

# **THE ROLE OF TERMS OF TRADE IN THE DEVELOPMENT OF THE UK INDEPENDENT PRODUCTION SECTOR**

**A REPORT FOR PACT**

**BY  
OLIVER & OHLBAUM ASSOCIATES LTD**

**JUNE 2011**



## INTRODUCTION

Oliver & Ohlbaum Associates Ltd (O&O) has been asked by PACT to provide a paper outlining the economic performance and contribution of the UK television content related sector both prior to the terms of trade intervention in 2002 and post intervention. The terms of trade referred to in this report are the set of agreements between UK public sector broadcasting (PSB) organisations and PACT that came into force in 2004 and which specify the deal terms for programme commissioning and rights ownership between UK independent producers and PSB broadcasters.

The UK programme supply market (i.e. the market for the provision of television programmes and associated intellectual property rights to broadcasters) remains characterised by some enduring features, including:

- **Buyer concentration** – In 2010, the five PSB networks and their spin-off channels represented 90% of UK broadcaster spend on first-run originated output, a situation that remains largely unchanged from pre-2002 levels<sup>1</sup>
- **Vertical integration** – For commercial broadcasters, maintaining a vertically integration broadcaster-producer model has become an increasingly important source of growth
- **Channel differentiation** – The main PSB networks continue to operate channels positioned so as to minimise overlap in the market, limiting direct competition for specific programme titles to only a small number outlets

These features remain consistent with the market environment that led to the introduction of production quotas in 1990 and terms of trade agreements in 2004. Since 2004, the UK independent production sector has grown to a position where UK companies can be considered as leaders in the global market for television programmes and associated intellectual property (IP).

A key enabler of this growth has been the ability under terms of trade of independent producers to own programme IP in the long term, with rights reverting to production companies after initial primary licence, catch-up and returning series 'hold back' periods. This asset ownership led directly to an inflow of capital to the sector post 2004, providing UK companies with the means to expand internationally and cement a position for the UK as a global hub for television IP trade.

In 2009/10, the UK independent production sector had grown to be a £2bn industry with the UK programme supply market ranked as the leading net exporter of television formats in the world. The success of the UK in the global market is due to a combination of strong indigenous IP investment from broadcasters, world-leading UK creative talent and strong overseas production and distribution businesses. The future success of the UK television content industry lies in maintaining the appropriate balance across all of these attributes plus maintaining the UK's competitiveness against other territories keen to be the next 'hub' for production activity.

This report explores the key themes and interventions in the development of the UK independent production industry and the challenges facing the sector in the coming years. The document is split into four sections:

1. **The story so far – key events in the development of the UK Independent Production sector**
2. **The performance of the UK Independent Production sector since 2002**
3. **Challenges for UK competitiveness in the global television market**
4. **Counterfactual on the likely impact of removing Terms of Trade**

---

<sup>1</sup> O&O analysis of Ofcom reported figures and company reports. Excludes news and sport programming spend

## **ABOUT O&O**

O&O is a leading independent strategy and policy advisor to the media and entertainment industry.

Established in 1995, O&O has been an advisor to over 200 different clients on many of the major developments in the UK, European and global television, radio, publishing, on-line and sports markets in the last fifteen years. Our clients are the leading players in the media industry in Europe and globally, together with regulatory bodies, lawyers, banks and potential investors in media businesses. Our work covers policy and regulation, high-level corporate strategy, commercial exploitation and M&A advice, amongst other areas, and is recognised across the media sector for its in-depth knowledge and analytical approach.

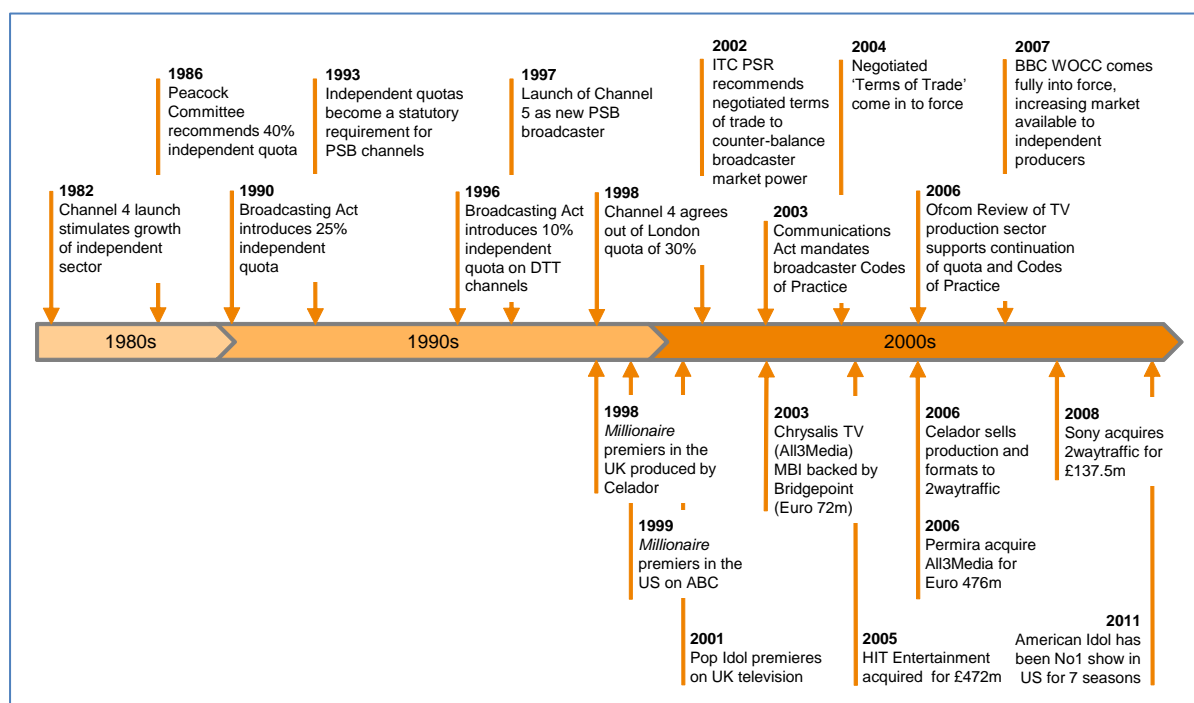
## SECTION 1:

### THE STORY SO FAR – KEY EVENTS IN THE DEVELOPMENT OF THE UK INDEPENDENT PRODUCTION SECTOR

The growth of the UK independent production sector has been one of the success stories of the UK creative industries over the last 20 years, underpinned by regulatory intervention that has allowed the sector to develop into a world leading enterprise.

The evolution of the sector has been supported by successive governments and regulators from the establishment of Channel 4 in 1982 (with its policy of external programme sourcing), through the introduction of production quotas in the 1990s to the development of production terms of trade between independent producers and UK broadcasters in 2004. This section discusses the key events along that timeline, supporting the development of the modern independent sector that we recognise today.

**Figure 1: Timeline of key events in the development of the UK Independent Production sector**



From a regulatory perspective, the first decisive intervention in support of the UK independent production sector came in the Broadcasting Act 1990<sup>2</sup> which requires all Channel 3 licensees, Channel 4 and Channel 5 to ensure that in each year not less than 25% of the total amount of time allocated to the broadcast of 'qualifying programmes' is allocated to a 'range and diversity of independent productions'. However, prior to 1990 there had already been developments to support the growth of the fledgling independent production sector, most notably in the creation of Channel 4 in 1982.

#### 1982-1990 - Channel 4 and voluntary quotas

The launch of Channel 4 as a 'publisher-broadcaster' with no internal production capability of its own and a remit to acquire or commission programmes from a wide variety of sources created the first significant broadcaster relationship for independent producers in the UK. While the availability of new

<sup>2</sup> Ofcom archive of ITC notes

commissions from Channel 4 undoubtedly helped to launch a new wave of independent production companies, the channel also pioneered the owning of copyright and distribution rights of the programmes it aired, limiting the participation of independent producers to a production fee while Channel 4 retained the rights for repeat and onward distribution to other broadcasters.

Alongside the presence of Channel 4 in the market, the development of independent production quotas was already in train. In 1986, the final report of the Peacock Committee on Financing the BBC recommended that both the BBC and ITV should be required to increase their proportion of programmes supplied by independent producers, recommending a 40% independent production quota. This ultimately led the IBA (predecessor of the ITC and later Ofcom) in 1987 to announce plans to increase the proportion of programmes made by independent producers on ITV to a government target of 25% of qualifying production, and subsequently to enshrine this voluntary arrangement with ITV in a 'terms of trade' agreement in 1988.

### ***1990-2002 - Creating a statutory basis for the independent production market***

While the introduction of Channel 4 to the UK television market and ITV's voluntary undertakings prior to 1990 had created some opportunity for independent producers, the market remained small and highly fragmented prior to 1990. Recognising the role that a strong independent production sector could play in furthering competition, creativity and diversity in the programme supply market, the Broadcasting Act 1990 created a defined and regulated market for independent producers in the UK, which required that operators of Public Service Broadcasting licences (the BBC, ITV, and Channel 4 at that time) devote not less than 25% of the total amount of time allocated to 'qualifying programmes' to independent productions.

The definition of 'qualifying programmes' was added subsequently in The Broadcasting (Independent Productions) Order 1991, and excludes acquired programmes, repeats, news and short duration items, focusing the use of independent producers on long-form, originated content. Within the same statutory order, the set of companies defined as being independent producers was specified as being those producers not controlled by broadcasters themselves, where control was defined as a 15% shareholding or greater (later increased to 25% or an aggregate shareholding of 50% if two or more broadcasters were involved) to prevent broadcasters circumventing quotas via acquisition or spinning off in-house production while retaining a majority stake.

The effect of the 1990/91 legislation was to open up the independent production market to a wider range of producers and a greater proportion of broadcaster spend on original programmes. By introducing ownership controls alongside the 25% quota, the changes forced broadcasters to look outside of their own in-house production units (or majority-owned ventures), allowing further growth in the transition of creative talent into wholly independent production. However, the underlying dependence on a few commissioning broadcasters remained, leaving negotiating power in the hands of commissioners and allowing programme rights to be retained and exploited by the broadcaster's distribution businesses.

As a result, the widening market opportunity for independent producers post-1990 remained essentially one driven by a basic 'cost-plus' business model. Typically, producers would agree programme production costs with the commissioning broadcaster and would receive a production fee in the range of 5%-15% on top of costs. As independent producers were commonly required to cede their post-broadcast programme rights to the commissioning broadcasters, few companies were able to build a position in intellectual property assets (programme rights) at this time, limiting the risk capital that could be raised and exploited within the sector.

The result was a sector wholly dependent on a few broadcaster relationships for their annual revenue and a set of companies with very little in terms of diversified revenue streams, ability to raise capital or strong incentives to develop programme ideas and IP for export. The effect of these market conditions on the independent sector was documented in the ITC Review of the Programme Supply Market (PSM) in 2002, which noted that the long term growth of the UK independent sector had

reversed between 1998 and 2001<sup>3</sup>. Profitability during this period was also reported to have ‘not been improving and may well be worsening’, attributed to the fact that about 85 per cent of independent commissions at that time were effectively being paid for on a cost plus production fee basis with, in most cases, the majority of rights going to the broadcasters and its distribution agent<sup>4</sup>.

Supporting this view, O&O’s analysis of the market for the ITC PSM review directly compared the revenue and profitability of the UK’s Top 50 independent producers between 1998 and 2001 estimated that their combined profits had fallen from £8.2m in 1998 to £3.5m in 2001. Though some of this reduction is undoubtedly due to the recessionary impact on commercial broadcasters’ spending during this period, the scale of the drop in profits (which was proportionately much greater than any reduction in broadcaster commissioning spend) strongly suggests that a further squeeze on the profitability of independent production was also present in the market at that time.

The squeeze on independent producers during the latter part of the 1990s was partly due to the growing propensity of broadcasters to commission programmes from third-party broadcaster’s related production arms such as Granada, Endemol and FremantleMedia, plus the continued use of in-house or fully owned production units. Research conducted for the ITC PSM Review showed that the percentage of qualifying hours produced by wholly independent production companies was 84% in 1998, but that this had fallen to 66% by 2001 as a result of these broadcaster strategies. This reflected the attitude of broadcasters at the time, who saw the independent production sector as something to be avoided wherever possible.

*‘The BBC’s relationship with indies has been rocky since [Greg] Dyke became director general in February 2000, with many complaining in-house production is given too much of a priority and terms of trade for indies are poor. Relations hit a low when Dyke told a committee of MPs earlier this year it was “not the BBC’s job to make a large number of independent producers extremely rich”’*

– Broadcast Magazine, ‘BBC to appoint indie champion’ 28 November 2002

Overall, the period from 1990 to 2002 saw the initial expansion of the UK independent production sector reverse as the growth opportunity afforded by the introduction of protected quotas in 1990 was gradually absorbed by broadcasters who retained market power and were therefore able to control production prices, fees and programme rights. By 2002 - exacerbated by the recession - the independent sector was on a backward trajectory and was yet to produce any companies with the scale and breadth to compete internationally.

### **2002-2004 – Recognising the need for Terms of Trade agreements**

The presence of broadcaster market power in UK television production had been recognised in 1993 when the Monopoly and Mergers Commission (MMC) was asked to review the way in which ITV’s regional licensees bought programmes from the independent sector. This review led the MMC to mandate a forerunner of the Code of Practice for ITV, including the opportunity for producers to negotiate directly with the network centre of ITV (rather than the regional ITV licence holders) and limiting ITV’s ability to acquire rights outside of the primary broadcast window.

Recognising the power that broadcasters retained in the market and the weakening position of independent producers, the Secretary of State for Culture, Media and Sport asked the ITC to review the overall economic health of the UK programme supply market (PSM) in 2002. The ITC PSM review identified a range of issues within the UK programme supply market that were limiting the opportunity for independent producers, including:

- **Buyer concentration** – in 2002, c.90% of the commissioning spend in the UK market was controlled by one of the four main PSB broadcasters

<sup>3</sup> ITC Review of Programme Supply Market, 2002, page 23

<sup>4</sup> ITC Review of Programme Supply Market 2002, page 24

- **Vertical integration** – while an attractive model for broadcasters to operate, the presence of vertical integration in the market can leave internal production divisions with no effective competition and can be used to transfer dominance in one part of the supply chain to others (e.g. to dictate the terms of trade for external suppliers). Specifically, control of the primary rights market is crucial in determining market power throughout the programme supply market, with potential for any market power to be leveraged through to secondary and tertiary rights markets;
- **Lack of bargaining leverage** – as a result of buyer concentration and channel differentiation in the UK market, producers can have very limited bargaining leverage with commissioning channels as only a small number actually compete directly for similar programmes (e.g. Channel 4 / BBC2, BBC1 / ITV1)

The combined impact was a programme supply sector where broadcasters controlled the majority of available commissioning spend and were able to dictate the terms of trade to the independent sector, allowing them to keep external producers financially weak and increasing their ability to retain the best programme making talent in-house. The market analysis in 2002 was therefore that the 25 per cent quota for independent production remained necessary but was not in itself sufficient to produce a vibrant independent producer sector that could compete within the UK and internationally.

In addition to impact of this buyer power on the independent production sector, the control of rights by UK broadcasters had also led to a situation where programme IP was relatively underexploited. Similarly to the situation in the US, where the main studio groups have traditionally dominated the programme supply market and used that dominance to squeeze competition, in the UK broadcasters were able to use their control of rights to limit the entry of new services. Coupled with a predominantly UK focus, this led to the exploitation of UK programme IP being of only secondary importance to broadcasters at that time (though this has now changed as international markets have grown in scale and significance).

To remedy the situation and introduce more competition to the programme supply market, the final report of the ITC PSM review recommended five priority areas for action, the first being 'measures to strengthen the longer term viability and growth potential of the independent production sector', including:

- All public service broadcasters to develop Codes of Practice to provide a clear high-level framework for their dealings with independent producers, and;
- Ofcom to take forward the investigation into the programme supply market and determine remedies to address competition concerns, likely to include:
  - Primary rights to be bought separately from all other rights;
  - An indicative tariff for different programme genres;
  - Distributors connected with broadcasters to bid on an arm's length basis for any secondary or tertiary rights from independent producers

The importance of a strong, vibrant independent production sector was clearly outlined by the ITC in its PSM review, summarised in two key passages<sup>5</sup>:

*'An economically healthy and competitive TV programme supply market is a vital part of our creative economy'*

*'Evidence from around the world suggests that a healthy programme supply sector depends on strong investment by broadcasters in local programming, and a balanced mix of in-house and independent producers to provide competition in the development of creative ideas, innovative formats, and production techniques. But for that competition to be truly effective, the independent sector needs to be viable and sustainable in its own right, rather than reliant on a quota for its continued existence.'*

---

<sup>5</sup> ITC Review of the Programme Supply Market, 2002, Page 4

In order to deliver this, the ITC found that the most effective way to balance the strength of the UK's vertically integrated producer / broadcasters in the market was for a set of negotiated codes of practice to be agreed between the independent production community and broadcasters, overseen by the appropriate regulatory body (subsequently Ofcom).

An additional consideration in the decision to broaden terms of trade agreements across the UK television sector was the ability of strong independent producers to better exploit international market opportunities. As the output of the main UK broadcaster-producers is overwhelmingly UK focused, to a certain extent the cultural and market specificity of this output can limit its international appeal. With the independent production sector freer to adapt programming for international markets, both in terms of content and its packaging with other rights, it was felt that a strong independent sector would be better positioned to exploit international markets and tap into more international investment as it grew.

This last point about the ability to tap into external investment has been fundamental to the subsequent growth and success of the UK independent production sector. Prior to the introduction of terms of trade, independent producers were in the main paid a fee for their programmes in a market where broadcasters dominated. Once terms of trade were introduced, independent producers had a clear basis from which to start building their intellectual property catalogues, providing an asset base against which capital could be raised and subsequently invested in UK programming, international expansion and generating long term returns for investors.

#### ***2004-Present – Ofcom ratifies terms of trade and the BBC introduces the ‘WOCC’***

The recommendations of the ITC PSM Review in 2002 were subsequently formed via a series of negotiations between PACT and UK broadcasters into an agreed set of codes of practice setting out the licensing of rights between broadcasters and producers within primary and subsequent windows. These agreements, known as the ‘terms of trade’ were overseen by Ofcom and came into force in 2004, allowing independent producers to retain rights in their productions following the agreed primary rights license. This fundamental change in the trading environment has underpinned the subsequent growth of the UK independent sector, its ability to expand into overseas markets and the interest of external investors in providing capital to fuel that growth.

Since terms of trade were introduced in 2004, two further significant regulatory reviews / interventions have taken place in the UK market. First, Ofcom conducted a consultation and review on the television production sector in 2006, resulting in a policy statement supporting the continuation of independent quotas and the agreed terms of trade. Ofcom’s consultation on the television production sector ran for 3 months and included an in-depth review of the market, concluding that the trading conditions identified within the previous ITC report continued to dominate the UK programme supply market and that the remedies taken forward remained appropriate.

Alongside the Ofcom review in 2006, the BBC was in the process of finalising plans to enshrine a ‘window of creative competition’ (WOCC) within its renewed Charter in 2006. Brought into force in 2007, the WOCC provides for an additional 25% of qualifying network television commissioning to be contestable between in-house production units and the independent production sector. The corollary of this contestable 25% (on top of a 25% independent quota) was that the BBC’s in-house production units retained a 50% guarantee of output from BBC commissioners, thereby capping the share of commissions that the independent sector can secure from the BBC at 50% or less.

The introduction of the WOCC created a further opportunity in terms of the volume of output accessible by the independent production sector seeking to trade with the BBC. However, the overall impact on the growth of the UK independent production sector has been small. Immediately prior to the introduction of the WOCC in 2006, the BBC commissioned 35% of qualifying programmes from independent producers, a figure that had slowly risen to 40% in 2009 under the provisions of the WOCC.

The other important factor relating to the WOCC and independent quotas overall is that they are specified at a channel level and that no specific mandate is placed on broadcasters to meet quotas by genre. As a result, the market share of the independent sector varies widely by genre. For example, in 2009, Ofcom reported that the BBC had commissioned 78% of its qualifying Hobbies and Leisure

output with independent producers whereas drama commissioning was only 30%<sup>6</sup>. This skew in genre commissioning via the independent sector can have a significant impact on producer's international revenues given the relative value of scripted and unscripted formats or finished programmes.

Overall the market for programme supply in the UK has changed little since 2002, with original commissioning spend still majority controlled by the main PSB broadcasters who – increasingly – are looking to re-invigorate their vertically integrated, in-house production models in competition with the independent sector. As in 2002, the main defence against this vertical integration squeeze remains a fair and balanced code of practice agreement between the independent production sector and UK broadcasters to ensure that the UK market remains competitive in a global market for creative ideas and rights.

---

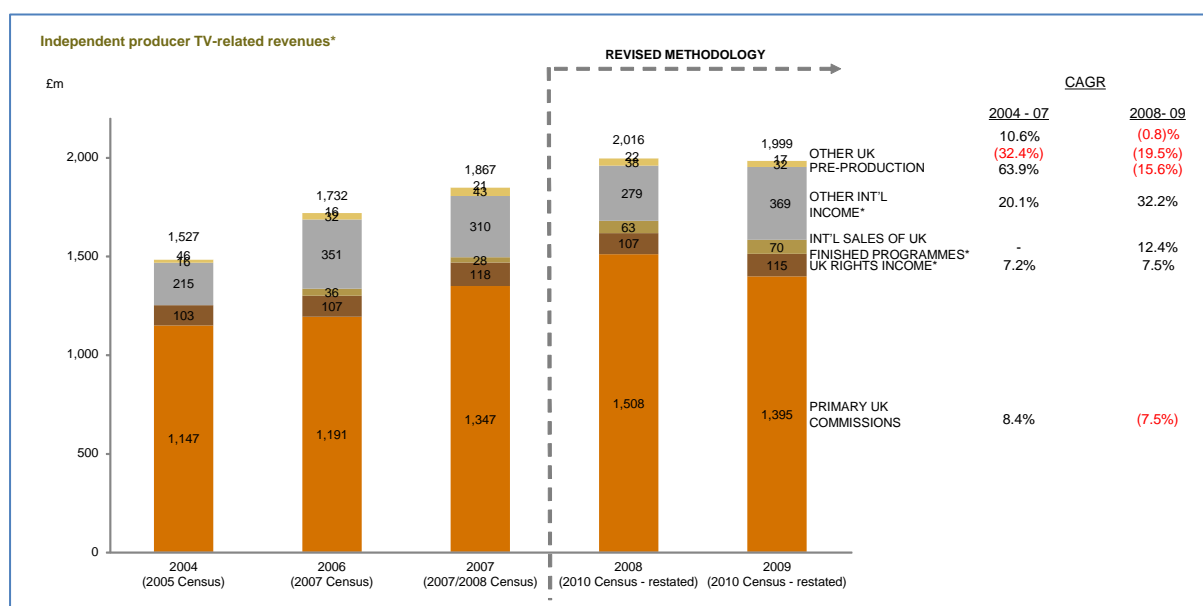
<sup>6</sup> Ofcom compliance reporting – PSB Report 2010 – Information Pack G

## SECTION 2:

## THE PERFORMANCE OF THE UK INDEPENDENT PRODUCTION SECTOR SINCE 2002

Since 2004, the UK independent production sector has grown into a £2bn industry, with a strong international presence and a wide portfolio of market leading programme IP, either in finished UK programming, overseas productions or international formats. The basis of this growth remains inextricably linked to the UK terms of trade, which provides producers with clarity and opportunity in developing new ideas in the UK which can then be exported to international markets. The growing importance of international income can be seen in the results from the 2010 O&O/PACT census of independent production companies, which recorded consistent growth in international income for the sector even though UK primary commissions fell in 2010<sup>7</sup>.

Figure 2: UK Independent Producer TV-related revenue, 2004-2010<sup>8</sup>



The result of this commercial success is a vibrant independent production sector, successful overseas as well as in the UK and generating strong export performance for the UK economy. The growth of the independent sector also continues to enable a rich diversity of organisations to participate, from small, individual talent-led vehicles to large international 'super-indies'. As a result, the UK independent production sector remains relatively fragmented, with the top 5 'super-indie' groups by revenue only representing 34% of total sector income in 2009.<sup>9</sup>

### ***Diversification of revenues helps the independent sector to expand***

Starting in 2004, the introduction of terms of trade initially created a larger available market for independent producers by granting them long term ownership of IP outside of broadcaster primary and catch-up windows. Importantly, the newly enshrined ability of producers to retain rights in their programming IP during this period allowed independent production companies to raise new investment capital and start to diversify their income away from a sole reliance on UK broadcaster primary commissions.

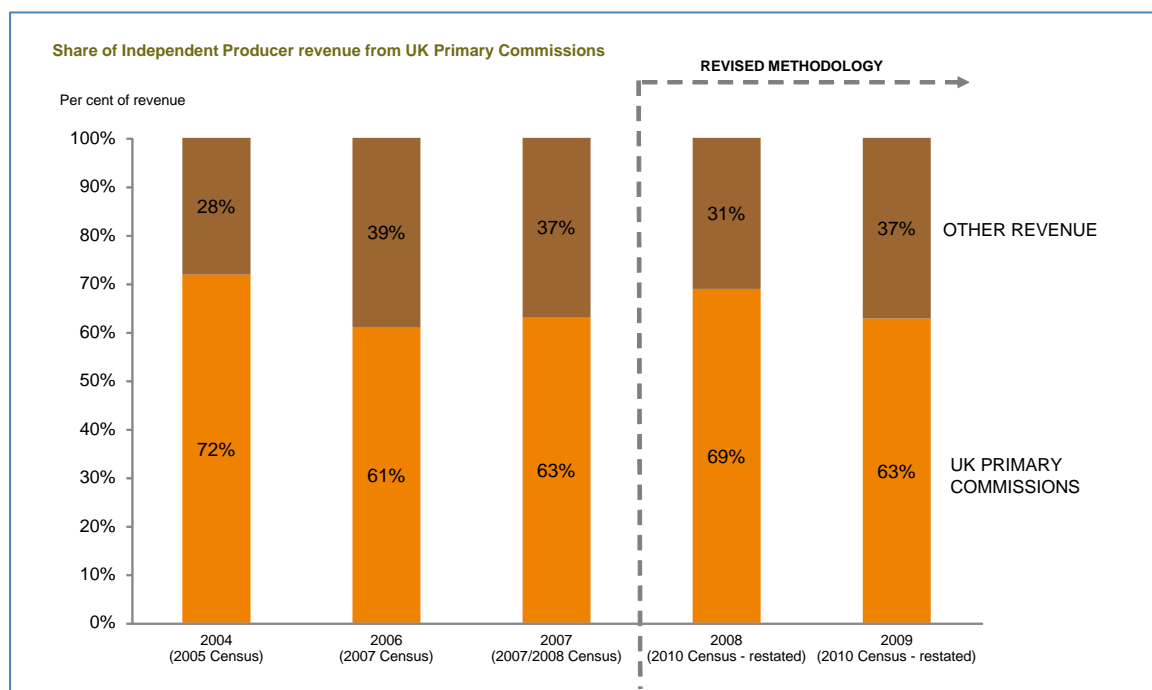
<sup>7</sup> O&O / PACT Census 2010

<sup>8</sup> O&O / PACT Census 2010

<sup>9</sup> Broadcast annual survey of UK Independent producers 2010/2011, O&O / PACT Census 2010, O&O analysis

Since 2004, the share of total UK independent producer revenue generated from UK primary commissions has fallen from 72% to 63% (though annual revenues have increased overall). This diversification of income has been driven mainly by growth in international sales of UK finished programming and investment by UK producers in international operations. The overall impact of this shift towards international activities has been to increase the UK's standing as a major production and creative hub within an increasingly globalised international TV market.

**Figure 3: Share of UK Independent Producer revenue from UK Primary Commissions, 2004-2009<sup>10</sup>**



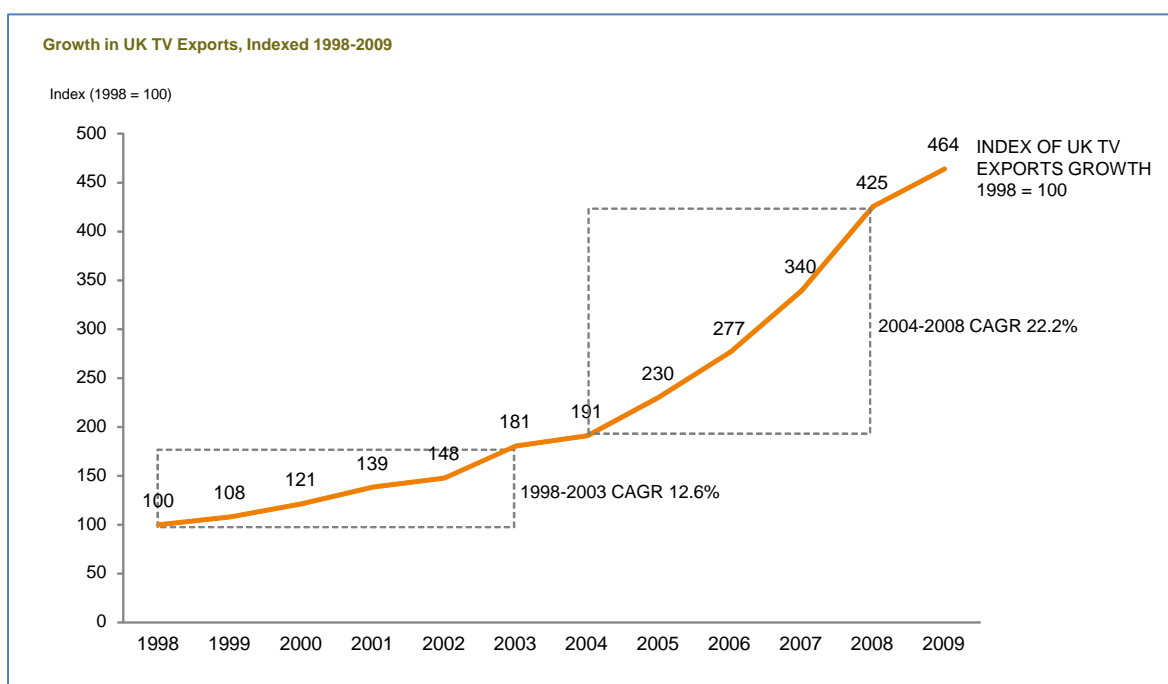
### ***Expanding the UK's position within a globalising TV market***

The success of the drive towards more overseas activity can be seen in the growth of UK TV export revenues as reported by successive BTDA / TRP reports. 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 growth increased markedly, expanding by 22.2% CAGR between 2004 and 2008.

The importance of this growth in export trade to the UK economy is fourfold:

- Access to international markets has enabled UK creative industries to grow beyond the limits of indigenous primary commissioning spend;
- Increasing international rights income provides a greater opportunity for producers to 'gap fund' projects, providing up front funding and reducing the cost to broadcasters of the UK primary licence;
- The increased strength and international ambition of UK independent producers has coincided with a period of globalisation in TV content markets, helping to secure the UK's position as an important global hub for production and programme rights;
- Independent television production represents a growing sector of the UK economy with a growing export base, positively contributing to the UK balance of payments

<sup>10</sup> O&O/PACT Financial Census and Survey 2010

**Figure 4: Indexed growth in UK TV exports, 1998 to 2009<sup>11</sup>**

Overall, UK TV exports continued to grow through 2009, with the trade in UK television rights and overseas production activity growing by more than four and a half times between 1998 and 2009. While the TV export market has undoubtedly gone through an expansion phase during the period, the ability of UK independent production companies to expand their market share in this area has been an important element of overall UK sector growth.

### ***The UK market in an international context – a clear market leader***

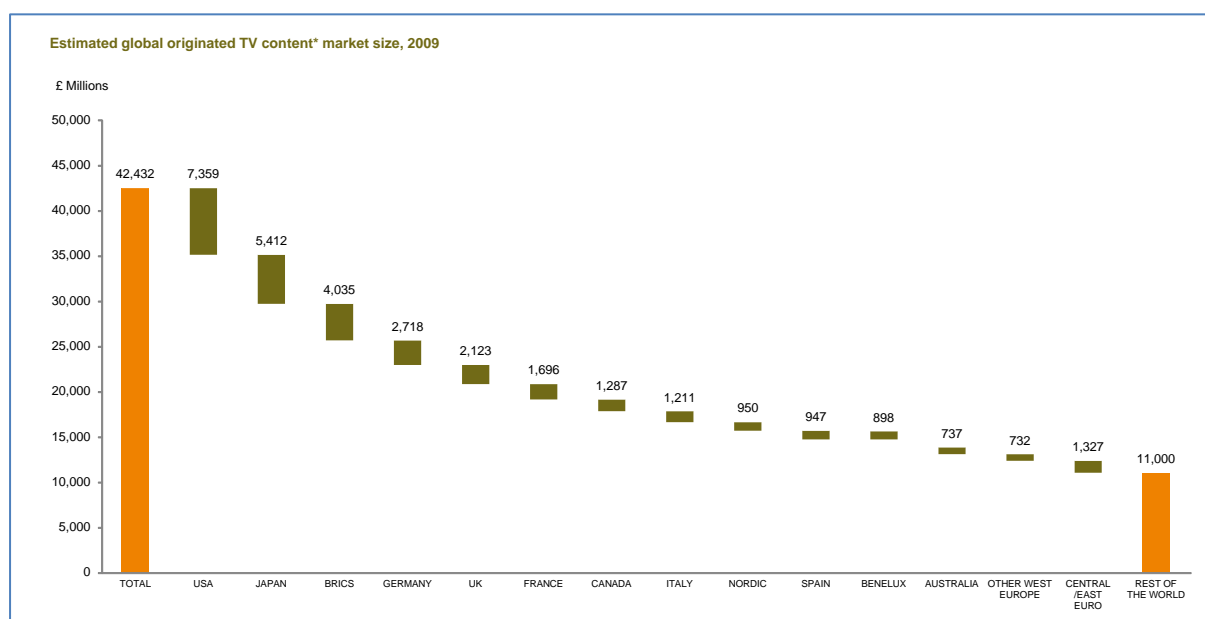
With an annual spend on originated content of c£2.1bn<sup>12</sup> in 2009, the UK television content market ranks as one of the top four in the world after the USA, Japan and Germany. Importantly, the PSB commissioning structure and presence of licence fee funding in the UK means that this leading position in original commissioning spend is spread across a wide variety of new, innovative and risk taking commissions each year.

The presence of an environment supportive of innovative and risk taking producers and commissioners is one of the fundamental underpinnings of the UK television sector's international success. Television in the UK remains, to a large extent, a medium where creative risks can be taken, helping drive new IP in the market and driving both export trade and inward investment. Each year, over 30,000 new individual programmes are trialled on UK television<sup>13</sup>. While other TV markets may have greater overall spending power, none of the other leading TV economies has this level of on screen experimentation driving their creative TV production sector.

<sup>11</sup> BTDA / TRP / PACT annual TV exports reports, O&O analysis (year-on-year reported nominal growth in UK exports applied to 1998 base year = 100).

<sup>12</sup> O&O analysis, excludes News and Sport programming

<sup>13</sup> O&O estimate based on previous BARB analysis

**Figure 5: Spend on originated content (excluding news and syndication), 2009<sup>14</sup>**

As a comparison, the US network model is to screen new programme ideas in ‘pilot seasons’, where new programme ideas are funded to make a single episode against which test screenings help networks to decide whether to commission a full series. While this helps to offset networks’ commercial risk when commissioning 22 episode series, it also serves to limit the amount of new creative programme IP that makes it onto screen. By contrast, the flexibility of UK broadcasters to commission new programming in different durations and formats – arguably something underpinned by the funding and objectives of the BBC and Channel 4 – helps the UK’s position as a leading creative hub, where new ideas are allowed to find their audience and can flourish.

### ***The success of UK content reaching the US***

One of the key themes supporting the growth in international revenues across the UK independent production sector has been in the increasing success of UK programme ideas in the US market. Traditionally, the US has been a relatively closed market to overseas IP, with the large integrated studio businesses (e.g. Disney / ABC, Fox, NBC) controlling the main prime-time channels and programme production, either through their in-house studios or ability to secure rights via production finance deals.

However, the last decade of trade with the US market in both finished programmes and formats has seen a substantially increasing openness to overseas content. Given the cultural proximity of the UK to the US – at least when compared to other markets – producers in the UK have found this trade route increasingly attractive as US cable networks and prime-time networks (e.g. NBC, Fox, ABC, etc.) have gradually opened up to UK programme ideas. In 2001, the TRP / BTDA UK export survey estimated that UK trade in finished programmes to the US market was worth £137m<sup>15</sup>. By 2009, BTDA estimated that finished programme trade with the US had grown to £485m, an average growth of 17% CAGR over 8 years.

While finished programme exports to the US market have been increasing significantly, the development of the global formats market has been the catalyst for further growth in UK IP making it into US prime-time schedules. Of particular note since 2001/02 has been the ability of the UK independent production sector to obtain programme format commissions from US networks, either in main network prime-time or on leading cable networks. Arguably the breakthrough for UK formats in

<sup>14</sup> OBS, SNL Kagan, Company reports, Oliver & Ohlbaum analysis

<sup>15</sup> BTDA 2001 export survey, \$US converted at \$1.45:£1

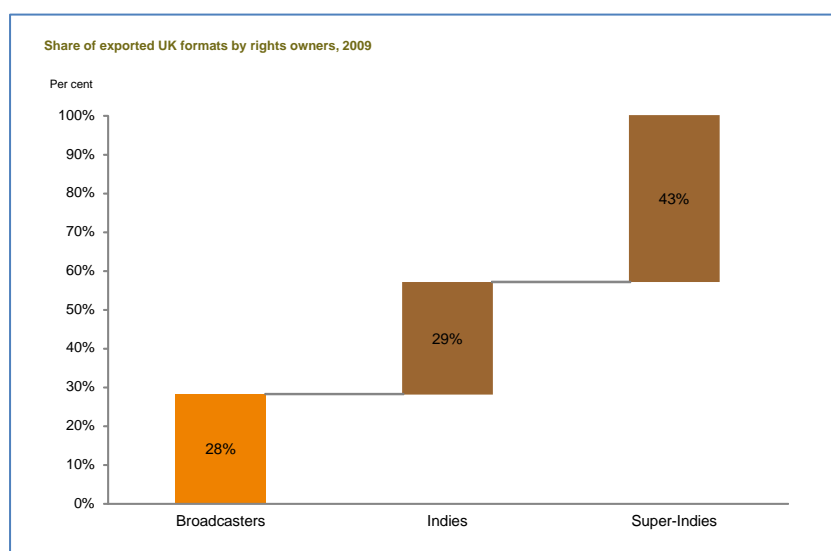
US prime-time came in 2001 with *Who Wants To Be A Millionaire?* Followed closely by the expansion into the US of the *Idol* format in 2002. Both of these formats – amongst many others - started out as UK commissions in conjunction with independent producers.

**Figure 6: Successful adaptations of UK formats in the US**

US format	Originally produced in the UK
Who Wants To Be A Millionaire?	1998
American Idol	2001
The Office	2001
Wife Swap	2003
Who Do You Think You Are?	2004
Shameless	2004
Supernanny	2004
Masterchef	Revised 2005
Skins	2007
Undercover Boss	2009

The international trade in UK generated formats has been largely driven by the independent production sector, with industry body FRAPA estimating that 72% of all exported formats from the UK in 2009 were owned by independent producers<sup>16</sup>. This compares favourably with only 40% of the BBC's qualifying output hours (i.e. original commissions excluding news) being delivered via the independent sector and 45% at ITV<sup>17</sup>.

**Figure 7: UK Independent Producers' share of UK format exports, 2009<sup>18</sup>**



<sup>16</sup> FRAPA Report 2009

<sup>17</sup> Ofcom compliance reporting – PSB report 2010 – Information Pack G (published 8<sup>th</sup> July 2010)

<sup>18</sup> FRAPA report 2009 – TV Formats to the World, page 102

In the same report, FRAPA estimate that the value of UK format exports in terms of 'exported production costs' (i.e. the cost of overseas adaptations linked to the original format) was c£585m<sup>19</sup> in 2009, almost twice that of the next largest format producing country. Though the independent sector has been the main driving force behind this lucrative market, both in terms of incentives to maximise format exploitation and investment capital to build out presence in international markets, the basis of UK success in this market segment is also inextricable linked to the funding of UK broadcasting and the terms of trade that continue to protect IP creators in the UK TV market.

### ***The development of the UK as a global production hub***

The influx of new capital to the UK independent production sector after 2004 helped to fuel a period of international expansion. This expansion, in turn, provided the basis from which some of the leading UK independent production groups have grown to become global market leaders. However, following this period of expansion, the competitive focus across international markets is increasingly shifting towards the battle for programme and talent rights to fuel production activity. As a result, countries that manage to cement a place as a regional or global production hub for IP expect to accrue substantial commercial benefits from the inward flow of capital and the export of new ideas and programmes.

The UK is not alone in this market and is participating in an increasingly competitive environment for new IP. Statements of intent for increasing competition in the market are coming from prosperous economies such as Singapore, who have announced their intention to become an Asian production hub from the US studio groups who have begun to buy into leading independent producers, and from other established production hubs such as Canada, which recently announced its own terms of trade (in addition to production tax incentives that have made Canada an attractive location for co-production finance).

The UK currently has an enviable position as a global production and content IP hub, with strong broadcaster funding, a wide and internationally recognised creative base and a unique position within the global flow of format IP. With value in the commercial TV industry polarising further between a small number of global hits and a long-tail of low budget output, the strength of the UK's position in formats is something that is critical to the continued international standing and commercial export success of the UK TV production industry.

**Figure 8: Ranking of net format hour exporters amongst leading television countries, 2006 to 2009 cumulative<sup>20</sup>**

NET EXPORT COUNTRIES FOR FORMATS (Ranked by net trade in format hours)	
UK	1
Netherlands	2
USA	3
Japan	4

Recognition of the UK's importance in international TV IP trading can be seen in the levels of interest and investment made over the last 18 months by US studio groups looking to build a strong position in the UK market. Vertical integration, such as News Corporation's acquisition of Shine and NBC's

<sup>19</sup> FRAPA report 2009 – TV Formats to the World, page 16

<sup>20</sup> The Wit, Company websites, C21 Media, Oliver & Ohlbaum analysis

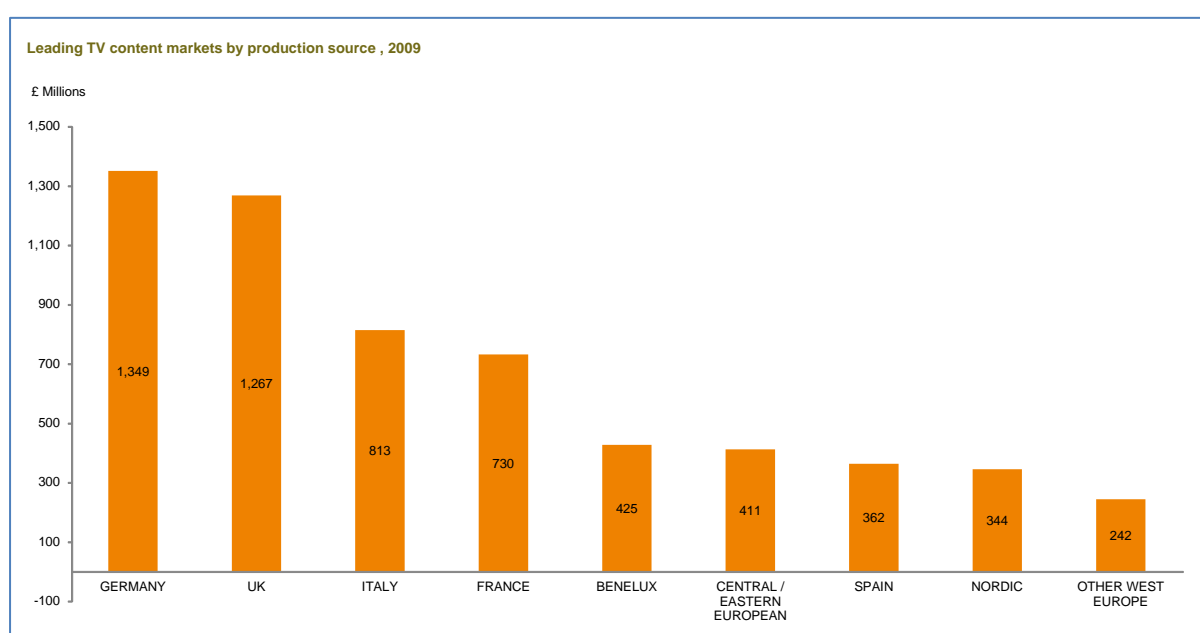
acquisitions of Carnival and Monkey Kingdom show a renewed interest in UK independent producers, especially those with leading credits in scripted or unscripted output and back catalogues of successful programming.

Overall, this battle for IP is expected to characterise the next stage of development in the global TV market, making the UK's approach to terms of trade and wider intellectual property rights protection critical to the competitive position of the leading UK broadcasters and independent production sector.

### ***Ranking against European independent production sectors***

With internationally appealing content and greater access to investment capital since the introduction of terms of trade, the UK independent production sector has been expanding its international footprint rapidly to take advantage of a more open, global content market. The UK currently boasts a leading position as one of the largest content markets outside of the US and has one of the largest and most vibrant independent sectors in Europe, a position built on strong indigenous funding for broadcasters and investment in original programming.

**Figure 9: Comparison of European Independent Production Sectors by Revenue, 2009<sup>21</sup>**



Taking differences in classification into account, the UK has arguably the largest independent production sector of any European country. In Germany for example, many of the leading producers are owned by commercial broadcasters which would invalidate their classification as an independent producer by UK market definitions. Again, this market position is due to UK independent producers leading in creative output and international growth and illustrates the UK's ability to lead in creative industries.

### ***Expansion in rights has minimal impact on UK secondary rights spend***

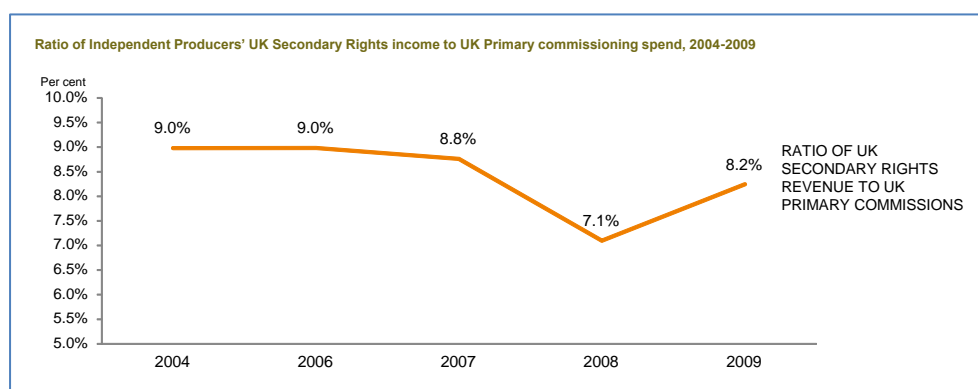
While the introduction of terms of trade has enabled UK independent production companies to build up a base of programme rights over time and expand overseas, the overall impact on UK broadcaster's spend on secondary rights has been limited. Data from the PACT census over the last seven years suggests that growth in UK secondary rights payments to UK independent producers has only been c.7% CAGR since 2004 while international TV revenues to the sector have grown by over 20% CAGR.

<sup>21</sup> Oliver and Ohlbaum analysis of OBS, SNL Kagan, Company reports

Part of the reason for the limited growth in UK secondary rights spend under the terms of trade agreements is in the various options for broadcasters to exploit returning series holdback provisions and VoD catch up windows. These provisions within the current terms of trade allow UK PSB broadcasters to retain secondary rights (or at least withhold them from the market) for the UK market where a series is recommissioned, thereby limiting their potential sell on value.

In fact, the ratio of UK secondary rights revenue to UK primary revenue has remained largely unchanged since 2004, with the secondary rights revenue of UK independent producers strongly correlating with their share of primary commissions (see figure 4). This illustrates the success of the current terms of trade in limiting inflation in UK rights while building a platform for the increasingly successful exploitation of UK IP internationally. From 2004 to 2009, the ratio of secondary to primary UK revenues has fallen from 9% to 8.2%, indicating that secondary rights costs in the UK may have actually reduced relative to new commissioning spend over this period.

**Figure 10: Ratio of UK Independent Producers' UK Secondary rights versus Primary commissioning revenue, 2004-2009<sup>22</sup>**



The story of the post terms of trade period is largely one of UK independent producers taking an increasing share of UK commissioning spend and using their growing holding in secondary and tertiary rights to sell internationally and compete with European and US producers and vertically integrated media groups. This has underpinned strong UK performance in creative exports and strong sector growth, though the benefits have also been shared by domestic broadcasters who are increasingly able to leverage the success of the UK independent production sector to secure alternative forms of production finance and offset primary commissioning costs in the UK.

### ***Recycling benefits to UK broadcasters via production finance***

The commercial opportunity for independent producers in taking a hit show to international TV markets as either a finished programme or recognised format has led to an increasing availability of so called 'gap finance' in the UK market. Traditionally, the agreed primary commission tariff between broadcasters and producers in the UK was set at the cost of the intended production plus an agreed production fee (effectively the profit retained by the producer). With the advent of terms of trade, broadcasters and producers have more leeway to trade off long-term rights value against primary commission licences.

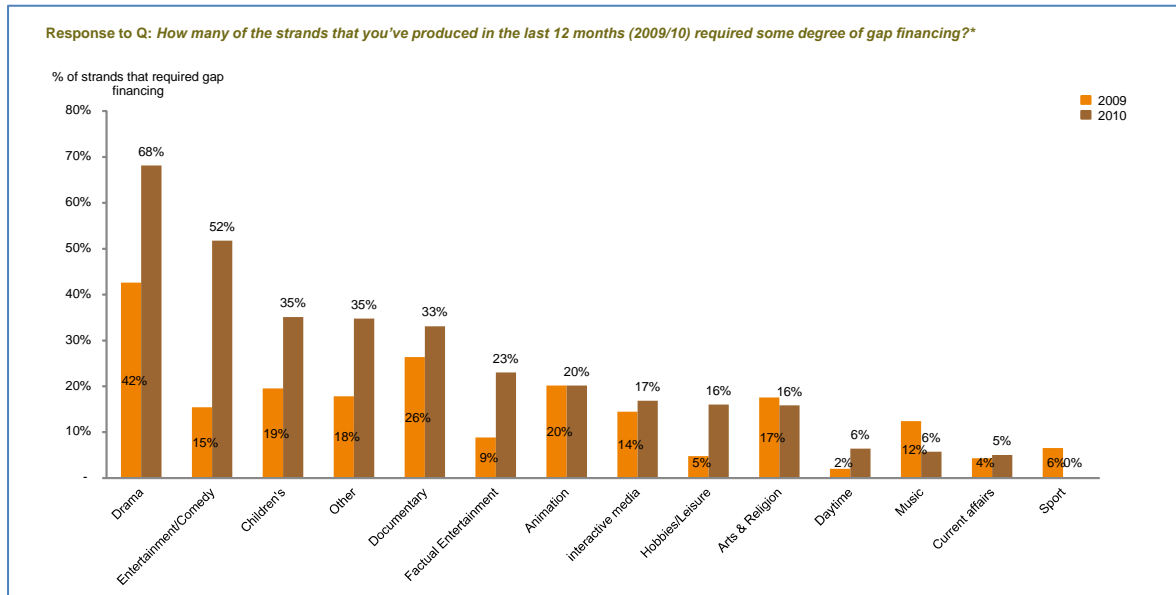
The result is the increasing prevalence of 'gap finance', where producer or third-party funds are used to make up the gap in funding a commission where the broadcaster contribution is less than the total costs of production. Gap finance is particularly prevalent in genre that have a high international appeal, such as drama, entertainment formats and children's programming (in the latter case due to the large merchandising potential of hit children's TV shows).

The benefit to broadcasters in independent producers being sufficiently well capitalised and diversified to take on more gap finance arrangements is that their primary commissioning budgets can

<sup>22</sup> O&O / PACT Financial Census and Survey 2010

be spread further, benefiting viewers in how much new, original content is available from UK broadcasters. Within the PSB broadcasting environment, where range and diversity are explicit objectives, the ability of the independent production sector to contribute to this is a further source of value add to the UK creative economy, estimated to have been worth c.£200m in 2009<sup>23</sup>.

**Figure 11: Percentage of strands requiring gap finance by genre, 2009-2010<sup>24</sup>**



In this regard, the success of the UK independent production sector overseas is directly correlated with its ability to financially contribute to the richness and diversity of UK PSB broadcast output. The perpetuation of this investment in diversity is also in the long-term interests of the UK independent production community who benefit in turn from the UK's position as one of the leading TV markets for experimentation and risk taking with new original commissions.

<sup>23</sup> O&O / PACT financial census and survey 2010 estimate

<sup>24</sup> O&O / PACT financial census and survey 2010

## SECTION 3:

### CHALLENGES FOR UK COMPETITIVENESS IN THE GLOBAL TELEVISION MARKET

The UK independent production sector has grown to be a major force in the global TV market, with leading international companies such as All3Media, Shed and Shine expanding rapidly to form a network for IP generation and exploitation. However, the UK's position within the global market is likely to come under increasing pressure as international competitors build out their own positions, both in terms of countries seeking to emulate – and take market share – from the UK creative sector and overseas companies moving in to the UK market through acquisition.

Competition is also expected to increase from UK broadcasters who are seeking to renew and grow their own in-house IP to drive future revenue growth. The publicly declared vertical integration strategy of ITV is perhaps the highest profile of these, with the potential to see a shift in the commissioning of key genres back to in-house production:

*“We really need to invest in developing our content business. The key thing is to see lots more programme ideas coming through, particularly in the three key areas that drive the big audiences here but are also the key export markets. These are entertainment shows, drama and factual entertainment. We want to see a real step up in the number of shows coming through ITV Studios”*

- Adam Crozier, ITV Chief Executive – Sunday Telegraph, 27 March 2011

While a strong ITV is an important part of the UK television content ecosystem, the risks to innovation and creativity from the vertically integrated model is one of the factors that led to the introduction of terms of trade in the first instance.

Against this background of likely increasing competition, the UK commissioning landscape has changed little in the last 10 years, with the PSB networks and their spin-off channels still accounting for c.90% of spend on original commissions (excluding news and sport)<sup>25</sup>. The continued concentration of buyer power in the market also remains in contrast to the relative fragmentation of the UK independent production market, where the top 5 groups account for only c.34% of total revenues<sup>26</sup>.

As the UK independent sector continues its successful expansion, a further set of challenges may be on the horizon, including:

- The potential for further overseas acquisition of UK independent production companies taking a greater share of UK creative output into non-UK groups (which can also take production companies outside of the ‘independent’ classification where the acquirer has a UK channels business)
- A much more competitive environment for leading IP and programme rights, with more parties bidding for the best programme ideas internationally
- International competition for production commissions, with large multi-national producers seeking to produce shows in the most cost effective locations
- A continued shift of risk onto independent producers via gap and development finance while commissioners seek to reduce up front commissioning costs

---

<sup>25</sup> O&O analysis of Ofcom reported figures and company reports. Excludes news and sport programming spend

<sup>26</sup> O&O analysis of Broadcast annual survey of UK independent producers 2010/2011, O&O/PACT Census 2010 – Top 5 in 2009 listed as All3Media, Endemol, RDF Media, Shine and Shed Media

- Competition from established and new production territories seeking to establish themselves as preferred 'hubs' for international trade (e.g. Canada recently announced agreed terms of trade on top of existing production tax breaks)

In order to remain competitive, the UK independent sector needs to retain its ability to trade in creative rights domestically and internationally. Supporting this, the UK's IP framework and protections needs to encourage the international commerce surrounding these rights or risk losing trade and talent to other countries and overseas companies more aggressively pursuing growth in this market.

**SECTION 4:****COUNTERFACTUAL ON THE LIKELY IMPACT OF REMOVING TERMS OF TRADE*****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 detailed earlier in this report, TV exports have grown by more than 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 report. 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.