

Response to Communications Review
Open Letter

pact.

June 2011

Executive Summary

- 1) Exports of UK television content have grown by more than 20% a year since the 2003 Communications Act, an annual rate of growth that is nearly double pre-2003 levels, according to analysis commissioned for this review by Pact from Oliver & Ohlbaum Associates (O&O).¹ Today, exports of UK television content are worth more than £1.3 billion per year, an increase of 250% on 2004's equivalent figure of £524m.²
- 2) This exceptional growth in exports is the clearest indication of how the Codes of Practice introduced in the 2003 Communications Act have increased competition in the exploitation of UK television Intellectual Property (IP) rights. The Codes of Practice did not prop up an ailing organisation or sector. Rather, they addressed a market failure whereby the four PSB broadcasters (BBC, ITV1, Channel 4 and Five) controlled 92%³ of investment in new UK programmes, and consequently could demand all IP rights to programmes. As a result, four entities controlled the majority of UK television IP rights, with a resulting lack of efficient competition in the exploitation of international and secondary IP rights. Channel 4's pre 2003 annual profit from exploiting its IP through its 4 Rights division was just £10.9m, for example.⁴
- 3) The Codes of Practice in the 2003 Act responded to this market failure by stipulating that there should be clarity in which rights were purchased by a broadcaster as part of the commission and, through Ofcom Guidance, creating a flexible framework for market-led negotiations. As is widely accepted, the result was to transform the independent production sector into £2 billion industry with a GVA of £4.3 billion.⁵ Companies of some scale have emerged and the sector is now a bigger employer than the BBC, ITV, Channel 4 and Five combined, helping drive a rise in employment in the television sector of 12% since 2004, despite difficult economic conditions and falling employment at PSB broadcasters.⁶

¹ Prior to 2003, revenue from UK television exports grew by 12.6% CAGR. From 2004, export trade growth has grown to 22.2% CAGR. See: The role of regulation / terms of trade in the development of the UK Indie sector, O&O for Pact, 2011.

Prior to 2003, revenue from UK television exports grew by 12.6% CAGR. From 2004, export trade growth has grown to 22.2% CAGR

² UK Television Exports, annual survey, TRP for Pact and UKTI

³ Ofcom's Second Public Service Broadcasting Review, Phase One: The Digital Opportunity, April 2008, page 56, states that the PSBs accounted for 92% of spending on network originations in 2004.

⁴ Channel 4 annual report 2003, page 35

⁵ Economic Impact of the BBC, Deloitte for BBC, 2009

⁶ Skillset Employment Census

- 4) In a relatively short space of time, the independent sector has also emerged as a significant investor in the development and production of domestic UK content. According to Pact's annual census, independents are currently investing more than £200m per year in the creation of UK content.⁷ Much of this investment is raised by the producer exploiting IP rights globally. In this submission we provide examples and case studies of independent producers investing in a wide range of genres, from drama, to children's, through to factual, across a variety of broadcasters.
- 5) This investment in UK content from the production sector has mitigated declining spending by PSB broadcasters. Ofcom's last review of Public Service Broadcasting review identified a funding shortfall of up to £235m per annum just to maintain current levels of UK-made, public service programming.⁸ Independents' total annual investment of £200m+ is now enough to almost entirely offset this, ensuring UK audiences continue to benefit from a high per capita investment in home-grown content.
- 6) Has this had a negative impact on PSB broadcasters? There is no evidence that the Terms of Trade have had any negative impact on PSB's businesses. Channel 4's pre 2003 annual profit from IP exploitation was £10.9m, representing just 1.4% of total 2002 turnover, as we have noted. ITV and Five can make 75% of their schedule in-house, with complete ownership of rights, but current levels of in-house production are far lower at both broadcasters. Finally, BBC Worldwide is flourishing despite the Terms of Trade, and has seen its operating margin increase year-on-year since 2004/05.⁹ We see this improved performance at BBC Worldwide as an example of how the Codes of Practice/Terms of Trade stimulated competition in the international distribution of UK television content, driving efficiency across the entire sector.
- 7) Increased investment in UK content development and production by independent producers also creates price flexibility for broadcasters – instead of a broadcaster funding 100% of a programme, the producer now regularly raises a significant level of investment. The Digital Britain report estimated that this had reduced the previous programme production costs for broadcasters by 25% since 2003.¹⁰

⁷ Pact Policy Survey and Financial Survey, O&O Associates for Pact, May 2010

⁸ Second Public Service Broadcasting Review, Phase 2: preparing for the Digital Future, Ofcom, September 2008, page 5

⁹ Digital Britain: Assessing the policy framework for Public Service Rights, Scoping and Discussion Document, Perspective Associates for BIS/DCMS, April 2009

¹⁰ Digital Britain, final report, BERR/DCMS, section 99, page 162

- 8) In addition, the PSBs have successfully launched a range of new services, such as VOD, complete with independent as well as in-house content, despite the presence of the Codes of Practice. In launching these services, they have successfully fought off competition from market entrants, leveraging their dominance in commissioning UK content and the “shop window” of the PSB licence, as the difficulties faced by would-be competitors such as Seesaw and Joost testify.¹¹
- 9) The PSBs’ ability to successfully launch VOD service demonstrates how the 2003 Communications Act created a broad policy framework which has allowed them to develop and innovate. The Codes of Practice themselves are high level, effectively requiring a negotiation to be had. The particular Terms of Trade – essentially which rights are exploited by the producer and broadcaster respectively and the revenue share associated with that exploitation - are left to market negotiations between Pact and the individual PSB broadcasters, within the context of broad Ofcom Guidance.¹²
- 10) The Terms of Trade themselves have evolved through market negotiation on a regular basis, and the relevant Ofcom Guidance is also subject to updating whenever appropriate. This system has led to significant changes in the Terms of Trade for all broadcasters, notably in 2006 to enable broadcasters to acquire certain VOD rights as part of their package of rights. We would also like to point out that Pact is in active talks with the BBC, ITV and Channel 4 over their respective Terms of Trade, continuing the long-standing process of developing the Terms of Trade through market negotiations. We would, however, like to stress that, while Ofcom’s Guidance is and should be regularly updated in light of market developments, the existence of this Guidance is a vital part of the framework – it provides flexibility by not being part of primary legislation, but also creates a constructive framework for negotiations.
- 11) While Pact of course accepts there is a need to regularly review any legislation, the Codes of Practice and the Terms of Trade have been subject to a number of reviews since they were introduced, the most recent one concluding just two years ago. This was part of the Digital Britain process and involved, along with the review team’s work and analysis from Ofcom, a detailed report from independent consultants Perspective Associates,

¹¹ The difficulties faced by competing services suggest that the current Terms of Trade could go further in opening up the market, and reduce the holdback period during which PSB broadcasters are able to retain exclusivity on VOD rights.

¹² For a more detailed description and analysis of the policy framework around the Codes of Practice and Terms see Perspective Associates report for BIS/DCMS’ Digital Britain Review – Digital Britain: Assessing the policy framework for Public Service Rights, Scoping and Discussion Document, Perspective Associates for BIS/DCMS, April 2009.

commissioned by the Government at tax payers' expense. The report's conclusions stated that:

"The evidence suggests that the regulatory regime involving Ofcom Guidance, broadcasters' Codes and individual Terms of Trade has worked well to build and grow a market."¹³

12) Prior to Digital Britain, Ofcom's 2006 review of the Television Production Sector looked at the Codes of Practice, also concluding that "the Codes of Practice are broadly working well."¹⁴

13) In terms of whether the Codes of Practice remain necessary, there is no doubt that they created a profound change in the content market by stimulating competition – crucially, however, the market failure that they were designed to address remains in place. The PSB broadcasters continue to retain similar levels of negotiating power to when the Codes of Practice were introduced. Although there has been a decline in broadcaster spend on UK content, the proportion of this spend controlled by the PSB channels has not changed significantly. The PSB channels (excluding digital services owned by PSB groups) currently account for around 80% of first-run UK commissions, and the PSB groups (i.e. with their digital channels) control around 90%, comparable to 2003 levels.¹⁵

14) While there has been consolidation in the independent sector, recent decisions by broadcasters to axe even the most high profile, successful programmes produced by some of the largest independents underline how, while there will always be a premium on a hit show, the ultimate decision making power as to whether to commission a show resides with the broadcaster. As Perspective Associates' report for Digital Britain concluded:

"It would appear that, while independents are now in a stronger negotiating position than before the passage of the Communications Act in 2003, it is nevertheless still the case that broadcasters have powerful levers available to them: not only the decision to commission in the first place, but also the decision whether or not to relax the hold-back."¹⁶

¹³ Digital Britain: Assessing the policy framework for Public Service Rights, Scoping and Discussion Document, Perspective Associates for BIS/DCMS, April 2009

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

¹⁵ Analysis by Oliver & Ohlbaum Associates. We note that Ofcom's Second PSB Review put this figure higher still, stating that PSB channels alone accounted for 90% and would do so until 2020. See Ofcom's Second PSB Review Phase 1: The Digital Opportunity, April 2008, page 66.

¹⁶ Digital Britain: Assessing the policy framework for Public Service Rights, Scoping and Discussion Document, Perspective Associates for BIS/DCMS, April 2009

- 15) Perhaps the clearest manifestation of broadcasters' ongoing market power has been the downward pressure on the primary prices they pay when commissioning, with independent producers contributing more and more investment to bridge the gap between what broadcasters pay for commissions and the actual cost of producing that commission. As we have mentioned, independent producers are now investing more than £200m per year in UK programme development and production in order to bridge the funding gap. Were leading independent producers genuinely able to dictate terms to PSB broadcasters, we would expect them to be able to prevent broadcasters from lowering the prices they pay. The reality is that broadcasters' continued buying power can force independents to produce at cost or even at a loss, aiming to claw back revenues on secondary exploitation.
- 16) Removing the Terms of Trade now would therefore have serious consequences for the independent production sector, enabling broadcasters to retain all rights and setting back the independent production by ten years. Our view is supported by analysis commissioned by Pact from O&O for this review (see a) accompanying report on role of intervention in the independent sector and b) Appendix to this submission for impact of abolishing the Terms of Trade), and a previous economic analysis we commissioned from Ingenious Consulting in 2009. Ingenious' analysis indicated that losing international rights would lead to 170 profitable independents becoming loss making and therefore at risk¹⁷ – which in terms of turnover we estimate would have represented the majority of the sector due to a skew towards larger companies.
- 17) Would broadcasters make up this revenue by exploiting export rights themselves? We do not see this as a zero sum game, and believe that the marked rise in exports growth post 2003 supports our view. Independents have proved they can excel at driving exports, but we cannot take this success for granted. Abolishing the Terms of Trade would turn back the clock at a time when major international competitors such as Canada and Germany are aiming to become more competitive by introducing their own Terms of Trade.
- 18) Domestically, abolishing the Terms of Trade would be likely to dampen innovation in content delivery for audiences. The four PSB broadcasters would be able to leverage their ongoing market power to withhold rights from the market in order to stifle competition and protect their core services. The ability and incentive of the PSBs to “warehouse” rights was acknowledged in the Competition Commission's 2009 inquiry into Project Kangaroo, the

¹⁷ Terms of Trade Impact Assessment, 2009, Ingenious Consulting for Pact

proposed VOD joint venture of BBC Worldwide, ITV and Channel 4. The Commission stated:

“We also considered whether ITV and C4C would have an incentive to syndicate catch-up content to third-party VOD retailers to which UKVOD would not choose to syndicate. We saw no reason why ITV and C4C would choose to enter into syndication deals that would be likely to undermine the success of UKVOD.”¹⁸

19) In our view therefore, unless compelling evidence is provided as to why there should another review of the Codes of Practice/Terms of Trade, a further inquiry into whether they remain appropriate would represent an unnecessary cost to the public. Left unchanged, the Codes of Practice will continue to underpin growth: exports of UK television content show no signs of slowing, with last year’s television export revenues (in-house and independent) up 9% year on year¹⁹. In terms of just the independent sector, revenues from international activities grew by 28% last year.²⁰

20) Providing a strong platform for future growth overseas, the business model for many independent production companies is now an international one. Of the top five independents, between 33% and 75% of respective turnover is from sales and production in overseas markets, notably the US.²¹ At the same time, the latest wave of mergers and acquisitions within the independent sector has resulted in a flow of inward investment into the UK, with some of the largest Indies taken over by overseas companies. This investment by global producers gives the UK a competitive advantage in accessing finance for UK productions. *Downton Abbey* may appear to be the epitome of British drama, but was significantly funded by NBC Universal, owner of the programme’s production company Carnival, by raising investment against projected international revenues. This helped ensure that an original period drama that, unusually for ITV, was not a remake or a literary adaptation could be made. As Maggie Brown wrote in *MediaGuardian*:

“[T]he producer, Carnival Film & Television, tempted ITV into investing, in the depths of last year’s advertising recession, by agreeing to substantially help fund the £7m, seven-part project itself.”²²

¹⁸ Report on the anticipated joint venture between BBC Worldwide Limited, Channel Four Television Corporation and ITV plc relating to the video on demand service, 2009, Competition Commission, Section 26, page 6

¹⁹ Annual export figures, TRP for Pact/UKTI

²⁰ Pact Policy Survey and Financial Survey, O&O Associates for Pact, May 2010

²¹ Broadcast annual survey of Independent Production Sector

²² “ITV gambles on Sunday night viewers getting the *Downton Abbey* habit: Julian Fellowes’s £7m drama relies on funding from its producer Carnival”, *MediaGuardian*, September 13 2010

21) It should also be noted that UK production companies owned by overseas companies with broadcast interests in the UK currently lose their statutory independent status – thereby excluding them from the independent quota and meaning that they have no statutory guarantee of Codes of Practice/Terms of Trade, which apply only to independents. This makes the independent quota and the Codes of Practice/Terms of Trade all the more important for growing the next generation of successful UK production companies. Companies that have already grown to the point where they are no longer qualifying independents may well become investors in the next wave of independent companies, taking a stake of up to 25% to preserve the companies' independent status in a similar way to how BBC Worldwide has invested in UK independents. In this way, larger external suppliers could provide access to finance for smaller independents, fostering a new wave of SMEs and a new cycle of growth.

Introduction

- 1) Pact is the trade association that represents the commercial interests of the independent production sector. The sector produces half of all new UK television programmes,²³ as well as content in digital media and feature film.
- 2) The independent television sector has grown strongly over the last decade – increasing turnover by 40% by conservative estimates²⁴ - and is now one of the biggest in the world. It contributes to the UK economy in a number of ways:
 - The sector has a GVA of £4.3 billion.²⁵
 - It employs more people than the television divisions of the BBC, ITV, Channel 4 and Five combined.²⁶
 - The sector has helped double exports of UK television since 2003.²⁷
 - Independents use a large part of the revenues from export sales to invest more than £200m per year in the development and production of UK content.²⁸
- 3) This submission responds to the question in the Open Letter on the content sector, namely questions 10 to 13. Separately, we have supplied an independent report commissioned by Pact from Oliver & Ohlbaum Associates (O&O) looking at the role of intervention in the television production sector. O&O have also provided a counterfactual on the effect of abolishing the Terms of Trade, included in this submission as an Appendix.
- 4) For further information, please contact Pact's director of policy, Adam Minns, at adam@pact.co.uk or on 020 7380 8232.

²³ Ofcom, Communications Market Report 2010: independents produced more than 50% of qualifying network programming by hours and 46% by value.

²⁴ Pact policy survey and financial census, 2010, O&O for Pact

²⁵ Economic Impact of the BBC, Deloitte for BBC, 2009

²⁶ Employment Census 2006, Skillset

²⁷ Annual export figures, TRP for Pact/UKTI

²⁸ Pact policy survey and financial census, 2010, O&O for Pact

List of key reports

PSB spending and market power

- Ofcom's Second Public Service Broadcasting Review, Phase One: The Digital Opportunity, April 2008, looks at level and proportion of spending on original content by PSB broadcasters through to 2020.
- Report on the anticipated joint venture between BBC Worldwide Limited, Channel Four Television Corporation and ITV plc relating to the video on demand service, 2009, Competition Commission. See Section 26, page 6, of analysis of market power and incentives to warehouse rights.

The independent production sector

- Economic Impact of the BBC, Deloitte for BBC, 2009, looks at the economic value of the independent production sector
- Broadcast, Indies: The Annual Survey of The UK's Independent TV Producers, covers turnover of top 150 companies.
- The Impact of Channel 4 on the UK independent sector, creative industries and the economy, PriceWaterhouseCoopers, March 2007
- Pact Policy Survey and Financial Survey, O&O for Pact, May 2010

UK export growth

- FRAPA report 2009 – TV Formats to the World
- UK Television Exports, annual survey, TRP for Pact and UKTI
- Rights of Passage 2007, July 2008, TRP for Pact and UKTI

Codes of Practice/ Terms of Trade

- Digital Britain, final report, BIS/DCMS, section 99, page 162
- Perspective Associates report for BIS/DCMS' Digital Britain Review – Digital Britain: Assessing the policy framework for Public Service Rights, Scoping and Discussion Document, Perspective Associates for BIS/DCMS, April 2009
- Review of the Television Production Sector, Statement, 2006, Ofcom
- Terms of Trade Impact Assessment, 2009, Ingenious Consulting for Pact
- The Role of Terms of Trade in the development of the UK independent production sector, O&O for Pact, June 2011
- Fostering creative ambition in the UK digital economy, Final report for the DCMS, Analysys Mason, May 2009

Response to questions

Creating the right environment for the content industry to thrive

Q10. Are there disproportionate regulatory barriers to investment in content? If so, what are they and how can increased investment in UK content production be encouraged?

- 1) Regulation or legislation can be a spur to growth and investment, particularly where it promotes greater competition by addressing market failures. The Codes of Practice for negotiations between PSB broadcasters and independent television producers in the 2003 Communications Act were not designed to prop up an ailing organisation or sector, but to create a competitive market. Before the 2003 Communications Act, companies in the independent production sector produced acclaimed and popular programmes, in the process delivering public value in the form of creative competition. But those companies were constrained by a market failure from exploiting those programmes. As the four PSB broadcasters (BBC, ITV1, Channel 4 and Five) controlled 92%²⁹ of investment in new UK programmes, they were able to demand all Intellectual Property (IP) rights to programmes, with independent suppliers working for hire.
- 2) As a result of this market failure, there was a lack of competition in the exploitation of international and secondary and IP rights to UK content. Broadcasters often failed to maximise the value of rights that were not part of their core businesses, or withheld them to stifle competition and protect their core services. For example, Channel 4's pre 2003 annual profit from IP exploitation was £10.9m, representing just 1.4% of total 2002 turnover³⁰.
- 3) The ITC examined these market conditions in its 2002 Programme Supply Review, identifying, according to its successor Ofcom: "a number of features of the UK programme supply markets which suggest that competition is not necessarily effective." These included a lack of transparency in rights which prevented the functioning of an effective price mechanism and restricted

²⁹ Ofcom's Second Public Service Broadcasting Review, Phase One: The Digital Opportunity, April 2008, page 56, states that the PSBs accounted for 92% of spending on network originations in 2004.

³⁰ Channel 4 annual report

producers' ability to raise additional funding, and a constraint on producers' ability to choose the best way to exploit rights to their content.³¹

- 4) Ofcom's subsequent 2006 review of the production sector explored the ITC's findings. Crucially, in light of how investment in UK content has subsequently developed into a price flexible model, Ofcom noted how market conditions constrained producers from raising alternative investment, meaning that broadcasters were required to fund 100% of production costs. As Ofcom stated:

"The ITC found that certain broadcasters were not transparent in the way they were pricing different elements of the rights packages they were acquiring from producers. The broadcasters were seeking to secure bundles of primary, secondary and ancillary rights without being clear about what they would be prepared to pay for them separately. In addition, broadcasters were in some cases not offering producers a realistic choice of funding routes based upon different rights packages. This restricted the ability of producers to develop alternative sources of funding, and evidence from the time showed that fully-funded deals (where broadcasters generally acquired all the rights to a production) accounted for the vast majority of commissioning deals for some broadcasters (although there was evidence that this may have varied by genre). The introduction of the Codes of Practice for each broadcaster sought to set a transparent basis for commissioning deals to mitigate the broadcasters' strong negotiating position."³²

- 5) The Codes of Practice in the 2003 Act responded to this market failure by stipulating that there should be clarity in which rights were purchased by a broadcaster as part of the commission. The division of rights was, however, left to market negotiations between Pact and the respective broadcasters, under high level guidance from Ofcom (we detail how the policy framework around the Codes of Practice leaves the market with a high degree of flexibility later in this submission).
- 6) The result was to transform the independent production sector. From a so-called cottage industry, the independent sector is now worth £2 billion, and contributes a GVA of £4.3 billion.³³ Companies of some scale have emerged, able to attract private investment from the City and inward investment from overseas companies. Total turnover of the top five independent companies has grown by more than 500% since the 2003 Act. In 2003, the biggest independent producer had a turnover of £77m and the top five had a

³¹ Review of the Television Production Sector, Consultation Document, Ofcom, January 2006, page

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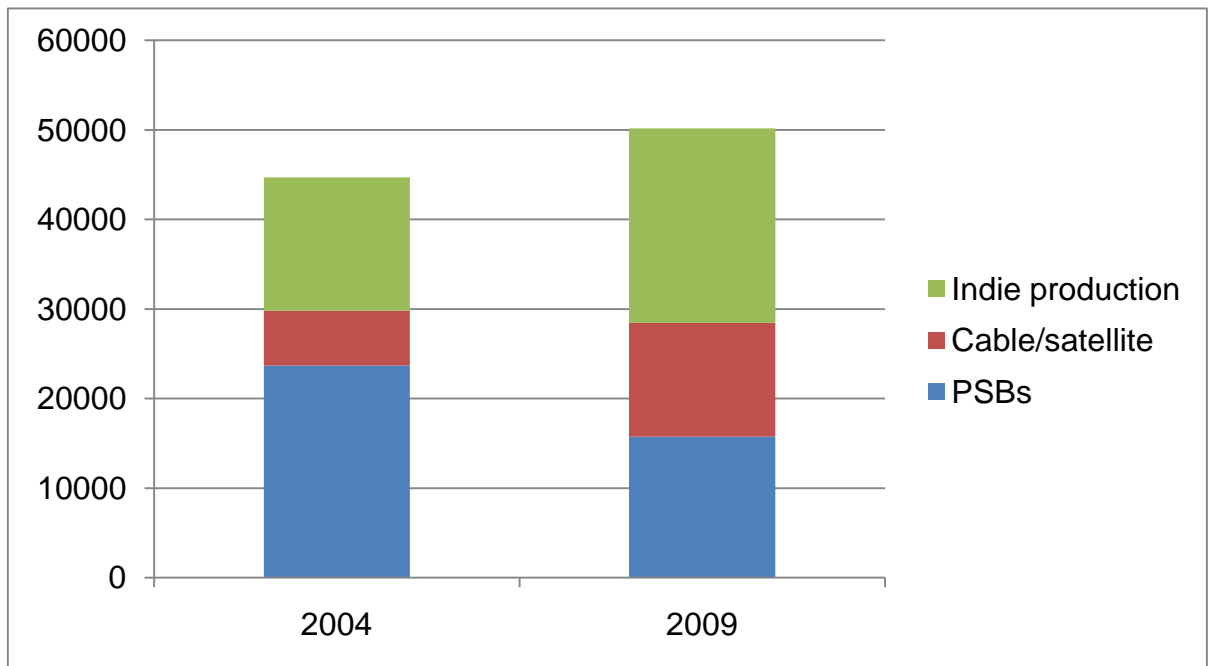
³² Ibid

³³ Economic Impact of the BBC, Deloitte for BBC, 2009

combined turnover of £286m. Now the biggest has a global turnover of around £400m, and the top five combined at least £1.5 billion.³⁴

- 7) The sector is now a bigger employer than the BBC, ITV, Channel 4 and Five combined and, alongside an expanding cable and satellite broadcasting sector, has helped drive an overall growth in employment in the television sector of 12% since 2004, despite difficult economic conditions and falling employment at PSB broadcasters, as shown below:

Figure 1: Employment in television sector post Communications Act



Source: Skillset Employment Census

- 8) The clearest impact of creating a competitive market for IP rights through the Codes of Practice has been in the exceptional growth of exports of UK television content since then. According to analysis commissioned for this review by Pact from Oliver & Ohlbaum Associates on the role of regulation in the independent sector (provided under separate cover), the annual rate of growth of UK television content exports (in-house and independent) has nearly doubled since the 2003 Act. Oliver & Ohlbaum's report for us states:

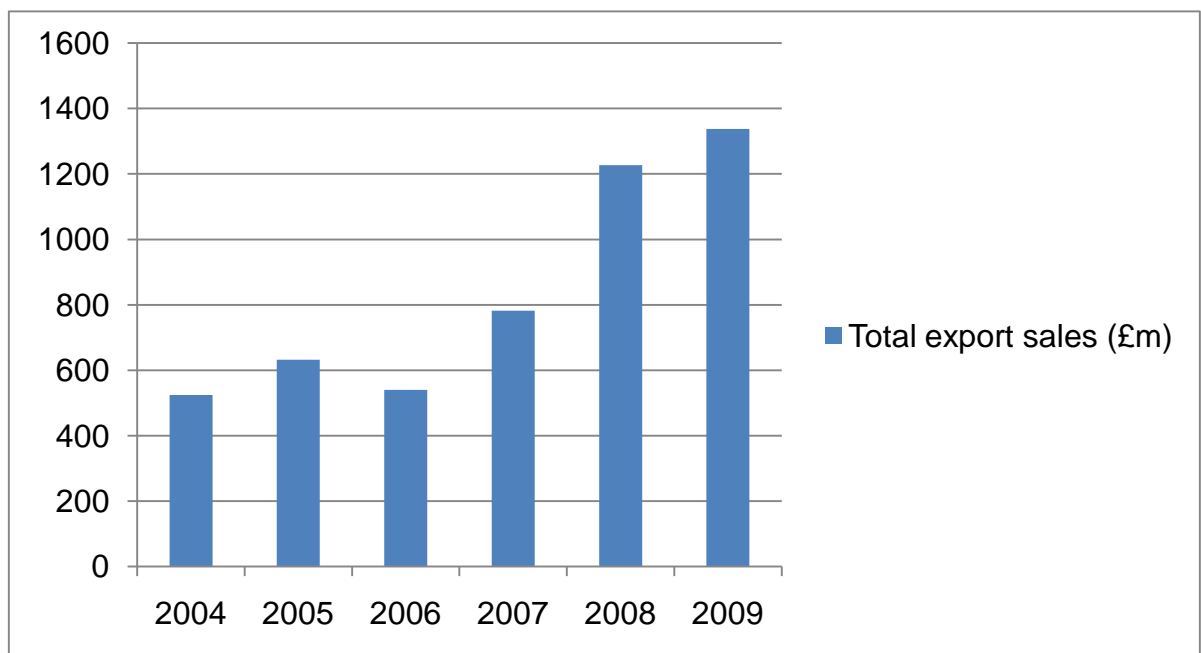
“From 1998 to 2003 – immediately prior to the introduction of UK Terms of Trade – the reported revenue derived from UK TV exports grew by 12.6% CAGR. Following the introduction of Terms of Trade in 2004, export trade

³⁴ Broadcast, Indies: The Annual Survey of The UK's Independent TV Producers

growth increased markedly, expanding by 22.2% CAGR between 2004 and 2008.”³⁵

- 9) Today, exports of UK TV content are worth more than £1.3 billion per year, an increase of 250% in nominal terms on 2004’s equivalent figure of £524m, as shown below.

Figure 2: UK TV content exports post Communications Act



Source: UK Television Exports, annual survey, TRP for Pact and UKTI

- 10) The strong growth in exports of formats (remake rights) highlights independents’ role in boosting UK exports following the 2003 Act. Industry body FRAPA estimates that 72% of all exported formats from the UK are owned by independent producers.³⁶ This has helped establish the UK as the world leader in the global format market, with a share of 53%, far larger than even North America. The UK’s performance in the global format market was analysed in TRP’s 2008 report on television exports for Pact and UKTI, Rights of Passage, which found that:

³⁵ The role of regulation / terms of trade in the development of the UK Indie sector, O&O for Pact, 2011

³⁶ FRAPA report 2009 – TV Formats to the World, page 102

“The UK now accounts for 53% of all exported format hours in the worldwide market. By comparison, the US represents 14% of global format hours, and the UK’s closest competitor, the Netherlands, 18%.”³⁷

- 11) To put a value on UK format sales, the sale to overseas broadcasters of UK format rights is now estimated to be worth £119m per year.³⁸ However, this is eclipsed by the subsequent production linked to UK format rights (i.e. the actual remaking of a programme for overseas markets), which is estimated to be £585m.³⁹ Increasingly, this production will be taken on by UK companies through their US divisions.⁴⁰ As The Times succinctly put it: “The British are coming – and bringing Wife Swap.”⁴¹
- 12) Perhaps most importantly in the longer term, the UK independent sector has used this foothold in overseas markets, particularly the US, to build businesses with global presence. UK companies have now reached the point where they are pitching for and winning purely original commissions from broadcasters in the US and around the world. Of the top five independents, between 33% and 75% of respective turnover is from sales and production in overseas markets, notably the US⁴² – see the case study below for All3Media, one of the largest UK independents.

Case study: All3Media – how the UK went global

“We launched in 2003, inspired by the Terms of Trade, and are now one of the biggest UK independent producers.

“From the start, international growth was key to our business plan. All3Media International, our international sales division, was acquired in 2003. Its aim was to compete in the new market for IP rights created by the Communications Act by building close relationships with internal and third-party producers in the UK and abroad, and exploiting their programmes, formats and ancillary rights overseas. The division has successfully taken shows as diverse as Midsomer Murders and Skins to the global market – Midsomer has sold to 220 countries worldwide, while Skins is showing in 130 - and we are very proud that All3media International was awarded the Queen’s Award for Enterprise in International Trade in 2009.

³⁷ Rights of Passage 2007, July 2008, TRP for Pact and UKTI

³⁸ UK Television Exports, annual survey, TRP for Pact and UKTI

³⁹ FRAPA report 2009 – TV Formats to the World, page 16

⁴⁰ Our accompanying report by Oliver & Ohlbaum outlines a few of the UK programmes being remade for the US, including Undercover Boss (for CBS), Skins (for MTV US), Masterchef US (for Fox), Shameless (Showtime) and Who Do You Think You Are? (NBC).

⁴¹ The Times, February 2009

⁴² Broadcast, Indies: The Annual Survey of The UK’s Independent TV Producers

International sales of UK programme rights are only part of our overseas growth, however. We have built up a group of 20 television, film and digital production companies as far afield as the US, Germany, Australia, the Netherlands, and New Zealand. We now employ around 3,000 people across the world, chiefly in producing content for UK and global markets. Our US offices have produced a range of formats and other programmes for the US networks, including Undercover Boss (CBS), Skins (MTV), Cash Cab (Discovery), Are You Smarter Than A Fifth Grader? (Fox) and several Gordon Ramsay programmes (Fox).

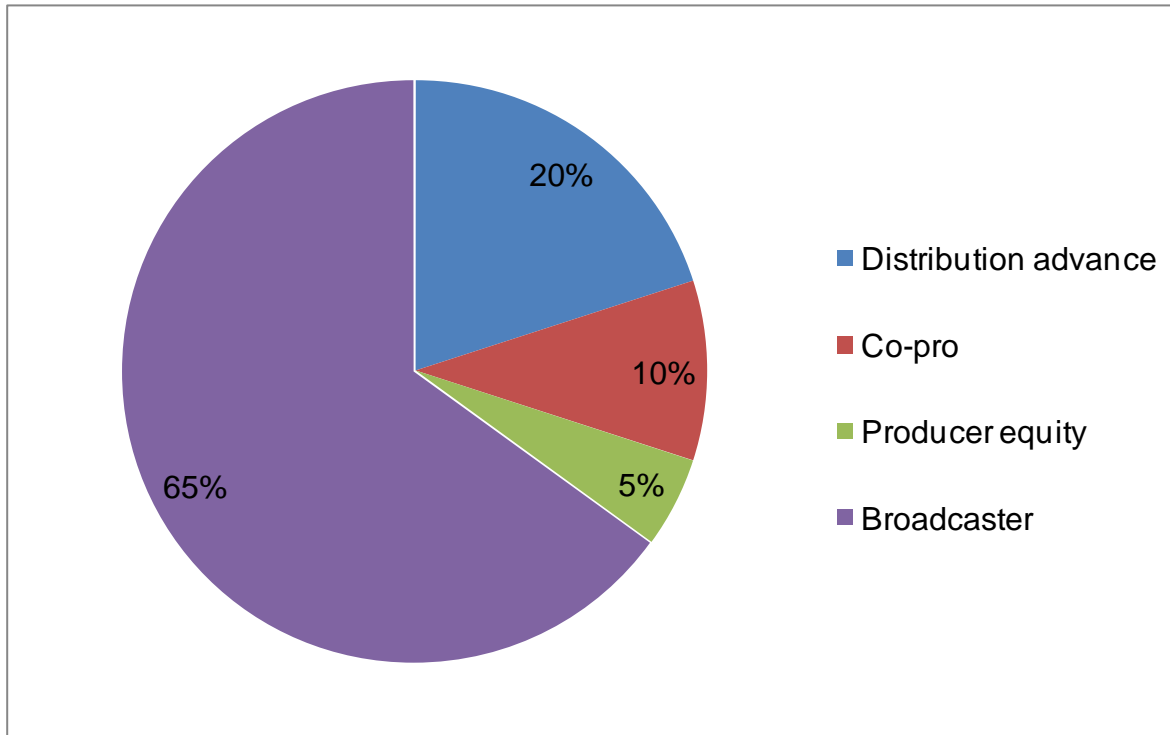
“Currently over 30% of our gross profit comes from secondary exploitation and over half of our revenue comes from overseas activity. Growth from secondary revenues and from overseas is therefore a significant contributor to our current performance. This is set to accelerate into the future and we have ambitious plans to build the international business. This year we have invested significantly in expanding our US offices to spearhead this growth.”

The virtuous cycle: raising investment from global markets for UK content

- 13) Increasing revenues from exports have enabled the independent sector to become a significant investor in the development and production of domestic UK content, in a relatively short space of time. According to Pact’s annual census, independents are currently investing more than £200m per year in the creation of UK content, a figure that has risen every year since we started recording it in 2009.⁴³
- 14) Much of this investment is raised by the producer exploiting IP rights globally, either by selling rights to a programme to overseas broadcasters before it is made, or receiving an advance from an international distributor (an international sales agent) against projected overseas sales. This is then ploughed into the production in order to bridge the gap between the total cost of the production and the fee paid by the UK commissioning broadcaster in return for a set of rights under the Terms of Trade.

⁴³ Pact Policy Survey and Financial Survey, O&O Associates for Pact, May 2010

Figure 3: Sample financing structure for indie drama (where deficit funding used)



15) While such deficit funding is most pronounced in drama, it occurs to varying degrees across many genres. Darrall Macqueen, a London-based independent producer of children's programming, reports that it has not made a television series that was fully funded by a British broadcaster for five years, and that it has raised £2m in recent years from overseas markets to make UK programmes such as the BBC's new pre-school children's show, *Baby Jake* (as reported in *The Observer* this month⁴⁴). In fact, Leeds-based True North Productions has used revenues from secondary sales to invest in capital, establishing its own 14-suite post production studio, as well as employing 200 people, and contributing to the production costs of its BBC commissions (see case study below).

16) This investment in UK content from the production sector has mitigated declining spending by PSB broadcasters, for the benefit of UK television audiences. Due to declining spending by broadcasters, Ofcom's last review of Public Service Broadcasting identified a funding shortfall of up to £235m per annum just to maintain current levels of UK-made, public service

⁴⁴ *Baby Jake*, the real 10-month-old set to be a star of children's TV, *The Observer*, June 25 2011

programming.⁴⁵ However, due to Ofcom's reliance on data supplied by broadcasters, this did not take into account increasing investment by the independent sector. Independents' total annual investment of £200m+ is now enough to almost entirely offset this funding shortfall, thereby ensuring UK audiences continue to benefit from a high per capita investment in home-grown content.

- 17) It must be stressed, however, that such multi-party financing arrangements must still enable production companies to generate an appropriate margin, and that broadcasters' continued buying power can make this difficult. In some cases, independents now produce at cost or even at a loss, aiming to claw back revenues on secondary exploitation. We examine the implications of broadcasters' continued buying power later in this paper.

Case study: True North Productions – growing SMEs

"We are a relatively small independent production company based in Leeds with a successful track record particularly in investigative current affairs programming, documentaries and other factual content, including Panorama's Forgotten Heroes and MacIntyre's Big Sting.

"Having launched in 2002, just before the introduction of the Terms of Trade, we have in many ways grown with them. Without the ability to retain IP in the programmes we have made for the BBC, ITV, Channel 4 and Five – and the opportunity to exploit them in the secondary UK and international markets – we believe we would have struggled to survive. Instead, we are a flourishing independent company, making high-profile programmes from a base in the heart of Yorkshire, providing work for at least 200 media professionals in the last twelve months, mostly resident in the north of England, and had our most successful year to date last year, making 200 hours of programming.

"The revenues we have raised from secondary exploitation for programmes such as such as Animal 24:7, Food Fighters and Crimefighters have been carefully re-invested back into the company. We have financed a fully-equipped post production centre with fourteen edit suites, which in turn allows us to retain further revenues within the company. Revenues from secondary exploitation have also funded the expansion of our development team, paying for personnel who can help us secure new commissions in the UK and the US to ensure we continue growing.

⁴⁵ Second Public Service Broadcasting Review, Phase 2: preparing for the Digital Future, Ofcom, September 2008, page 5

“True North has also agreed to invest some of its own money in programmes we make for the BBC. This ensures a high level of quality, but it can only be achieved if we can recoup the investment through secondary markets. This was not envisaged when the Terms of Trade were drawn up, but it is proof that broadcasters and production companies are finding ways to complement each other’s needs to our mutual benefit. The current system encourages us to form partnerships – with domestic broadcasters, a wide range of international broadcasters, other production companies, multi-media specialists and advertisers, all of whom have helped to invest in content.

“The vast majority of independent are like us – small, well-run and competing in an increasingly globalised industry. While pitching our programme ideas to US broadcasters, I am constantly told that the US market is stale and static because there is no competition for IP – and that is why it is ripe for exploitation by stronger, fitter production companies from the UK.”

The effect on UK broadcasters: price flexibility

18) Increased investment in UK content development and production by independent producers creates price flexibility for broadcasters – instead of a broadcaster funding 100% of a programme, as widely occurred pre 2003, the producer now regularly raises a significant level of investment. The Digital Britain report estimated that, since 2003, programme production costs for broadcasters had reduced by 25% as a result of funding raised by independent producers from exploiting their rights.⁴⁶

19) Such price flexibility enables the UK’s PSB broadcasters and content sector to take advantage of digital and global developments in a fast changing industry. Perspective Associates’ report for BIS/DCMS in the Digital Britain review examined this in detail, concluding that:

“By defining and paying only for primary rights, it appears that PSBs may have been better able to enjoy price flexibility. By formally restricting the broadcaster to paying for the primary rights bundle, the linkage between the value of those rights and the full cost of production has been weakened.”

A flexible approach for the digital era: no constraint on PSBs developing new services

20) The Codes of Practice have not prevented the PSBs from successfully launching a range of new services, such as VOD, complete with independent

⁴⁶ Digital Britain, final report, BERR/DCMS, section 99, page 162

as well as in-house content. In launching these services, they have successfully fought off competition from market entrants, leveraging their dominance in commissioning UK content and the “shop window” of the PSB licence. Writing about Arqiva’s troubled VOD service, Seesaw, Media Guardian’s Mark Sweney recently observed:

“Third-party internet TV aggregators have struggled to compete with broadcasters’ own in-house on-demand services, and SeeSaw failed to gain a significant following compared to rival offerings such as the BBC iPlayer, ITV Player and Channel 4’s 4oD. Joost, the web-TV service founded by the Dutch technology entrepreneurs behind Skype, closed its UK service in 2009.”⁴⁷

21) Indeed, the difficulties faced by competing services suggest that the current Terms of Trade could go further, and reduce the holdback period during which PSB broadcasters are able to retain exclusivity on VOD rights in order to facilitate the growth of other innovative services.

22) Nevertheless, the PSBs’ ability to successfully launch VOD services demonstrates how the 2003 Communications Act created a broad policy framework which has allowed them to develop and innovate. The Codes of Practice themselves are high level, effectively requiring a negotiation to be had and that, as part of that negotiation, there should be transparency in terms of which rights are acquired and transparency in the price paid for those rights. At no point does the Communications Act stipulate which rights (e.g. international or domestic) should belong to the broadcaster or producer, the price that should be paid, or what the revenue share should be on subsequent exploitation. In fact, the Act requires Ofcom’s Guidance on the Terms of Trade be “general guidance” and that it should not “specify particular terms to be included in the agreements to which the Guidance relates.”⁴⁸

23) The particular terms – essentially which rights are exploited by the producer and broadcaster respectively and the revenue share associated with that exploitation - are left to market negotiations between Pact and the individual PSB broadcasters, within the context of broad Ofcom Guidance. The result of those market negotiations are the Terms of Trade (so, for example, the fact that export rights were left with the producer to exploit, with a negotiated share of exploitation revenues to the broadcaster, was the result of negotiation between Pact and the PSBs).

⁴⁷ MediaGuardian, “Seesaw targeted by Bebo buyers”, June 21 2011

⁴⁸ For a more detailed description and analysis of the policy framework around the Codes of Practice and Terms see Perspective Associates report for BIS/DCMS’ Digital Britain Review – Digital Britain: Assessing the policy framework for Public Service Rights, Scoping and Discussion Document, Perspective Associates for BIS/DCMS, April 2009.

24) The Terms of Trade themselves have evolved through market negotiation on a regular basis, and the relevant Ofcom guidance is also subject to updating whenever appropriate. This system has led to significant changes in the Terms of Trade for all broadcasters, notably in 2006 to enable broadcasters to acquire certain VOD rights as part of their package of rights. High level legislation has therefore enabled the market to remain dynamic, adapting to innovative new services such as VOD.

25) We would like to stress, however, that while Ofcom's Guidance is and should be regularly updated in light of market developments, the existence of this Guidance is a vital part of the framework – it provides flexibility by not being part of primary legislation, but also creates a constructive framework for negotiations.

26) While Pact of course accepts there is a need to regularly review any legislation, the Codes of Practice and the Terms of Trade have been subject to a number of major reviews, the most recent one concluding just two years ago. This was a public review as part of the Digital Britain process that involved, along with the review team's work and analysis from Ofcom, a detailed report from independent consultants Perspective Associates, commissioned by the Government at tax payers' expense. Broadcasters' concerns were acknowledged and examined at length, as was the impact of the Terms of Trade on the broadcasting sector as a whole. The report, which was led by Tim Suter, formerly a senior executive at Ofcom, concluded that there were significant benefits to producers and broadcasters, and that the policy framework was sufficiently flexible to enable the market to adapt to digital innovation. The report's summary of the policy framework was as follows:

“The evidence suggests that the regulatory regime involving Ofcom Guidance, broadcasters' Codes and individual Terms of Trade has worked well to build and grow a market. It has shown itself adaptable to changing patterns of consumption and their likely impact on how value is attributed across the life-cycle of broadcast content. And both producers and broadcasters have shown themselves capable of negotiating acceptable outcomes. The thrust of the current regulatory regime is to set a framework within which the market can operate most effectively. While we believe it is appropriate for the regulator to exercise judgement about the bundles of rights that constitute the primary licence, we believe that intervening to set the terms of revenue negotiations is a significantly greater, and unjustifiable, intrusion. Were there evidence that negotiation did not work, or that one party to the negotiation was seriously

disadvantaged, it might be easier to contemplate such intervention. We do not believe, on the evidence we have seen, that these conditions apply now.”⁴⁹

27) Prior to Digital Britain, Ofcom’s 2006 review of the Television Production Sector focused on the independent quota, commissioning between broadcasters and producers, and the Codes of Practice. On the latter, Ofcom reported that “the Codes of Practice are broadly working well”, its caveat being that there was a need to evolve the Terms of Trade to incorporate VOD and new media rights through market negotiations, which was duly done by Pact and the PSB broadcasters, as we have noted.⁵⁰

28) We would also like to point out that Pact is in active talks with the BBC, ITV and Channel 4 over their respective Terms of Trade, continuing the long-standing process of developing the Terms of Trade through market negotiations.

29) In our view therefore, unless compelling evidence is provided as to why there should be another review of the Codes of Practice/Terms of Trade, a further inquiry into whether they remain appropriate would represent an unnecessary cost to the public resources. This is in addition to the inevitable uncertainty it would create for industry.

No evidence of material impact on PSB businesses

30) There is no evidence that the Terms of Trade have had any negative impact on PSB’s businesses. In terms of Channel 4, pre Terms of Trade annual profit from IP exploitation was just £10.9m, as we have mentioned. As Channel 4’s former director of television and content, Kevin Lygo, stated in 2009:

“Transferring rights would not solve the [Channel 4] funding issue. The current system can work for us, for you, and more importantly for the wider economic growth of the creative industries.”⁵¹

31) For their part, ITV and Five can make 75% of their schedule in-house, with complete ownership of rights, if they choose. Current levels of in-house production are far lower at both broadcasters. Ofcom’s conclusion in its last PSB review was that indie commissions were not “a significant opportunity cost to ITV plc.”⁵²

⁴⁹ Digital Britain: Assessing the policy framework for Public Service Rights, Scoping and Discussion Document, Perspective Associates for BIS/DCMS, April 2009

⁵⁰ Review of the Television Production Sector, Statement, 2006, Ofcom

⁵¹ Kevin Lygo speech to Television from the Nations and Regions conference, Salford, January 2009.

⁵² Ofcom’s Second Public Service Broadcasting Review – Phase 2: preparing for the Digital Future, Section 7.7, page 114

32) Finally, BBC Worldwide is flourishing despite the Terms of Trade. In fact, Perspective Associates' report for Digital Britain suggested that the Terms of Trade had forced BBC Worldwide to raise its game to compete with other independent distributors who were vying to exploit independents' IP rights internationally. The report noted that:

"No longer having the guaranteed business from their related commissioning broadcasters, PSB-owned distributors may have been incentivised to become more competitive and efficient in order to win independent business. Although it is not possible to trace a direct link, it is nevertheless striking that BBC Worldwide has seen its operating margin increase year-on-year since 2004/05 (from 8.1% then, to 12.8% in 07/08)."⁵³

33) We see this improved performance at BBC Worldwide as an example of how the Codes of Practice/Terms of Trade stimulated competition in the international distribution of UK TV content, driving efficiency across the entire sector, and maximising the value of IP rights to UK content.

The effect of abolishing the Codes of Practice/Terms of Trade

34) The Codes of Practice created a profound change in the content market by stimulating competition, but the underlying market failure that they were designed to address remains in place. The PSB broadcasters continue to retain similar levels of negotiating power when commissioning content as when the Codes of Practice were introduced. Although there has been a decline in broadcaster spend on UK content, the proportion of this spend controlled by the PSB channels has not changed significantly. O&O's analysis indicates that the PSB channels alone account for 80% of first-run UK originations, and the PSB groups (i.e. including their digital channels) represent 90%, comparable to 2003 levels.

35) While there has been consolidation in the independent sector, recent decisions by broadcasters to axe even the most high profile, successful programmes produced by some of the largest independents underline how, while there will always be a premium on a hit show, the ultimate decision making power as to whether to commission a show will always reside with the broadcaster. As Perspective Associates' report for Digital Britain concluded:

"It would appear that, while independents are now in a stronger negotiating position than before the passage of the Communications Act in 2003, it is

⁵³ Digital Britain: Assessing the policy framework for Public Service Rights, Scoping and Discussion Document, Perspective Associates for BIS/DCMS, April 2009

nevertheless still the case that broadcasters have powerful levers available to them: not only the decision to commission in the first place, but also the decision whether or not to relax the hold-back⁵⁴ during the licence period in return for a better share of revenue – essentially trading off exclusivity for revenue.”

- 36) Perhaps the clearest manifestation of broadcasters’ ongoing market power has been the downward pressure on the primary prices they pay when commissioning, with independent producers contributing more and more investment to bridge the gap between what broadcasters are willing to pay for commissions and the actual cost of producing that commission. As we have mentioned, independent producers are now investing more than £200m per year in UK programme development and production in order to bridge the funding gap. Were leading independent producers genuinely able to dictate terms to PSB broadcasters, we would expect them to be able to prevent broadcasters from lowering the prices they pay.
- 37) The reality is that broadcasters’ continued buying power can force independents to produce at cost or even at a loss, aiming to claw back revenues on secondary exploitation.
- 38) The Terms of Trade therefore remain vital to countering this buying power and ensuring there is competition in the IP market. Removing the Terms of Trade now would have serious consequences for the independent production sector, enabling broadcasters to retain all rights and returning the production sector to a fee-based model. This would render the sector unattractive to private investment, leading to significant contraction and setting back the independent production by ten years.
- 39) Our view is supported by analysis commissioned by Pact from Ingenious Consulting in 2009, which concluded that: “Changes to the Terms of Trade in favour of the broadcaster would have a significant negative impact on the UK production market.” Ingenious’ analysis of profit margins and revenues across the sector, broken down by company turnover, indicated that the loss of international rights would put 170 independents “at risk” – i.e. 170 profitable independents would become loss making⁵⁵. Because of the skew in revenues from international exploitation towards larger independents, we estimate that

⁵⁴ As Perspective’s report explained: “Licence terms typically run for 5 years, often with an automatic option to renew. However, within the licence period, broadcasters may waive the “hold-back” – the bar on exploitation by others – in return for safeguards about scheduling or other impacts. Typically, where the hold-back is waived, broadcasters will negotiate a more advantageous split of revenue with the producer.”

⁵⁵ Terms of Trade Impact Assessment, 2009, Ingenious Consulting for Pact

this would have put companies with a combined turnover of more than half sector at the time at risk.

- 40) Would broadcasters make up this revenue by exploiting export rights themselves? We do not see this as a zero sum game, and believe that the marked rise in exports growth post 2003 that we have outlined supports our view. Abolishing the Codes of Practice/Terms of Trade would, by enabling the four PSBs to retain all rights, destroy the competitive market that has underpinned the exceptional exports growth of the last decade where a wide range of rights owners successfully exploit their IP via a variety of distributors.
- 41) The four PSB broadcasters would be expected to engage in some international co-production activity in order to help fund production (resulting in a loss of those rights anyway), but their track record in exploiting IP rights pre 2003 was mixed. The reality of the market is that when one competing broadcaster lowers its investment in content, others tend to follow suit. There is in our view a strong likely less of independents' investment would therefore not be replaced: it is more likely that broadcasters will seek to move to cheaper genres of programming, or cut spend per hour, with the resulting risk to the range and quality of their offering.
- 42) Abolishing the Terms of Trade would also turn back the clock at a time when major international competitors such as Canada and Germany are aiming to become more competitive by introducing their own Terms of Trade. Canada in particular has comparable Terms of Trade, as well as significant tax-based support for production and proximity to the world's largest market, making it highly attractive to inward investment as well as an exports competitor.
- 43) The threat to inward investment from removing the Terms of Trade is addressed in the Appendix in this submission by O&O. Analysing the recent influx of global content producers into the UK, O&O notes that abolishing the Terms of Trade would be likely to dampen interest in the UK and UK SMEs by global producers, who would be likely to consider moving away from the UK. O&O concludes that abolishing the Terms of Trade:

“[W]ould be likely to cause the migration of global content companies away from the UK, and a collapse of international interest in the next successful small UK producer to emerge. Eventually both talent and money would migrate away from the UK.”⁵⁶

⁵⁶ See Appendix to this submission and accompanying O&O report on the role of intervention in the UK TV production sector.

44) Domestically, abolishing the Terms of Trade would be likely to dampen innovation in content delivery for audiences. The four PSB broadcasters would be able to leverage their ongoing market power as the dominant investors in UK content to undervalue secondary rights, which they could then withhold from the market in order to stifle competition and protect their core services. The ability and incentive of the PSBs to “warehouse” rights was acknowledged in the Competition Commission’s 2009 inquiry into Project Kangaroo, the proposed VOD joint venture of BBC Worldwide, ITV and Channel 4. The Commission stated:

“We also considered whether ITV and C4C would have an incentive to syndicate catch-up content to third-party VOD retailers to which UKVOD would not choose to syndicate. We saw no reason why ITV and C4C would choose to enter into syndication deals that would be likely to undermine the success of UKVOD.”⁵⁷

45) Even with the Terms of Trade, new entrants have found the VOD market to be challenging, faced with competition from the PSBs’ own VOD services, as we have noted. However, there are signs that new services are establishing themselves. With backing from Tesco, Blinkbox offers a range of free and paid-for downloads, including successful independently-produced shows such as *Shameless* and *Peep Show*. Removing the Terms of Trade now would in our view put the growth of such services at risk, with the loss of innovation for audiences and indeed the UK economy.

46) The second major issue for audiences would be the potential loss of investment in UK content that is currently delivered by independent producers. As we have mentioned, when one competing broadcaster lowers its investment in content, others tend to follow suit. Instead of replacing independents investment by increasing their own spending, it is in our view more likely that broadcasters will seek to move to cheaper genres, schedule more imported acquisitions, or cut spend per hour, with the resulting risk to the range and quality of their offering.

47) The overriding issue here is not the development of the independent sector for its own sake but the fact that the Terms of Trade have increased opportunities for the exploitation of content in secondary/ancillary markets in the UK and worldwide. This has resulted in more choice for the UK consumer in how content is accessed, and in the ability of UK indies to generate investment from global revenues that is being used to fund UK content.

⁵⁷ Report on the anticipated joint venture between BBC Worldwide Limited, Channel Four Television Corporation and ITV plc relating to the video on demand service, 2009, Competition Commission, Section 26, page 6

The next decade: sustaining growth

- 48) Left unchanged, we believe the Codes of Practice will continue to underpin growth. Exports of UK television content shows no signs of slowing. Last year, the estimated total revenue from the international sale of UK TV programmes (in-house and independent) and associated activities was up 9% year on year.⁵⁸ In terms of just the independent sector, revenues from international activities grew by 28%, fuelled by rising international primary commissions, a doubling of international rights income and over 10% growth in international sales of UK finished programmes.⁵⁹
- 49) Providing a strong platform for future growth overseas, the business model for many independent production companies is now an international one. Of the top five independents, between 33% and 75% of respective turnover is from sales and production in overseas markets, notably the US.⁶⁰ Around a fifth of all respondents to Pact's 2010 policy survey stated they have international subsidiary companies (up from 14% in the 2009 census).⁶¹
- 50) At the same time, the latest wave of mergers and acquisitions within the independent sector has resulted in a flow of inward investment into the UK, with some of the largest Indies taken over by overseas companies. This investment by overseas companies gives the UK a competitive advantage in accessing finance for UK productions. *Downton Abbey* may appear to be the epitome of British drama, but was significantly funded by NBC Universal, owner of the programme's production company Carnival, by raising investment against projected international revenues. This helped ensure that an original period drama that, unusually for ITV, was not a remake or a literary adaptation could be made. As Maggie Brown wrote in *MediaGuardian*:
- “[T]he producer, Carnival Film & Television, tempted ITV into investing, in the depths of last year's advertising recession, by agreeing to substantially help fund the £7m, seven-part project itself.”⁶²
- 51) It should also be noted that UK production companies owned by overseas companies with broadcast interests in the UK currently lose their statutory independent status – thereby excluding them from the independent quota and

⁵⁸ Annual export figures, TRP for Pact/UKTI

⁵⁹ Pact Policy Survey and Financial Survey, O&O Associates for Pact, May 2010

⁶⁰ Broadcast annual survey of Independent Production Sector

⁶¹ Pact Policy Survey and Financial Survey, O&O Associates for Pact, May 2010

⁶² “ITV gambles on Sunday night viewers getting the *Downton Abbey* habit: Julian Fellowes's £7m drama relies on funding from its producer Carnival”, *MediaGuardian*, September 13 2010

meaning that they have no statutory guarantee of Codes of Practice/Terms of Trade, which apply only to independents. This makes the independent quota and the Codes of Practice/Terms of Trade all the more important for growing the next generation of successful UK production companies. Companies that have already grown to the point where they are no longer qualifying independents may well become investors in the next wave of independent companies, taking a stake of up to 25% to preserve the companies' independent status in a similar way to how BBC Worldwide has invested in UK independents. In this way, larger external suppliers could provide access to finance for smaller independents, fostering a new wave of SMEs and a new cycle of growth.

Q11. Should the core focus of public service broadcasting be on original UK content?

- 1) Ofcom's last PSB review concluded that UK-made content was crucial to reflecting UK cultural identity and representing diverse viewpoints. In Ofcom's consumer research, the regulator found that 83% of the public thought it important for the PSB channels to provide content made in the UK and reflecting life in the UK.⁶³
- 2) More specifically, UK-made content is essential to the four public purposes identified by Ofcom through the PSB review:
 - Informing our understanding of the world: home-grown content is crucial to informing ourselves about the UK and ensuring that events in the rest of the world are made relevant to UK audiences;
 - Stimulating knowledge and learning: UK content is clearly intrinsic to learning about UK topics; however, it also help UK audiences to understand international issues by using appropriate reference points;
 - Reflecting UK cultural identity: UK-made content is essential in reflecting the culture of the UK as a whole, including the devolved nations and English regions, both to UK audiences and to the wider world; and
 - Representing diversity and alternative viewpoints: UK programming is crucial in making us aware of diverse communities and views from within the UK; at the same time, it plays a valuable role in interpreting viewpoints from around the world for UK audiences.
- 3) In addition to this cultural and social value, investment in original content by PSB broadcasters has been and continues to be crucial to the growth of the UK production sector. This investment, through the statutory independent

⁶³ PSB Review Phase 1: The Digital Opportunity, Ofcom, page 32

quotas on all PSBs, Channel 4's publisher broadcaster status, and the BBC's 25% Window of Creative Competition, provides seed capital for UK production companies to develop and make programming that is exported around the world. A recent Deloitte report for the BBC examined the spillover benefits for the UK economy of the BBC's investment in the external supply sector, noting the beneficial effect of enabling independent producers to exploit secondary/overseas rights to the content created, as well as the stability of the licence fee. Deloitte estimated that in turn the independent sector contributed Gross Value Added of £4.3 billion to the UK economy.⁶⁴

- 4) In our view, this investment in the external supply sector delivers numerous benefits for broadcasters as well. It enables them to cherry pick the best programming from a broad range of different companies within a highly competitive external supply sector. Channel 4's current stated process of creative renewal is in our view underpinned by its ability to choose to commission what it considers to be fresh and exciting ideas from different suppliers. It does not have to seek to transform an in-house production department over a period of time, or invest in recruiting new staff. Rather, it has simply identified and announced a change in editorial direction, and opened its doors to a wide range of suppliers competing with each other to offer commissioners the best, most innovative ideas. A study by PriceWaterhouseCoopers for Channel 4 found that:

"If Channel 4 had not pursued this strategy it would have had to rely on a narrower established list of suppliers with a potential reduction in the innovation and interest in the programmes it has broadcast. We believe that Channel 4's chosen strategy has benefited itself, the viewer and by extension, the UK creative economy."⁶⁵

- 5) In terms of specific genres of UK content, we would like to ask the Government to ensure that Channel 4 delivers its new children's remit. This was added to Channel 4's remit in the Digital Britain review, and is a separate addition to the broadcaster's ongoing educational remit. While we fully appreciate that Channel 4's new management team needs time to develop its strategy, we are not aware of any plans by Channel 4 to deliver children's content as yet, despite the children's remit being agreed in the 2010 Digital Economy Act.
- 6) We realise that Channel 4 must deliver its new children's remit without any change in its funding model, but note that the broadcaster has posted an annual surplus – essentially profit – of £50m this year due to a better than

⁶⁴ The Economic Impact of the BBC: 2008/09, Deloitte for the BBC

⁶⁵ The Impact of Channel 4 on the UK independent sector, creative industries and the economy, PriceWaterhouseCoopers, March 2007, page 4

expected advertising performance. In addition, the new management team has already agreed to a £5m annual funding increase for feature film, which was another new commitment in the Digital Economy Act, albeit one built on an existing department.

- 7) Channel 4 has considerable flexibility under its PSB remit to provide content via television channels, online or other services. We would like to stress that, in delivering this remit, Channel could provide a safe destination for children and young people to engage with high quality UK content, and in so doing help address some of the concerns raised by the Bailey Review of the Commercialisation and Sexualisation of Childhood. This is particularly important now that the BBC has decided to cut back stand alone online content, leaving Channel 4 with a clear USP in innovative digital content for older children.
- 8) We note that the Bailey report followed a 2011 EU survey of 23,000 children, conducted in the UK in partnership with the London School of Economics, which found that: “only one in three 9-12 year olds feels that there are enough good things for them online”.⁶⁶ The study also indicated that one in eight children have upsetting experiences online and they still lack skills and confidence using Internet.
- 9) At the same time, as part of its Digital Agenda, the European Commission recently highlighted a range of innovative European online and interactive content for children and young people through a competition for Best Children’s Online Content. The winners of this competition highlight the range and quality of online content in this area, and offer some examples of the type of content that Channel might consider as part of its delivery of its children’s remit.⁶⁷
- 10) Longer term, we also ask the Government to the case for tax-based incentives for the UK animation sector to compete globally, and to consider the analysis currently being commissioned by Animation UK from Ingenious Consulting on the economic case for such intervention.
- 11) Finally in this section, we have already raised concerns at the Welsh Affairs Committee’s 2010 inquiry into S4C that S4C’s long term investment in UK content through the independent production sector and its editorial independence should remain guaranteed beyond 2015. We support provisions to guarantee funding, publisher-broadcaster status, and independence being included in the new Communications Act, as well as the next BBC Royal Charter and Charter Agreement.

⁶⁶ <http://www2.lse.ac.uk/media@lse/research/EUKidsOnline/Home.aspx>

⁶⁷ <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/746&type=HTML>

12) We have also suggested S4C considers a new approach to commissioning in order to increase its positive impact on the Welsh economy. Our thinking was based on the Welsh Assembly Government's recent report, *The Heart of Digital Wales* by Ian Hargreaves, which stated that public funding was failing to maximise the growth of Welsh creative companies and proposed a greater focus on exports. We therefore propose that S4C develop a strategy to help producers develop businesses on a global level, with a greater focus on exportable genres. This could be underpinned by introducing a stronger economic element to S4C's statutory remit.

Q12. What barriers are there to innovation in new digital media sectors, including video games, telemedicine, local television and education?

- 1) As we have outlined in response to Question 10, the market failure that the Codes of Practice were designed to address remains in place. The PSB broadcasters continue to retain similar levels of negotiating power when commissioning content as when the Codes of Practice were introduced. Although there has been a decline in broadcaster spend on UK content, the proportion of this spend controlled by the PSB channels has not changed materially, as we have detailed in this submission already.
- 2) Removing the Codes of Practice would therefore enable PSB broadcasters to use their dominant position as the main buyers of UK content to retain all rights. This would be likely to dampen innovation in content delivery for audiences, as the PSBs would either withhold secondary rights from the market, or at least delay the release of those rights, in order to stifle competition and protect their core services. This ongoing incentive to "warehouse" rights was acknowledged in the Competition Commission's inquiry into Project Kangaroo, the proposed VOD joint venture of BBC Worldwide, ITV and Channel 4. The Commission stated:

"We also considered whether ITV and C4C would have an incentive to syndicate catch-up content to third-party VOD retailers to which UKVOD would not choose to syndicate. We saw no reason why ITV and C4C would choose to enter into syndication deals that would be likely to undermine the success of UKVOD."⁶⁸

⁶⁸ Report on the anticipated joint venture between BBC Worldwide Limited, Channel Four Television Corporation and ITV plc relating to the video on demand service, 2009, Competition Commission, Section 26, page 6

- 3) Even with the Terms of Trade, new entrants have found the VOD market to be challenging, faced with competition from the PSBs' own VOD services, as we have noted. Indeed, the difficulties faced by competing services suggest that the current Terms of Trade could go further, and reduce the holdback period during which PSB broadcasters are able to retain exclusivity on VOD rights.
- 4) Nor should it be accepted that the Codes of Practice/Terms of Trade are inflexible in the light of digital developments. As we have detailed in response to question 10, the policy framework surrounding the Codes of Practice/Terms of Trade combines high level legislation with market-led negotiations and has allowed significant innovation. In particular, the Terms of Trade were changed in 2006 to enable the PSB broadcasters to successfully launch their VOD services. We are currently in talks with most of the PSBs about evolving the Terms of Trade further.
- 5) Finally, we welcome the Chancellor of the Exchequer's focus on stimulating the UK digital economy by ensuring that digital content creators making content for the public sector under Public Sector Procurement should be able to retain and exploit appropriate secondary rights to that content. This follows the BBC's introduction of framework agreements that enable digital content suppliers to re-use IP rights to their content. We believe encouraging an IP market in digital content in this way is a significant boost for the UK's digital economy and that the Government should consider ways to stimulate competition in the IP market as widely as possible.

Q13. Where has self- and co-regulation worked successfully and what can be learnt from specific approaches? Where specific approaches haven't worked, how can the framework of content regulation be made sufficiently coherent and not create barriers to growth, but at the same time protect citizens and enable consumer confidence?

- 1) In our view, self regulation should generally be seen as preferable to other forms of regulation, providing of course that the interests of industry and the public are closely aligned. This is because it provides industry-led regulation that is likely to have a minimal burden of bureaucracy and red-tape, as well as serving the aligned interests of consumers.
- 2) If backstop powers are necessary through some form of co-regulation, we agree with the criteria set out in Ofcom's 2004 Statement on the Criteria for promoting effective co and self regulation. In summary, these criteria are the co-regulatory framework should:

-
- Benefit consumers;
 - Have a clear division of responsibility between co-regulatory body and Ofcom;
 - Be accessible to members of the public;
 - Be independent from interference by interested parties;
 - Have adequate funding and staff;
 - Achieve and maintain near universal participation;
 - Have adequate funding and staff;
 - Have effective and credible sanctions;
 - Be subject to auditing and review by Ofcom;
 - Be transparent and accountable;
 - Be consistent, proportionate and targeted regulation;
 - Include an appropriate appeals mechanism;
 - Be able to diverge from the above criteria where appropriate.
- 3) With these criteria in mind, we welcome ATVOD's recent announcement to introduce a new fees structure that provides concessionary rates for non profit organisations and smaller companies. This step was in our view necessary to help ensure that ATVOD achieves near universal participation without placing undue burdens on small companies that could stifle innovation and growth.

Appendix: Counterfactual on likely impact of removing Terms of Trade requirements from the main PSB Broadcasters in the UK**Commissioned by Pact from Oliver & Ohlbaum Associates June 2011**The temptation to end Terms of Trade intervention

The independent TV sector has proven remarkably successful over the last eight years, since new Terms of Trade were applied to the UK PSB broadcasters. As this submission and Oliver & Ohlbaum's accompanying report details, TV exports have grown by more 20% a year, and independent producers now recycle £200m a year back into new commissioning investment.

Some of the UK's foremost independent producers have become the main hubs within global content producers like Shine Group, All3Media, NBCUniversal International, Warner Brothers TV Production International, Zodiak Media, Fremantlemedia and Endemol. Some see the growing strength of these globally active UK suppliers (some of whom remain formally defined as independent producers and some of whom are now part of widely diversified global content and broadcasting groups) as a reason to end Terms of Trade intervention – in effect Terms of Trade have done their job, and are no longer needed.

A likely return to stagnation

However, if Terms of Trade were removed from PSB broadcasters, there is a very strong likelihood that UK-based TV production would return to the low margin, low investment, low growth sector it had become from 1998 to 2001 (when the ITC/Ofcom reviewed the issue prior to introducing specific terms of trade measures). This would be likely to cause the migration of global content companies away from the UK, and a collapse of international interest in the next successful small UK producer to emerge. Eventually both talent and money would migrate away from the UK.

The market conditions that created the need for intervention in 2003/04 still apply. The main PSB broadcasters still account for 90% of new commissioning spend in any given year across their main networks and their spin off channels, as we have noted in this submission. While commercial PSB spin off channel commissioning is not formally covered by Terms of Trade intervention, the fact that Terms of Trade apply to their main network has a broader impact on their overall approach to commissioning to the benefit of the independent sector and overall UK content investment.

Furthermore, this handful of dominant buyers still has quite differentiated broadcast strategies which limit the extent to which they compete head to head for specific programme ideas. Such market conditions would be likely to lead to downward pressure on commissioning prices were Terms of Trade intervention removed.

But the greatest problems from removing Terms of Trade would result from vertical integration within the broadcast sectors. First, broadcasters all have incentives to limit future downstream competition from new platforms and services. This gives them added incentives to force independent producers to return control of secondary and ancillary rights back to broadcasters, by effectively offering very low prices for commissions if the producer retains the rights and reasonable prices only if the producer gives up the rights.

Second, the BBC and ITV still have significant in-house production activities, which increases their incentives to squeeze independent producers. If the BBC and ITV put pressure on the viability of independent production, this helps their own production activities secure the best creative talent going forward, even if by so doing it leads to a general migration of investment monies and entrepreneurial talent out of the UK sector.

The broadcasters' move to secure more rights, squeeze the independent sector and prevent downstream competition would be likely to cause a vicious circle of reduced investment in UK content and a slowing of exports. Broadcasters would be under less pressure to invest in new content, with future market entry controlled through their ownership of key rights. Independent producers' contribution to new content investment – about £200m a year – would dry up, as they failed to retain the rights driving this investment.

Global Producers Might Remain Financially Healthy, But They Would Move Away from the UK

While some commentators maintain that the largest independent production groups could withstand this onslaught from the broadcasters, they fail to see two things. First, when it comes to new ideas generated in the UK, the broadcasters would have the upper hand with any producer, given buyer concentration, differentiated strategies and vertical integration. Second, the ability of a global producer to withstand the pressure from UK broadcasters would be directly linked to their sourcing of successful IP from outside the UK. It would be those producers able to source successful IP from non UK markets that would have the remaining leverage over broadcasters. While such producers would remain successful despite a reversal of Terms of Trade it would be by transferring their new IP development outside the UK, and most likely moving their entire global creative hub outside the UK. This in turn would migrate investment and global rights trading activity overseas.