky, the context is unavoidably very different. Newco would not be like Sky. Today, Sky is a large, financially independent company with a range of products and services offered direct to consumers and Sky News is a relatively small part of its business. By comparison, Newco would be a relatively small company, with (at least to begin with) a small range of products – Sky News would be its sole product. Most importantly, it would be commercially dependent on its relationship with the merged News Corporation/Sky entity for about 85% of its revenues and 25% of its costs. This fundamental commercial dependency is inherently created by the spin-off process, and therefore inevitable in this context.
7. Therefore, in our view, to address our concerns about the impact on plurality, the following cumulative package of governance matters are needed. In outline:
 - The Board of Newco should consist of a majority of independent directors, “independent directors” being directors who have no other News Corporation or News Corporation associated interest;
 - The Board of Newco, including the independent non executive directors, should have a combination of both senior editorial and business experience/expertise;
 - The Chairman of Newco should be an independent non executive;
 - There should be a sub-committee of the Board of Newco to oversee editorial independence and integrity of Newco’s services (“the Board Editorial Committee”).

Independent non-executive directors

8. The proposed UILs provide that the Board of Newco would comprise a majority of independent non-executive directors (not including the Chairman), complying with the UK Corporate Governance Code (the Code)³. We believe this is a positive commitment to support the independence of Newco.
9. However, we consider that it is essential that these directors are truly independent from any potential News Corporation conflict of interest. Under the UK Corporate Governance Code, a board identifies each non-executive director it considers to be independent in character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director’s judgment. Under the Code, a board may determine that a director is independent (stating its reasons) notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

³ UK Corporate Governance Code, B.1.1

- has been an employee of the company or group within the last five years;
 - has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
 - has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
 - has close family ties with any of the company's advisers, directors or senior employees;
 - holds cross-directorships or has significant links with other directors
 - through involvement in other companies or bodies; represents a significant shareholder; or
 - has served on the board for more than nine years from the date of their first election.
10. In our view, in order to address our plurality concerns, a director should not be considered independent if there are any such relationships or circumstances in existence.
11. By letter on 11 February 2011, News Corporation informed us that it is willing to amend its proposed UILs also to undertake that a definition of "independent director" would be enshrined in Newco's constitutional documents, and that definition would exclude the circumstances and relationships set out above.
12. There would be a need to embed this in the constitutional documents, and for News Corporation to undertake to vote against any proposed changes to them.

Expertise

13. The proposed UILs gave a general undertaking to adhere to the obligation imposed by the Listing Rules as regards compliance with the principles set out in Section 1 of the UK Corporate Governance Code.
14. In our view, to address our concerns about the impact on plurality, the Board of Newco, including the independent non executive directors, should be required to have a combination of both senior editorial and business experience/expertise.
15. By letter on 11 February 2011, News Corporation informed us that it is willing to amend the proposed UILs also to undertake:
- That the requirement in provision B.1 of the Code (that "the Board and its committees should have the appropriate balance of skills, experience,

independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively") be enshrined in Newco's constitutional documents; and

- That at least one independent member would have editorial and/or journalistic experience.
16. There would be a need to embed this in the constitutional documents, and for News Corporation to undertake to vote against any proposed changes.

Independent Chairman

17. In our view, to address our concerns about the impact on plurality, in addition to a majority of independent non-executives, we believe the Board of Newco would need to be independently chaired, as clearly recommended by the Corporate Governance Code⁴. Such independence should be determined on the same basis as for other non-executives outlined above.
18. By letter on 11 February 2011, News Corporation has informed us that it is not willing to undertake that the Chairman would be independent. We do not understand the basis for this refusal, particularly since the clear recommendation of the Corporate Governance Code is that the chairman should, on appointment, meet the independence criteria set out in the Code, which News Corporation has agreed to on the stricter basis set out above, to ensure the independence of non-executive directors.
19. Without such an undertaking, it would be open to the Newco Board to appoint a Chairman who is affiliated with News Corporation. Given the nature of Newco and its relationship with News Corporation as set out above, we consider this would undermine the effectiveness of the proposed UILs in meeting our plurality concerns and the credibility of the undertakings.

Editorial committee of the Board

20. In order to meet our concerns on plurality, we believe that there should be a transparent mechanism in place to ensure editorial integrity and independence of Sky News is at the heart of the Newco Board's interests. We proposed to News Corporation that an editorial committee of the Board be established as follows:
- Members of the Board Editorial Committee to contain a majority of independent non executive board members, one of whom is the Chairman of the Board Editorial Committee. We would expect the Chairman to have senior editorial experience and expertise.

⁴ UK Corporate Governance Code A.3.1 - The chairman should on appointment meet the independence criteria set out in B.1.1

- We would expect the terms of reference for the Board Editorial Committee to include:
 - the editorial independence and integrity of Sky News
 - the hiring, firing or replacement of the Sky News Editor and all key editorial appointments (including any material changes in terms and conditions which could give rise to constructive dismissal)
 - any changes to the authority, reporting relationship and consultation rights of the Sky News Editor.
21. News Corporation was not willing to agree to this. However, by letter on 11 February 2011, News Corporation informed us that it is willing to amend the proposed UILs to undertake that:
- Newco's constitutional documents explicitly provide that Sky News TV service will abide by the principle of editorial independence and integrity in news reporting and that it will comply with the Broadcasting Code;
 - The hiring and firing of the head of Sky News (i.e. the most senior editorial position of Sky News) would have to be approved by Newco's Board, (which would comprise a majority of independent directors);
 - Newco would establish a Corporate Governance and Nominations Committee. This would operate under terms substantially similar to those of Sky's current Corporate Governance and Nominations Committee. It would comprise a majority of independent members, including the independent member with editorial and/or journalistic experience. It would be chaired by an independent board member. It would be specifically entrusted with oversight of compliance with both Newco's corporate governance provisions (as provided for under the UIL) and Newco's constitutional provisions relating to the principle of editorial independence and integrity in news reporting, and compliance with the Broadcasting Code.
22. We believe it is critical to the effectiveness of the undertakings in addressing our plurality concerns, that editorial issues are put at the heart of the Board's function, but note this could be achieved in a number of ways. The terms now proposed by News Corporation are a promising basis from which to work. There would be a need to embed provisions relating to the constitutional documents, and for News Corporation to undertake to vote against any proposed changes to them. However, we note that the terms of reference of Sky's current Corporate Governance and Nominations Committee require the committee's recommendations to the Board to be made in consultation with the Chairman [of the Board], which means that, absent an independent Chairman, we would continue to have concerns.

Duration

23. We note that the OFT's assessment of the practical and financial viability of the proposed UILs is that they are likely to be effective over the short to medium term (no longer than 10 years) and are unlikely to be effective over the long term.
24. We agree that the proposed UILs are not a permanent solution and that their effectiveness may start to diminish in the run up to the end of the 10 year period. As advised to the OFT, we consider that a carriage agreement of a 10-year term in the context of industry dynamics in this sector is long term. This is because we consider there is likely to be significant evolution of the market and consumers' use of news and current affairs over the next decade. As a result, the situation with regard to plurality may be significantly different in 10 years time.

Advice

25. In the circumstances, we advise that the proposed UILs as currently drafted do not address the potential impact on media plurality identified in Ofcom's report.
26. However, were it possible to resolve the question of the independence of the Chairman, then together with the amendments accepted by News Corporation, the proposed UILs may represent a way forward in principle.
27. Depending on your decision, we consider (as, we note, does the OFT), that further negotiation with News Corporation may be necessary on the precise terms of the UILs offered by them. It is important to note that the financial and practical viability of the proposed UILs and their effectiveness in addressing our plurality concerns, will depend on the detail of the arrangements, including on specific contract terms and conditions between Newco and Sky/News Corporation.
28. In addition, in the time available, Ofcom has had discussions with News Corporation and received from News Corporation in writing amendments which News Corporation is willing to make to the original text of the proposed UILs. Given the time available, News Corporation has not provided Ofcom with a revised version of the proposed UILs. We therefore think that if the Secretary of State is minded to accept revised UILs, it would be sensible that any final draft be approved by Ofcom and the OFT.
29. In the context of the short to medium term effectiveness of the proposed UILs, as you will recall from our report, we recommend that the Government consider undertaking a wider review of the statutory framework to ensure plurality in the public interest. Specifically, we said that there may be value in providing for intervention where plurality concerns arise in the absence of a corporate transaction involving media enterprises and which are not safeguarded by the current media ownership rules. If the Government followed this recommendation, such a review could consider and provide

for the longer term position as appropriate and this would provide additional assurance in relation to the position beyond the 10 year term of the proposed UILs

Yours sincerely



Colette Bowe



Ed Richards

cc. *Clive Maxwell, Executive Director, OFT*