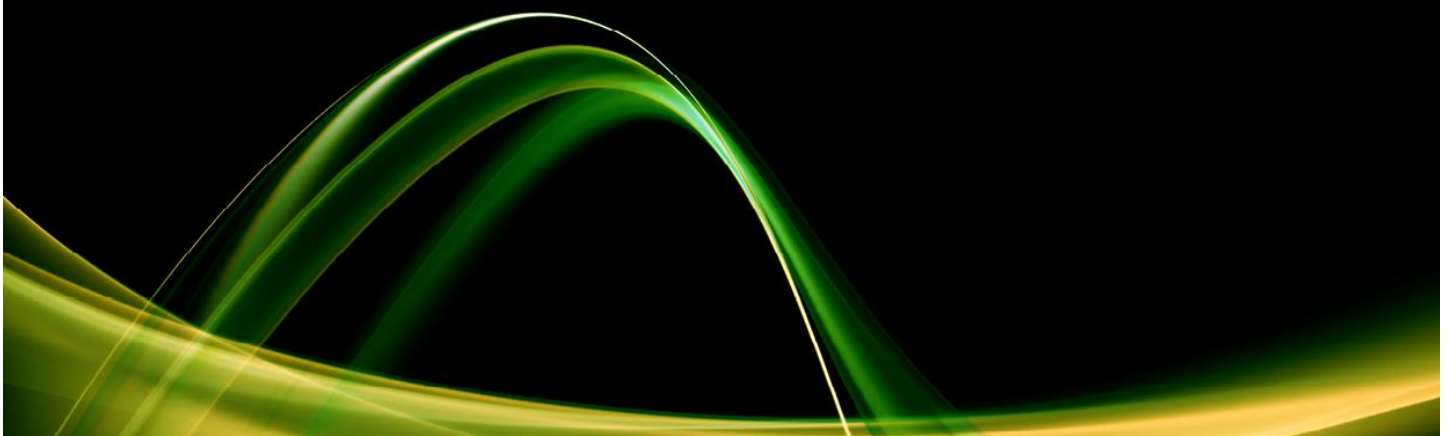




TV Producer consolidation, globalisation and vertical integration – myths and realities

A report for Pact
prepared by Oliver & Ohlbaum Associates Ltd

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Glossary

3P/4P	Triple Play / Quad Play
FTA	Free to Air
IP	Intellectual Property
PSB	Public Service Broadcaster
SVoD	Subscription Video on Demand
NQI	Non-qualifying Independent
WoCC	Window of Creative Competition

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Executive Summary

Production sector consolidation – some myths and realities

The main aim of this report is to examine and clarify some of the arguments being made about perceived issues within the UK TV programme supply market and to set out where the reality of market impact does not support the ‘myths’ gaining traction in policy discussions. This is the case across a number of areas:

	The ‘Myths’...	The realities...
1	Producer consolidation is tilting the balance of power within the UK market in favour of the independent production sector	<p>Buyer power amongst three PSB groups remains the dominant feature of the UK programme supply market</p> <p>No single independent group has been able to secure as great a share of the UK commissioning market as currently enjoyed by BBC in-house and ITV Studios</p> <p>Producer consolidation is more about benefiting from global scale and scope across genres than attempting to dominate a specific national market</p>
2	Vertical integration of global channels and/or platform groups with international production groups is a threat to the terms of supply of programme IP to UK PSB	<p>So called ‘value chain’ integration in the international pay TV sector is principally about securing lines of supply and gaining leverage in the pay TV market</p> <p>Maintaining access to FTA commissioning remains the key to the long-term value of acquired production groups, meaning they are unlikely to jeopardise these relationships</p> <p>To date, no clear trend of a squeeze on UK PSB terms of trade is evident and in some cases the loss of qualifying Indie status has led to more favourable terms to UK broadcasters (i.e. a broadcaster squeeze on producers is more likely)</p>
3	Globalisation in the ownership of the UK independent production sector is a net negative for the UK programme supply market and PSBs	<p>Inward investment in UK production companies and UK original commissions continues to be a net positive for UK PSBs</p> <p>If producer copyright ownership or other terms of trade are diluted, overseas players might be less motivated to bring co-production, presales and development finance to UK PSB commissions</p>
4	The only way for UK PSBs to respond to a more global market is to re-exert their strength in the UK market through either more in-house production or more favourable terms of trade	<p>There are significant risks that a combination of resurgent in-house production units at the BBC and ITV coupled to a two-part market in producer terms of trade, as argued for by Channel 4, could lead to a significant weakening of the UK independent production sector</p> <p>Weighed against these risks and the lack of evidence of real change in programme supply, a watching brief appears more appropriate than drastic change</p>

Television is a global market and the UK has a strong position within it

Through a combination of its strong and effective PSB ecosystem and deliberate support to stimulate the growth of a diverse and creative independent production sector, the UK has become one of the most important IP generating 'hubs' for TV programming in the \$400bn global TV market. PSBs and, increasingly, multichannel broadcasters invest in a wide range of risk taking and innovative new programmes each year that helps to underpin a reputation for invention and quality that has made UK programming globally in demand. Success always attracts attention and the characteristics of the UK market have made it a focal point for overseas investment as international groups jockey for position across many markets.

As TV goes global, consolidation activity has followed

Consolidation within the TV industry was one of the hot topics of 2014.

- Shine, Endemol and Core Media announced that they were seeking to merge, creating the world's largest independent production group
- Liberty Global caught the industry's attention by acquiring All3Media in partnership with Discovery Networks and then going on to take an opportunist stake in ITV as Sky sought an exit
- Viacom emerged as the successful bidder for Channel 5, creating an intriguing conglomerate of youth-orientated pay TV businesses and the third ranked UK commercial FTA channel group (including one of the few remaining independent ad sales houses in the market)
- Sky announced that it would be acquiring its sister operations in Germany and Italy to form Sky Europe (in the process returning capital to 21st Century Fox)

A consistent theme within this consolidation activity is the recognition of the value of content. As a result, the growing demand for content ownership, alongside the unique characteristics of the UK market, almost inevitably means that acquisition activity will alight here.

Three specific issues affecting producers

At the heart of this activity is a positioning by multi-national media groups to be better prepared for the next phase of competition in the global TV market. While the nature of this competition is often complex, a central theme has been the importance of content assets – and the producers of those assets – to all players in the TV value chain. This has led to three specific consolidation effects with the potential to impact on the programme supply market – in the UK and further afield:

- **Producer consolidation** – i.e. does the presence of larger and larger producer groups begin to alter the balance of power in the programme supply market?
- **Globalisation in the ownership of content supply** – i.e. does the fact that an increasing proportion of the production base is owned by overseas companies start to erode the strength of the UK creative sector?
- **Vertical integration** – i.e. does the folding of more production groups into large platform and / or broadcast businesses change the leverage that players have in the market?

On balance, the current wave of consolidation activity is unlikely to harm the effective operation of the UK programme supply market and could bring net benefits to the sector overall

In each of the three areas identified above, the perceived threat to the balance of the UK programme supply market is weak and in some cases is not supported by the market evidence at all. For example, producer consolidation has not resulted in an obvious increase in supplier power – in fact, absent the protections of terms of trade, once a group becomes ‘non-qualifying’ there is evidence that commissioning terms have worsened for producers, suggesting that PSB buyer power is still the dominant characteristic of the market.

Similarly, global owners of production companies have not sought to try and squeeze broadcasters on commissioning terms and in many cases are bringing their greater financial strength to the market in co-production, pre-sales and deficit finance arrangements that benefit UK PSBs. The greater financial security that comes from being part of a global group can also allow Indies to take more risks and invest in talent.

Finally, vertical integration activity outside of the PSB sector of the market is being driven by increasingly fierce pay TV competition. Here, investment is recognition of the importance of high quality original content in competition for pay TV subscribers and owners are much more likely to increase the flow of funds into UK original content than reduce it – something evidenced by the continuing growth in multichannel originations spend.

Considering some of the key points further:

- ***Producer consolidation in the market is yet to result in clear evidence that larger production groups are able to wield market power over PSB commissioning groups***
 - o Overall, the case that having larger production groups in the market leads to reduced buyer power - and consequential harm to PSBs - is not proven
 - o To date, no single combined entity has control of supply over more than 15% of UK commissioning activity
 - o Consolidation activity in the UK market has been a long-standing trend but the largest groups have found it hard to break through a combined market share of c.40%
 - o The UK programme supply market still has a highly concentrated buy-side, with the four PSB commissioning groups representing c.85% of demand in the market
 - o The market still operates on the basis of differentiated demand – i.e. each broadcaster looks for something different, making it harder for a single actor to consolidate supply or leverage a higher price from two rival buyers
 - o A side effect of consolidation activity is that many large groups have become Non Qualifying Independents (NQIs) and now no longer have recourse to the UK PSB terms of trade, further strengthening the negotiating position of the PSBs
- ***Globalisation in ownership is likely to bring investment benefits to the UK market and owners have no incentive to materially damage domestic commissioning***
 - o The impact of globalisation in ownership on the UK programme supply market is likely to be a net positive as:
 - The UK remains one of the most attractive TV production markets in the world, with a high level of investment in original programming, a high level of renewal and innovation in on-screen IP and a rights framework that allows producers to own their works
 - A significant part of the value of many acquired UK production companies is inextricably linked to their continued success in winning UK PSB commissions
 - o Recognising the strength and attractiveness of UK content, overseas players are bringing co-production and pre-sales finance to UK projects
 - o The UK’s value as a production hub for international groups is increasing, and overseas investment in leading production companies is, in part, a recognition of this

- The risks that overseas groups will try to ‘siphon off’ the returns from UK IP are low and countered by existing PSB protections
- ***Vertical integration between platforms, broadcasters and producers is a complex area and many of the plays being made are about hedging against future risks***
 - Vertical integration outcomes will be complex and many of the investments are focused on protecting pay TV assets from erosion rather than gaining leverage over PSBs
 - In the platforms part of the TV market, global players are concerned about the impact of retransmission fees, more intense competition for premium content assets and the advance of global SVoD rivals on their core businesses – having ownership over some content assets has become strategically important in this battle for pay TV revenues
 - Platform / producer vertical integration is therefore mainly about leverage within the pay TV market and defence against a growing threat from SVoD competition
 - In the broadcaster part of the TV market, PSB groups are concerned about the long-term erosion of advertising funding and the relatively weak set of diversification options that they are presented with – hence either gaining scale in production or taking a greater share of the available revenues around productions seem like ‘win-win’ strategies for ITV, the BBC and Channel 4 (where benefits can be realised either in terms of reduced primary licence fees and / or a greater share of rights income on commissioned programmes)
 - Broadcaster / producer vertical integration is more of an issue as this trend could lead to a reduction in the opportunities in the programme supply market for non-aligned players and a re-emergence of buy-side market power as a key feature of the UK TV industry
 - Broadcaster / producer integration is only likely to be a significant problem where an integrated group has a high share of market demand and supply, pointing to ITV and the BBC

Growing vertical integration within the UK market is more of threat than international alignment of content and platforms - existing protections remain crucial

The first step in assessing whether there is an emerging problem within the UK programme supply market should be to demonstrate that the existing protections are no longer working as they should.

Independent production quotas were introduced to ensure that the presence of buyer power and vertical integration in the UK market did not result in Indies being crowded out. The blanket 25% quota has remained unchanged for over ten years and applies only to ‘qualifying’ Indies – i.e. those not owned by groups with UK channels businesses. So as sector consolidation plays out, there are effectively fewer qualifying Indies left in the market and hence the protection for those Indies is likely to improve, not worsen.

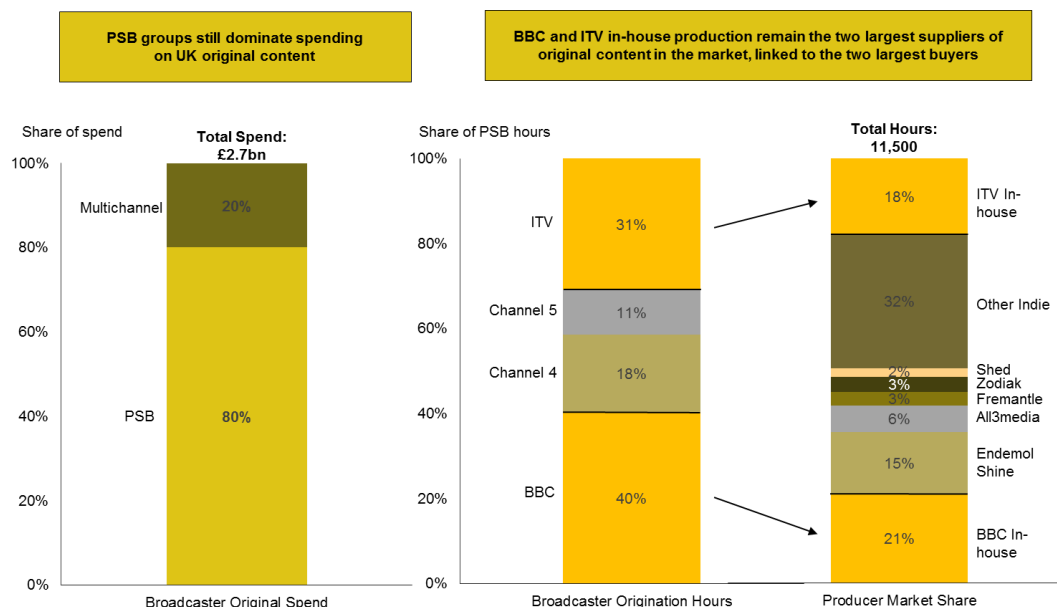
Similarly, the requirement for negotiated terms of trade has been effective in concert with Indie quotas as it has applied to the majority of the available external supplier base. This is still the case, and hence terms of trade continue to represent the starting point for the majority of external programme supply to PSB groups.

A move to create specific improved or more protective terms of trade for smaller groups risks upsetting this balance, by making the minority of suppliers in the market less attractive to broadcasters. This would in turn either lead to fewer commissions to smaller Indies, or a call for a further small Indie quota, which is likely to be ineffective in itself as it would be relatively easy for larger groups to subvert through corporate restructuring.

This leads to two clear conclusions. First, that a removal of quotas and terms of trade would be seriously detrimental to the UK independent sector and lead to resurgent vertical integration between broadcasters and producers – the closed shop that existed before 2003. Second, that creating specific differential protections for smaller Indies in a consolidating market is likely to fail and has significant potential to damage the operation of the market.

In any assessment of future regulation or policy in relation to the UK programme supply market, key facts about market structure need to be kept in mind – in particular, that the BBC and ITV remain not only the two largest single buyers of original content in the market, but also the largest suppliers of that content.

Figure 1: Spending on UK original content; PSB commissioned hours by buyer / supplier, 2013



Note: Total Spend is all network and multichannel originated spend (excluding news). Total hours is only BBC1, BBC2, ITV1, Channel 4 and Channel 5 (excluding news). Sources: BARB (Attentional), Oliver & Ohlbaum analysis

A call for change from PSBs, but not linked to any particular evidence of market failure

Of particular importance to the UK market is whether any of these trends – mainly driven by actors with significant interests outside the UK – pose a threat to the balance of trade between UK producers (both qualifying and non-qualifying independents) and the UK PSB groups who still represent over 80% of annual commissioning spending. Clearly, at least two of the PSB groups believe that there is an issue:

- The BBC is arguing that its in-house production units should be placed on a commercial footing and allowed to compete for third-party commissions against the rest of the production market
- Channel 4 is arguing that while smaller producers still need protection, larger producers should no longer benefit from terms of trade. Ultimately, this argument is expected to extend into changing the way by which rights revenues are divided between C4 and its producer suppliers, with the overarching argument that C4 should get a larger share of secondary rights income for a lower primary commissioning fee

With the BBC's proposals, it is hard to pin down exactly what change in real UK market circumstances justifies its proposed change of approach. BBC in-house production remains the largest single production entity in the UK market (the second largest being ITV Studios) and under current arrangements continues to be allowed to compete for up to 75% of the qualifying output of the BBC – the largest single source of demand for UK original content in the market.

Given well-established lines of supply from the independent sector to ITV, Channel 4 and Channel 5 it is hard to see a strong case for a more commercial, competitively orientated BBC in-house production unit building a significant share of supply to those broadcasters, and in some areas, there could be a conflict of interest with the principles of PSB (for example, how does plurality of supply suffer if the BBC is making news and current affairs programmes for ITV and C4?). BBC 'in-house' could supply some multichannel outlets with original content, but increasingly demand in this segment of the market is in areas such as US/UK drama co-production or factual entertainment formats and – critically – these are areas where the main commissioning broadcasters will want to retain IP ownership.

This leaves the most likely source of expansion for a commercial BBC ‘in-house’ production company being in providing content to overseas broadcasters in overseas markets, and in servicing a greater need for tailored original content across its growing network of BBC overseas channels, operated by BBC Worldwide. With a growing proportion of UK independent producers owned by overseas players competing with BBC Worldwide in the international channels market, the BBC might perceive a long-term threat to its content supply to those channels as UK commissioned content is exploited by the likes of Discovery Networks rather than being available to the BBC. However, the same arguments that apply to the UK market also apply here, namely that (1) many alternative forms of content supply still exist and no one player is able to service all of the demand in the market and (2) the BBC retains a strong in-house production presence and remains strong in the types of content most likely to drive an international channels strategy – drama, specialist factual, natural history, etc.

While the BBC has undoubted strengths in some genres and a very strong global brand, an overtly overseas focus would pose questions about how the balance between UK and overseas activity is being managed, and the amount of investment being made by the BBC overseas versus its returns to support new UK PSB content. This would need to be transparent and regularly reviewed to make sure that the BBC is not unduly focusing its in-house resources and talent on other markets rather than retaining the best for the UK licence fee payer.

While Channel 4’s proposals may seem less dramatic, they are more worrying in terms of their potential impact on the UK programme supply market. As Channel 4’s constitution prevents it from owning in-house production assets, its main commercial options for content supply all revolve around how it interacts with the independent production sector. Consequently, Channel 4’s proposals are focused on tilting the balance of power further in its favour versus the independent production sector – something that is likely to have adverse consequences for UK producers.

The first issue concerns the idea put forward by Channel 4 and others that large producers can ‘stand on their own’ and no longer need terms of trade protections while smaller producers may need extra protections. This misrepresents what is going on in the market at present and is likely to fail both large and small producers alike for a number of reasons, including:

- Channel 4 has already demonstrated a willingness to exert downward pressure on commissioning terms for ‘non-qualifying’ Indies – extending this non-qualification status to all larger independent groups would allow this practice to spread
- Creating differential protections for independent producers based on the size of their turnover is likely to lead to a ‘levelling down’ of available commercial terms across the whole independent sector – the threat of alternative supply can be used to drive down primary licence fee rates from larger ‘non-qualifying’ groups and the presence of this cheaper supply can be used to drive down the terms available to all other potential suppliers

An alternative that may be proposed is for the ownership of copyright on a Channel 4 commissioned programme to be split on a territorial basis, giving Channel 4 ownership of UK rights while the producing company retains overseas rights. However, given Channel 4’s historical reliance on imported formats, US acquisitions and a commissioning bias towards more creatively risky UK output, this would risk Channel 4 taking all of the available revenues from its most important secondary market (the UK) and leaving little for producers facing limited overseas sales potential.

Channel 4’s concerns about increasing supplier power are not borne out by its own commissioning behaviours at present. non-qualifying Indies have reported a greater pressure from Channel 4 on the terms offered to them, and if such power were to emerge, Channel 4’s commitment to creative risk taking should give it sufficient flexibility to viably commission from a wider pool of independent producers. Working with a broader range of suppliers in the UK is likely to be the best defence against global consolidation.

The most likely market outcome is a squeeze on independent producers, not on commissioning broadcasters

For many independent producers, the biggest short-term threat is that a reinvigorated BBC with a commercial production arm and clear profit maximising incentives would start to row back on its reliance on the independent production sector for supply, and could actively seek to grow by acquisition and through a more inward-looking set of commissioning incentives, much in the same way as ITV Studios has. Under these conditions, the gains made by independents supplying programmes to the BBC under the WoCC could be reversed as the BBC seeks to maximise its IP throughput to BBC Worldwide.

However, these types of competition have been met, and overcome, by independent producers in the past and there is nothing to suggest that – given a level playing field – they would not continue to do so. The larger threat of the two is therefore that Channel 4's arguments are allowed to drive legislative change, and a two part market for independent programme supply in the UK is created. This would give all commissioning broadcasters leverage to drive down primary licence fee rates and negotiate up rights ownership and revenue share deals in their favour. This would reduce the available revenues to UK independent producers, reducing their scope to contribute to UK original content through deficit finance and R&D activities and breaking the successful linkages between UK commissioning broadcaster budgets and independent sector success in driving exports of UK IP.

Taken together, the strategies being proposed by the PSB groups – the BBC's drive for a more commercially successful vertically integrated in-house production, and Channel 4's drive to divide up the programme supply market into different segments based on size of company – risk driving the UK programme supply market more rapidly towards the highly-consolidated and globally-influenced market conditions imagined in the BBC / C4 arguments, by reducing the opportunities for independent producers and weakening UK independent production sector revenues. By seeking to protect themselves at the expense of UK Indies, the BBC / C4 risk undermining the diversity of UK independent programme supply and – in the longer-term – harming Indies' options to resist the impact of consolidation on the market.

1 Introduction

The Scope of this report

Globalisation and consolidation are now long established trends in the TV industry. Today, national TV markets exist as part of a much wider content ecosystem driven by the opportunities for international trade in IP. As a result, major national TV markets feel much more 'open' than in the past: to overseas programme ideas, producers and broadcasters alike. To date, this has been a net benefit to the UK TV industry as UK producers have grown their operations overseas on the back of growing demand for high quality, UK-developed IP, and these overseas sales have helped to fund the contributions made to UK broadcasters via deficit finance, pre-sales agreements and co-production.

Inevitably, success brings competition, and as that competition plays out in the market, incentivising mergers between companies and attracting overseas investors to the vibrant UK TV market, some parties are starting to question whether the pendulum is starting to swing in the other direction and the UK may actually start to become a weaker market, dominated by multi-national overseas-owned players. In this paper we examine some of the arguments being made, the balance of evidence for and against those arguments and conclude that the case for current trends to be damaging to the UK TV industry is not yet made.

Our central thesis is that imposing dramatic changes to the current effective balance of demand, supply and regulation in the UK programme supply market would in themselves be higher risk than the current globalisation trends being experienced and that any interventions deemed necessary to protect the sustainability of the UK PSB sector should be clear about their underlying motivation and full potential scope of impact.

About Oliver & Ohlbaum Associates

Oliver & Ohlbaum Associates Ltd (O&O) is the leading independent adviser to the European media, sports and entertainment sectors and has advised Pact, leading UK based and international independent producers, broadcasters, regulators and investors on aspects of TV sector economics, policy and competitive strategy since 1995 – our UK TV clients have included all players across the TV supply chain from All3Media, Endemol and Fremantlemedia, to the BBC, BBC Worldwide, ITV plc and Channel 4, to BSkyB, Virgin Media and BT. We advised both Ofcom and Pact on terms of trade intervention in 2003, and the BBC on the original implementation of the WoCC back in 2006.

About Pact

Pact is the trade association representing the commercial interests of UK independent television, film, digital, children's and animation media companies. Pact supports its members with legal and business affairs advice and support, as well as a wide range of services and campaign work.

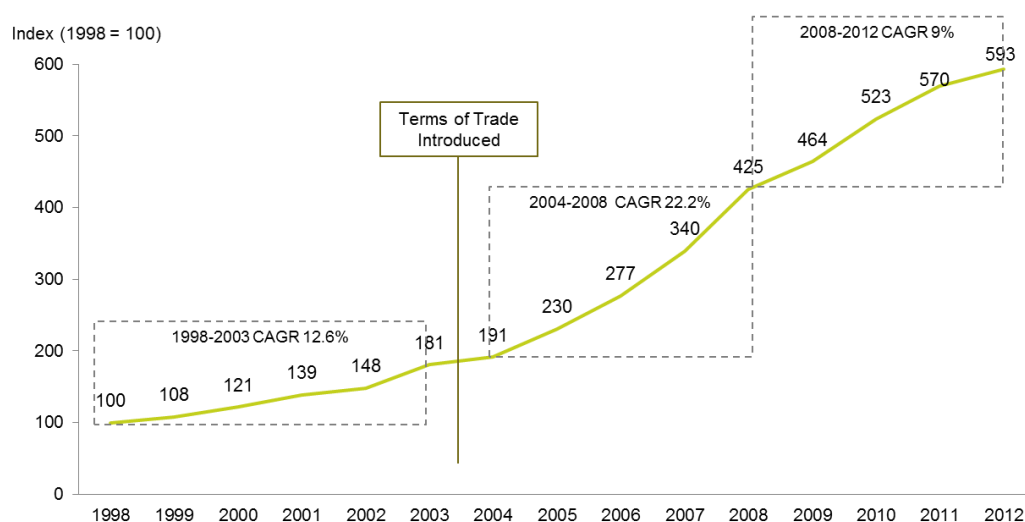
Pact helps to shape the best possible regulatory and legislative environment for the independent production sector to grow domestically and internationally – the association has a strong record of success in campaigning for producers' rights.

2 Context and recent market developments

The UK within the global content market

Over the last ten years, the UK TV market has grown to become an important part of a \$400bn global TV content industry. UK finished programmes and format IP can be found in most major TV markets around the world, testament to our diverse, risk taking and entrepreneurial domestic TV market. Alongside this success in the global trade in IP, UK content companies have flourished, selling to more customers, growing their international presence and recycling some of the profits from global trade into developing new original UK IP. This virtuous circle of strong domestic originations and growing international demand has helped the UK TV sector to become one of the UK's export success stories in recent years, a trend that still has strong momentum.

Figure 2: Income growth of UK TV exports, 1998-2012 (Index, 1998=100)



Source: BTDA / TRP / UKTI / PACT, Oliver & Ohlbaum analysis

Globalisation within the TV content industry is nothing new. The UK TV production market has long been a beneficiary of this, gaining from inward investment and overseas demand. The engine of this success remains largely unchanged and can be found in the relationship between a strong PSB sector and a diverse independent production sector. This relationship has several key components, including:

- PSB groups who still spend the majority of their budgets on new, original commissions
- A market dynamic that encourages innovation and risk taking in commissioning
- A consequently high volume of new IP trialled on screen each year
- A diverse and strong programme supply market, underpinned by a commitment to work with independent producers as well as using in-house production departments
- 'Terms of trade' protections for producers that allow them to trade on fair terms with large PSB groups and to own the IP resulting from PSB commissions – something that provides incentives to invest in UK production

Without the combination of strong commissioning PSB groups and producer terms of trade, the UK market would be significantly less attractive to independent producers and overseas investors.

Consolidation and globalisation go hand in hand

The observed trends towards consolidation and globalisation are, in practice, inseparable. The opening up of trade across national TV markets has created a need for content owners to develop global scale and scope to be able to compete effectively if they wish to own the exploitation of their IP internationally. In recent years this has been a driving force behind the expansion strategies of both broadcasters and producers. Both BBC Worldwide and ITV Studios now have significant production and distribution activities in multiple markets, and a handful of international Indie groups are following a similar model.

An important distinction here is in the difference between consolidation to gain global scale and scope versus consolidation to dominate a single commissioning market. While there are clear commercial benefits to building a global network of businesses all driven from a few IP-generating 'hub' markets, the trends over the last five years suggest that it is much harder for any single producer to dominate within a single production market. In the UK, large and international independent production groups have existed for around ten years, but no single player has yet managed to aggregate more than 15% of annual output hours, and the BBC and ITV in-house divisions still lead in terms of market share. Gaining scale in a single national TV market is both difficult to achieve and unnecessary for success. Rather, large producer groups are incentivised to focus on developing new IP in the UK that can travel and help to drive their overseas operations. The important part for the UK market is that the original focus of innovation and investment remains here.

Overseas success supports UK commissioning activity

All of the players in the UK programme supply market are in the business of selling content to overseas markets. Some have large, in-house sales and distribution arms working alongside a network of international production companies, others have trading relationships with third-party distributors and producers and some participate indirectly through partners. The common denominator is that the funds generated by overseas sales of UK content IP have become an important feature of how the UK market operates.

Revenues from overseas markets find their way back to the next iteration of UK original productions in a number of ways, for example:

- Pre-sales agreements (essentially advances on secondary distribution rights from some markets) often form part of the upfront financing of new projects
- Producer deficit finance is predicated on the money that can be made from finished programme and IP sales to other markets
- Co-production deals with overseas broadcasters allow participants to share the upfront investment in a new programme – and to have more of a say in how a production develops – thereby pooling their risk on big budget commissions

In each case, the financial contribution made is based on having access to overseas markets and is to the benefit of the UK commissioning broadcaster in helping to lower their cost of commissioning. Indies also recycle revenues by funding greater investment in R&D activity which can be hard to recoup.

How the current regulations balance out domestic market power

Prior to terms of trade being introduced, the UK programme supply market was characterised by numerous relatively small independent producers competing for commissions from one of the large PSB groups. The demand side of the market was highly concentrated and the two largest commissioners of original content (the BBC and ITV) also had large in-house production units to run. While the 25% independent production quota was in place, external producers had no power to retain the intellectual property rights associated with their works, so IP was retained by the commissioning broadcasters, and third-party production was therefore a low margin, 'work-for-hire' business to be in.

From a market power perspective, the PSB groups were dominant. Between them they represented over 90% of spend on original programming and the largest two single groups were also vertically integrated and likely to favour in-house production where practicable. This can be seen in the squeeze on the independent production sector that the BBC was able to execute between 1998 and 2001.

these investments have been predominantly about securing a production position in the UK market and about buying into strong creative talent and IP vehicles.

iii. Vertical integration

Overlapping with the globalisation trend has been an increasing interest in vertical integration, both from platform owners and channel operators. This area of competition can be split into two sub-segments:

- Platform / producer vertical integration

This is an evolving area of competition with different platform providers – often with a distribution presence in many countries – looking to acquire content producers. While there might be very few synergies in such deals between a platform's channel portfolio and the acquired producer's content, these deals should probably be seen as a hedge against other strategic threats, including FTA broadcasters seeking retransmission fees and new SVoD services taking customers away from traditional platforms. In both cases, having the potential to deny some content supply to rivals could be useful at a future point.

- Broadcaster / producer vertical integration

While platform operators such as LG and Sky investing in content producers has made the headlines, broadcaster vertical integration with producers has continued to happen, for example at ITV Studios (where the acquisition of independent producers in the UK, USA and Nordics continues) and at multichannel players such as Sony and Discovery. Add to this Channel 4's recently announced Growth Fund for small Indie investments and the BBC's plans to move its in-house production units onto a more competitive footing, and it can be seen that this remains a key focus for FTA broadcasters keen to secure their pipelines of IP and diversify revenues away from advertising revenue or a hard to grow licence fee settlement.

The BBC and Channel 4 have responded by setting out an agenda for regulatory change

To date, the BBC and Channel 4 have been the most vocal in setting out the argument that there is a threat from sector consolidation and globalisation of ownership to the sustainability of the UK PSB ecosystem and the programme supply market that helps to drive it. Via different arguments, their position is that remedies are required to help them play a role – to varying degrees – in protecting the UK TV content market from the worst excesses of international consolidation and overseas control.

In July 2014, the BBC introduced its desire to see its in-house production arm freed to compete for third-party commissions in the UK and overseas in return for the abolition of the WOCC (the current mechanism by which BBC in-house obtains a 50% minimum guarantee on BBC output and a further 25% is open for 'creative competition' between in-house and the independent sector). Subsequently, the BBC Trust published its consultation document in January 2015 and is currently seeking feedback on a draft set of principles by which the BBC would seek to operate in a future content supply market subject to greater competitive pressures driven by consolidation. This includes provisions to:

- Open up all BBC commissioning to creative competition
- Give BBC commissioners greater latitude to take into account opportunities to secure external funding (e.g. co-production partners) and other commercial income
- Using a wide range and diversity of supply, including sustaining network production capabilities in Scotland, Wales, Northern Ireland and the English regions
- Ensure that any changes in how the market operates can continue to provide the BBC with access to the necessary capacity, skills and talent in a sustainable way and with access to significant infrastructure investment as needed
- Ensure that any new arrangements in how rights revenues are shared between external producers and the BBC allows the BBC to retain a 'fair share' of the commercial value realised outside of the public service window

- Maintain an appropriate level of separation between publicly funded BBC activities and its commercial services, including compliance with the BBC's fair trading policies, state aid regulations and an as yet unspecified BBC Trust commercial framework

The BBC's argument to policy makers is that, given a better deal on the value of the content that it commissions from third parties and the freedom to be a competitor in the global programme supply market, the BBC can itself be better sustained and in doing so can better protect the UK programme supply market from a US-led squeeze on rights, revenues and creativity. Alongside this, Channel 4's arguments have been more about ensuring that there is scope within the regulatory framework for more favourable terms of trade and specific protections for smaller players in the market.

If there was a shift in the balance of power away from UK PSB, what might we expect to observe?

All of this begs the question: Is consolidation activity at a global level likely to be a net negative or positive for the UK programme supply market, and in particular, for the continued ability of PSBs to invest in UK original content? If there is an imbalance in the market, what would we expect to see as an indicator of things worsening?

The first impact that we might expect to see would be a combination of price increases and rights withholding from UK PSBs as global rights owner seek to push up prices and drive harder bargains for access to their IP. To date we have seen little evidence that this has been the case.

The second impact might be some 'siphoning off' of UK originated IP by global production groups, but for this to be any different than current practices (i.e. giving UK original commissions to international production groups) the levels of 3rd party production finance in the UK market would need to be falling, and this is not currently the trend.

The third impact would be a defensive one, with UK commissioning broadcasters looking for new partners for the supply of important new programmes. This is one of the key strengths that broadcasters still have in that, in a globalised market, they can always find another partner or producer to take on a project. As a result, any attempt to exercise a 'consolidation squeeze' on UK PSBs by key suppliers is likely to result in supplier churn in key genre and output. Again, this does not currently seem to be the case.

Overall, consolidation activity is changing the arrangement of pieces on the chessboard of the global TV market, but is yet to result in a concrete change to how the game is being played. Players appear to be hedging their positions across markets rather than changing the balance of power in any single market. Commissioning broadcasters still have significant strengths in their 'home' markets and as long as plurality of supply is maintained (i.e. there is someone else to go to for new output) this is likely to remain the case.

3 What changes are being proposed and what are the risks?

The most vocal parties in seeking a change to the status quo within the UK programme supply market have been the BBC and Channel 4. Their respective positions and the related issues are set out in the section.

What is the BBC arguing for in terms of responding to market changes?

Given its greater scale and scope of operations, understandably the BBC's response to the perceived and actual market changes goes further. Essentially, the BBC is arguing a policy position that its scale and global reputation make it best-placed to carry the torch for the UK TV industry in the face of overseas owned global players encroaching on the UK market. The quid pro quo for this role is that the BBC is allowed to move its in-house production resources onto a level, commercially competitive footing with the rest of the market and make for other commissioners. At the same time, the BBC would like to abolish the WoCC, identifying that this mechanism has served its purpose and is now equally likely to limit producer choice as to enable it.

The BBC's proposals raise a number of issues for the independent production sector. In particular, concerns are manifested in three main areas:

1. Whether the removal of the WoCC will actually result in greater or fewer opportunities for independent producers
 - a. The BBC has been losing market share under the WoCC for years, something a more commercially minded subsidiary would seek to redress
 - b. The BBC has an opportunity to leverage its retention of long-running strands and dominant position as a producer of key PSB genre output to grow aggressively in other areas of third-party commissioning – hence it will be motivated to retain a significant share of in-house activity for itself
2. With key PSB production specialisms and financial scale, the BBC would have the opportunity to aggressively pursue third-party business to the detriment of smaller, independent specialists
 - a. The BBC's commercial funding rationale for BBC Worldwide would cause it to pursue expansion opportunities in the third-party commissioning market. While competition as a peer is acceptable, the BBC could have market power in some areas
 - b. Similarly to ITV Studio's strategy, the BBC could also grow through acquisition, furthering the issues around vertical integration in the PSB segment of the programme supply market
3. Overall, the opening up of BBC Production and commissioning activities has the potential to introduce many conflicts of interest and to reinvigorate the BBC's market power in the programme supply market
 - a. Basic Indie sector protections – quotas, terms of trade – are still required to protect against a growing, vertically integrated BBC and ITV
 - b. There remains an unresolved question around who will adjudicate and make sure that the BBC conducts a 'fair fight' for commissions?

What is Channel 4 arguing for in terms of responding to market changes?

In his MacTaggart speech in August 2014, David Abrahams argued that vertical integration, producer consolidation and the rising influence of US investors in the UK TV content market required two specific responses:

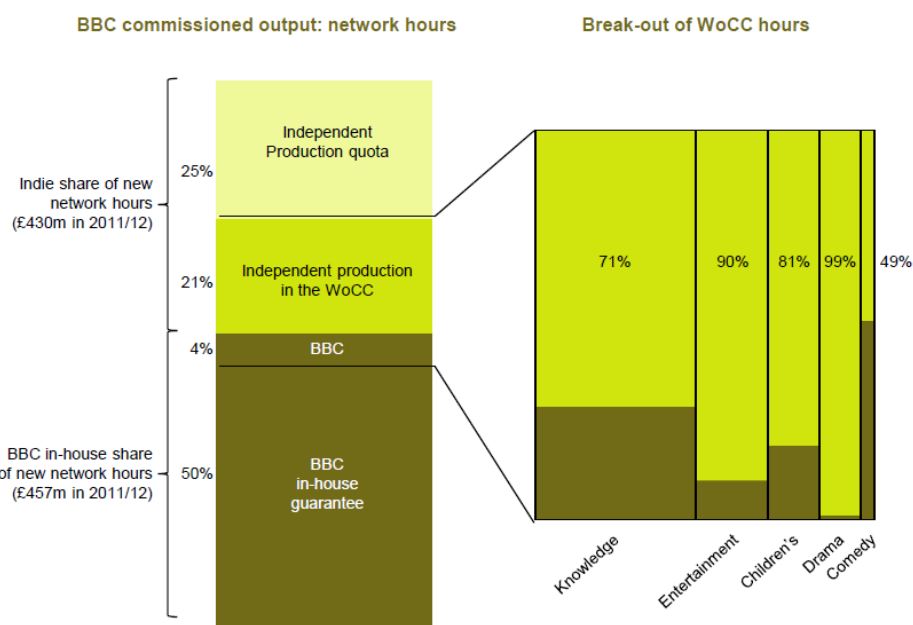
- An improved terms of trade, with the implication that Channel 4 should get a better revenue share on rights revenues or enjoy lower commissioning costs, and;
- That smaller companies would need to be given specific and potentially enhanced protections to stop them from being squeezed out of the market by larger rivals.

Following this discussion, it is anticipated that Channel 4 will lobby for a variety of potential changes to the way in which terms of trade works, potentially including the removal or dilution of terms of trade protections for larger production groups and a territorial split on copyright ownership (or other mechanism) that would give it greater access to secondary and ancillary revenues from commissioned works. Such changes would represent a substantial redrawing of producer terms of trade in the UK market and have the potential to not only alter the basis of competition but also to limit the overall opportunity for independent production groups.

3.1 A commercially driven BBC in-house will be strongly motivated to correct for its loss of market share under then WoCC

On paper, the removal of the minimum in-house and Indie sector guarantees as well as the WoCC means that all BBC commissions are up for grabs from all parties (subject to the 25 per cent Indie quota). Therefore, not only can Indies increase their share of BBC commissions but BBC Productions can also increase the amount of content they produce. The BBC Trust’s review in March 2013 suggested that overall by March 2012, external producers had done disproportionately well in securing their supply of the WoCC. Overall, external producers were gaining 21 percentage points of output of the total 25 percentage points available i.e. over 80 per cent of the open market by the end of 2011/12. The success across genres is varied, with independent producers winning 99 per cent of drama commissions available (Figure 12).

Figure 4: Proportion of BBC commissioned network hours under the WoCC, 2011 to 2012



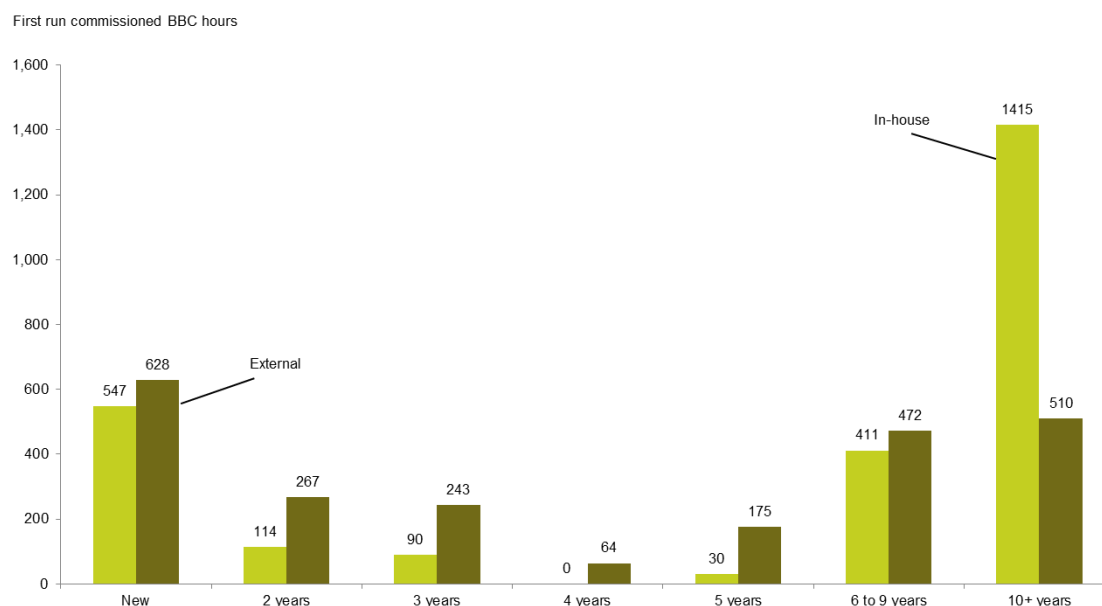
Source: BBC Trust Third WoCC Review: March 2013. BBC Annual Report 2012/2013

The problem with this situation isn't whether BBC in-house can effectively compete with the independent sector for BBC commissions. The trends in market share under the WoCC demonstrate that - all other things being equal – the independent sector can win business competing against the BBC's own production teams. The issue is whether, with a stronger commercial motivation running through the Corporation to retain rights and support BBC Worldwide's profitability (and hence the dividend back to BBC Public Service divisions), commissioners would be more minded to favour in-house supply.

The BBC's retention of long-running strands gives it a competitive advantage over other independent suppliers

Within the BBC's current in-house output there is a large proportion tied up with delivering long running BBC strands. On BBC1 in 2013, only 17 per cent of strands were new (i.e. first run) with the remaining 83 per cent returning strands. This was slightly better on BBC2 with 27 per cent new and 73 per cent returning. By comparison, Channel 4 had the highest percentage of new strands at 29 per cent while ITV had the lowest with only 11 per cent new strands. With the exception of Channel 4, these ratios have decreased since 2008, although Channel 4's ratio has decreased from its peak in 2010 of 37 per cent (Figure 18). Given the small proportion of new strands in any one year up for genuine "open pitch" competition, and the proportion of long-term schedule bankers underpinning the BBC in-house output, it is uncertain to what extent a genuine competition for new commissions exists now in the WoCC.

Figure 5: First run BBC in-house and external commissioned hours by age of title, all day, 2013



Source: BARB, Attentional Limited, Oliver & Ohlbaum analysis

These in-house strands make up the majority of BBC's in-house 50 per cent quota and if the BBC doesn't tender these out for competition to the Indie sector then there is little further market share it can lose. An 'independent' BBC Productions would be able to leverage the financial strength conferred by the stability and scale of its long running strands and use this as a competitive tool in the wider market. Using this strength to buy market share in both the BBC internal and wider external market is therefore a risk to the current balance of supply and demand.

The BBC could also grow through acquisition, furthering the issues around vertical integration

BBC Productions, either owned by BBC Worldwide or a third party company, would have every incentive to grow. While some growth is likely to be organic - for example, through winning third-party commissions and potentially transferring these skills into winning a greater share of in-house commissions - it could also come through acquisition activity.

In the previous section we discussed concerns about further vertical integration between PSBs and producers. The BBC remains both the largest commissioner and producer of programmes within the UK programme supply market (with ITV a close second). Should the BBC be allowed to aggressively expand its production activities, the results would see the independent sector squeezed further – in a flat market, one producer's gain is likely to be another's loss.

Under the WoCC, independent reviews of the BBC's commissioning system have shown that in-house production enjoys a closer relationship to in-house commissioners and channel controllers than independent production groups. With a broadcaster having a greater commercial incentive to commission from in-house (or its subsidiary companies) and no major competitive constraints, there is no reason to believe that this close relationship would not be exploited by the BBC to the detriment of 3rd party producers.

3.2 The BBC's concerns around being 'crowded out' of international B2C markets are probably overstated

One of the main growth strategies of BBC Worldwide in recent years has been through an expanding global channels business, operating BBC branded channels in overseas territories. The BBC has also experimented with the idea of rolling out its iPlayer technology as a global VoD player, potentially offering subscription access to BBC original content in international markets. Both of these business models ride on the back of UK generated programme IP, either produced and owned by the BBC in-house or licensed from independent production partners.

As some of the independent production groups operating in the UK market become more vertically integrated with global parents, the BBC may have some concerns about whether it will continue to have access to the same range and breadth of independent content for its global B2C businesses as has historically been the case. This concern is most likely to emerge where leading suppliers to the BBC are acquired by companies with rival global channel operations such as Discovery Networks International, offering the potential that some BBC commissions are not available to BBC Worldwide channels as the IP is retained for Discovery to exploit globally.

In reality, this threat to the rights pipeline is probably overstated. As currently constituted, the BBC still sources a greater share of supply from its in-house operations than it has reliance on any single external production group and its key in-house strengths – Drama, Specialist Factual, Natural History – remain highly valuable to its overseas channel businesses. There also remain many alternative suppliers for BBC commissions who would undoubtedly be amenable to rights sharing with BBC Worldwide channels and B2C VoD services at a competitive market rate.

Finally, the issues of co-dependence between large production companies and the main commissioning PSBs would still remain. This means that a company like All3Media or Shine / Endemol would still need to secure access to BBC, ITV or Channel 4 commissioning to remain at scale in the UK market and this, in turn, is likely to ensure that the commissioning broadcasters retain significant negotiating power in a consolidating programme supply market.

3.3 Overall, the BBC's proposals contain the potential to introduce many more conflicts of interest and to reinvigorate the BBC's market power in the programme supply market

With the BBC being not only the most important commissioner of programmes but also the largest producer of content there is a potential conflict of interest. The BBC would have significant financial interest and capital investment tied up with the success of its own production house commercially. ITV has been in a similar situation to the one that the BBC is arguing for over the past five years and the results on its strategy are clear. Getting bigger in production is a key plank of how they both hope to secure their future.

The independent production sector has always been open to competition – it is one of the principles by which it has always operated. But previous experience has demonstrated that left unchecked, the main PSB producer-broadcaster groups will always move to favour and grow their in-house production units at the expense of external suppliers. Ultimately, this leads to a reduction in the plurality of supply, a fall in the diversity of creative ideas and a weakening of the competitive intensity and focus that has helped to drive the UK programme supply market and the players within it over the last ten years. In setting out their response strategies for sector consolidation, the risk is that the UK PSB groups end up acting against the long-term interests of the market and accelerating the pressure on smaller independent producers.

Basic Indie sector protections – quotas, terms of trade – are still required to protect against a growing, vertically integrated BBC and ITV

The existing regulatory framework was set up, in part, to combat vertical integration within the PSB groups. Quotas were introduced first as a mechanism to force the use of independent producers for some programme supply. However, quotas in themselves were insufficient to enable the independent sector to grow and fund innovation. Only following the introduction of terms of trade following the Communications Act 2003 did the independent sector gain the opportunity to grow based on recycling the value of their own works via IP ownership and a regulatory mechanism that halted the worst excesses of buyer power in the market.

This remains substantially the case today. Buyers are as powerful in the market as they were pre-2003 – in some cases arguably more so given their efforts to rebuild in-house production (e.g. ITV). Overall the case for major regulatory change doesn't stack up on current evidence and in the first instance the flexibilities included in the current mechanisms (i.e. negotiation within terms of trade) should be allowed a chance to respond to changing market conditions.

Who will ensure that the BBC conducts a 'fair fight' in commissioning?

The WoCC system allowed independent producers to challenge for up to 50 per cent of BBC commissions while the BBC was not permitted to work with other broadcasters. The BBC's plans could be a win-win for itself as it will allow it to make programmes for all other broadcasters which could further enhance its own in-house operations and increase its own market share. With so much of BBC's in-house content tied up in long running strands, if these were not tendered, there seems little potential upside for independent producers and a significant set of downside risks.

Therefore, there remains a question as to how these new market conditions could be managed to ensure that the BBC does not exploit its market position and independent producers are not squeezed out. Ultimately, if the BBC plans were granted, an independent role is likely to be required to ensure that all future BBC commissioning decisions are fair and made based on transparent and auditable criteria.

3.4 Channel 4's proposals have the potential to undermine the opportunity for UK independent producers

While the BBC's proposals need careful consideration, if openly and transparently implemented they do not threaten to significantly alter the balance of buyer and supplier power in the market. By contrast, Channel 4's proposals threaten to undermine the opportunity for their suppliers in two key ways:

The removal of terms of trade protections for all independent producers over a certain size of turnover would create a two-part market and enable more 'divide and rule' behaviour

A cornerstone of UK terms of trade is that it applies equally to all UK independent producers. While the number of NQI production companies in the market has increased over time, the acquiring groups have all made their own assessment of the risks of non-qualifying status and likely concluded that the impact would not be significant. However, Channel 4's idea that the market should be divided in two and that only smaller production groups should enjoy a full range of protections risks changing the trading dynamics in the sector to the detriment of all external producers.

At the heart of this is how a two part market could be exploited by commissioning broadcasters to drive down the cost of primary licences and drive up the available rights income from commissioned content. Where large and small producers have the opportunity to compete for the same commission, this could result in a 'levelling down' of available revenues to the long-term detriment of the independent sector (both qualifying and non-qualifying) and to the incentives that have continued to underpin independent sector investment in UK original commissions.

Differential regulation based on company size could lead to a 'levelling down' of terms for all independent producers and would be a barrier to growth

Having been bought by groups who also have UK channel operations, many large Indie groups already fall outside of the qualifying criteria for PSB terms of trade and therefore stand on their own in commercial negotiations with broadcasters. This means that the 'qualifying' Indie sector of the market is increasingly made up of a mixture of a few mid-sized companies and a wide variety of smaller Indies.

The problem with introducing differential protections for small Indies is that it acts against the incentives at work in competition for programme supply contracts. For example, in a future market with specific small Indie protections we might find a situation where:

- Around half of the external market demand is met by non-qualifying Indies, typically companies that are part of large, multinational groups (and hence able to withstand aggressive PSB negotiation on commissioning terms)
- The remainder of the external market demand is met by a mixture of small and medium sized Indies, increasingly competing with broadcaster in-house units for new commissions

For any new commission with significant international potential, the non-qualifying producers would be incentivised to bring additional production finance to the project in order to win the work. Outside of greater access to international formats, this would be a key source of leverage for large, consolidated non-qualifying groups.

Under current market conditions, other bidders would be forced to try and match these terms, lowering the effective cost of the primary licence to the commissioning broadcaster. As a result, introducing a more favourable terms of trade for smaller Indies would be unlikely to yield much opportunity to win work without being prepared to match – or come close to – the terms on offer elsewhere in the market. This inevitably leads to the conclusion that small Indie enhanced terms of trade would only work in conjunction with a specific small Indie quota (but even then the market forces at work are likely to mean that small Indies would be limited in the genres that they are able to compete for).

This would, in turn, create a problem for the ‘squeezed middle’ of the UK independent production sector. Regulators would effectively have to choose at what scale of operations a producer should be expected to be able to compete on equal terms with large consolidated non-qualifying groups. This could lead to the mid-sized Indies being the segment of the market that loses out most dramatically to any resurgence of in-house supply operations, as under the BBC’s current proposals.

Sharing copyright ownership by territory would undermine producer income and incentives

One further idea that might be explored by Channel 4 is whether the ownership of the copyright from commissioned works should be split differently between producer and commissioning broadcaster. At present, producers and broadcasters share revenues from commissioned works but the copyright ownership resides with the producer. Introducing an ownership split (for example where the broadcaster would retain UK rights and the producer overseas rights) is likely to introduce a new, complex set of incentives that might not be revenue maximising and are, again, likely to reduce the revenue opportunity for independent producers.

This risk would be particularly acute if a UK / overseas split were to be applied to Channel 4’s commissioning activities. Given its UK-focused, risk taking and experimental output, Channel 4’s secondary rights income on UK original series is likely to be heavily skewed towards the UK market – only a few Channel 4 original titles have travelled internationally and secured a regular place on overseas networks. As a result, the loss of UK copyright ownership to Channel 4 would significantly undermine the rights revenue opportunity on Channel 4 commissions for UK independent producers and could lead to a reduced willingness from producers to invest in new Channel 4 shows.

Taken together, Channel 4’s proposals are likely to substantially weaken revenues to the UK independent sector and its relationship with key producers

As a structural rather than purely competitive change, Channel 4’s proposals threaten to undermine the balance of the UK programme supply market. While this could be to Channel 4’s advantage in the short term, in the longer term a move to weaken its supplier base and worsen the available terms of trade for independent production groups (either directly through watering down protections or indirectly by allowing for greater ‘levelling down’ negotiation in the commissioning process) is likely to damage the group’s access to the best talent and the most innovative new programme ideas.

Channel 4’s relationship with the independent production sector is key to its continued success. Its unique status as a publisher-broadcaster increases the importance of this relationship. However, the current proposals being set out risk handing much more buyer power to Channel 4 in its negotiations with the independent sector and undermining the levels of investment that producers can bring to R&D around the new, innovative and risk taking IP that Channel 4 has made its key differentiator in the market. Any change to terms of trade creating a two-part market for producers and splitting copyright ownership by different types of rights or by territory is likely to introduce a new and potentially value destructive set of incentives into the market with real risks for long-term sector investment.

3.5 A watching brief on the sector would be better than premature intervention

Since the current regulatory framework was introduced, the independent production sector has grown into a £3bn industry. With the independent production sector continuing to be a source of growth, by over 25 per cent since 2011,¹ the evidence suggests that the current regulatory framework around the PSB commissioning market has been – and continues to be – highly effective in promoting market outcomes that deliver an increase in diversity of supply (both by genre and geographical location) and protect independent producers against the risks of a ‘vertical integration squeeze’ from large producer-broadcasters.

Consolidation activity has not yet produced a clear, tangible threat to the UK PSB sector or the functioning of the wider programme supply market. By contrast, the feedback from some non-qualifying independent producers has been that commissioning terms have worsened, supporting the thesis that where there is an opportunity for greater negotiating leverage, some commissioning broadcasters will take it. In a situation where there are risks but no emerging evidence, the prudent course of action would be to define a watching brief to ensure that the functioning of the UK programme supply market is not compromised at some future point. This watching brief could include:

- Whether the rate of cost inflation in key areas of PSB content supply from third party producers increases in the next few years
- Whether resurgent buyer power at the vertically integrated PSB producer-broadcasters manifests itself as a falling Indie share of supply and / or lower cost per hour productions
- Whether pay platforms and / or channel groups start to exhibit withholding or aggressive pricing behaviours to PSB groups in rights deals

Alongside this watching brief, the BBC’s plans and actions to respond to the threat of international consolidation effects contain their own risks and need to be carefully scrutinised. In particular, the framework by which future BBC commissioning decisions are made concerning in-house versus external supply will need to be scrupulously fair and transparent to avoid a return to the anti-competitive effects of vertical integration seen in the era before terms of trade.

If terms of trade was removed there is a strong likelihood the market would return to the low margin, low investment, low growth sector it once was

Terms of trade, producer margins, investment and sector growth are all inter-related. By giving independent producers ownership of the copyright to their works, the current regulatory framework incentivises producers to invest in UK programming on the understanding that they can then use the resulting IP to drive export revenues by selling packages of rights into overseas TV markets. The working of these incentives can be seen in the industry trends over the last ten years – producer profits remain low by international standards while exports continue to grow and investment remains stable.

To remove – or significantly alter – producer terms of trade would be to alter the balance of incentives that has underpinned strong sector growth over the last ten years. With independent production sector net margins already as low as 5.3% on average² a reduction in rights income would need to be balanced by a reduction in investment. In a market where investment in original programming by PSB groups is in real terms decline, such a move is therefore unlikely to bring any ‘new money’ into the programme supply ecosystem and more likely to drive more UK creative talent to look towards other, higher margin markets overseas.

¹ Pact Census, 2014

² Pact Census, 2014

This illustrates the point that the PSBs actions and arguments for change in the UK programme supply market risk becoming a self-fulfilling prophecy. If broadcasters respond to revenue pressures by seeking to hoard a greater share of the value in the programmes that they commission (either directly or indirectly) then the incentives for UK independent producers will be reduced. With a weaker path to returns and no long-term ownership of copyright, external investment in the UK independent sector would also suffer, leading to a more risk averse and less well capitalised sector overall.

Having strong lines of independent supply– creatively and financially – is an intrinsic part of the success of the UK's PSB ecosystem. However, both the BBC and Channel 4's proposals for the programme supply market contain elements that could undermine those lines of supply by altering the balance of competition and, potentially, the long-term ownership of copyright in the market. Either – or a combination – of these outcomes would be to the detriment to the PSB ecosystem as a whole, undermining long-term plurality of supply and the continued economic contribution of the independent production sector. Both of these are factors that should be helping to sustain UK PSB in the face of increasing global competition but which could be substantially harmed by the current proposals being made.

4 Some facts about the balance of power in the UK programme supply market

Before looking at the specific concerns around how globalisation and vertical integration might impact on the UK programmes supply market, it is worth pausing to review the enduring structural characteristics of that market and whether producer consolidation might start to tilt the balance of power to the detriment of commissioning broadcasters or smaller independent production groups.

Traditionally, the UK programme supply market has been led by a few large, vertically integrated producer-broadcaster groups (the BBC and ITV) alongside a large FTA publisher-broadcaster (Channel 4) and a growing multichannel sector. Within this mix, Channel 5 has always been a relatively small player in terms of its annual spend on UK original content. Against this relatively consolidated buy-side of the programme supply market, the independent production sector has been highly fragmented and populated by a wide range and diversity of companies.

In assessing whether this balance of market power is altered by recent trends, some key points to consider include:

1. The balance of power in the UK programme supply market is still very much in favour of commissioning broadcasters for the majority of output
 - a. PSB commissioning is still the majority of original content spend in the market, and in some genres, represents almost the entire available market
 - b. Multichannel spend is important, but will remain small relative to the PSBs and tends to be concentrated in a small number of genres
 - c. SVoD growth is unlikely to impact on this spending pattern as it is mainly US focused and is largely concentrated on the secondary rights market
2. Plurality of supply in most genres remains strong
 - a. There are still many more producers than commissioning broadcasters
 - b. Differentiated demand has led producers to specialise, but many can nevertheless compete for each commission
 - c. Consolidated production-companies still retain their in-house creative teams and will compete with one another for commissions
 - d. First look deals have not traditionally been a feature of the market, so supply is not tied to specific broadcasters
 - e. The area most closed to new competition is in the supply of global entertainment formats, but this is nothing new
3. The latest wave of consolidation does not represent an immediate threat to small Indies:
 - a. An increasing number of non-qualifying Indies (i.e. those bought by parents with UK broadcast operations) creates more room for those remaining qualifying Indies
 - b. The competitive focus of smaller Indies is often different from large consolidated groups
 - c. Small Indies often have a unique selling point which remains unaffected by larger consolidation

In this section, we take a closer look at these factors.

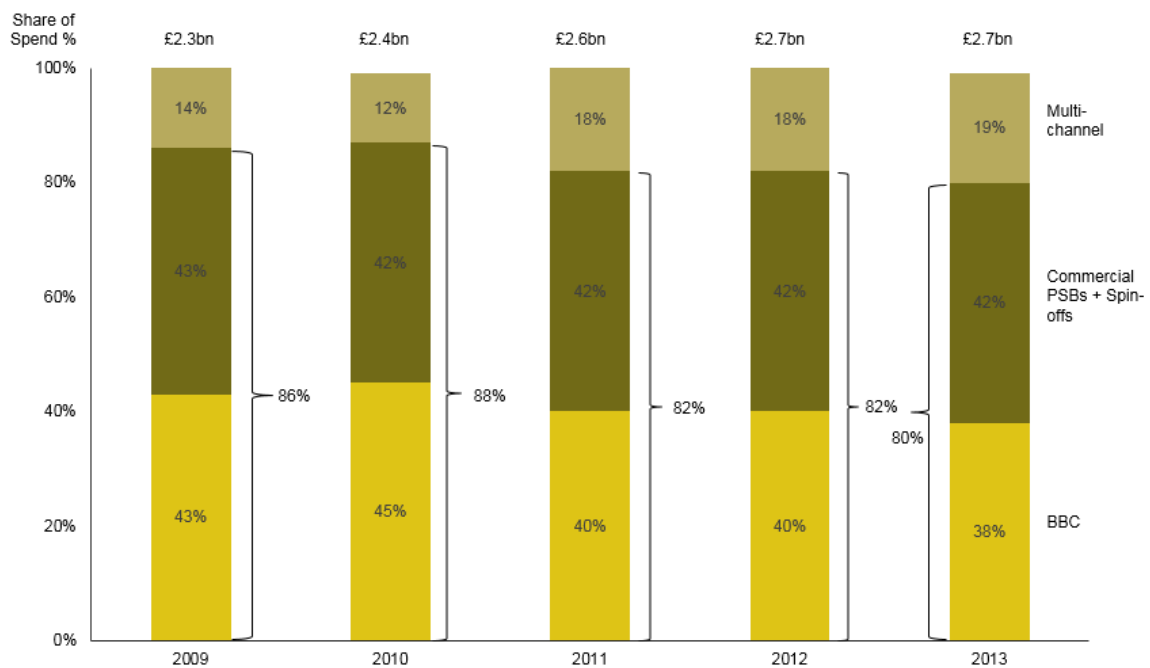
4.1 The balance of power in the UK programme supply market is still very much in favour of commissioning broadcasters for the majority of output

When we refer to the ‘balance of power’ in the UK programme supply market we still mainly refer to the relationship between the commissioning UK PSB groups and the external – mainly independent – suppliers of programmes to those groups. This basic trading dynamic has changed little over the last ten years, with the majority of commissioning spend coming from PSB groups. Consolidation on the supply side of the market is yet to alter this situation, and as long as the independent supplier base overall remains diverse and numerous, concentration on the buy-side of the market will continue to be the dominant factor.

PSB commissioning remains c.80% of the total spend on non-news UK original output

In 2013, the four PSB networks represented 80 per cent of annual commissioning spend (Figure 2). While this share of spend has been declining slowly – by an average of 3.8% year on year since 2008 – as multichannel commissioning has grown, the market structure for commissioning remains largely unchanged.³

Figure 6: Total UK commissioning spend (excluding news), 2009-2013



Note: Public Service Broadcaster regional spend excluded
 Source: OFCOM PSB Review 2014, COBA, Oliver & Ohlbaum analysis

³ OFCOM PSB Review 2014 and COBA

Multichannel spending on UK original content is an important source of growth, but this growth is likely to slow in the face of competing priorities

Multichannel spending on original content has been one of the main drivers of growth in the UK commissioning market over the past few years. Sky and a few other leading channels groups have sought to add high profile original content to their schedules as a way to differentiate their channels and build a stock of IP that can be leveraged by overseas operations or monetised via distribution activities. Within this segment of the UK programme supply market, Sky is the most significant player having invested to build an in-house production capability and having made a few targeted acquisitions in the production sector (e.g. Love Productions, maker of *The Great British Bake Off* and *Benefits Street*).

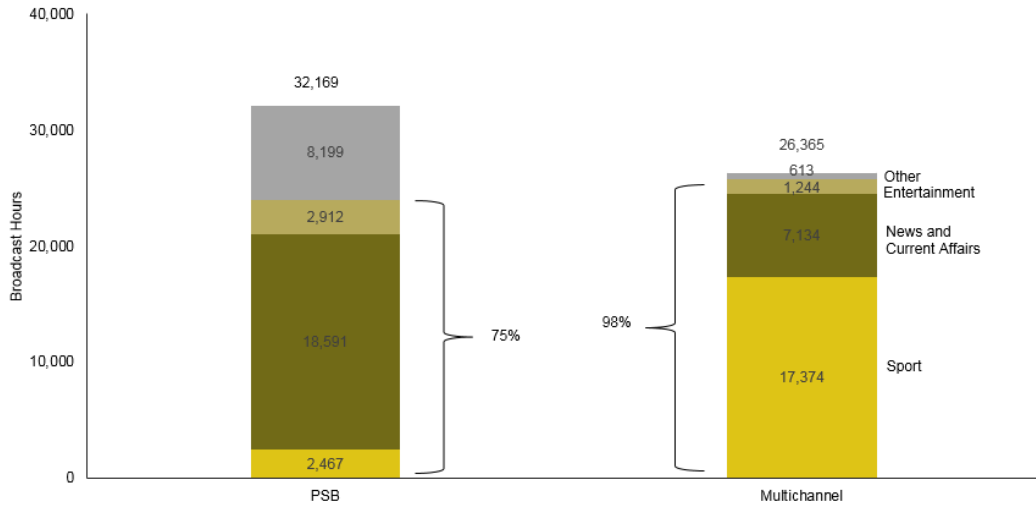
The growth to UK commissioning spend provided by multichannel commissioning is a welcome addition to the UK programme supply market at a time when PSBs are under increasing financial pressure. However, future growth in spending from this segment of the market is expected to slow as:

- The business model of most operators in the UK channels market cannot sustain a large shift into original content – a mix of a few original titles alongside acquired content is more likely
- For international channel groups, UK original content is effective in driving audience interest in other markets, but will for the most part need to exist alongside US original content from the same groups – as a result, overall demand will be limited
- For integrated pay platform and channel operators (e.g. Sky), the competitive set includes UK channel operators but also global SVoD players and US studios – in this mix, original content investment outside of sport is likely to be focused on US and European co-productions more than specific commissions for the UK market only
- Inflation in other key content rights is an important factor in overall spending and hence the ability to spend on UK original content is limited by growth in the cost of other ‘must have’ assets (e.g. leading US acquisitions in a first pay window plus leading sports rights)

As a result, future growth beyond the next 2-3 years might be limited. It is also worth remembering that terms of trade only apply to PSB commissioning and hence incremental demand from the multichannel sector does not have the same value to producers in the revenue share arrangements available and ability to retain ownership of IP in the long-term.

A further factor to be considered when looking at the impact of multichannel commissioning on the UK market is that spend remains concentrated in only a relatively small number of genres – News, Sport and Entertainment. In 2013, of the 26,365 hours of UK originated content broadcast on multichannel TV only 2 per cent came from outside of these three genres. By contrast, PSB original output hours were spread across many more genres with 25 per cent of the original broadcast hours coming from genres such as Drama, Factual, Arts and Children’s (Figure 5).

Figure 7: Broadcast hours of UK commissioned programmes across PSB and multichannel, 2013



Note: Figures include PSB services: BBC One, BBC Two, BBC Three, BBC Four, CBBC, CBeebies, BBC News, BBC Parliament, ITV, ITV Breakfast, Channel 4 and Channel 5. The analysis does not include S4C, BBC Alba or BBC HD. Figures exclude nations/regions programming. Output hours are based on slot times. Multichannel data consists of returns from Sky, Viacom, UKTV, BT, Discovery, AETN, Turner, Disney, CSC and Baby TV. Output hours are based on running time.

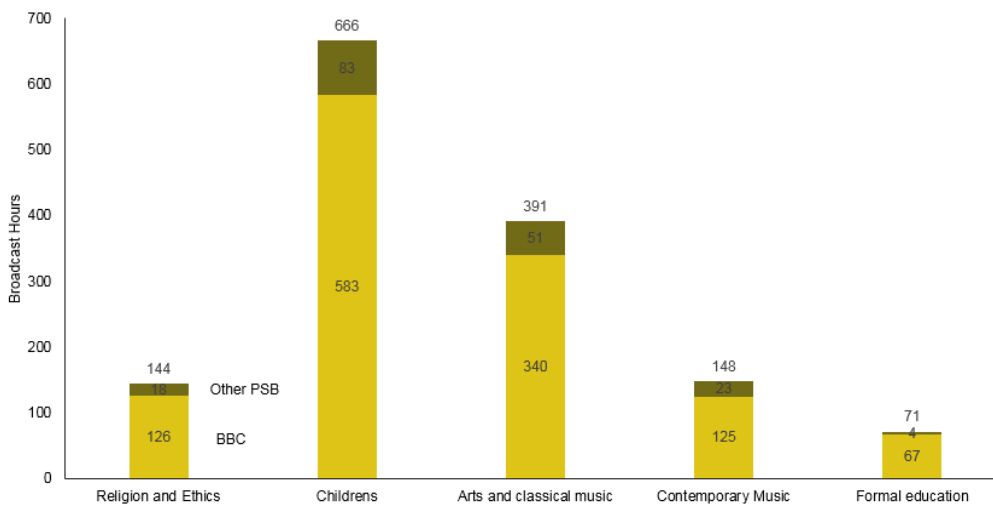
Source: Ofcom/broadcasters.

In some genres, BBC spending represents almost the entire available PSB market

For some specialist producers, the BBC represents almost the entire available market for their genre or style of output. This arguably gives it enhanced market power in some areas of the commissioning market.

For example, across the five genres shown in Figure 6 below, the BBC represents the vast majority of the original commissioned hours of all the PSBs:

Figure 8: First-run UK originated hours, all day, 2013



Source: Ofcom PSB Review 2014

More widely, differentiated demand gives commissioning broadcasters additional buyer power

The concentration of spend on UK original programmes at three main PSB groups, coupled to the fact that they all require different styles of output, leads to so-called 'differentiated demand' being a dominant characteristic of the UK programme supply market. This leads to situations where there is effectively only one buyer for a particular programme in the UK market, something that broadcasters can exploit within the commissioning process.

For example, an independent producer and commissioning broadcaster can work together in the development of a new programme idea with the producer investing in funding the R&D effort at a pre-commissioning stage. In doing so, they are effectively tailoring the development of IP to a specific broadcaster and hence, as the process continues, any hopes of recouping their R&D spend is increasingly linked to that one broadcaster relationship. This trading dynamic gives commissioning broadcasters significant power over independent producers as the decision to greenlight a new programme approaches and producers face mounting – and potentially unrecoverable – development costs.

New sources of demand for original content have only a limited impact on the UK market

The emergence of global SVoD players such as Amazon Instant Video and Netflix is one of the few genuinely new developments in the TV market in recent years. These businesses have seized on the potential created by IP-based content delivery systems to open up a new category of pay TV services in the market, and have achieved rapid growth in many markets. This growth has been to the benefit of existing TV programme rights holders (who have a new channel to sell secondary rights into) and a handful of producers who have secured some high profile original commissions.

Despite headline grabbing growth in this part of the market, two trends are – at least for the moment – also certainly true:

- SVoD services remain characterised by having a small number of highly marketable original series alongside a large catalogue of acquired material
- Of the original content being commissioned by SVoD players, the vast majority is commissioned from the US market (and this is likely to continue)

The US is the largest single consumer market for SVoD services and US content also has the highest 'transferability' in terms of consumers in other TV market being willing to accept US finished programmes. This cultural acceptance of US content has been built up over many years and means that big budget SVoD original series are likely to remain predominantly US focused. Some UK commissioning activity has come from SVoD growth (e.g. *The Crown*), but this is more likely to be the exception than the rule.

Figure 9: Netflix original commissions, 2013-2015

Programme	Year	Genre	Producer	Country of Origin
House of Cards	2013	Drama	Media Rights Capital	US
Orange is the New Black	2013	Drama	Tilted Productions & Lionsgate	US
Hemlock Grove	2013	Horror / Thriller	Gaumont International Television and ShineBox SMC	Canada
Turbo FAST	2013	Animation	Dreamworks & Titmouse	US
Bad Samaritans	2013	Comedy	Fox Digital Studio	US
Marco Polo	2014	Drama	The Weinstein Company & Electus	US
BoJack Horseman	2014	Animation	The Tornante Company ShadowMachine Films	US
Veggie Tales in the House	2014	Animation	Big Idea Entertainment & Dreamworks	US
All Hail King Julien	2014	Animation	Dreamworks	US
Unbreakable Kimmy Schmidt	2015	Drama	Universal Television & Little Stranger	US
Bloodline	2015	Drama	Sony Pictures	US
Daredevil	2015	Drama	Marvel Television / ABC Studios	US
F is For Family	2015	Animation	Gaumont International Television Wild West Television	US
Grace and Frankie	2015	Comedy	Skydance Productions	US
Marseille	2015	Drama	Federation Entertainment	France
Marvel's A.K.A. Jessica Jones	2015	Drama	Marvel Television / ABC Studios	US
Narcos	2015	Drama	Gaumont International Television	US
Sense 8	2015	Drama	Studio JMS, Georgeville Television, Unpronounceable Productions	US
The Crown	2016	Drama	Left Bank Pictures / Sony	UK

Source: Oliver & Ohlbaum analysis

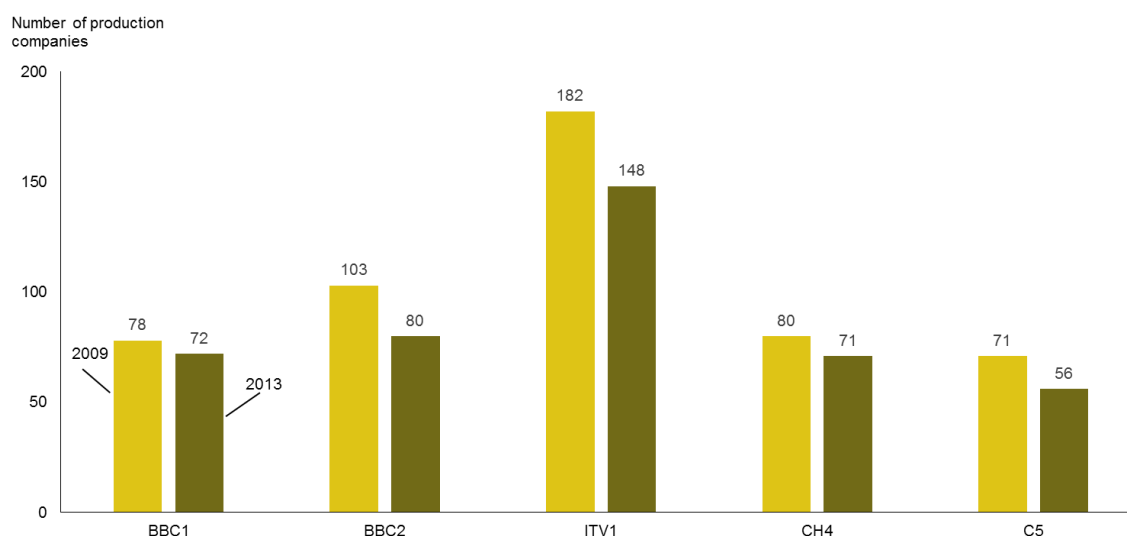
4.2 Plurality of supply in most genres remains strong, suggesting that the current system is effective

In assessing the balance of power in the programme supply market, the second thing to look at is whether the structure and performance of the supply-side is being radically altered. For example, if the number of suppliers is being dramatically reduced or smaller Indies are being squeezed out of the market, we might conclude that consolidation was starting to impact on the choices that PSBs have in how they works with the independent sector.

There are still many more producers than commissioning broadcasters

Competition for new commissions from PSB networks remains strong. In 2013, there were 136 independent production companies with turnover of more than £1m. This is up from 106 such companies in 2008.⁴ While there has been some reduction in the number of producers gaining commissions from the main PSB networks, the overall number of companies engaged by these channels remains high and is sufficiently large to ensure that a reasonable level of competition is sustained.

⁴ Annual Survey of UK Independent Producers, Broadcast

Figure 10: Number of production companies commissioned by PSB networks, 2009-2013

Source: Attentional/BARB and Oliver & Ohlbaum Analysis

Differentiated demand remains an important feature of the UK market

So-called 'differentiated demand' remains an important feature of the UK PSB system. In practical terms, the style, tone and target audience of output in similar genre tends to be significantly different across the BBC, ITV, Channel 4 and Channel 5, leading to a situation where producers tend to specialise in particular output styles within a particular genre. This helps to sustain plurality of supply as no single genre specialist producer is able to capture all of the demand in the market – simply put, sustaining diversity of demand is a good way of encouraging diversity of supply.

This is important in assessing how consolidation affects the programme supply market. By sustaining differentiated demand, PSB requirements from the programme supply market are more fragmented in practice than a simple analysis genre trends might indicate. The growth of multichannel commissioning has arguably added to this diversity of demand in the UK market over the last five years as commercial pay TV has its own set of styles and audience needs.

The lack of 'first-look' deals in the UK market suggests a programme supply ecosystem that is comfortable with risk and not afraid of losing specific supplier relationships

'First look' deals, where broadcasters have contractual arrangements with some key producers giving them a pre-emptive option on new programmes ideas in development, are commonplace in some commissioning markets, but are yet to gain prominence in the UK. This suggests that the UK programme supply market is less dependent on a small pool of leading creative talent than other markets may be, and that the main buyers in the market do not feel threatened by losing access to their main lines of programme supply (two of the main reasons why a 'first look' deal might seem like a good strategic move).

In general, one of the great strengths of the UK programme supply market is that PSB commissioning groups are less risk averse than leading broadcasters are in other markets. This translates into a higher experimentation rate, putting more new original IP on screen, and accepting that not every new idea can be a hit. The lack of 'first look' deals in the market can be seen as a continuation of these healthy trends.

Where pinch-points in the supply of some sub-genre output does occur, this is nothing new and large FTA networks still have some power

Plurality of supply in specific sub-genres is partly driven by how narrow broadcasters become in their commissioning strategies. A prime example of this is in the dependence that ITV has developed over the last ten years on independently owned peak-time entertainment formats. This has enabled companies like Fremantlemedia (principally via its relationship with Simon Cowell's SyCo Entertainment) to become a critical supplier to ITV for its prized Saturday night output with *X Factor* and *Britain's Got Talent*. Both the continued success of these shows in commercial terms for ITV and the lack of strong alternatives have led to a situation where ITV is moving towards a value pricing arrangement for this output (ITV is believed to have paid in the region on £150m for its most recent three year deal to 2016).

This situation is not a function of sector consolidation, but rather a reflection of how the global formats industry has developed and the fact that a relatively small number of entertainment formats have grown to achieve near global domination. Even then, this narrow example where a few suppliers have arguably enjoyed some market power has little impact on the operating of the wider programme supply market (i.e. Fremantlemedia has not enjoyed disproportionate success in other genres as a result of the leverage they have through representing the *X Factor*) and may be a trend reaching a natural conclusion as existing formats slowly lose their audience appeal and replacements become harder to find.

4.3 The latest wave of consolidation does not represent an immediate threat to small Indies

Some, including Channel 4, have set out arguments that sector consolidation will be to the detriment of smaller companies operating in the programme supply market. The implication here is that with larger production groups active in the programme supply market, competition for all commissions will increase and smaller producers will find it increasingly difficult to compete with the financial scale and key supplier leverage that larger producers enjoy. While larger production groups do obviously enjoy advantages of scale and scope over their smaller rivals, this has always been the case and the enduring presence of small independent production companies in the market suggest that this scale inequality is not sufficient to foreclose the opportunity for smaller groups.

Terms of trade have led to a reduction in the costs of contracting new productions, levelling the playing field for Indies irrespective of scale

One of the less obvious benefits of standardising terms of trade is that it has led to a lowering of the costs of contracting new commissions. This benefits both broadcasters, who enjoy a more streamlined contracting process and who have been able to reduce the associated business affairs and legal costs, and also producers, who have more of a level playing field in the cost and complexity of contracting for new work.

In practical terms, this means that there are no major structural barriers to contracting with independent producers of any scale and that – as a consequence – projects can be assessed on their merits rather than on the basis of who has existing supply arrangements in place. This is crucial for small independents to be able to access opportunities in competition with larger suppliers.

Most independent producers have clear points of differentiation in what they offer to broadcasters – consolidation is unlikely to significantly alter this scope for differentiation

The broad range and diversity of output on UK PSB networks has led to a wide variety of independent suppliers and a very broad scope to differentiate that supply – for example based on talent, production style and genre specialisms. This is a key feature of how the programme supply market operates and is why the range and diversity observed in the UK independent sector has proved sustainable despite consolidated commissioning demand. As long as the breadth of demand is maintained, smaller and larger producers should still be able to co-exist and compete for new commissions based on the strength of their offer rather than the scale of their parent companies.

5 Overseas investment has been a net positive for the UK TV market

To a significant extent, the attractiveness of investing in UK production assets is inextricably linked to the health of the UK broadcast sector, and particularly the PSB-driven ecology of original content demand that sits within it. From an investment perspective, the UK has an attractive TV market, offering:

- A high level of spending on original content driven by a less risk averse PSB commissioning culture
- A resulting high level of innovation in new IP that makes it onto screens
- A regulatory framework that protects producer's interests and enables them to own their IP
- Competitive tax incentives and corporate tax rates

In combination with the international appeal of English-language output and the UK's regulatory proximity to Europe, the UK has therefore been a net beneficiary of globalisation in recent years, seeing many international TV companies (producers and broadcasters) choose to locate and grow their international operations here. Having chosen to invest in the UK, the fact that overseas investors then want their UK subsidiaries to be successful and to generate valuable IP means that many have also actively invested in UK original production projects.

However, some fear that the pendulum is starting to swing the other way and that continued growth in overseas ownership of UK TV companies will start to erode the strength of the UK domestic TV market. In particular, concerns are being voiced that global groups will start to 'siphon off' the returns from UK IP and exert increased pressure on the UK commissioning market (for example trying to extract higher rents for some programme IP or shipping more UK talent overseas). In this section we examine those concerns in more detail.

5.1 'Siphoning off' of UK IP has not yet emerged

One concern being voiced is that overseas ownership of UK production companies could result in 'siphoning off' of the returns from UK IP exploitation. The flow of funds around IP exploitation is often complex and bears further examination.

To start with, let's take the example of a large UK-based independent producer making a programme for one of the main PSB groups. If this production qualifies for terms of trade (i.e. it is being made for one of BBC1, BBC2, BBC digital channels, ITV, Channel 4 or Channel 5) then the producer will 'own' the IP in perpetuity but will also have a commitment to share a proportion of the revenue from its exploitation with the original commissioning broadcaster. In this way, commissioning PSBs may not 'own' the IP but are guaranteed some participation in the revenue flows around it (usually 50:50 within the primary licence period and then 85:15 in favour of the producer thereafter).

The term 'siphoning off' implies two levels of impact. First, the returns from exploiting UK-developed IP around the world would not be reinvested in growing UK production activities. Second, the UK commissioning broadcasters would not benefit from the recycling of funds into new programme development and production. This is at odds with both the trend towards greater inward investment in the UK market, and the trend for a growing proportion of PSB programme finance to be made up of co-production, producer deficit finance and distribution pre-sales arrangements. If anything, the main risk in 'siphoning off' comes from the multichannel segment of the UK market where terms of trade do not apply and international channel groups that can retain IP ownership and exploit UK works for little incremental cost around their global channel networks.

5.2 No strong evidence that overseas groups have been able to use their leverage to execute ‘value pricing’ demands

One of the clearer indicators of there being some degree of producer market power at play in the UK programme supply market would be if the number of key strands being driven towards ‘value pricing’ was increasing over time. To date, the examples of such practices in the UK are very limited, suggesting that in most cases commissioners find that there are alternative schedule and / or suppliers choices that can be made to avoid being forced to accept lower broadcast margins.

This situation is also supported by the fact that UK PSBs tend to limit their dependence on US acquired programming and that the BBC and ITV tend to keep long-running, channel defining strands in-house (e.g. *Coronation St*, *Emmerdale*, *EastEnders* and *Doctor Who* are all made by in-house production units).

Value pricing in the UK market is rare as there is usually sufficient alternative supply to stop this

The practice of ‘value pricing’, where the rights owner for a given programme can charge the commissioning broadcaster a price based on the economic value of the programme rather than the cost of making it plus a margin, is rare in the UK TV market. With many credible suppliers for new commissions and a wide range of subtle alternatives in how commissioners build their schedules overall, only a handful of situations have arisen in recent years where a show becomes too important to drop.

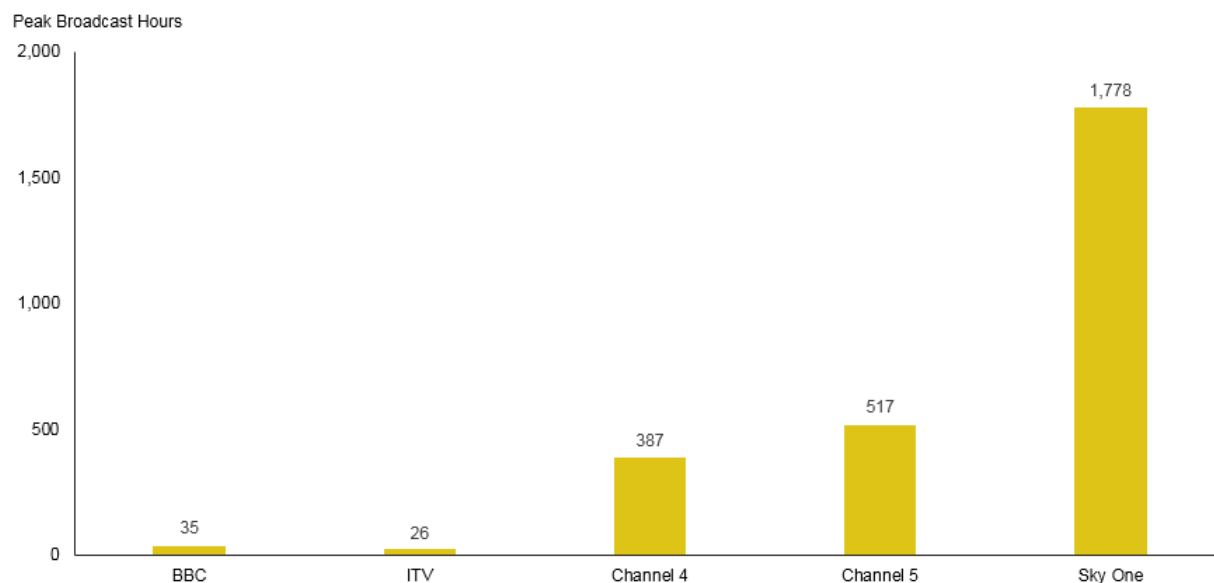
Even where such supplier power exists, it is often not long lived. The most recent example of this was arguably in Channel 4’s dependence on *Big Brother* as its main driver of high-reach high-share event TV. As the importance of the show to Channel 4 increased, Endemol was able to push for an increased fee until eventually the cost was deemed too high relative to a waning audience interest, and Channel 4 chose not to recommission. Similar examples of a channel’s dependence on some key strands include ITV’s reliance on *X Factor* and *Got Talent* franchises to drive Saturday evening peak time audiences. Both of these franchises are under pressure to perform given the rising costs of renewal.

In the UK, value pricing is not achievable on the vast majority of producer commissions. Broadcasters have many alternative suppliers for a given commission and the balance of power means that producers are more likely to discount to receive a commission (either explicitly or by taking on more risk through deficit finance arrangements) than have any realistic prospect of holding out for a higher primary licence fee.

Commercial PSB not over-exposed on US acquisitions so leverage is reduced

While pay-TV is dominated by US acquisitions (and sports), commercial PSB’s reliance on this source of supply is much less. In 2013, ITV1 broadcast only 26 hours of acquired US content during peak time, which was mainly attributable to just one show, *The Americans*. In contrast, Sky 1 broadcast 1,778 hours of acquired US content during peak time. Channel 4 and Channel 5 have the largest commercial PSB exposure to US networks, broadcasting 387 hours and 517 hours respectively during 2013.

However, often US Studios will deliberately choose to licence a show to a leading FTA network to gain more exposure for new output and to build the brand in the local market. This role – primarily provided by Channel 4 and Channel 5 – ensures that the pricing pressure exerted by US Studio groups on these more acquisition dependent channels is limited and that the totality of US supply is not absorbed by pay TV groups and SVoD players. As with large entertainment formats, the promotional power of leading FTA networks in the UK market means that there is some level of symbiosis between content owners and PSB networks.

Figure 11: Hours of broadcast peak-time US acquisitions, 2013

BBC includes BBC1 and BBC2. ITV relates to just ITV1
 Source: Attentional, Oliver & Ohlbaum analysis

5.3 Acquired producers still focus on the UK market

The rationale for each overseas acquisition is different. While some US acquisitions have been about the US parent company acquiring rights and local production expertise in UK drama, others have different purposes. Time Warner's acquisition of Shed and NBC Universal's acquisition of Carnival are two examples of a US company being particularly interested in buying into UK drama production. However, Liberty Global's/Discovery's acquisition of All3Media appears to have different motivations: for Discovery, it was most likely about broadening its genre mix away from documentaries and into other areas, while for Liberty Global, owner of Virgin Media, it was probably more about gaining leverage relative to its competitors and channel suppliers by taking a stake in the production market and owning some successful IP.

None of these strategies would be successful if the acquired company was to fail in securing new UK commissions or if key talent was to turn its back on the UK market and head to America. In the overwhelming majority of cases, overseas companies invest in ventures in the UK market wanting them to be successful and to grow here.

Acquired UK production companies continue to have a clear UK focus

To date, there has been no clear indication that sector consolidation or overseas ownership materially reduces the creative scope or growth ambitions of the acquired companies within the UK market. In many cases the opposite is true. NBC's investment in Carnival has become a vehicle for co-production investment as well as a key drama producer for leading broadcast networks. Under UK terms of trade, NBC could sit back and wait for the IP around shows like *Downton Abbey* to pass into their hands, but the presence of series holdbacks in the UK market coupled with the desire to broadcast the series at the same time in the UK and US markets led NBC to take the show on as a co-production partner rather than just providing the minimum necessary drama contribution that ITV might have expected via deficit finance.

In general terms, the fact that large overseas content companies are investing in the UK TV sector is a vote of confidence in our creative talent, a reflection of the fact that the UK remains a good place to trade (underpinned by the right producers have to own their IP) and has been a driving force in the continued growth of the sector. Companies are also bringing more overseas commissions to the UK market, driven by a competitive tax regime and the UK having a globally recognised creative talent pool to draw on. At the heart of this is the fact that the UK remains an attractive TV market for the generation and ownership of new IP, something inextricably linked to the balance of power between PSB commissioners and external producers. As a result, this balance is something that neither side should be incentivised to materially harm.

5.4 **Having strong overseas backing in a globalising TV production market is more of a strength than a weakness**

Few would deny that the UK TV market is now part of a globalised industry, with trade flows between major TV markets growing at a rate faster than many domestic markets have been able to achieve over the last five years. In this situation, countries are vying with one another to become a recognised ‘hub’ for international players in TV production to locate, invest and build regional and / or global supply businesses. In this market situation, the UK has some traditional advantages:

- Our relatively ‘open’ market, cultural proximity to the US and trading proximity to the rest of Europe has made the UK the preferred location for US channels groups to locate (i.e. all of the US majors have their European operations headquartered in the UK)
- The regulation supporting the growth of a strong independent production sector in the UK is stronger than in other European markets and hence has been more successful in helping to support the growth in this form of content supply (and indirectly creating a strong secondary market for UK content as the commissioning broadcasters do not retain long term control of IP)

At the most basic level, the strength of the UK commissioning market, coupled with the attractiveness of the UK independent production sector and the presence of so many US companies in the UK already, makes increasing US investment in UK Indies an almost natural conclusion. However, the fact that this investment is coming to the UK and not to other markets is an important competitive factor, as the TV market continues to globalise and demand from international commissioning groups becomes more important in some genres. Keeping this demand anchored in the UK market should be seen as a competitive advantage rather than a strategic weakness.

Being part of a global network of businesses can help small and mid-sized UK Indies to grow

The acquisitions of smaller UK Indies by larger, international groups can help these businesses to grow and the impact of this on the sector should be evaluated against a counterfactual view of how the market might develop. A company with an existing global network can immediately open up new markets for rights exploitation creating new secondary revenue streams from existing content and enhancing the value of future commissions. In doing so, profitability can be enhanced, increasing the funds available to compete for the next round of commissioning.

Overall, exploitation of secondary and ancillary rights is likely to be more effective as part of a much larger content group than continuing as a relatively small, standalone business. This is where we need to consider the counterfactual of how the UK production market might evolve if there was no overseas investment in UK Indies.

For small and medium-sized independent production groups there are three broad opportunities to drive incremental growth:

- Winning a greater share of UK commissioning activity
- Gaining access to more international markets for the sale of finished programming and formats
- Diversifying into other overseas commissioning markets

As illustrated earlier in this report, the structure of the buy-side of the UK programme supply market – concentration of buying groups, differentiated demand, many producers vying for commissions – means that it is very hard in practice to for a small or medium-sized UK producer to sustainably grow its share of the commissioning market. Gains tend to be cyclical for all players, competition is effective and strong and long-term supply arrangements are not commonly used by broadcasters. In some genres – notably in drama, but also applicable to other areas – competing for new business increasingly involves having access to a wide array of financing partners and overseas relationships, something that places small independents at a disadvantage relative to larger groups. Hence consolidation in these parts of the market is not only likely, but also potentially attractive to smaller UK producers.

Similarly, being part of a larger group with international scale and scope in sales and back office functions can be attractive to smaller producers. For example, in recent years the economics of independent TV programme distribution have become more challenging as a few large, integrated players have come to dominate the market. For smaller UK producers, this increasingly means giving a share of their secondary rights revenue away to either a vertically integrated broadcaster (e.g. BBC Worldwide) or a large production rival (e.g. Endemol, All3Media, etc.). Given the incentives at play in these broad, global distribution businesses, returns can be relatively low for smaller producers in genres such as Factual, Factual Entertainment and Lifestyle content. However, as part of a larger integrated group, producers will often have access to global distribution and an owner incentivised to make the highest possible returns from their IP, driving incremental trading improvements.

Lastly – and self-evidently – being part of a global group brings more opportunities to work with overseas partners and leverage the strength of the group. While organic growth into increasingly competitive overseas production markets can be daunting, with greater backing and a wider network of sister companies, this opportunity can be more open to smaller UK producers when they become part of a larger group than would otherwise be the case.

As with most areas of business investment activity, overseas investors in the UK TV production industry are looking for a ‘win-win’ scenario where they gain ownership of IP and profits in the long-term, but the synergies of ownership also drive growth in the acquired company.

5.5 The main cost synergies from US acquisition are likely to come in distribution businesses and back office roles, but the overall impact on UK employment is likely to be small

We obviously need to recognise that acquisition activity also tends to come with a pressure to realise savings via cost synergies between the merged entities. In the case of large, international trade buyers acquiring smaller UK production companies, these cost synergies are expected to be small.

For example, the back office functions of a small independent producer will typically be very tightly run yielding little scope to achieve savings through merging with a bigger business. Similarly, small Indies are much less likely to have invested in a significant distribution effort and back office rights processes will be relatively lean. As a result, the direct risk to UK employment from this type of acquisition activity is expected to be low.

When larger companies merge, there is greater scope for cost synergies but even then the direct employment impact might not be great. Unlike other large corporate mergers, independent producers are less likely to have invested heavily in the sorts of head office functions found in other industries (for example, corporate treasury, investor relations and a large finance function). When acquired by a trade player, the main synergies are therefore likely to come from merging areas such as rights sales / distribution and HR functions, where there is more often a clear duplication of activity and scope to achieve greater economies of scale. Compared to the levels of employment supported by primary commissioning activity and relatively complex / labour intensive areas such as rights clearance, employment in pure rights sales activity and HR functions are typically small.

6 New forms of vertical integration have a limited impact on PSB programme supply

In terms of its impact on the programme supply market, vertical integration activity can be categorised into two broad camps:

1. Integration between producers and dominant commissioning broadcasters (mainly the UK PSBs) which has the potential to distort competition for new commissions (i.e. where the incentives are towards growing in-house activities at the expense of the external market), and;
2. Integration between producers and pay channels / platforms, where the investment rationale is more about growing leverage in an increasingly competitive 3P/4P pay TV market rather than building large, vertically integrated producer-broadcaster businesses.

These two sets of activities overlap to some extent – e.g. Liberty Global is primarily a pay platform owner while Discovery Networks operates pay channels around the world and can use parts of All3Media for its programme supply – but the distinction is important nonetheless as the main regulatory concern in the UK is around the functioning of the PSB producer / commissioner relationship and less so about the subtleties of global pay TV competition (dealt with separately by Ofcom's pay TV regulation).

As vertical integration becomes more of a feature of the sector, the implicit concern raised by the BBC and Channel 4 is that programme supply will become more limited and that PSBs will therefore be left with inadequate or more expensive supply options. This has given rise to three specific concerns:

1. That vertically integrated production companies will have a competitive advantage over the remaining independent sector players, leading to a crowding out of the market opportunity
2. That a reduction in the diversity of supply to PSBs will result in diminished quality and innovation within the sector
3. That, in the long-run, having limited alternatives for external supply will lead to PSBs being limited to more expensive supply options and sector efficiency will be harmed

While there are risks to increasing vertical integration activity affecting the UK market, the evidence to date suggests that it has only had a limited impact on how the programme supply market operates:

- Vertical integration is only a major concern where a commissioning broadcaster controlling a large share of market demand aligns with one or more producers in a market to crowd out other suppliers
 - There are many forms of vertical integration and most are unlikely to impact materially on the operation of the UK programme supply market
 - The evidence to date in the market suggests that overseas acquisitions of UK independent producers increases rather than dilutes competition for commissions
 - Some of the newly 'non-qualifying' production groups in the UK have reported an increased pressure on commissioning terms from PSB groups – notably Channel 4 – since their change in status
- Given their dominant position in commissioning, maintaining diversity of supply in the UK market remains largely in the gift of the main PSB groups
 - Controlling c.80% of annual spend on new UK original productions, the PSB groups can choose who to work with and can actively support an range and diversity of UK suppliers

- As discussed earlier in this report, maintaining diversity of supply in the UK market should be in the long-term interests of the UK PSB groups as it will ultimately help them to resist any attempts at exerting pressure by any of the global production groups
- The evidence in headline PSB spending on UK original content suggests that supply options are not getting more expensive and sector efficiency has improved, not worsened
 - Headline spending by PSBs on UK original content has declined in real terms over the last five years while stated audience satisfaction and perceived quality has been maintained
 - There is some anecdotal evidence to suggest that downward pressure has been being exerted on newly ‘non-qualifying’ independent groups within the PSB commissioning process

6.1 Vertical integration is only a major concern where it involves the alignment of UK broadcasters and producers controlling a high share of demand and supply

Vertical integration is a blanket term applied to a wide range of consolidation activities in the market. However, only a small number of cases have the potential to materially impact on the UK programme supply market. The different types of integration – and the main risks – are set out in the following section.

The basic types of vertical integration affecting the TV market

We identify two major types of vertical integration, with various sub-strategies taking place within each broad grouping:

1: Broadcaster / Producer vertical integration (e.g. ITV Studios acquiring Big Talk etc.)

The second type of sector consolidation activity can be defined as Broadcaster / Producer consolidation, leading to larger vertically integrated groups acting in the UK market. The resurgence of this activity in recent years is driven by the recognition from broadcasters that ownership and control of IP is an important part of their future portfolio activities. However, within this broad category there are also distinctly different rationales for investment:

- **1A: Adding scale and scope to existing UK producer-broadcaster groups**

The most obvious player in this area has been ITV Studios, where UK and overseas acquisitions have effectively rebuilt ITV’s ‘in-house’ production capabilities. This strategy is principally driven by a need to diversify core revenues and the obvious synergies of vertical integration in a market where independent producers can retain rights.

- **Type 1B: Adding UK production IP to global channel groups**

This can be seen in the activities of groups such as Discovery Networks, where acquisition synergies can best be explained by the current and future programme rights that a UK production group brings to an international channels business (i.e. gaining catalogue and avoiding future secondary acquisition costs).

- **Type 1C: Adding production IP to UK pay TV channels**

This last sub-category within broadcaster / producer vertical integration has seen international content production and rights groups buying in to the UK channels market. This can be seen as an extension of long-standing strategies to maximise the value in long-tail content by selling through local channels and – more recently – in the leverage that these options provide content owners relative to global SVoD players (who might otherwise be the only viable outlet for content). Examples in this area include Sony’s acquisition of CSC Group.

Type 2: Platform / Producer vertical integration (e.g. Liberty Global acquiring 50% of All3Media)

This last major category of vertical integration has only emerged more recently, with players such as Sky and Liberty Global (owners of Virgin Media in the UK) investing in production assets. This is a more complex area of competition, with ownership of producers adding programme supply and rights ownership for channels and VoD platform businesses but also forming part of a strategic leverage game between competitors in pay TV and between 3rd party channel groups and platforms.

Which of these types of consolidation is a threat to functioning of the programme supply market?

So having established that there are different types of sector vertical integration trends at play in the UK market, do any of them pose a threat to the effective operation of the UK content supply market, the sustainability of the PSB ecosystem or both? Our overall conclusion is that while there are risks there is not currently any strong evidence of harm.

Again, it is worth looking at the arguments taking the different types of consolidation in turn:

1. Extending the scale and scope of existing broadcaster / producer vertical integration (i.e. the BBC and ITV) also increases buy-side bargaining power and is likely to result in greater crowding out of the remaining independent supplier base

Managing the inherent conflict of interest between the in-house commissioning and production sides of a vertically integrated producer-broadcaster business is a long-standing issue in the programme supply market. This is particularly the case where – as is the case in the UK market – the majority of demand for original programmes comes from only three sources (i.e. the BBC, ITV and Channel 4). Indeed one of the major drivers for the regulatory changes that led to independent production quotas and negotiated ‘terms of trade’ being introduced in the first place was a desire to counter excessive buyer power in the market and control the natural inclination towards favouring in-house production over external suppliers.

Over the last ten years, the structure of the buy side of the UK programme supply market has changed little. We still have three major buyer groups for UK original programmes (with Sky emerging as a fourth albeit with a more limited range of output) and vertical integration is resurgent as commercial broadcasters try to diversify away from the long-term slow erosion of advertising revenues.

Given the pressures on revenue mix (whether advertising or licence fee related), producer-broadcasters have greater incentives under current and expected future programme supply market conditions to grow their non-advertising commercial revenues, driving a greater focus on the value of in-house production (where all rights are retained) and on the share of revenue available from external supply (where broadcasters will seek more). Under these market conditions, continuing with a fair, negotiated share of revenues to help sustain both broadcaster and independent production sectors of the market is more likely to result in delivering the aim of commissioners always having access to the best creative ideas than a renewed drive to grow in-house capacity to the exclusion of alternative supply.

2. Acquisition of UK producers by international channel groups is unlikely to materially impact on PSB commissioned content prices or supply of IP

There has been some notably vertical integration activity where international channel operating groups (e.g. Discovery, Sky) have bought into the production sector. This activity tends to be in two sub-categories:

- Acquiring smaller producers with some specific and complementary IP (e.g. Sky's acquisition of Love Productions, giving it control over the *Bake Off* brand and in-house capacity in Factual / Factual Entertainment output)
- Buying into larger, international production groups with potential synergies in multiple markets (e.g. Discovery Networks acquisition of 50% of All3Media)

In the first example, acquired companies are often highly complementary to the acquiring channel group's output requirements and the rationale for internalising this supply tends to be around backing creative talent and controlling the monetisation of rights (something evidenced by Sky also acquiring a distribution business 2012). This does not exclude the acquired companies from continuing to work with PSBs on new commissions or returning series, but does give the channel groups more control over the resulting programme assets. However, in order for this trend to become an issue, evidence of a transfer of pricing power and / or withholding behaviours would need to be present in the market – and neither of these have occurred to date.

In the second example – where groups have acquired much larger production assets – it is consequently much harder for them to threaten to withhold key content from PSBs. This might feel counter-intuitive, but given the consolidated buy-side of the UK programme supply market, attempting to leverage higher commissioning prices out of UK PSBs would be high risk for the acquirer of a large UK production company as the value of the acquired asset is likely to be closely linked to its continued ability to trade with these entities and secure new business (hence growing its portfolio of IP that sustains future exports and can drive the next wave of international hits).

3. *UK pay channels being acquired by global production companies is predominantly about asset value and leverage*

Some deals (e.g. Sony's acquisition of CSC Group) are more about leverage in the UK channels market, with Sony able to drive asset value by bringing its content rights to the combined group and having a sizeable channels portfolio useful in leverage with platforms for carriage and ad sales houses for share of revenues. Neither of these factors is likely to have a significant impact on UK originating PSBs.

4. *Platform / producer vertical integration is most likely to impact on PSB groups' ability to acquire VoD rights, but these are also protected by terms of trade so the impact is small*

Platform groups acquiring production assets (e.g. LG acquiring a stake in All3Media) can have a range of impacts on the content market, including leverage between platforms for key rights (i.e. threatening to withhold some VoD rights from rival platforms) and as an indirect way of influencing negotiations between platforms and commissioning channel groups. In both cases, the rationale for acquisition is more about the ongoing battle for the share of revenues between platform rivals and between platforms and channel groups.

While this leverage could have indirect effects, such as increasing the cost of VoD inventory for some platform players or helping to ameliorate current asymmetries in competition (for example Sky's market power as a pay channel provider versus its relative weakness in VoD), the nature of these strategies suggest that they will only work if a production asset is of sufficient scale to have a material impact. In these cases, the same argument would apply as for other forms of large producer acquisitions – namely that there remains a co-dependency on large commissioning PSBs to sustain the size (and hence value) of the acquired groups.

Where there is a threat of more VoD rights being withheld in the market as a result of this type of consolidation, PSBs remain relatively well protected by the VoD holdbacks in place as part of current terms of trade.

6.2 Maintaining diversity of supply is within the PSBs gift

Arguably the most important response from UK PSB groups to any perceived globalisation and production sector consolidation threats should be to invest in maintaining the range and diversity of supply available in the market. This means continuing to work with a broad range of UK Indie groups – of all sizes and specialisms – to ensure that there are always viable alternatives to trading solely with vertically integrated global players.

UK PSB groups still control over 80% of the available spend on UK original commissions and have the power to shape the market through their commissioning decisions. This has been the single most enduring feature of the UK TV programme supply market and continues to be so in the multichannel, digital age. As a result, continuing to invest in diversity of supply and working with a broad cross-section of the available UK supplier base should continue to be in the long-term interest of PSB commissioners faced with increasing globalisation.

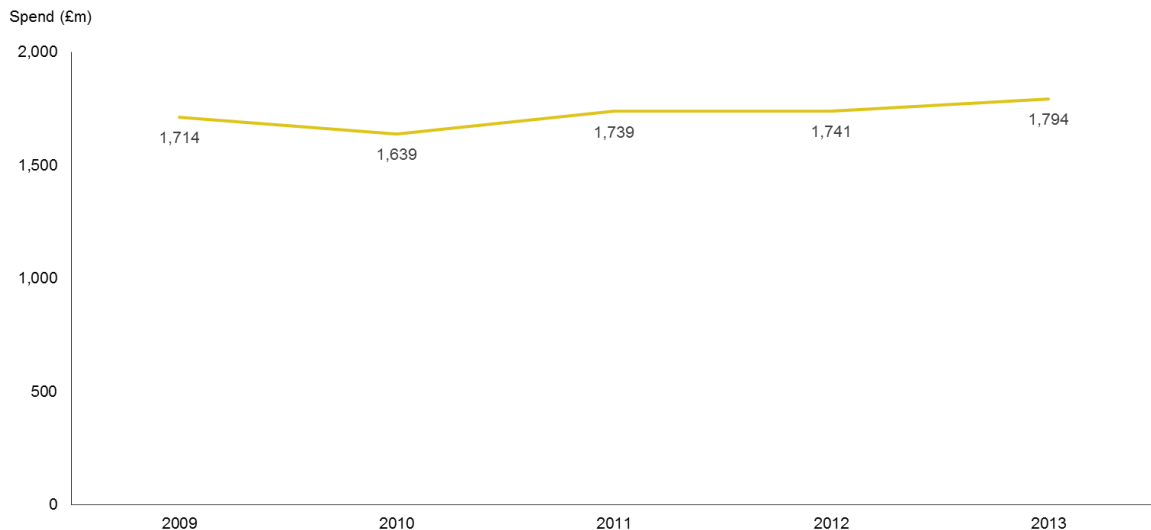
6.3 PSB cost inflation has been limited and more non-qualifying Indies in the market may increase PSB leverage

As explored earlier in this report, if a vertical integration squeeze is being brought against the UK PSB groups, this is likely to be seen in areas such as cost inflation in programme supply, a lack of access to key TV formats and some withholding strategies in secondary rights markets. To date, this has not been the case.

PSB cost inflation appears limited

A vertical integration squeeze on the terms of programme supply to UK PSB groups would only really be viable if a single supplier become disproportionately important. At present, no single supplier aggregates more than 12% of market supply in UK original TV productions. Similarly, if a vertical integration squeeze on PSBs were to become the dominant force in the programme supply market, the costs of supply could be expected to rise over time. While it is hard to observe these trends at a sub-genre level, the broad scale and scope needed to execute such a squeeze suggests that it would occur more broadly and hence would show up in headline commissioning costs (absent any major shift in output mix). To date the opposite trend has been true, with average PSB commissioning costs flat in nominal terms over the last five years.

Figure 12: PSB spend on UK original content (excluding news and sport), 2009-2013 Nominal



Figures expressed in nominal terms. Includes BBC One, BBC Two, BBC Portfolio Channels, ITV1, Channel 4 and Channel 5. Excludes Nations and Regions
Source: OFCOM PSB Reviews, 2010 to 2014

Leading international formats still need FTA network participation to achieve their full potential

To a significant extent, large format producing producers have become co-dependent with leading FTA network groups. The drive towards de-risking some areas of the schedule while building a few big 'event' programmes that can drive viewing share and reach in prime-time slots has made global formats increasingly valuable to FTA network groups. At the same time, producers need FTA commissioning networks to give new formatted shows the best opportunity of gaining traction with audiences and being accepted into the global marketplace as a viable, large-scale FTA prime-time show.

This co-dependency means that there is always a balancing factor in the trade between large format-owning Indies and large FTA networks in the UK, as the unique characteristics of the UK PSB system make the UK TV market a very attractive place to try out new format ideas and grow new hits.

Figure 13: Most successful UK formats around the world

Formats	Country of Origin	Production company	Commissioning UK channel
Come Dine with Me	All UK	ITV Studio / Shiver Productions	C4
Dancing with the Stars		BBC Worldwide Productions	BBC
Farmer Wants a Wife		Fremantle Media	ITV
Headcases		ITV Studios	ITV
Idols		Fremantle Media	ITV
Just the Two of Us		BBC Worldwide Productions	BBC
Masterchef		Union Picture	BBC
Money Drop		Endemol UK	C4
Pointless		Brighter Pictures	BBC
Super Nanny		Ricochet Entertainment	C4
The Weakest Link		BBC Worldwide Productions	BBC
Who Wants to Be a Millionaire		Celador	ITV
X Factor		Talkback	ITV

Note: "successful" has been defined by 3 criteria: value created, number of international viewers and award winning formats
Source: TBI, Oliver & Ohlbaum analysis

In practical terms, this means that the strength of a future pipeline of IP for a company like All3Media or Endemol remains strongly linked to the commercial viability of commercial PSB groups, the continuation of their high reach / share ad-funded business model and their willingness to work with those organisations on new format commissions. Their incentives are to sustain the UK market and export the resulting IP overseas, not to kill the organisations that enable their experimentation and put new ideas on screen.

Pay TV groups cannot substitute for the volume and quality of output financed by the PSB sector and hence withholding strategies are not really viable

Though pay TV groups are actively acquiring independent producers, those producers remain reliant on trade with the UK PSB groups for commissions. Given this reliance, more extreme strategies such as withholding some rights supply to PSB VoD services or trying to extract higher rents for specific uses of content are highly unlikely. In a head to head war with PSB commissioners, the downside risk would still be mainly on the producer's side.

More non-qualifying ‘Indies’ in the market may serve to increase PSB buying power

The main trend resulting from production sector consolidation and vertical integration is an increasing proportion of the UK independent sector being made up of ‘non-qualifying’ independent groups (NQIs). This means that a greater proportion of the available external supplier base to PSB groups is now falling outside of the independent production quotas and producer terms of trade. As a result, commissioning negotiations with these groups can take a more aggressive line and commissioning broadcasters are free to push for better terms.

For the reasons examined earlier in this report – e.g. continuing buyer power concentration among the PSB groups versus a wide range and diversity of supply – the balance of power in these NQI commissioning discussions is still likely to remain with the PSB groups. Anecdotal evidence from Pact members suggests that this is currently the case in the UK commissioning market, with Channel 4 reportedly taking a tougher negotiating position with new NQIs than was previously the case under terms of trade. Conversely, it appears that any fears that global content groups can bully their way to a stronger trading position in supplying UK PSB groups are not founded on current custom and practice in the market.

6.4 The main threat to the independent production sector from vertical integration is from resurgent PSB producer-broadcaster integration

While much of the vertical integration to date has occurred between pay-TV operators and independent production groups, the main threat to the plurality of supply and sustainability within the UK production sector is from vertical integration within the PSB producer-broadcaster model. ITV has already demonstrated its intention to grow in-house supply organically and through acquisition of independent production companies as part of its strategy to diversify revenues away from a reliance solely on advertising revenue and Channel 4’s Growth Fund could be the start of its strategy to become more involved in content production.

Prior to the introduction of terms of trade, producer-broadcaster vertical integration was already problematic in the UK TV market. A loosening of the current constraints on these groups – particularly on the BBC and ITV – would likely see a return to these previous market trends, forcing the UK independent production sector into a combination of greater overseas focus while accepting a lower share of spend in the UK market. If anything, the pressures forcing commissioning broadcasters to own more of the value chain around new original programming has increased over the last ten years. Advertising income continues to be under pressure and competition for viewers has steadily increased over the period, leading to a situation where diversification of income is becoming a strategic imperative for commercial PSBs and a necessary thing to demonstrate at the BBC.

Evident in the BBC’s preferred strategy for its in-house production units, in ITV’s actions in growing ITV Studios and in Channel 4’s Growth Fund initiative is a resurgent drive for PSB groups to play a greater role in the supply side of the UK programme supply market. As set out earlier in this report, little has changed over the last 10 years in terms of their dominance of the buy-side of the market, but over that period terms of trade has incentivised and supported independent producers to grow their share of supply in the UK and to use the resulting IP to grow UK exports and the UK’s position as a vibrant production centre in an increasingly globalising market.

A resurgent vertical integration drive from the BBC and ITV could damage the prospects for both UK-based independent producers and overseas investment in UK original series. As witnessed in the BBC’s strategy prior to the introduction of terms of trade, left unchecked, the attractions of directing a greater proportion of commissioning activity through in-house production units are strong and can lead to a squeeze on the volume and value of independent supply. Linked to this, a strategy that results in the weakening of the UK independent production sector is also likely to reduce the attractiveness of the UK market as a place for overseas groups to invest, potentially limiting the long-term prospects for the UK as a global production ‘hub’ and as a place to invest in the creation of new IP. This would be to the detriment of the UK creative sector as a whole and to the diversity and plurality of supply in the sector.