

Submission to Ofcom's third review of
public service broadcasting: Public
Service Content in a Connected Society

pact.

February 2015

Introduction

- 1) Pact is the UK trade association representing and promoting the commercial interests of over 500 independent television, feature film and digital content producers.
- 2) The UK independent television sector is one of the biggest in the world. Despite the difficult economic climate, independent television sector revenues have grown from £1.3 billion in 2005 to nearly £3.1 billion in 2013, making a major contribution to the UK creative economy and exports.¹
- 3) The UK public service broadcasters (PSBs) are by far the biggest investors in UK original content and as such, their future is of paramount importance to Pact and its members.
- 4) Pact welcomes this opportunity to consider and comment on the future of UK public service broadcasting as part of Ofcom's review of public service content in a connected society.
- 5) For further information, please contact Pact's Head of Policy, Emily Davidson, at emily@pact.co.uk or on 020 7380 8232.

¹ Pact Census Independent Production Sector Financial Census and Survey 2013, by Oliver & Ohlbaum Associates Ltd (July 2014).

1. Overview

Pact is a strong supporter of the UK public service broadcasting system

- 1.1 Public service broadcasting in the UK is a hugely valuable public asset which delivers economic, social, cultural and citizen benefits to viewers.
- 1.2 The delicate balance of legislative and regulatory interventions has led to the creation of a broadcasting ecology here in the UK which is internationally recognised as one of the most dynamic, innovative, creative and diverse in the world. The public service broadcasters sit at the heart of this.
- 1.3 The current PSB institutions – the BBC, Channel 4 Corporation (C4C), ITV plc, STV group plc, UTV Media plc, S4C and Channel 5 – remain by far the biggest investors in original non-sport UK content, with the PSB channels² accounting for 85% of all origination spend.
- 1.4 Pact welcomes the recent extension of the PSB licences to the current holders for a further ten years. This provides certainty for commissioning and enables businesses in both the buyer and supplier sides of the market to plan strategically for the future.
- 1.5 Given the important role which they play in this market, independent producers work closely with the PSBs in order to support them whenever possible in developing and retaining British audiences, thereby enabling them to continue investing in original content.

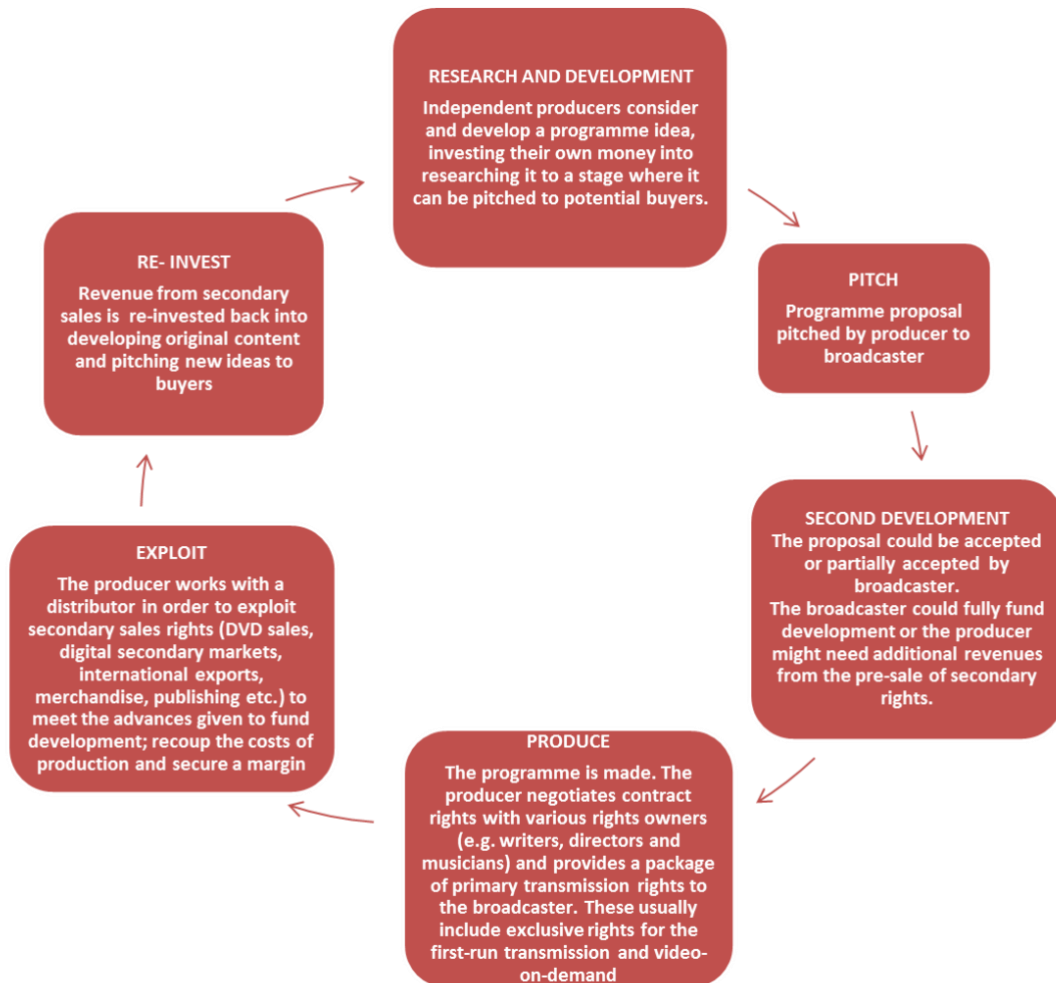
Independent producers share in the risks of creating content with the PSBs

- 1.6 The flexibility of the legislation in Section 285 of the 2003 Communications Act³ has enabled the PSBs and Pact to work together to regularly negotiate Terms of Trade. Through a series of negotiations over the years, independent producers have granted additional usage rights to the PSBs, often at no additional cost, so as to enable them to launch new services and deliver their content to audiences in different ways. In return, holdback periods have been reduced, thereby enabling independent producers to sell their content in secondary markets.
- 1.7 Not only has this enabled independent producers to grow their businesses, creating a £3 billion sector from what was a small cottage industry in only a decade, but it has also provided the means for producers to increasingly share the risks of production and bring money back into the development and production processes, as outlined below.
- 1.8 Figure 1 below provides an overview of the programme production cycle, which shows how independent producers invest heavily in PSB content by funding a large proportion of idea development and bringing additional sources of funding (often including their own production fee) into the production process.
- 1.9 . It is important to note that each stage of the process is inexorably linked to another. If any section of the chain were to be broken (for example, if the Terms of Trade were revoked so as not to guarantee that independent producers would retain control of their intellectual property rights), then this would have significant knock-on effects for the producer's ability to invest in idea development and programme production in future projects and to operate as sustainable enterprises.

² The PSB channels are: BBC One, BBC Two, BBC Three, BBC Four, BBC News, CBBC, CBeebies, BBC Parliament, BBC HD services, BBC Alba, ITV, STV, UTV, Channel 4, Five, S4C.

³ Section 285 of the 2003 Communications Act requires Ofcom to issue guidance which form the basis of the Codes of Practice, which stipulate that there should be clarity in which rights are purchased by a broadcaster as part of a commissioning deal.

Figure 1: the TV programme production cycle



1.10 Through owning their intellectual property (IP) rights, independent producers are able to invest in the development and production cycle at several key stages. The first is in research and development (often referred to as R&D). It is extremely expensive and time consuming to invent, research and develop programme ideas to a stage at which they might be commissioned. Independent producers invest millions of pounds in R&D each year, which brings considerable benefit to the UK PSB ecology. Very little of this is ever recouped, with many projects developed and never commissioned.

1.11 If a broadcaster is interested in a project, it might put some money towards the cost of funding development. This in effect locks the producer out of the market in terms of preventing the idea being taken elsewhere while the original broadcaster is considering it.

1.12 If a producer accepts development funding from a broadcaster before it receives a commission, this opens the door to further dialogue with the commissioner, which is valuable to the production company. However, pilots and other forms of development are often expensive and it is extremely rare for the producer only to use the broadcaster's money in development. In order to try to win a commission in this highly competitive industry, the producer will often add their own investment into funding further development. If the project is commissioned, it is likely that they will be able to recoup. However if the idea is not commissioned, the producer is liable for the full costs of the development, and must also repay the broadcaster who originally put in the development funding if their idea is commissioned at a later date by a different broadcaster. It is unlikely that the new

broadcaster would pay the full cost of the earlier development, thereby leaving the producer out of pocket for the money which they invested, even if the programme is eventually commissioned.

1.13 Moving from development to the production process, it is becoming increasingly rare for a UK PSB to pay for the whole cost of producing a television programme. The commissioning broadcaster will often pay for a percentage of the programme budget – the amount varies widely, depending on the genre – and the producer will fund the deficit through presale agreements and by investing money which it calculates it will be able to make back from finished programme sales. The producer might also seek a co-production deal with an overseas broadcaster who could also invest in the cost of programme production.

1.14 This demonstrates how the UK independent production sector plays a critical role in supporting UK public service broadcasting.

The existing legislation is flexible and efficient

1.15 Section 285 of the 2003 Communications Act enables qualifying independent producers to share in the risk of programme production in a manner which would not be possible if they did not own their intellectual property rights.

1.16 The legislation requires Ofcom to issue guidance, in the form of Codes of Practice, which stipulate that there should be clarity in which rights are purchased by a broadcaster as part of a commission deal. The Codes of Practice form the basis on which Pact and each of the PSBs negotiated the Terms of Trade.

1.17 The Terms of Trade are the set of agreements between each of the PSBs and Pact, on behalf of UK independent producers. They specify the deal terms for programme commissioning, rights ownership and revenue sharing between UK independent producers and public service broadcasters.

1.18 This is an extremely effective piece of legislation, in part because it is flexible and therefore enables PSBs and independent producers to renegotiate terms as required in order to allow for the sector to adapt to changing consumer demands and technological needs. As a means of illustrating this, the tables in Annex 1 to our response (which is confidential to Ofcom) highlight the key changes in the Terms of Trade between Pact and each of the PSBs, noting how they have evolved over time.

1.19 Parliament's rationale for introducing this legislation was to address a market failure in the UK television industry. At the time when these were introduced, the four PSB channels (BBC, ITV1, Channel 4 and Five) controlled 92%⁴ of investment in new UK programmes. Consequently, they could demand all intellectual property rights to programmes shown on their channels. This led to a lack of efficient competition in the exploitation of international and secondary IP rights for television content in the UK and an under-capitalised and dependent UK production sector.

1.20 As highlighted in Ofcom's consultation document, the PSBs continue to play a vital role in the success of the UK independent sector, accounting for 85% of the investment in original programming each year. In 2013, the PSBs account for 80% of the total external spend (including acquisitions).

⁴ Ofcom's Second Public Service Broadcasting Review, Phase One: The Digital Opportunity, April 2008, page 56, states that the PSBs accounted for 92% of spending on network originations in 2004.

- 1.21 For this reason, we strongly believe that the market failure due to buyer power which the legislation was introduced to address remains relevant. Furthermore, recent consolidation in the supply side of the market has not, as others have claimed, had a significant impact on this rationale.
- 1.22 The overwhelming majority of largest independent producer groups no longer qualify as independent producers under the legislation. This means that programmes commissioned by the PSBs from these production companies no longer qualify under the 25% independent production quota. Furthermore, they do not automatically qualify for the Terms of Trade.
- 1.23 By owning IP rights to the content which they create, independent producers benefit from being able to invest in content themselves, thus enabling some TV programmes to be made which might not otherwise have been if the broadcaster was not able to pay for the full cost of production.
- 1.24 The Terms of Trade have also enabled independent producers to build sustainable businesses and take risks in programme development through funds generated from the exploitation of their rights in secondary markets. The sector is incredibly entrepreneurial, with relatively low barriers to entry. It is through the security of copyright ownership and control of exploitation that independent producers are able to be flexible and access international markets to bring money back to the UK. As well as increased exports of both finished programmes and formats, putting content rights into the hands of producers has also made the UK an attractive place for inward investment. Without these legislative protections, the entrepreneurial success of the sector would be put at risk.
- 1.25 The Terms of Trade have had a ripple effect throughout the whole market, and both qualifying and non-qualifying independent producers⁵ benefit from them. Without the Terms of Trade underpinning the rights of producers to own copyright for the content which they create for PSBs, producers would find it extremely difficult to put together flexible funding models such as pre-sales, co-financing, and access to tax credits, if they weren't the copyright owner and they did not control the distribution rights.
- 1.26 As a result, it is not only the producers but also the PSBs who benefit from the current legislation. Because of the Terms of Trade, the PSBs no longer pay the full cost of developing or producing a programme in all but a few genres.
- 1.27 Taken together, this delicate balance of light-touch but effective legislation and regular free-market negotiations has led to the creation of a strong independent production sector that is now a world-leader in global markets, and in turn, strong UK PSBs.

2. The context for Ofcom's review

Question 1: Do you agree with our assessment of the context in which the PSB system operates, and how the trends identified might affect the PSB system? In particular, do you agree with our analysis of the independent production sector?

- 2.1 Pact supports Ofcom's hypothesis that, projecting forward the current market trends, it seems that the PSB market is likely to continue down an evolutionary path rather than undergo significant change in the foreseeable future.

⁵ The definition of an independent producer in legislation is noted in paragraph 1.55 of this submission.

2.2 However, this is assuming that there are not any significant regulatory changes which could disturb the delicate balance in the ecology.

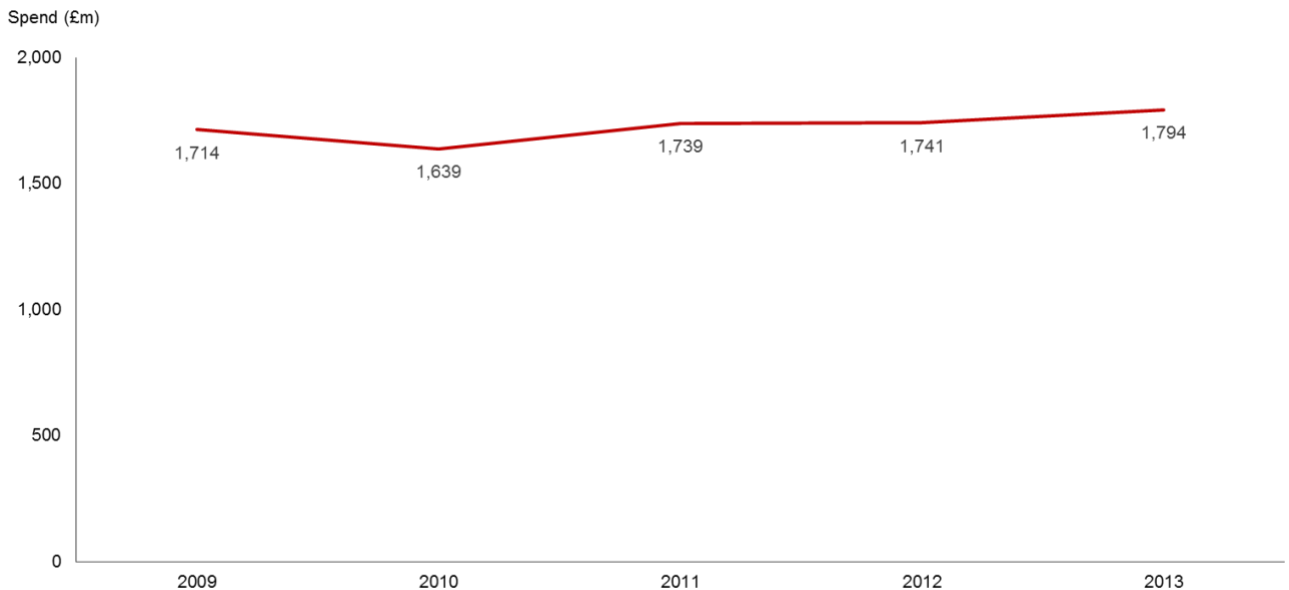
The UK market for new programme commissions has experience some challenging economic conditions over the past few years

2.3 Pact acknowledges that the PSBs have experienced challenging economic conditions over the past few years. The commercially-funded PSBs have experienced a decline in net advertising revenues during the economic recession. Although this has now bounced back, we note that TV advertising revenues are linked to the general economic climate and that another cyclical downturn might arise in the future. The BBC has had to find savings of £700 million as a result of the licence fee being frozen at the time of the last settlement in 2010.

2.4 Ofcom's analysis is that the total spend on all UK content (as opposed to first-run spend, which is noted below) by all broadcasters (PSB networks and multichannel broadcasters, excluding multichannel sports rights) fell by 1.2% between 2009 and 2013, despite an increase of 7.9% in multichannel first run commissions. This is principally because of spend on first run commissions by the PSBs remaining largely flat in recent years, as shown in figure 2 below.

Figure 2: PSB spend on UK original content excluding news and sport, 2009-2013, in nominal terms

Original content spend, excluding news and sport, in nominal terms, 2009 to 2013



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

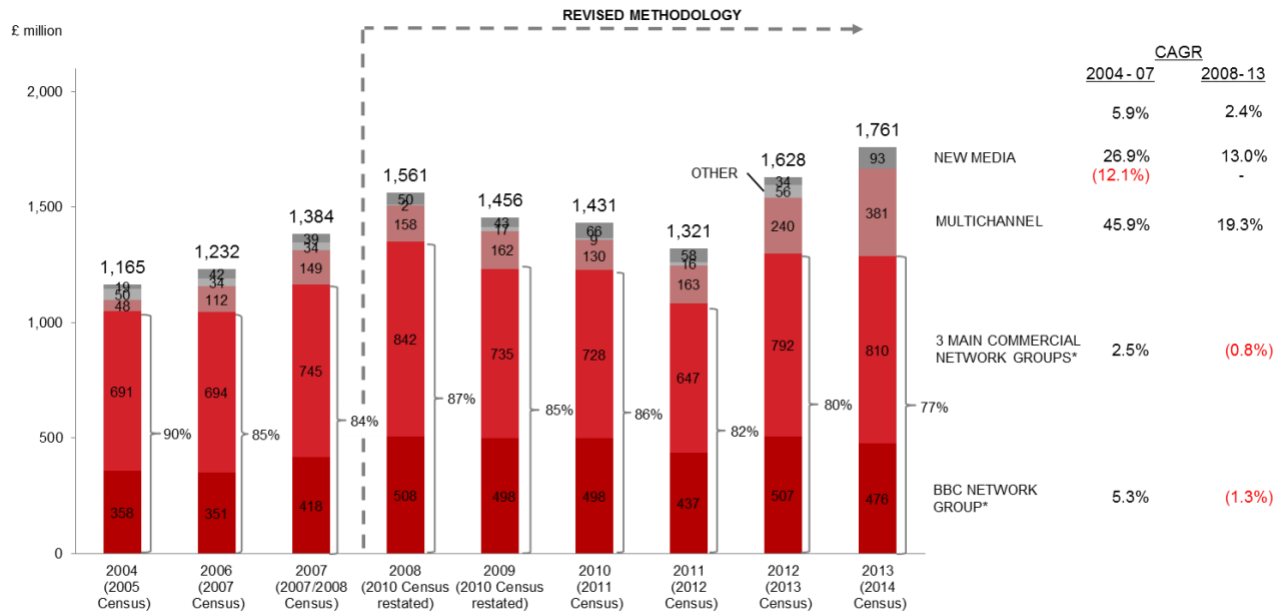
Source: Ofcom PSB reviews as noted in analysis by O&O or Pact in *TV Producer consolidation, globalisation and vertical integration – myths and realities*, Feb 2015

2.5 Analysis in the Pact Census 2014 also shows strong growth in multichannel and new media UK commissioning over the past five years at a time when PSB commissioning has fallen. In 2008, PSB commissions accounted for 87% of independent production sector revenues. By 2013, this had fallen to 77% (see figure 3 below).

2.6 This chart also highlights the importance of the non-PSBs to the UK content investment market. They are the only source of growth in commissioning in the UK. In just three years, multichannel broadcasters (non-PSB group) have increased their investment on UK commissioning by 66%. In 2010 it was £130 million, by 2013 it was £381 million.

Figure 3: Value of UK commissions by broadcaster (including new media)

Value of UK Commissions by Broadcaster (Including new media)**



* Includes spin-off channels; **Total value of commissions derived from 'Primary UK commissions' on slide 8 combined with 'New media' and 'other' revenues
Source: Oliver & Ohlbaum analysis, Pact census

Source: Pact census 2014

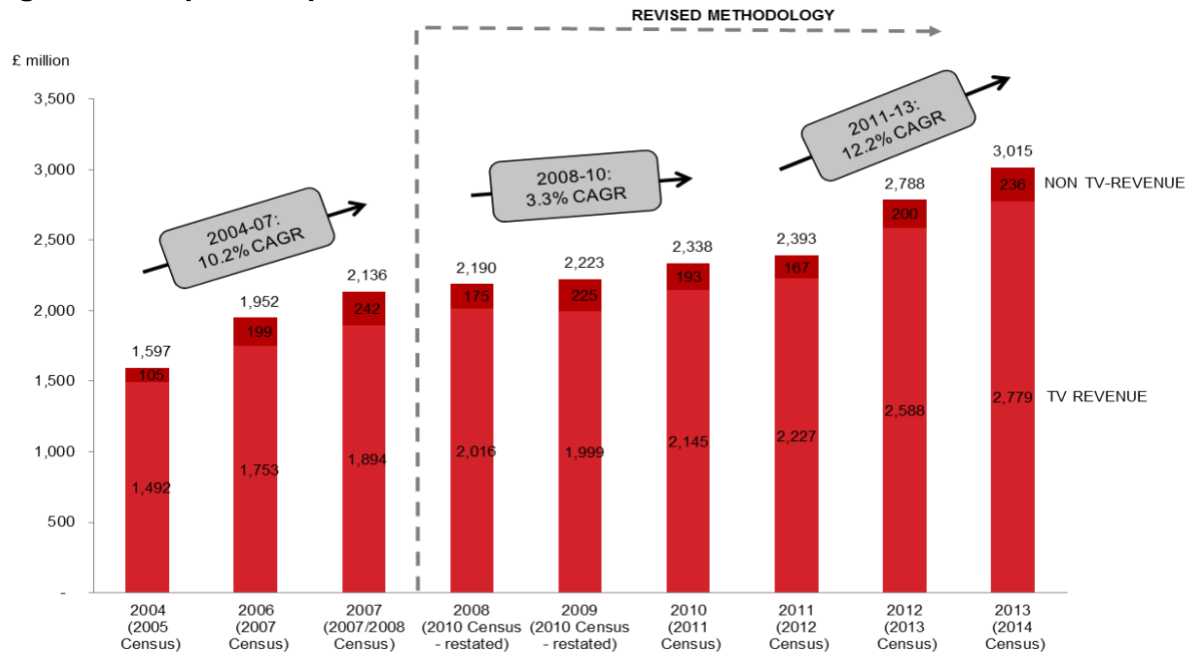
Growth in the independent production sector is driven by multichannel investment and international sales

2.7 2013 was another strong year for the UK independent production sector, with revenues up 8.1% to just over £3bn. Although revenue from primary UK commissions increased for the second consecutive year post-recession, the growth was driven by multichannel investment and international sales. During this period of revenue growth, independent producers have invested a significant amount of their income in research and development and programme production, which has been of substantial value to the UK PSB system. As a result, independent production sector margins have fallen from a high of 13% in 2010 to 5.3% in 2013. This is low by international standards.

2.8 As noted above, this growth has not come from increased investment by the PSBs, which has remained largely flat. Over the past five years, the only sector of UK investment in content which has been growing is the multichannel sector, and independent producers have successfully won a large proportion of new commissions from these channels.

2.9 Figure 4 below shows that although non-TV sector revenues are gradually increasing, the majority of independent production sector revenues (92% in 2013) continue to come from television activities.

Figure 4: Independent production sector revenues, TV and non TV

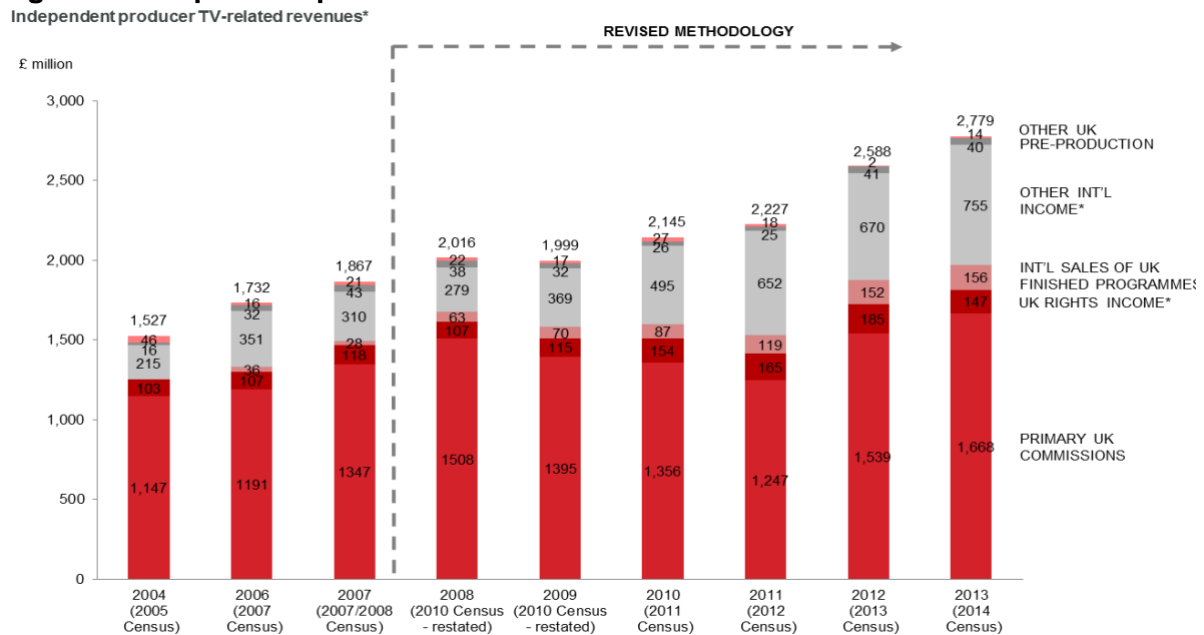


Source: *Pact Census 2014*

2.10 Figure 5 below shows the importance of international income for UK independent producers. A third (31%) of all sector revenues now come from non-UK activities such as the international sale of completed programmes; format rights; and original commissions from overseas territories.

2.11 International income in this sector has increased at a phenomenal rate in recent years due to the entrepreneurial nature of the UK independent sector. In 2010, independent producers as a sector earned £582 million from international sales, including the sale of finished programmes, formats, and original commissions. In just three years this had risen to £911 million – an increase of 64%.

Figure 5: Independent producer TV-related revenues



Source: *Pact Census 2014*

2.12 If changes were to be made to the underlying legislation which enables independent producers to control and exploit their rights in secondary markets (Section 285 of the 2003 Communications Act), then the key driver for growth in the sector – international income – would no longer be possible.

2.13 Given that independent producer margins are increasingly being squeezed, if producers were unable to generate a return on their investments through secondary and international exploitation, they would have less capacity to invest in research and development and in deficit funding for programme production, which would have implications for investment in UK PSB content.

UK content businesses are attractive targets for global investment

2.14 Pact agrees with Ofcom's analysis that there has been a significant shift in the scale and structure of the content production and distribution industries over the last ten years.

2.15 The high level of interest in the UK television industry – both in the supply and buyer side – is a sign of the economic success of the sector, underpinned by talent and creativity, supported by an effective legislative and regulatory regime.

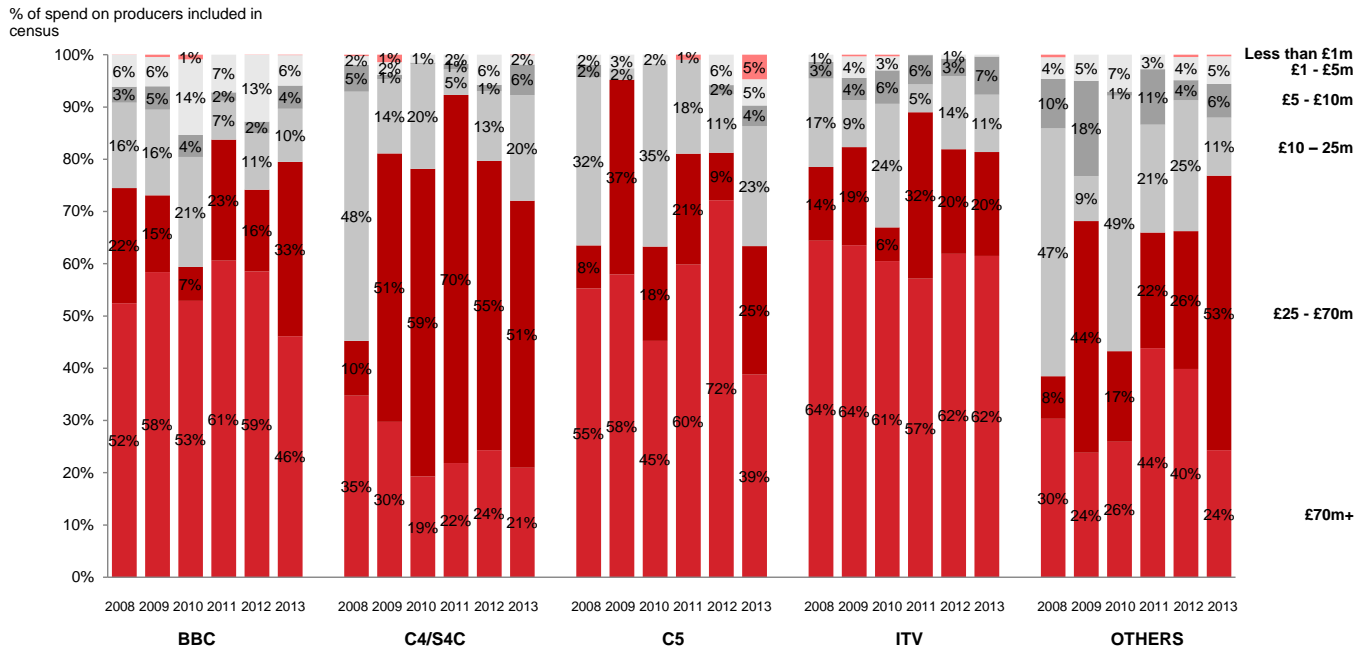
2.16 Because of the continuing high-level of investment in original UK content by the PSBs, British creative entrepreneurs have been able to grow increasingly successful global businesses by exploiting their intellectual property rights in secondary and international markets.

There appears to be little evidence that consolidation has led to fewer opportunities for smaller producers to win commissions

2.17 Pact agrees with Ofcom's statement that "despite the trend of consolidation and increasing concentration in the market, smaller independent producers have actually increased market share."

2.18 As shown in figure 6 below, the distribution of commissioning spend across different sizes of independent producers shifted back in favour of smaller and medium-sized producers in 2013. In particular, Channel 4 and Channel 5 increased their proportion of spend with smaller independent producers.

Figure 6: External commissions by UK broadcaster split by company turnover band, 2008 to 2013



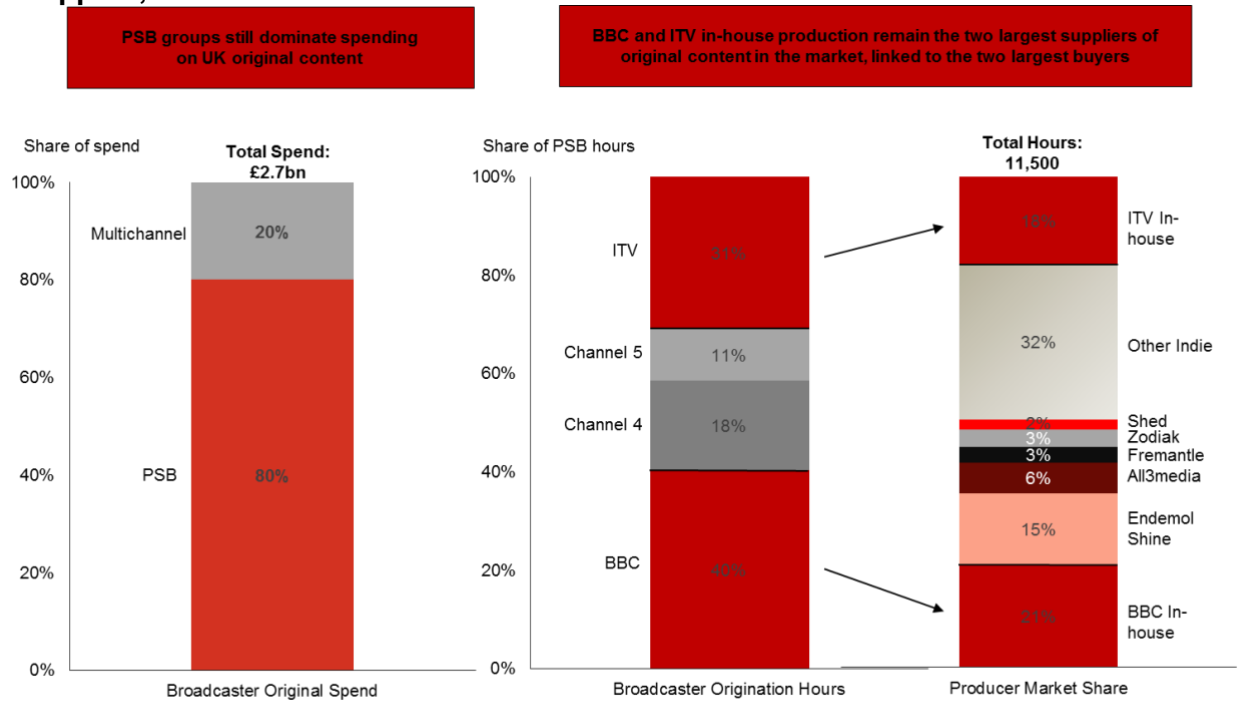
Source: Pact Census 2014

2.19 During this period, the share of the largest independent producers in the market (with a turnover greater than £70m) has gone down. The turnover of mid-tier and small independent producers is rising.

2.20 Next, it is important to put the size of the UK independent production sector, in comparison to the vertically integrated production sector, into context.

2.21 Despite consolidation in the market, none of the large independent production groups has managed to aggregate more than 15% of annual output hours. As shown in the chart below, BBC in-house has a 21% market share, with ITV Studios accounting for 18%.

Figure 7: share of spending on UK original content and PSB commissioned hours by buyer/supplier, 2013

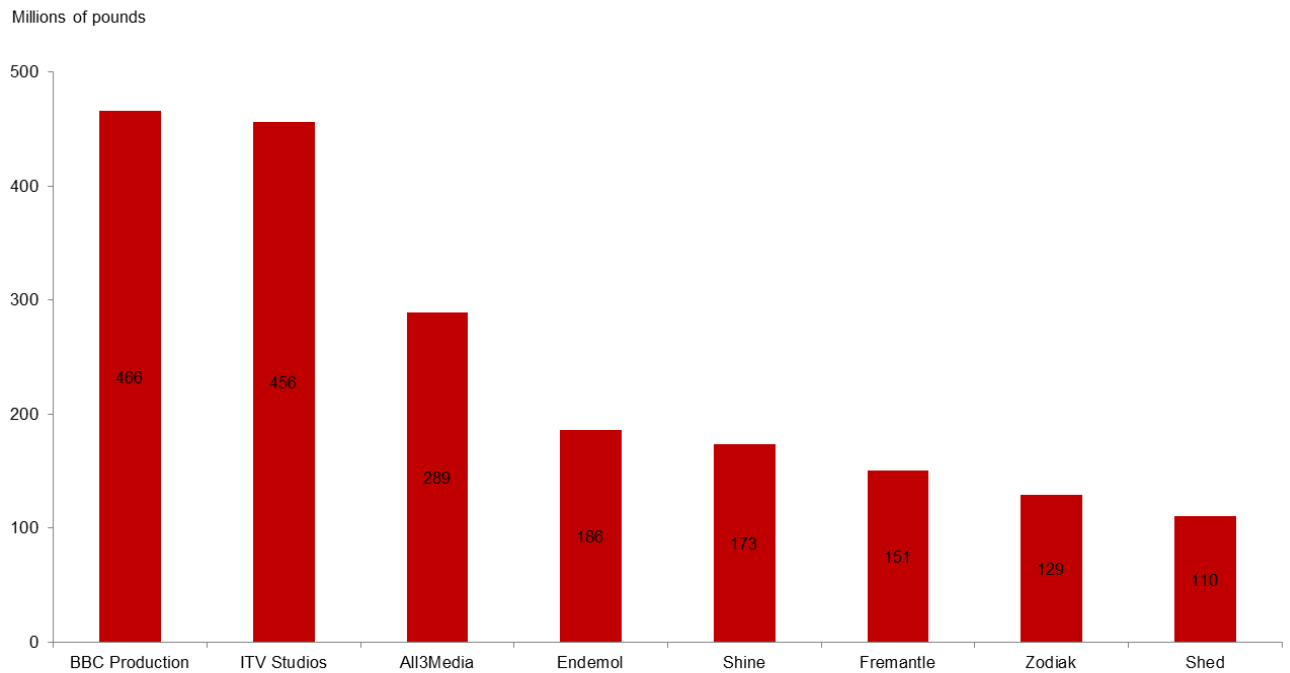


Note: Total Spend is all network and multichannel originated spend (excluding news). Total hours is only BBC1, BBC2, ITV1, Channel 4 and Channel 5 (excluding news). Sources: BARB (Attentional), Oliver & Ohlbaum analysis

Source: O&O report on TV producer consolidation globalization and vertical integration – myths and realities, February 2015

2.22 Figure 8 below shows that, by revenue share also, none of the so-called ‘super-indies’ has a share anywhere near that of the vertically integrated production arms of the BBC (BBC in-house) or ITV (ITV Studios) – even if the revenues of Shine and Endemol are combined as would now be the case post-merger.

Figure 8: UK Turnover of BBC in-house production, ITV Studios and large indies (2013)



Sources: BBC, ITV, Broadcast Indie Survey 2014, Oliver & Ohlbaum analysis
 Turnover comprises primary UK commission income and other rights income – UK secondary sales, publishing, formats, DVD sales etc.

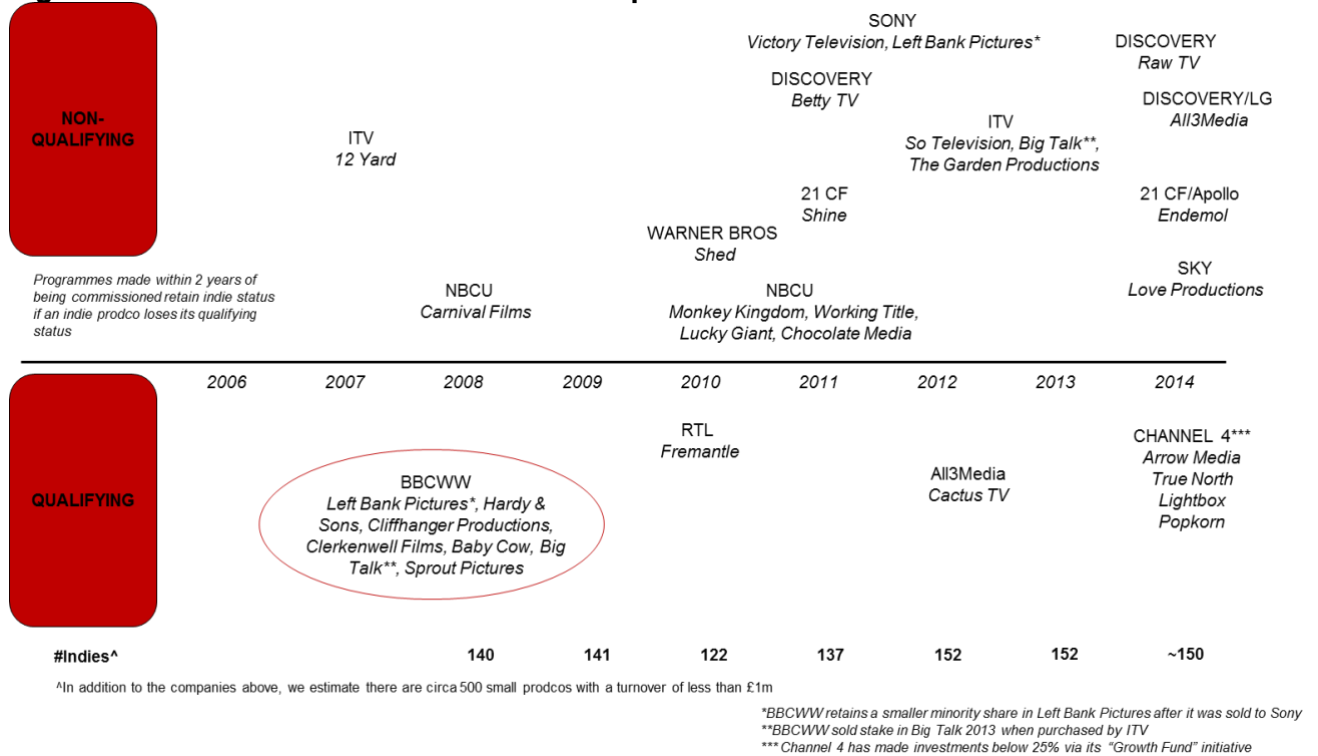
Source: O&O report for Pact on a New Age of UK TV Content Creation and a New Age for the BBC, O&O for Pact, August 2014

2.23 One of the concerns which has been expressed by the commercial public service broadcasters in recent months – including in David Abraham’s MacTaggart lecture at the Edinburgh TV festival⁶ – is that the balance of power between the supply side of the market and the buyer side (i.e. the PSBs) has changed as a result of consolidation in the market. Pact strongly contests this point.

2.24 It is true that there has been consolidation in the independent production sector in recent years. However, as illustrated in O&O’s analysis on ‘the evolution of the TV content production sector’ which was published by Ofcom as a discussion document accompanying this review, because the sector has successfully attracted external investment, there has been much higher consolidation into non-qualifying ownership than vice versa.

⁶ <http://www.channel4.com/info/press/news/after-the-gold-rush-david-abrahams-mctaggart-lecture-in-full>

Figure 9: the evolution of the UK TV content production sector



Source: Oliver & Ohlbaum analysis

2.25 Furthermore, the way in which the PSBs commission programmes illustrates that, in practice, the balance of power has not changed during this time, despite consolidation. There are many ways in which buyers can put pressure on the supply side of the market.

2.26 Firstly, there are many more suppliers than buyers in the market, meaning that competition for commissions is fierce. As such, what matters is not the size of the production company, but the quality of the idea.

2.27 Even in the case of returning series, buyer power remains strong. It is not uncommon for a broadcaster to delay a decision as to whether or not a programme will be recommissioned until close to the end of the transmission period of the previous series. This creates a significant level of uncertainty for the producer, and will often mean that they have to invest money in securing talent and developing ideas without the certainty of knowing that they will be able to recoup. In addition, broadcasters often ask for a reduction in their licence fee on a returning series on the assumption that efficiencies can be made on the cost of sets etc. However in practice, rather than lowering from one series to another, production costs often increase over time if a programme is successful, as securing talent becomes more expensive.

The Terms of Trade continue to be effective in addressing buyer power in the market

2.28 Ofcom's consultation states that consolidation has resulted in a number of large companies ceasing to qualify as independent producers for the purposes of the independent production quotas and Codes of Practice. This is, in our opinion, an important point.

2.29 As noted in the overview to our response, Section 285 of the Communications Act requires that the Codes of Practice set out by Ofcom, which underpin the Terms of Trade negotiations, apply to independent producers who qualify as such under the Broadcasting (Independent Productions) Order (most recently updated in 2014).

2.30 The definition of an independent producer as per this legislation is a producer:

- a) Who is not employed by a broadcaster;
- b) Who does not have a shareholding greater than 25% in a UK broadcaster; or
- c) In which any one UK broadcaster has a shareholding greater than 25% or any two or more UK broadcasters have an aggregate shareholding greater than 50%.⁷

2.31 It is at the discretion of each PSB whether or not they decide to offer the Terms of Trade to producers who do not meet this qualifying criteria as part of commissioning negotiations.

2.32 Pact strongly contests any suggestion that the Terms of Trade are no longer operating effectively and that legislative change is required as a result of market consolidation. The key reasons for this are as follows.

2.33 Firstly, the balance of power in the UK programme supply market is still very much in favour of the commissioning broadcasters for the majority of output. This is because PSB commissioning is still the majority of original content spend (85% - and considerably higher in some genres).

2.34 Although much has been made of investment in content directly for video on demand services such as Netflix and Amazon Instant Video, this additional investment - although welcome - remains small. It is also largely focused on commissions from American content producers, as shown in the table below. These programmes are commercially focused and aimed to attract global audiences.

2.35 Last year, Netflix made its first UK content commission by commissioning Leftbank Pictures to make 'The Crown'. This ten-part series is due to be released on Netflix in 2016. It is based on the west-end play, 'The Audience' and it tells the story of Queen Elizabeth II and her relationship with post-war Downing Street.

Figure 10: 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

⁷ http://www.legislation.gov.uk/uksi/2014/3137/pdfs/ukxi_20143137_en.pdf

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	Leftbank Pictures (Sony)	UK

Source: Oliver & Ohlbaum analysis

2.36 Therefore, whilst investment in content by non-linear platforms such as Netflix is welcome, it is unlikely that they will become significant alternative commissioners of PSB content in the UK market.

There is still a lot of competition in the supply side of the market

2.37 The plurality of supply in most programme genres remains strong. There are still many more producers in the UK than commissioning broadcasters.

2.38 Even as numbers have fallen as a result of consolidation, in practice, production companies within larger groups often retain their separate company brands, staff, and areas of specialism, thereby increasing diversity and competition of supply.

2.39 First-look deals are not, and do not appear to be becoming, a common feature in the UK TV market. This means that producers are not tied to a specific broadcaster. Even if a production company is bought by a company which also has broadcasting interests in the UK, they tend not to make it a requirement that the broadcasting arm of the parent company has a first-look right on content ideas produced by the production arm.

2.40 The latest wave of consolidation therefore does not pose a threat to small UK independent producers, as has been made out in recent months by Channel 4 and others.

2.41 As noted by Ofcom in its consultation document and as referred to earlier in our submission, if a production company is purchased by a company which has broadcasting interests in the UK, it no longer qualifies for the independent production quota, or for the Terms of Trade.

2.42 The fact that consolidation has led to the creation of several large non-qualifying groups in recent years means that there is more, not less, room for competition within the 25% independent production quota for competition amongst the remaining qualifying producers.

2.43 The competitive focus and specialisms of small independent producers often tend to be different to larger production groups. For example, smaller producers might focus on factual commissions, whereas large groups might focus on formattable entertainment shows, or high-end drama.

- 2.44 The Terms of Trade are extremely efficient, in large part because of the flexibility which enables PSBs and Pact, on behalf of the independent production sector, to regularly renegotiate terms.
- 2.45 The tables in confidential Annex 1 provide a summary of the ways in which the Terms of Trade have evolved over the last decade. They illustrate the extent to which the PSBs have secured additional usage of intellectual property rights for content made by external producers, so as to enable them to launch new services as technological advances have offered new ways in which they can meet audience demands.
- 2.46 In illustrating these key changes in the Terms of Trade for each of the UK PSBs, we wish to draw attention to the extent to which producers have granted greater and greater use of rights to the commissioning broadcasters, in return for shorter holdback periods. The purpose of these tables is also to illustrate the extent to which each broadcaster has acquired increasingly bespoke Terms over time, based on their specific aims and objectives, over time. In 2004, the Terms of Trade were broadly similar across the board. There are now significant differences between the terms which each PSB has negotiated, freely and on a commercial basis, with Pact.
- 2.47 In the 11 years since the Terms of Trade were first negotiated, there has never been a formal complaint to Ofcom by any party about the operation of this piece of legislation.
- 2.48 Should the UK PSBs seek an amendment to this legislation, as has been suggested by Channel 4 in recent months, then we would expect them to provide evidence to Ofcom that they have suffered material detriment as a result.
- 2.49 This is Ofcom's third review of public service broadcasting. In 2006, it conducted a thorough review of the independent production sector. Yet despite these reviews, to date we have not seen any convincing evidence which makes the broadcaster's case as to why the Terms of Trade should be revised.
- 2.50 If they are to make the case that the current legislation is no longer appropriate or effective, then this should be subject to a proper regulatory review, in which all of the interested parties could make representations to the regulator, on the basis of sound economic evidence.
- 2.51 As noted above, Pact would strongly contest any argument that the Terms of Trade have been anything but beneficial to the buyer side, as well as the supply side, of the UK TV market.
- 2.52 The attraction of risk capital into the independent production sector and its success in exploiting UK IP globally has helped to keep programme commission prices down as UK independent producers have invested approximately £200 million per annum into TV production, possibly much more when the full costs if it was possible to account for the full costs of R&D investment by UK independent producers in developing ideas before they are ready to pitch to commissioners.
- 2.53 Research by O&O for Pact found that on a like-for-like basis, commission prices have been largely flat in nominal terms since 2006. This means that, in real terms, they have fallen by about 10-15%. Audiences have benefited from this as UK PSBs have been able to commission more high-quality original UK content at a lower cost.

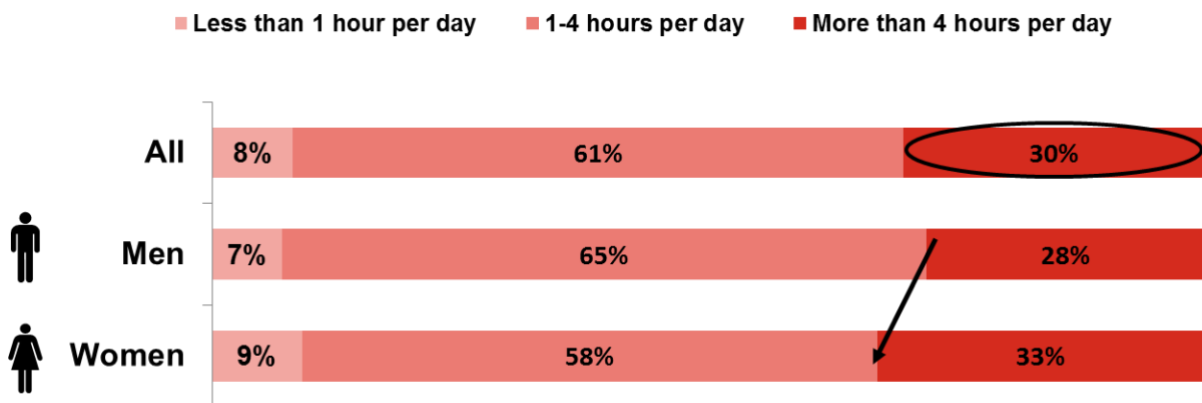
2.54 During this period, there has been no lessening of the quality of UK content in terms of its ability to win prizes, both at home and overseas.⁸

Changes in audience needs and behaviours

2.55 In order to better understand audience attitudes towards TV programmes and who makes them, in the summer of 2014 Pact commissioned GFK to conduct a piece of quantitative and qualitative research⁹.

2.56 In this report, GFK found that television remains at the heart of people’s lives, with 30% of respondents claiming to watch more than 4 hours of TV per day, as shown in figure 11 below.

Figure 11: Audience viewing habits



Source: GFK consumer research for Pact

2.57 With regards to accessibility, this research found – in line with Ofcom’s own analysis – that the ability to access content on a range of devices, whenever it was convenient to them, was important to viewers.

2.58 GFK’s research also found that recording and rescheduling programmes is now very widespread, particularly in drama as opposed to soaps or current affairs. Rescheduling was popular on personal video recording devices (such as TiVO and Sky Planner), through digital content providers such as Netflix, and on catch-up services such as BBC iPlayer; 4OD; ITV Player and Demand 5.

2.59 Pre-recorded programmes were often watched as solitary viewing and several respondents talked about “binge-watching” back-to-back episodes of a series.

⁸ A New Age of UK TV Content and a New Age for the BBC, O&O report for Pact, August 2014

⁹ Methodology: a 10 minute quantitative questionnaire with 2002 nationally representative adults using the GFK online omnibus survey covering the nations and regions of the UK, conducted between 30 July and 6 August 2014, followed by 6x2h focus groups comprising of 7-8 participants with a representative sample of different genders, lifestages and location across the UK.

Figure 12: reasons for rescheduling programmes versus watching live

Why re-schedule programmes?	Why not re-schedule programmes?
<ul style="list-style-type: none"> • To watch when free to relax • Fast forward past ads and programme credits • Binge viewing during bad weather • Record early evening programmes for 'me-time' later in the evening 	<ul style="list-style-type: none"> • Soaps can be missed without losing the plot – omnibus editions are often preferred • Programmes like X-Factor have normal repeats during the same week • News and current affairs need to be viewed 'on the day'

Source: GFK consumer research for Pact

2.60 It also found that audience appreciation of the PSBs remained high, with the 5 terrestrial channels the most frequently watched. YouTube also featured highly, being mentioned by 26% of respondents (see figure 15).

2.61 GFK's qualitative research highlighted the strong channel identities which the PSBs have in the eyes of their audiences, and how much they differ from each other. The different consumer perceptions of the PSB channels are illustrated in the diagrams in Annex 2.

2.62 These personifications were devised by GFK as a means of illustrating the descriptors most commonly referred to by members of 6 two hour focus groups which were held with members of the public in different locations around the UK. The views are not those of Pact, but rather of a demographically representative group of viewers who were asked unprompted questions about how they would describe each PSB channel if they were to walk into the room.

Question 2: Have we identified the key differences in Northern Ireland, Scotland and Wales?

2.63 The PSBs have an important role to play in supporting and maintaining investment in the nations and English regions. This includes both supporting the growth of indigenous production bases as well as through direct investment, for example, as with the BBC in Salford, Pacific Quay and Bristol.

2.64 Ofcom has on the whole identified the differences in the broadcasting landscape in Northern Ireland, Scotland and Wales. Some of the key issues are highlighted in the supporting documentation published by Ofcom. This underlines the different dynamics in each nation. Pact would have welcomed further analysis by Ofcom of current spend and investment in the English regions alongside this.

2.65 Although, overall the volume of UK-wide network production made in the nations has been rising, this hides the underlying facts that:

- The volume of hours of network programming made in Northern Ireland still remains at a low level and has done since 2008. There are considerable concerns locally, particularly around the low levels of BBC network spend in NI.
- Spend and volume of production has increased in Scotland at a faster rate than in the other nations, but this is largely due to the BBC increasing its production from Scotland. With the loss of Waterloo Road, which was made in Greenock by Shed Media, the BBC will have to work hard to maintain similar levels of investment into the future.

2.66 The analysis around broadband access and connectivity is useful and highlights that Scotland and Wales in particular are behind the rest of the UK. We would underline the importance as suggested by rolling out superfast broadband to all rural areas in the nations which is particularly important for younger viewers to help them access the range of online content platforms available.

3. PSB performance

Question 3: Do you agree with our assessment that the PSB system remains strong overall?

3.1 Pact agrees with Ofcom's analysis that the PSB system remains strong, but that there have been declines in spend, output and viewing. Taking each of these areas in turn, the following section of our submission notes the implications of changes in the PSB sector with regards to the impact which this has on independent producers.

Sector revenues and the key sources of funding for PSB have recovered well from recession and continue to grow

3.2 We support Ofcom's analysis that the key sources of funding for the commercial PSBs have begun to recover from the recession, but that at the same time public funding has decreased in real terms as the BBC licence fee has remained flat in nominal terms.

3.3 The BBC is the cornerstone of the British public service broadcasting system. Ofcom's research illustrates that ITV 1's investment in content is directly linked to the investment made by the BBC on BBC One.

3.4 Furthermore, the BBC plays a crucial role in investing in certain types of content which are core to public service values, such as children's and religious programming, where the BBC is the only major UK buyer.

3.5 In order to ensure the future of a properly-funded BBC, which plays a vital role in the British broadcasting ecology, Pact calls on the next Government to tie the BBC licence fee to inflation in the next settlement. Anything less than this would represent another real-terms cut in BBC funding, which has already fallen by 6% in real terms since 2008.

3.6 Pact believes that there are many ways in which the BBC can be more efficient in how it spends this public funding, and we will be raising our concerns with the BBC Trust as part of its content supply review. However, we believe that the BBC will not be able to meet any future cuts to its income through efficiencies alone. A decline in the licence fee will lead to a decline in content investment by the BBC, which cannot be in the best interest of licence fee payers.

3.7 Pact welcomes Ofcom's analysis that sector revenues have recovered well from the recession, and continue to grow. We note that TV advertising revenues have fallen by £362m in real terms since 2008, largely as a result of the recession.

3.8 However, the impact of this decline in the primary means of funding commercial PSB content does not seem to have had a significant impact on the volume of output on-screen, nor its quantity.

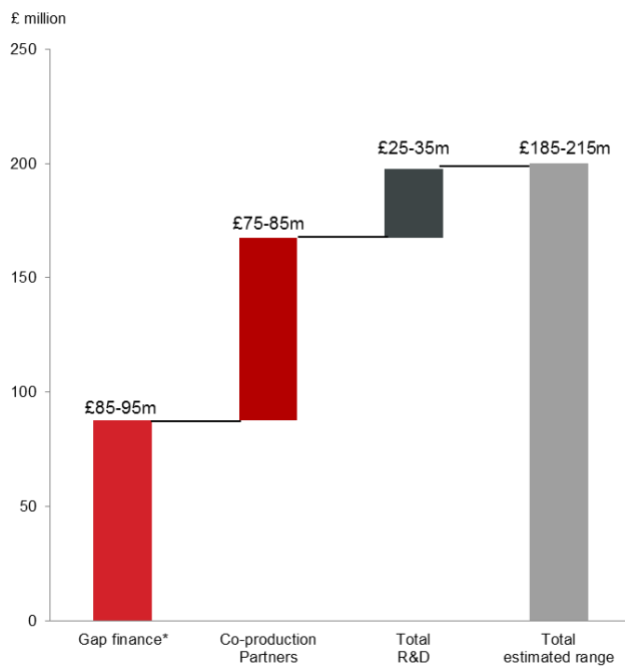
3.9 This is because independent producers have shielded PSBs from the full-impact of the recession, by bringing additional sources of programme funding to the table through

revenues which they have been able to generate from efficiency savings; pre-sales and overseas sales of finished programmes and formats. At the same time, PSBs have looked to reduce their own costs where possible, including by negotiating down the costs of expensive shows and key talent.

3.10 As shown in the chart below, independent producers have worked hard during the economic recession, when television advertising budgets were squeezed. Through the exploitation of their intellectual property rights, independent producers have been able to co-invest and share risk in the creation of UK original content.

3.11 Figure 13 shows a breakdown of where this gap-funding came from in 2013. What this chart illustrates is the broad range of additional sources of finance which independent producers bring to the table as producers' equity. This is a market response to PSBs no longer fully funding the cost of developing and producing a programme, as they had had to do the in the past, before independent producers controlled the rights to the content which they made under the Terms of Trade.

Figure 13: Estimated value ranges of contribution by UK independent producers to productions, 2013

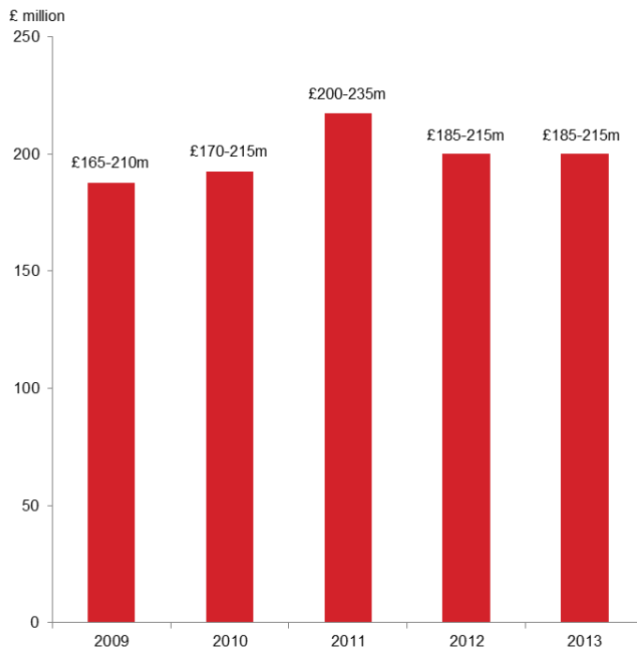


Source: Pact census 2014

3.12 The levels of research and development (R&D) are likely to be significantly greater than those accounted for in the chart above. This is because a lot of the first stage of development, as listed in the flow chart in Figure 1, is not accounted for by independent producers in their financial reporting. This is likely to only account for development funding at the second stage, when an idea is being pitched to a broadcaster. Taking a standard measurement that approximately 5% of a company's revenue will go into R&D, based on sector revenues from primary UK TV commissions of £1.668 billion in 2013, we estimate that the total investment by the sector in R&D is likely to be closer to £83 million per annum. This is a significant contribution made to UK public service broadcasting by UK independent production companies.

3.13 As shown in figure 14 below, the Pact census shows that independent producers have invested approximately £200m of additional investment into PSB content per year over the past five years. This leads to a cumulative spend of between £905m and £1,090bn over five years. As noted above, these figures could be even greater, by an additional £50 million per annum if investment in R&D by independent producers is accepted as being greater than the amount accounted for in the Census.

Figure 14: Estimated value ranges of contribution by UK independent producers to productions, 2009-2013



Source: Pact Census 2014

Subscription revenues are strong and TV advertising has recovered from the economic downturn

3.14 Another important source of investment in content comes from subscription revenues, which Ofcom identifies as having been the key driver of growth in total TV sector revenues, rising by 15.2% in real terms.

3.15 Pact welcomes the increase in investment in content by the cable and satellite channels, up 43% since 2008 to a total of £350m. This additional investment plays an important role in the health of the UK broadcasting sector, including by providing more avenues for a variety of programmes to be made and shown to different audiences.

3.16 Television advertising tends to operate in a cyclical manner, with peaks and troughs tied to the general health of the UK economy. Pact is pleased to note Ofcom's analysis that the television advertising market appears to be recovering from the last economic downturn.

3.17 Focusing again on deficit funding, independent producers have played an important role in protecting UK PSBs from the full impact of the advertising recession, as they have invested some of their profits into programme development and production, at the expense of their own profit margins.

3.18 Without the guarantees to control and exploit their IP rights, as set out in the Terms of Trade, independent producers would not be able to continue to invest in the content which they create. Should this happen, UK commercial PSBs would be much more vulnerable to cyclical changes in the TV advertising market than they currently are, with additional investment coming from UK independent producers.

UK PSBs increasingly also own IP

3.19 The BBC and ITV own IP through their in-house production departments. As a result, they have been able to generate revenues through international distribution in a wide range of different markets.

3.20 Furthermore, the UK PSBs are increasingly acquiring stakes in UK and international production companies. For example, in August 2014 Channel 4 acquired stakes (less than 25% so that they remain qualifying independent producers) in Arrow Media, Lightbox, Popkorn and True North. These investments were made for the £20 million growth fund which the channel has set up with the aim of nurturing the independent sector.

3.21 BBC Worldwide also has stakes in UK independent production companies such as Hardy & Sons, Cliffhanger Productions and BabyCow.

3.22 ITV has acquired stakes in several American production companies, for example, it has an 80% stake in Leftfield, which produces Real Housewives of New Jersey. ITV Studios is now the largest independent producer in the USA.

3.23 Like independent producers, UK PSBs are able to control and exploit the IP rights to the content which they own in secondary and international markets, thereby generating additional revenues which can be used to fund UK PSB content.

PSB spend on all programs, and investment in new first-run UK originations, have both fallen substantially in real terms

3.24 Pact notes Ofcom's analysis in paragraph 3.18 of the consultation document that over the last decade it has used total investment levels in content as a proxy for the overall quality of programmes. Pact agrees with this measurement. However, it is important that all the methods of funding programme production are taken into account when using spend as a measurement for quality.

3.25 Ofcom's broadcaster returns provide a useful data set to illustrate the decline in spend on first-run content by the UK PSBs. However in order to get an accurate view of the decline, it is important to also note the role which independent producers play in bringing third-party investment to content investment, through deficit funding.

3.26 Another important source of investment in content comes from subscription revenues, which Ofcom identifies as having been the key driver of growth in total TV sector revenues, rising by 15.2% in real terms.

The overall viewing share of PSB channels has fallen

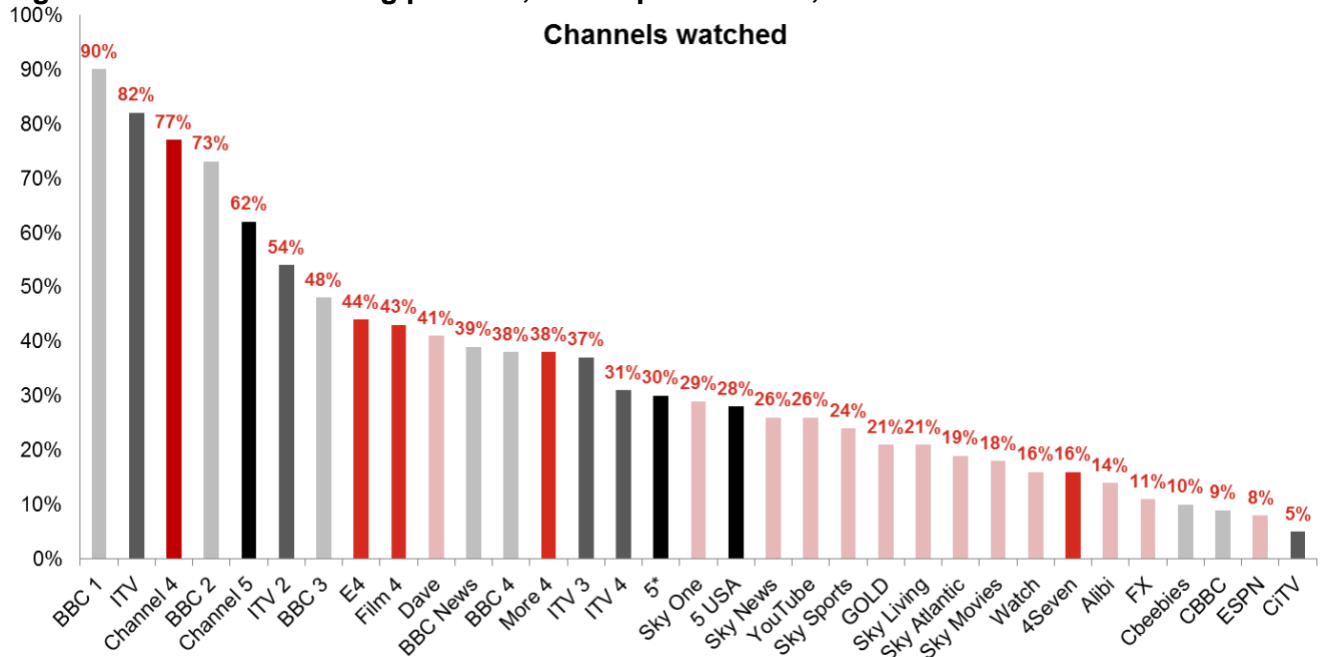
3.27 We note Ofcom's analysis in paragraph 3.32 of the consultation document that in aggregate, viewing to the PSB channels remains very high and that together they continue to account for over half of all UK television viewing.

3.28 This chimes with the findings of GFK's consumer survey for Pact, which found that the PSB channels remained very popular with viewers, as shown in figure 15 below.

3.29 The five main terrestrial channels remain the most watched amongst UK viewers, with the PSB portfolio channels also amongst the most frequently watched.

3.30 This shows that the PSBs – particularly when their portfolio channels are taken into account – remain by far the largest channels in the UK in terms of audience share. All but one of the top ten most-watched channels in the GFK research were PSB or portfolio channels.

Figure 15: audience viewing patterns, GFK report for Pact, summer 2014



Source: GFK consumer research for Pact. Full report available in Annex 1

Programming for children by the PSB channels has fallen since 2008

3.31 As the Ofcom analysis clearly shows at Figure 31 in the consultation document, UK children's production has declined dramatically over the last ten years. This is largely due to i) the removal of the requirement for commercial PSBs to carry children's programming and ii) the ban on HFSS advertising in 2008,¹⁰ which made children's programming much less commercially attractive to produce.

3.32 Together, the commercial PSBs have reduced their collective investment in original British children's TV by 97% over the last decade, from £65m in 2002 to £2m in 2011. This has left a situation where the BBC, with reducing budgets¹¹, is a monopoly buyer in this genre.

3.33 ITV and Channel 4 invest very little in children's programming and there has been a substantial drop in hours of original programming on Channel 5 too. At Channel 4 there has been no real children's content, despite obligations which were placed on the broadcaster under the 2010 Digital Economy Act to cater more for older children (10-14 year olds) in the digital space. CiTV previously demonstrated a major decline in children's content. There

¹⁰ Foods which are high in fat, sugar and salt

¹¹ BBC Trust Review of Children's Services report (2013)

have been, however, recent signs of investment in this genre by ITV through programmes such as Horrible Science and Thunderbirds, which Pact welcomes.

3.34 The introduction of the children's TV and animation tax credits will to a certain extent help incentivise production and keep this in the UK by providing financial support for productions which qualify as British under the cultural test. However, in order to guarantee the long-term future of this vitally important genre, the PSBs must be willing to invest in this genre again.

3.35 In a parallel submission to the Ofcom PSB Review, Pact has collaborated with the Ragdoll Foundation and the consultancy Communications Chambers to make a more detailed case for addressing this collapse in PSB spend on a key public service genre. Pact challenges the broadcasters to work with Ofcom to develop new approaches that will reverse these trends without the recourse to primary legislation. If change is not forthcoming then the paper argues that future legislation will be needed¹².

Question 4: Given the resources available, to what extent is the system meeting the needs of a wide a range of audiences as practicable?

There are some questions about the extent to which the PSBs fully meet the needs of a range of audiences across the UK as a whole

3.36 Pact has been playing a key role in the pan-industry discussions about how to improve diversity, both on and off-screen, in the television and film sectors.

3.37 Our commitment to this agenda is demonstrated by Pact CEO's John McVay recent appointment as the new Chair of the pan-industry Creative Diversity Network (CDN) for the next two years.

3.38 Since it was introduced in 2009, an impressive 510 production companies have now signed up to the CDN Diversity Pledge. This is a public commitment by independent production companies, in-house producers and other suppliers to take measurable steps to improve diversity in the TV industry.

3.39 One of the top priorities for the CDN this year is to successfully implement the introduction of 'Project Diamond' – a system of pan-industry diversity monitoring. This system will introduce a more accurate means of capturing data across the industry about diversity, both in terms of on-screen portrayal and off-screen employment, as noted by Ofcom in the consultation document.

3.40 In recent months, Sky, Channel 4, the BBC and ITV have all launched ambitious diversity targets and strategies in order to improve opportunities and access for all, and on-screen representation. The strategies introduce targets for on-screen and off-screen diversity.

3.41 Pact welcomes these initiatives which seek to improve diversity in the television industry. We are working with the broadcasters to develop guidance for independent producers as to how they can meet the broadcasting targets in their projects, whilst also complying with the legislative requirements under the Equality Act.

¹² Children's Programming and the Commercial PSBs, Communications Chambers report for Pact and the Ragdoll Foundation, February 2015

3.42 Another way in which the independent production sector is working to improve diversity and access in the sector is through the Indie Diversity Training Scheme. This scheme is aimed at new entrants to the industry from diverse backgrounds (both graduates and non-graduates). The scheme provides a framework in which independent producers offer a training opportunity to a trainee on the scheme in their business. In addition, the indies work together to mentor, nurture and develop talent by providing master-classes and training to enhance their learning. Now in its third year, a large proportion of trainees who have graduated from this scheme are now working in the independent production sector.

Performance also varies in the nations

3.43 Pact notes the comments made by viewers in Wales, Belfast and Glasgow in the consultation document. Clearly, there is more work to be done to secure programming that is truly diverse and representative of the different communities within the nations and regions.

3.44 Pact considers that the PSB targets for the nations and regions should be respected and challenged into the future. We need to move beyond the 'lift and shift' model from London to the nations and regions towards more sustainable growth by investing across the whole of the UK by investing in strong indigenous centres outside the M25.

Independent producers in the nations and regions have a long track record of producing high-quality programmes which are popular with audiences and commercially and creatively very successful.

Recent examples include *The Fall*, a crime drama made for BBC network by Artists Studio in Belfast. This production was filmed on location in Northern Ireland and used local talent on screen.

Bafta-winning *Katie Morag* is filmed and produced by Move On Up. This is a children's live action TV series for CBeebies based on the books by Mairi Hedderwick and it is filmed on the island of Lewis and at MG Alba's studios in Stornoway.

Embarrassing Bodies is a reality medical series which was produced by Maverick in the Midlands for Channel 4. The 'Live from the Clinic' episode used Skype technology and had a multi-platform presence on web and mobile devices.

Another example of content produced in the English regions is Icon Films, based in Bristol, which makes a range of factual programmes such as *Africa's Giant Killers*, *Ben Franklin's Bones* and *Survive the Tribe*.

Requiem, a three part series on S4C, is a documentary where singers and composers from Wales discuss the history, development and future of the requiem. This was produced by Boom Pictures in Wales.

Question 5: Given the resources available, does the PSB system deliver the right balance of spend and output on programming specifically for audiences in Wales, Scotland and Northern Ireland and programmes reflecting those nations to a UK-wide audience?

- 3.45 Pact recognises the progress made over the last five years in Out of London production spend, with just under half (49.4%) of first-run network programme hours being produced within the M25.
- 3.46 Notwithstanding the points made in response to Question 2 in our submission, Pact continues to be encouraged by the commitments made in recent years by the PSBs towards increasing investment and spend in Wales, Scotland and Northern Ireland. The BBC has committed to commissioning 17% of its output from the Nations by 2016, and it has set itself a target that 50% of network spend will be made outside of London by the same year. Channel 4 has committed that 9% of its content by volume and spend will be commissioned in the nations and regions by 2020. Pact would welcome ITV and Channel 5 making similar commitments.
- 3.47 Pact is concerned that spend on first run originated nations and regions programming by the BBC, ITV, STV and UTV fell between 2008 and 2013 by 26%.
- 3.48 Maintaining these agreed quotas for the nations and regions into the future is paramount if we are to see long term and sustainable growth in these areas. Pact will particularly be pushing for quotas to be maintained within the context of upcoming negotiations around BBC Charter Renewal.
- 3.49 Pact has long expressed concerns around the PSB practice of 'lift and shift' that moves production operations and commissioning culture from London rather than focusing on working with indigenous companies and developing talent and expertise locally.
- 3.50 We would like to see further steps by the PSBs to build relationships with a diverse pool of local independent production companies and work to strategies for sustainable growth and developing talent in the longer term. We would like to see them taking risks and reaching out beyond established contacts and larger companies to being open to working with smaller companies.
- 3.51 Useful engagement strategies (such as those launched by the BBC and Channel 4 in Scotland) are a good starting point. Where broadcasters work with independent producers on their ideas and help them develop skills by sharing insight and expertise, looking to longer term capacity building, help secure returning series and development of the industry. Pact considers that it would be beneficial if such strategies were developed and emulated in Wales and Northern Ireland too.

Question 6: is declining investment affecting the quality of PSB and is it a cause of concern?

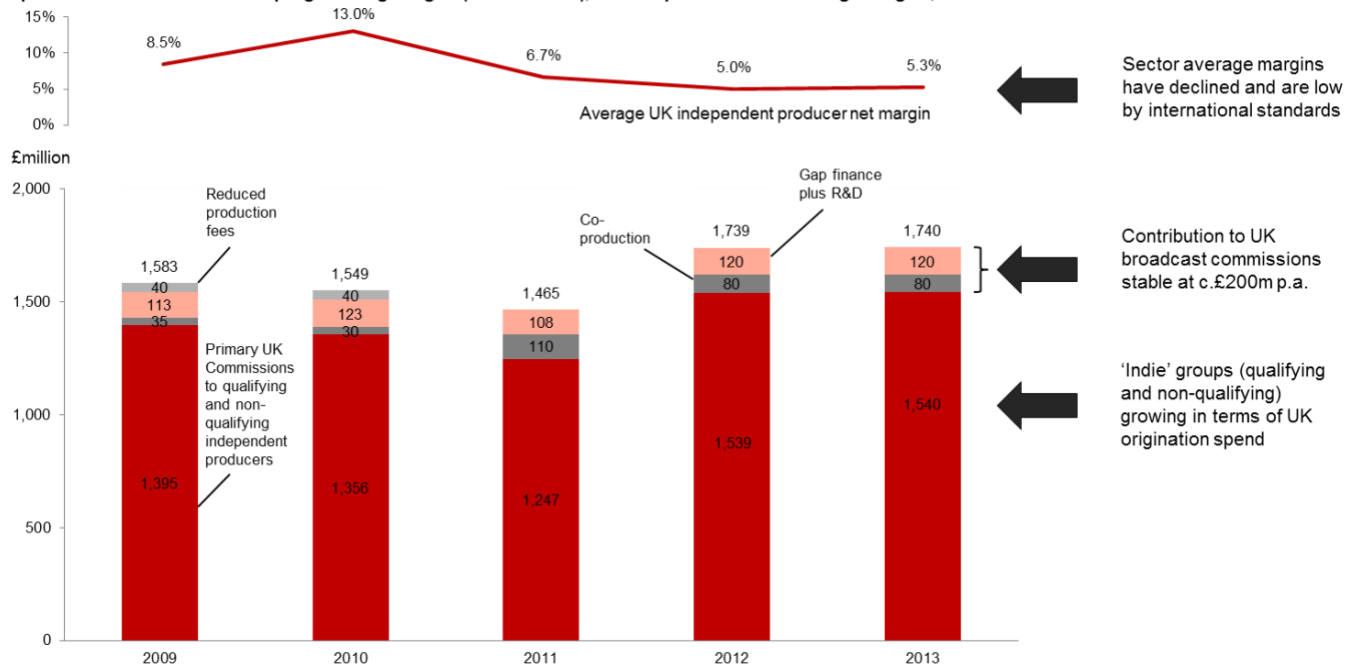
- 3.52 Pact welcomes Ofcom's acknowledgment in the report that direct broadcaster investment in programmes is not the only source of funding for programmes, and that co-production investment and producer deficient finance and/or distributor advances are also critically important.
- 3.53 The data shown in figure 40 of the Ofcom PSB consultation show that third-party contribution to first-run UK originations of the PSB channels was approximately £200m per

annum in 2011-13. This mirrors our analysis, as shown in figure 14 above, taken from the Pact Census 2014.

3.54 Furthermore, during this period as independent producers have been able to maintain steady levels of deficit funding into original UK content production, they have seen their margins fall from approximately a high of 13% in 2010, to approximately 5% (low by international standards) since 2012.

Figure 16: independent sector contribution to programming budgets over time

Independent sector contribution to programming budgets (whole market), and independent sector average margins, 2009-13



Source: Pact Census' 2010-2014

3.55 In the consultation document, Ofcom states that the vast majority of value generated by secondary rights appears to lie in drama, whereas factual and entertainment have not, so far, generated the same levels of secondary market value, although in some cases the format has been sold in many countries.

3.56 UK drama is incredibly successful internationally, with shows such as Sherlock and Downton Abbey being sold all over the world. It is true that for some of the independent producers which specialise in other genres, for example, specialist factual producers such as history and arts where the subject matter tends to be domestically focused and there are high clearance costs for secondary rights material such as archive footage, secondary income can be expensive and unlikely. Deficit funding for development and production of these sorts of programmes is still necessary, but it tends to come out of the independent producer's margins without much hope of recoupment.

3.57 However, when it comes to the international exploitation of programme formats, the UK is the world-leader. These are generally comprised of factual entertainment, entertainment and reality programmes.

3.58 Many of the most popular international formats of the last 10 years such as Who Wants to be a Millionaire and Pop Idol were made in the UK.

3.59 A recent report commissioned by Pact from O&O found that of the top 100 formatted commission programme titles in Europe over the last 5 years - both by hours and estimated

airtime value – forty of them were sourced from original UK IP. The same survey noted that 32 of the 40 British formats were originally developed by UK independent producers. Five of the other UK formats were from ITV Studios, and 3 from BBC Worldwide.¹³

3.60 O&O notes in its report that international sales of ready-made UK programmes grew by almost 20 per cent a year between 2008 and 2013, while sales of non-domestic rights in their international commissions grew from £34m to £104m during this period.

Additional sources of funding play an increasingly important role in content investment

3.61 The important role which independent producers play in sharing in the risk of programme development and production cannot be underplayed. Without this investment, which is only feasible because the legislation enables independent producers to exploit their secondary rights, then undoubtedly certain programmes would not be able to be made, or only made with greatly reduced budgets, potentially affecting quality.

3.62 In recent years, other means of content investment have become more prevalent in the UK market. These are generally to be welcomed, although they do also come with certain risks which must be monitored.

3.63 There are three main types of advertising which provide incremental financial support for UK content creation (beyond traditional advertising in a defined slot). These are:

- *Programme sponsorship* - which includes a short advertisement by the programme sponsor at the start and end of the programme, as well as after each commercial break. Generally the broadcaster retains the income generated from programme sponsorship.
- *Product Placement* – is when a company pays for their product or service to be included within a programme, subject to Ofcom rules¹⁴. Product Placement can be passive (i.e. a prop in the background of a scene), active (e.g. a close-up of the product) or very active (e.g. an actor reading a text message from a branded mobile phone). Each of these types of advertisement carry different values to the advertiser. The split for product placement within a TV programme is often 50/50 between the broadcaster and the production company.
- *Off-air activation* – this is when a product is linked to a television programme but not in the context of the linear television broadcast. For example, a cast member might record a video blog which is posted on the programme Facebook page showing how they do their hair for the show, using the advertiser's products. Off-air activation is usually controlled directly by the production company.

3.64 This form of investment in content creation by advertisers is still a relatively nascent market in the UK. For example, Product Placement was only introduced in 2011. As a result, there are very few figures available on the value which this brings to the UK content market, although Thinkbox has published some estimates. In time, this is something which Ofcom might wish to look at in more detail.

3.65 Another way in which advertisers are investing in UK TV content creation is through direct investment by an advertising agency.

¹³ TV Formats in Europe (2014), ETS, Madigan Cluff and Digital TV Research.

¹⁴ Section 9 of the Ofcom Broadcasting Code, Commercial References in Television Programming:

<http://stakeholders.ofcom.org.uk/broadcasting/broadcast-codes/broadcast-code/commercial-references-television/>

- 3.66 Whilst additional means of funding content is welcomed by Pact, particularly at a time when the PSB channels' investment is declining, it is crucial that there is always a clear line between editorial independence and financial investment.
- 3.67 Public service broadcasters should not allow funding for a programme that comes from any source that has, or could have, any influence on the content or the editorial integrity of the programme. This should always remain at the discretion of the producer and the commissioning broadcaster. If a potential conflict might be possible, the PSB must be responsible for satisfying itself and the regulator that no conflict exists.
- 3.68 Any potential external funders for a TV programme should not be allowed to influence the commissioning of content by a PSB broadcaster. Such funding should only be considered after the commissioning decision has been made, so that it can be demonstrated that there was no link between the broadcaster's decision to commission the programme and the third-party finance which might be available.
- 3.69 As the Ofcom rules state in Section 9 of the Broadcasting Code, broadcasters are required to ensure that there is a distinction between editorial content and advertising. Advertisers and media agencies must therefore ensure that they respect the editorial independence of programme makers and broadcasters. If advertisers contribute towards the funding of a programme, this should not give them input into editorial decisions.
- 3.70 It is therefore crucial that in any deal between an advertising agency and a broadcaster or producer, there is total separation between the producer and the sponsor.
- 3.71 Furthermore, where advertising agencies invest directly in content, it is important that this is not used by broadcasters as a back-door in order to commission content in a context which sits outwith the regulated Terms of Trade. Every commission of a qualifying independent producer by a UK PSB must be made within the regulated Terms of Trade, regardless of how the programme has been funded.

Question 7: do you agree with Ofcom's provisional findings in the Review of C4C's delivery of its media content duties?

- 3.72 We recognise the unique role which Channel 4 Corporation has, as result of changes introduced in the Digital Economy Act in 2010, to deliver PSB duties on its full range of services, including all of its TV channel portfolio, on-demand services, online services and Film4Productions.
- 3.73 C4C increased investment on first-run originated content for the main Channel by 8% in real terms between 2010 and 2013. Pact welcomes this increase, which is particularly important for the future economic success of the UK TV content production sector given Channel 4's unique role as a publisher-broadcaster.
- 3.74 Hit shows such as Gogglebox; Fresh Meat; Educating Yorkshire; Southcliffe; and Utopia; have been extremely successful, both creatively and economically. They represent just a few examples of the types of risk-taking, innovative content which sit at the heart of Channel 4's PSB remit.
- 3.75 Pact is, however, disappointed that given that Channel 4 is a publicly owned PSB, its investment ratio is lower than that of its commercial competitor, ITV.
- 3.76 In O&O's report on the future of BBC production, produced for Pact in summer 2014, the economic consultants noted that the BBC spends 76% of attributable licence fee income

on TV content. Sky as a subscription platform invests 34% of its revenues in content.”¹⁵ Looking specifically at the UK PSBs, there are significant variations between the broadcasters.

- 3.77 Our estimates based on analysis of data which is in the public domain show that ITV and Channel 4 spend approximately two-thirds of their net advertising revenues on first-run original content production, which is lower than the publicly-funded BBC, but significantly higher than the proportion of NAR spent on first-run content by Channel 5 (about a third) and Sky.
- 3.78 Pact has responded to requests from Channel 4 to enter negotiations to enable it to respond to market developments and to launch new services to meet consumer demands. For example, in 2007, Pact granted Channel 4 the rights to syndicate its catch-up service 4OD across different platforms including Sky and Virgin Media.
- 3.79 More recently, Pact negotiated with Channel 4 and granted it the rights to launch the linear catch-up service, 4seven. This enables viewers to catch up on programmes which they might have missed on television for a duration of seven days.
- 3.80 The independent production sector understood the importance of this service to C4 in order to enable them to maintain their audience share. As such, Pact worked with the corporation to negotiate the necessary repeat rights free of charge, to enable them to launch the service, in exchange for granting earlier release periods.
- 3.81 This demonstrates the flexibility in the current regulatory system and the ability for producers and broadcasters to work together in order to negotiate terms which enable all parties to benefit from, as illustrated in the confidential tables in Annex 1.
- 3.82 Pact welcomes Channel 4's commitment to meeting its duties with regards to diversity with the commissioning of a broad range of relevant media content of high quality which appeals to the tastes and interests of a culturally diverse society.
- 3.83 Programmes such as the Undateables; Benefits Street; Youngers and Cucumber – all made by UK independent producers – are fantastic examples of high-quality, culturally diverse programming which is popular with audiences which lie at the heart of Channel 4's remit.
- 3.84 Pact also welcomes Channel 4's increased investment in current affairs; feature film development; and in supporting and developing new talent, as per the new duties which it adopted in 2010. However, we are concerned that Ofcom has found that there remains limited provision of content for older children on Channel 4.
- 3.85 Channel 4, through programmes such as The Snowman, used to champion UK animation, but it has migrated from leading in this field to lagging behind in a matter of a few years. Pact would welcome more information about Channel 4's plans to cater for a younger audience and particularly the 10-14 age group (as per its obligations under the Digital Economy Act) into the future.

4 The delivery of the public service objectives by the wider market

¹⁵ A New Age of UK TV Content Creation and a New Age for the BBC, O&O for Pact, August 2014

Question 8: To what extent do you agree with our assessment of the degree to which the non-PSB services play a role in helping to deliver the public service obligations? In doing so please set out your views on the delivery by the PSB portfolio channels, other non-PSB channels, on-demand and internet services and also radio services separately.

PSB portfolio channels

- 4.1 At paragraph 4.11 of the consultation document, Ofcom states that: “the role of the commercial PSB portfolio channels is very different to that of the PSB channels. As purely commercial services, they have none of the licence obligations and receive none of the benefits associated with being a PSB channel. The main purpose of the portfolio services is to increase commercial revenues by extending reach and share through a mix of previously broadcast originations from the PSB channels and other acquisitions.”
- 4.2 We agree with Ofcom's analysis that “while the share of viewing to PSB channels has fallen over the past six years, viewing to the wider portfolio of channels ... has been important to these broadcasters' overall group performance.”
- 4.3 Pact is disappointed that the amount of first-run UK originated hours on the portfolio channels has decreased from 2,684 in 2008 to 1,556 hours in 2013.
- 4.4 Given the important role which the PSB portfolio channels play in offering an alternative mix of programming and reaching a broader range of audiences than the main channels, it is important that PSB corporations continue to invest in original content to meet audience needs on their portfolio channels. However this must not be to the detriment of their main channels, which are still the most popular with audiences and which are regulated under the Terms of Trade.

Non-PSB services

- 4.5 Pact welcomes Ofcom's analysis that multichannel sector and the PSB portfolio channels combined (excluding sport) have increased their content spend by 43% in real terms since 2008. As shown in figure 42 of Ofcom's consultation document, in 2008 the non-PSB channels spent £242m on non-sport first-run originations. By 2013, it was £345m.
- 4.6 We note that this is in the only section of content investment in the market which is currently increasing, a welcome development while the PSB sector investment is in decline.
- 4.7 Competition is important and Pact welcomes the investment in content production by non-PSB channels as an important means of increasing the number and range of buyers in the TV content market, thus offering more opportunities for independent producers to pitch ideas, and generating a benefit to audiences as a broader range of programmes make it on screen.
- 4.8 There are many examples of non-PSB channels broadcasting PSB-like content, as illustrated by Ofcom in its report. Below is one such example, which was made by an independent production company.

Kingdom of Plants is a natural history documentary series. It was produced in 3D by the British independent production company, Atlantic Productions, for the Sky 3D network. The series was also simulcast in 2D on Sky Atlantic HD. The series is presented by Sir David Attenborough and it was filmed over the course of a year at the Royal Botanical Gardens in Kew. This type of content clearly fulfils a remit of entertaining and informing audiences, which lies at the heart of public service broadcasting. When GFK asked about this programme in the consumer research which it conducted on behalf of Pact, it found that less than 20% of respondents were able to correctly identify the channel which this programme was shown on, implying that the majority of respondents associated this sort of PSB content with the public

- 4.9 Whilst Pact strongly welcomes the growth in UK commissioning spend by the multichannels in the UK, particularly at a time when the PSBs are under increasing financial pressure, we note O&O's analysis that spending from this segment of the market is expected to slow in the coming years. There are several reasons for this.
- 4.10 Firstly, 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.
- 4.11 Next, for international channel groups, UK original content is effective in driving audience interest in other markets, but for the most part it will need to exist alongside US original content from the same groups.
- 4.12 For integrated pay platform and channel operators (e.g. Sky) the competitive set includes UK channel operators but also global video on demand players and US studios and in this mix, original content investment outside of sport is likely to be focused on US and European co-productions rather than specific commissions for the UK market.
- 4.13 Finally, inflation in other key content rights might impact on the ability of the multichannels to increase their investment in UK original content. In this context we note that Sky recently paid £1,392 million per annum for each of the three years of the new agreement for the Premier League rights – an 83% increase over the cost of the existing contract.

The role of online media services

- 4.14 Pact agrees with the success, as outlined in the Ofcom report, of the PSB on-demand players and this has given additional platforms for content produced by independent companies to be seen and enjoyed.
- 4.15 Pact is keen that future upgrades to services such as BBC iPlayer include engagement with industry, using their knowledge and expertise to secure the best and value for money solution, which has not been the case in the past.
- 4.16 Moving with developments in technology, Pact would like to see more mainstreaming of digital by the PSBs in the future, with programmes and formats that are interactive from the outset rather than the commissioning of add on games and apps.
- 4.17 Furthermore, Pact is concerned that the PSBs have not fully implemented the recommendations of the Graf review¹⁶, which called on them to develop standalone or complementary digital content offerings alongside television commissions.
- 4.18 If PSBs get this right, it could offer a big boost to the diversity of content available to UK audiences, and to enable the UK digital content sector to grow and become successful IP-owning businesses, rather than agencies as is often the case at the moment.
- 4.19 The ambitions of the Graf review have not come to pass because none of the PSBs have implemented a comprehensive digital commissioning strategy. All too often digital content commissions are not encompassed at the same time as a TV programme is commissioned. Furthermore, digital content is not commissioned under Terms of Trade.
- 4.20 Enabling UK digital content producers to control and exploit their IP rights in secondary markets would not only build a strong UK digital content sector, it would also

¹⁶ Report of the Independent Review of BBC Online, Phillip Graf, 2004

benefit the PSBs as independent producers would have more resources available to invest into research and development.

- 4.21 This is an area of the market in which the PSBs are currently failing in their duties to provide services to consumers and Pact wishes to see greater investment and clear digital strategies from each of the PSBs in the future.

5 Potential future market developments

Question 9: How likely are we to see steady evolution and have we identified all of the potential alternative scenarios and risks to the system?

- 5.1 Pact agrees with Ofcom's hypothesis that the PSB ecology will continue down a trajectory of steady evolution.
- 5.2 New entrants to the content investment market – including linear channels such as the cable and satellite broadcasters – and non-linear services such as Netflix and YouTube are greatly welcomed as new avenues for content to be made and brought to audiences in the UK.
- 5.3 However economically, the overwhelming majority of investment continues to come from the public service broadcasters, and to an increasing extent, their portfolio channels.
- 5.4 Ofcom's prediction that live viewing of broadcast TV channels may well still account for around 80% of all TV viewing in 2020 appears sound, provided that the light-touch regulatory regime which has proven to be so effective to date remains in place.
- 5.5 Where broadcasters might require additional access to content in order to meet changing audience needs, for example, with ever increasing use of DVRs and catch-up services, Pact and the independent production community are open to working with broadcasters to see if deals can be reached which enable the broadcasters and platform operators to launch new services, whilst adequately rewarding the IP owners and those holding underlying rights for use of their content.
- 5.6 The legislation is sufficiently flexible so as to allow these negotiations to take place as regularly as required. The industry has a proven track record of reaching regulated settlements without any regulatory intervention to enable the PSBs to meet their business strategies and consumer demands by launching new products and services, as illustrated in the tables in confidential Annex 1.
- 5.7 For example, from 2007 – 2009, Pact negotiated new Terms of Trade with each of the PSBs so as to enable them to launch their catch up services. More recently, Pact reached agreements with Channel 4 to enable it to launch their seven day linear catch up service, 4seven, and with the BBC, who will be launching a download to own service containing content produced both in-house and externally, called the BBC Store, later this year.
- 5.8 The future potential risks in the PSB system which Ofcom has identified are:
- A faster shift to on-demand viewing;
 - New disruptive entrants may emerge (this could have the positive effect of creating greater competition in the buyer side of the market, which the supply side would willingly respond to, in order to meet audience demands);
 - Faster fragmentation of audiences;
 - Production cost inflation not matched by increase in funding; and
 - Structural changes to the key sources of funding.

5.9 Should any of the risks or opportunities which Ofcom has identified in the consultation document emerge, Pact believes that there is sufficient flexibility in the existing regulatory regime so as to enable industry to make the necessary changes in the marketplace in order to address these risks.

Question 10: how might incentives to invest change over time?

5.10 Pact notes Ofcom's findings that there are pressures in investment – particularly for the commercial PSBs – in certain types of programming. These include important PSB genres such as arts; classical music; current affairs; children's; religious programmes; regional news; nations news and nations non-news programming.

5.11 Pact agrees with Ofcom's analysis that "over the next five years the key commercial sources of funding: principally TV advertising and video advertising around programmes from on-demand players should grow...but growth in the TV advertising and other sources of income for the commercial PSBs does not necessarily translate into growing investment in content, unless the right incentives are in place."

5.12 This is an important assertion by Ofcom, and one which we will come back to later in our response, when considering the issues of the balance of payments or retransmission fees, between the commercial PSB channels and the cable and satellite operators.

6 Maintaining and strengthening the system

Question 11: have we identified all the relevant ways in which the PSB system might be maintained and strengthened?

6.1 The four key areas which Ofcom is considering in order to maintain and strengthen the PSB system are:

- Modernising availability and discoverability rules;
- Providing greater institutional flexibility;
- Rebalancing the relationship between broadcasters and production sector; and
- Considering additional sources of funding.

6.2 These appear to be relevant issues for Ofcom, as the sectoral regulator, to be considering with regards to maintaining a strong PSB system which delivers Parliament's intention to provide audiences with content which meets the requirements of promoting and respecting British cultural and social values, and benefiting citizens in the ways which PSB is intended to do so.

6.3 In assessing each of these areas, we call on Ofcom to consider the implications of each proposal not just on the PSB providers, but also on the wider industry which also plays an important role in increasing the programme offerings and thereby contributing towards the quality of PSB content which delivers to UK audiences.

Question 12: Does universal availability and the easy discoverability of PSB remain important and how might it be secured in future?

6.4 In paragraph 6.2.1 of the consultation document it states that "if Parliament continues to want to ensure that PSB content achieves universal reach and impact in a connected environment, it may be necessary to reform the current regulations around prominence and carriage, and to define what is meant by universality in a more complicated and connected environment."

6.5 Pact agrees with Ofcom's analysis that prominence is likely to remain a key part of the PSB 'compact' in the future, as universality and prominence have a direct impact on the ability of the commercial PSBs to attract advertising revenues and thereby their ability to invest in original UK content.

6.6 Pact does not have a view on what form prominence should take in the future.

6.7 However Ofcom might wish to consider the potential impacts which improvements of the EPG listings of PSB portfolio channels might have in terms of the possible displacement of the television channels which currently occupy higher slots. The multichannel sector is increasingly investing in content production, and the impact of a possible decline in their share of advertising must be considered for the implications which this could have on the market.

6.8 In particular, Pact wishes to highlight that should any regulatory changes further limit the commercial PSBs' ability to attract advertising revenues around their children's channels or programming on the main channel, this could have a disastrous effect on the market. Our concern, as noted in earlier in this submission, is that this would leave the publicly funded BBC, at the moment by far the largest provider of children's TV content in the UK, as the sole provider of children's TV content.

Question 13: should we explore the possibility of giving greater flexibility to PSB institutions in how they deliver public service content, including examining the scope (in some or all case) for regulating by institution, not channel?

6.9 In paragraph 6.31 of the consultation document Ofcom identifies two approaches which might enable PSBs to better deliver their policy goals. These are:

- Applying some or all of the obligations and benefits which are currently applied only to the specific PSB channels to some or all of the other services offered by the PSBs, including online; and
- Applying benefits and obligations to the PSBs, rather than to specific services, and allowing them the flexibility to choose how best to deliver the purposes and objectives in line with audience expectations.

6.10 Pact understands that it might be appealing to the commercial PSBs to seek the extension of the PSB benefits afforded to the status to include their portfolio channels and potentially, their digital services. This would potentially enable them to attract greater advertising revenues due to the universality and prominence which these channels would receive. It would also enable the PSBs to spread their PSB obligations across many different services, rather than focusing on their main linear channel, thus potentially freeing up more revenues to invest in more profitable genres on the main channel.

6.11 However, we believe that there are several risks associated with this proposal. Firstly, there are the risks which Ofcom has identified in the review. For example, that by allowing PSBs more flexibility in where to schedule content, although this might maximise their revenues, it might also lead to some PSB output being placed in less-widely used parts of the TV schedule (e.g. on portfolio channels) or online, which means fewer people would access the content.

6.12 As well as posing a risk to audiences, who might not be able to access the content as readily as when it is broadcast on one of the main linear channels, this could also have a detrimental impact on content producers, as budgets for productions on portfolio channels tend to be lower than those on the main channels.

6.13 Next, any extension of the PSB benefits beyond the main PSB channels must also include an extension of the PSB obligations. This would include increasing the independent

production quota on the portfolio channels from the 10% European minimum to the 25% PSB quota as required under Sections 16(2)(h) and 25(2)(f) of the Broadcasting Act 1990.

- 6.14 Before it is possible to conduct a thorough analysis of the extent to which Pact considers these proposals to be beneficial to the UK production sector, it is important for Ofcom to consider – and publish evidence on – the impact which allowing the PSBs greater flexibility in a new PSB compact would have on the UK independent production quota and on the overall ecology.
- 6.15 With limited resources available, our concern is that the commercial PSBs might campaign for a 'levelling down' of the independent production quota, making the argument that it would be impossible for them to commission enough original UK content from independent producers so as to meet a 25% quota across the board.
- 6.16 Pact would strongly contest this claim, should it be made. The supply side of the production sector is thriving, and has demonstrated time and again its capacity to make high-quality original content which meets the PSB values.
- 6.17 If the portfolio channels were to be classed as PSB, then they must meet the requirements of public service broadcasting by investing in a diversity of supply of content, which includes investing in a range of suppliers from across the country.
- 6.18 If Ofcom is to assess this proposal further, we seek assurances that the 25% independent production quota would be extended to include any additional services or channels which would seek to receive PSB benefits.
- 6.19 Furthermore, the extension of PSB status to any linear channel beyond the existing PSBs must also extend the scope of Section 285 of the Communications Act, thereby making them subject to the Terms of Trade.
- 6.20 Finally, Ofcom must consider the potential impact which improvements of the EPG listings of PSB portfolio channels might have in terms of the possible displacement of the television channels which currently occupy higher slots. The multichannel sector is increasingly investing in content production, and the impact of a possible decline in their share of advertising must be considered for the implications which this could have on the market.
- 6.21 Without such assurances, Pact is unable to support a proposal for greater institutional flexibility for the PSBs through the extension of PSB benefits to include their portfolio channels at this stage.

Question 14: do the current interventions in relation to the independent production sector need to change in light of industry developments?

- 6.22 Pact wholeheartedly supports the benefits which Ofcom has identified as resulting from the regulatory interventions of the independent production quota and the codes of practice (Terms of Trade).

Underpinning the PSB system

- 6.23 As highlighted in the overview to this response, the Terms of Trade enable independent producers to exploit their rights in secondary markets – as they have successfully done in consecutive years since this legislation was introduced in 2003 – thereby enabling the independent sector to help PSBs to provide a wide range of high-quality output.

6.24 There are approximately 400 independent television producers in the UK. They work across a wide range of genres making content which is culturally significant, innovative and economically and creatively successful. This provides a wide, competitive supplier-base from which all broadcasters – PSB and non-PSB; in the UK and internationally – can source content from.

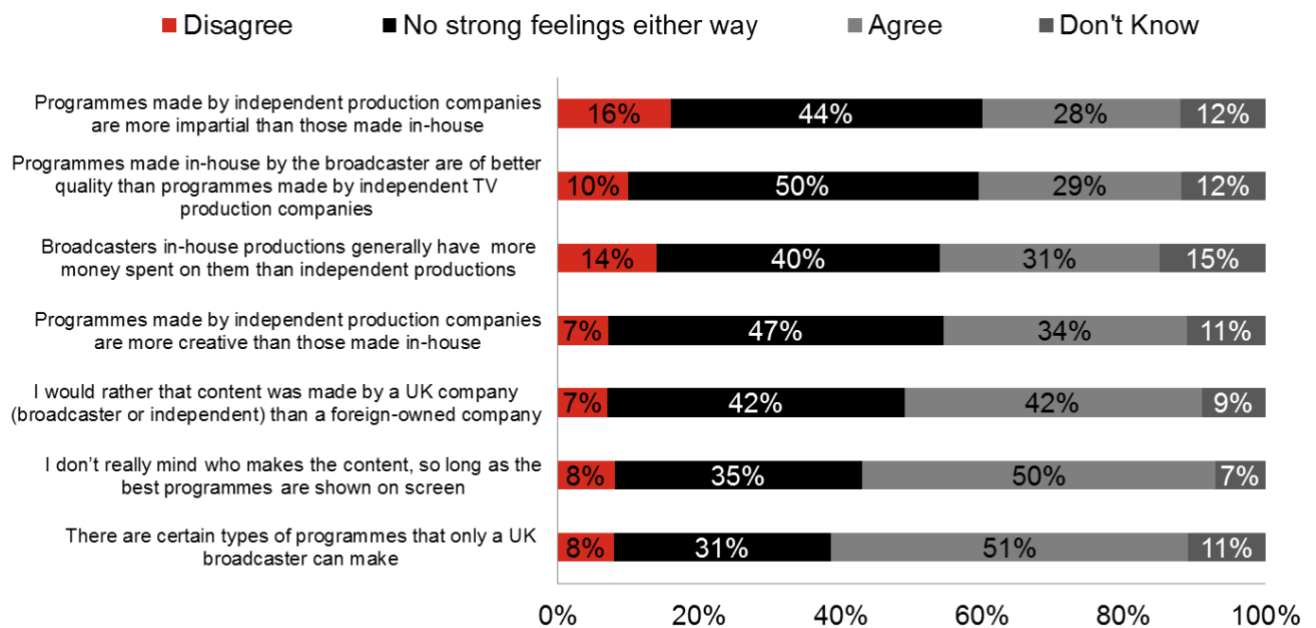
Ensuring plurality of ideas and cultural diversity

6.25 Pact strongly supports Ofcom's analysis that "the best programme ideas originate from across the whole market and external producers often cater for a wider mix of genres, therefore the regime helps to ensure that a range of creative voices is delivered on screen to the viewer."

6.26 In the consumer research which GFK conducted for Pact, they found that 50% of respondents didn't really mind who makes the content, so long as the best programmes are shown on screen. Thirty five per cent of respondents had no strong feelings either way.

6.27 In addition, over a third (34%) of respondents to the GFK research said that programmes made by independent production companies were more creative than those made in-house, with 47% citing to have no strong preference either way and only 7% disagreeing with this statement.

Figure 17: viewer understanding of programme production



Q9. Extent you agree with this statement? Total Sample (2002)

Source: GFK consumer research for Pact

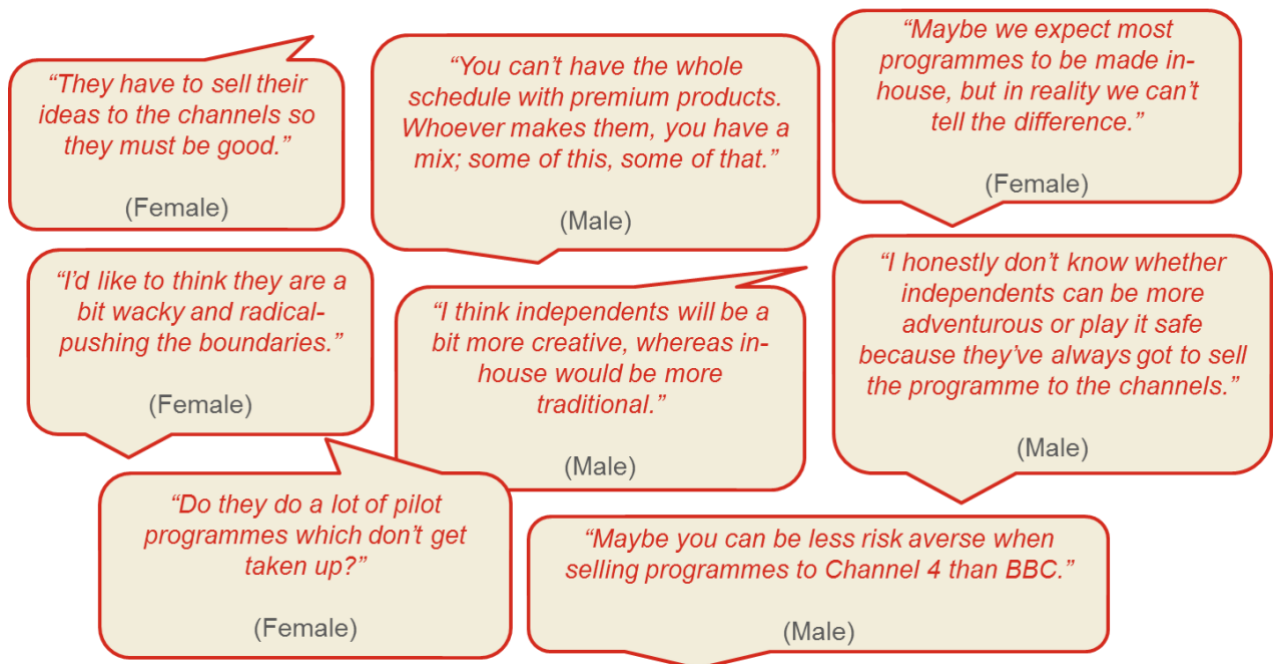
6.28 When asked specifically about the benefits of independent productions over content made in-house, respondents said that they thought that they cost less, that they were more varied, more creative and of better quality, as shown in the diagram below.

Figure 18: viewer understanding of programme production



Source: GFK consumer research for Pact
 Question: Benefits of programmes being made by Independent production company. Total sample (2002)

Figure 19: spontaneous imagery of independent producers



Source: GFK consumer research for Pact

Widening production’s geographic footprint

6.29 Pact supports Ofcom’s analysis that the independent production quota provides an additional incentive (together with the Out of London production quotas, and the Nations quotas on Channel 4) for the PSBs to invest in content made outside of London, which helps to bring additional voices to the screen.

Serving UK interests internationally

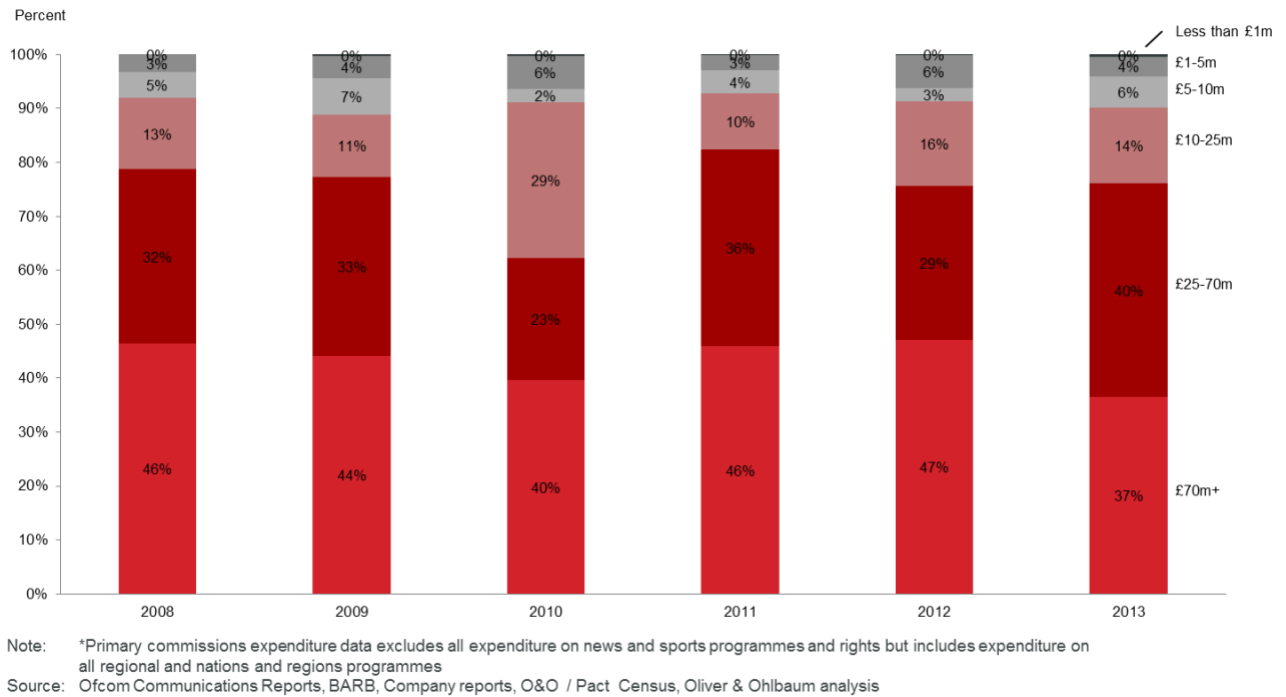
- 6.30 Another benefit of these interventions – as identified by Ofcom in the consultation document – is that they have helped to promote British intellectual property in an increasingly globalised market and helped to attract overseas investment to a strong domestic sector.
- 6.31 The UK is now the second largest export market for TV content in the world, behind only the USA. In 2013/14, the last year for which data is available, the estimated total revenue from the international sales of UK TV programmes and associated activities was £1,284m, a 5% increase from £1,223m in 2012.¹⁷
- 6.32 Without the strong intellectual property regime, and the ability for UK content producers to grow their businesses on the back of commissions with UK PSBs, the international success of this sector would never have been possible.
- 6.33 Going forward, provided that the light-touch, efficient, regulatory protections remain in place, we see no reason why this projected rate of growth will not continue in future years, with a particular focus on new and emerging markets.
- 6.34 In line with previous years, the USA continues to be the UK's largest export market for TV content, with sales up by 10% to £523m. However the largest increase in revenue sales came from China, which grew by 40% between 2012 and 2013/14, generating revenues of £17m.

Stimulating the growth of SMEs

- 6.35 Pact notes Ofcom's analysis in paragraph 6.53 of the consultation document that enabling independent producers to establish themselves as SMEs helps to promote creativity and to foster new talent in the sector by reducing barriers to entry.
- 6.36 It is true that the barriers to entry in TV production are relatively low, and as shown in figure 20 below, small and medium sized producers have retained their share of spend healthily during the last five years.

¹⁷ UKTV exports report 2014, a TRP report for Pact, BBC Worldwide and ITV Studios

Figure 20: Share of spend on UK externally produced primary commissions segmented by turnover band of producer, 2008 to 2013



6.37 Pact considers that the evolution of the television sector has led to the entry and growth of new online services, some of which have gained significant traction with consumers. Broadcasters no longer uniquely compete just amongst themselves, they also need to launch new services to be competitive in the wider content market. In order to maintain their relevance, especially to younger audiences, PSBs need to provide content in a way which is accessible on both primary services and throughout the wider market, whether on services owned by PSB institutions or third parties.

6.38 As noted in Ofcom's consultation document, consumers expect that content will be universally available on the services of their choosing. Pact agrees that this is important. While the market's answer to these expectations can never be perfect, Pact makes the general point that producers, as rights owners, always have as a marginal incentive the widest spread of distribution of their programmes. The marginal incentive for broadcasters is often too restrict distribution of content to their own core services.

6.39 Pact considers that such protectionism will always find itself in conflict with the fact that current institutions can no longer control all the outlets enjoyed by the consumer.

Balancing vertical integration trends

6.40 The UK television market has evolved at a rapid pace over the last few years and this has led to a number of consolidation steps being taken. It is important to note that these have not been confined to the production sector alone, but have been taken both within all sectors of the value chain (platform sector, broadcaster sector and production sector), as well as across different sectors.

6.41 By way of example, Liberty Global acquired Virgin Media; Scripps acquired a 50% stake in UKTV; and Viacom acquired Channel Five at around the same time as the Shine/Endemol merger.

- 6.42 In relation to cross-sector transactions, examples include Liberty investing in ITV; Sky acquiring Flextech channels; ITV acquiring production companies; and Discovery/Liberty acquiring All3Media.
- 6.43 While these consolidation activities represent one aspect of the evolution of the UK television sector, the production supply sector remains highly diverse. Furthermore, buyer power has not significantly changed, partly because consolidation has not been a producer-only phenomenon.
- 6.44 Pact notes Ofcom's comments that "the vertical integration of broadcasters and producers in the supply market may lead to a lack of diversity of supply and therefore not deliver the best outcome for viewers in terms of the range of genres and value for money".
- 6.45 As noted above, the balance of power still very much lies with the UK PSBs. Every production company, large or small, pitches in the same way to one broadcaster at a time. Unlike the US model, it is incredibly rare in the UK for producers to auction their ideas to several broadcasters at once in order to seek a commission.
- 6.46 There are still many more producers than commissioning broadcasters in the UK market. We estimate that there are approximately 400 independent producers in the UK, with fewer than 10 buyers. For some genres, there is only one buyer as each channel has a different identity and area of focus (as shown in Annex 2).
- 6.47 Analysis conducted by O&O for Pact found that in 2013 there were 136 independent producers with a turnover greater than £1 million. This was up from 108 such producers in 2008.¹⁸ The overall number of companies engaged by the PSB channels remains high and is sufficiently large so as to ensure that a reasonable level of competition is sustained.
- 6.48 The buyers therefore play an extremely important role in supporting the diversity of the supply side of the market. By commissioning content from as wide a range of producers as possible, they can ensure that there remains a diverse supply of producers seeking to make content for them.
- 6.49 Furthermore, Pact would argue that the vertical integration of broadcasters and producers in the supply market can improve diversity, particularly with regards to talent. With the support of larger financial backers, production companies which are part of larger groups may have greater resources to be able to attract and maintain key talent, and to invest in important training and development. They may also be more willing to take on risks.
- 6.50 It is also important to note that in practice, whereas several companies might be owned by a single group, each usually retains its individual specialisms, talent and corporate culture.
- 6.51 While there has been no evidence to date of any lack of diversity of supply (indeed the balance of supplier power to buyer power is broadly similar to what it was 10 years ago), any perceived risk to diversity of supply reinforces in our view the need for strong Terms of Trade protections for the supply side of the PSB ecology.
- 6.52 In this respect, we take strong issue with the argument made by the PSBs in recent months which suggests that the counter to increased vertical integration as a result of consolidation is yet more vertical integration of rights.

¹⁸ TV producer consolidation, globalisation and vertical integration: myths and realities, O&O report for Pact, February 2015.

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

- 6.53 O&O concludes in its analysis for Ofcom that the case that having larger production groups in the market leads to reduced buyer power – and consequential harm to PSBs – is not proven.
- 6.54 This is because to date, no single combined entity has control of supply of more than 15% of UK commissioning activity (see figure 8 of this submission).
- 6.55 Furthermore, consolidation activity in the UK market has been a long-standing trend, but the super-indie groups have found it hard to break through a combined share of the total market of c.40%, with BBC in-house and ITV Studios remaining by far the largest producers in the sector in terms of revenues.
- 6.56 Given that the UK PSBs still account for over 85% of demand in the market, the balance of power between the buyers and the suppliers has not changed in recent years, despite market consolidation. What matters in terms of supply and demand is the strength of the idea, and what buyers are looking for.
- 6.57 Because of their distinct brands and PSB requirements, each of the PSBs looks for something different in terms of commissioning. This makes it harder for a single actor to consolidate supply or to leverage a higher price from two rival buyers. For this reason, unlike the US model where it is common for a producer to sell-in an idea to several buyers at once in the hope of potentially attracting a higher commissioning rate, in the UK market it is still common practice for a producer to pitch an idea to one buyer at a time, so that it is tailored to their specific requirements.
- 6.58 Because of the way in which the market works, in practice, individual production companies will pitch and win commissions from broadcasters under their own brand, rather than that of the parent company. This reiterates the fact that the balance of power in the market has not fundamentally shifted, despite some recent changes in ownership.
- 6.59 In addition, as illustrated in figure 9 of this submission, almost all of the larger independent producer groups in the UK no longer qualify under the legislation. This means that they no longer have automatic recourse to the Terms of Trade in their negotiations with 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

- 6.60 As analysis by Oliver & Ohlbaum for Pact,¹⁹ concludes consolidation and globalisation are two parts of the same trend. 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 effectively compete if they want to own the exploitation of their intellectual property rights internationally. Both ITV Studios and BBC Worldwide have significant production and distribution activities in multiple markets, and a handful of large producers are following a similar model.
- 6.61 What is important, in our opinion, is not ownership across different markets, but rather whether any company gains significant market share. The supply side of UK content production remains extremely competitive. As noted above, despite 10 years of consolidation, none of the large independent production groups has yet managed to aggregate more than 15% of annual output hours.

¹⁹ TV producer consolidation, globalisation and vertical integration: myths and realities, O&O report for Pact, February 2015.

- 6.62 Pact notes that the UK remains one of the most attractive TV production markets in the world. It is the second largest exporter of TV programmes, and the world-leader in the export of TV formats.
- 6.63 A significant part of the value of many acquired UK production companies is inextricably linked to their continued success in winning UK PSB commissions. The future strength of the UK independent production sector is therefore intrinsically linked to the future success of UK PSB, and vice-versa.
- 6.64 The UK is also an attractive place for foreign investment in content, with many global companies bringing co-production and pre-sales finance to UK projects.
- 6.65 This is likely to increase, as already evidenced, with the introduction of creative sector tax reliefs for high-end TV, animation and (soon to follow) children's TV programmes. These reliefs offer a 20% rebate on the surrenderable losses of qualifying British production expenditure.
- 6.66 Figures recently published by the British Film Institute, supported by a range of partners including Pact, found that for every pound spent by the Government on the high-end TV tax relief, the return on investment to the Exchequer is £8.31²⁰. This report found that the high-end TV tax relief contributed additional revenues of £249 million to the Exchequer, and the animation relief generated £52 million. It also noted that spend on high-end TV production in the UK was 87% higher in the first year of the relief being in place (2013/14) than in the preceding year.
- Vertical integration between platforms, broadcasters and producers is a complex area and many of the plays being made are about hedging against future risks*
- 6.67 Pact supports O&O's conclusion that broadcaster/producer integration is only likely to be a significant problem where an integrated group has a high share of market demand and supply.
- 6.68 With regards to vertical integration, we consider that this is largely taking place in order to enable broadcasters to protect against future market trends, by ensuring that they have access to a content offering.
- 6.69 For these reasons, we do not consider that there is any evidence to suggest that consolidation activity in the UK supply market is having a negative impact on the UK PSBs.
- Providing protection during commercial negotiations*
- 6.70 Parliament's main intention in introducing Section 285 of the Communications Act 2003 was to address the balance of power in commercial negotiations between the UK PSBs and their suppliers, which sat firmly with the buyer side given that they controlled 90% of the market at the time.
- 6.71 Given that the PSBs continue to account for 85% of UK original content spend, we strongly believe that the rationale for providing protection for suppliers, the majority of whom are SMEs, during commercial negotiations remains.
- 6.72 Furthermore, we support O&O's analysis that the first step in assessing whether there is an emerging problem within the UK programme supply market should be to demonstrate

²⁰ The Economic contribution of the UK's film, high-end TV, video games and animation production sectors, Olsberg SPI and Nordicity. Commissioned by the BFI, Pinewood Studios, the British Film Commission, UKIE and Pact, February 2015.

that the existing protections are no longer working as they should. This is currently not the case.

- 6.73 The 25% minimum independent production quota for UK PSBs has remained unchanged for over ten years. Like the Terms of Trade, this applies only to 'qualifying' independent producers as per the legislation.
- 6.74 As sector consolidation plays out, there are effectively fewer qualifying independent producers left in the market, and hence the opportunities for qualifying independent producers could improve.
- 6.75 Similarly, the requirement for negotiated Terms of Trade has been effective in concert with the independent production quotas as it has applied to the majority of the available external supplier base. This is still the case and hence Terms of Trade still represent the starting point for the majority of external programme supply to PSB groups.
- 6.76 A move to create specific improved or better protected Terms of Trade for smaller groups, as mooted as a possible future option by some of the commercial PSBs, risks upsetting this balance by making the minority of suppliers in the market less attractive to broadcasters.
- 6.77 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.

It is therefore vitally important to the future success of the independent production sector that the status quo is maintained

- 6.78 For the reasons outlined above, Pact strongly believes that a removal of the 25% minimum independent production quota and of the Terms of Trade would be seriously detrimental to the UK television sector.
- 6.79 Should changes be made to the current interventions in this way, this would lead to a resurgence of vertical integration between broadcasters and producers, and a return to the closed shop that existed before 2003 when production companies were effectively paid as "work for hire", gaining a production fee but no control over their IP rights. Not only would this have serious implications for the future of PSB, it would also seriously damage a creative industry which generates revenues of over £3bn per annum in the UK economy.
- 6.80 Pact considers that the creation of specific differential protections for smaller independent producers in a consolidating market is likely to fail. No details have been put forward by Channel 4, who proposed the idea, as to what the financial limit would be set as, and how compliance would be monitored. Not only would this add unnecessary red tape for producers and broadcasters, but it would also act as a barrier to success in a growing market.

Question 15: have we identified the right options when considering potential new sources of funding, are there other sources of funding which should be considered, and which are most preferable?

- 6.81 Ofcom has identified seven options for consideration at this stage as additional potential sources of funding for PSB in the future.

Changes to TV advertising regulations

- 6.82 Given Ofcom's relatively recent decision not to recommend that the Competition Commission conducts a review of TV advertising trading in 2011, Pact does not consider that

it is appropriate to examine the case for changing TV advertising volume and scheduling rules, or for relaxing wider TV advertising rules, so soon after the last review.

Introducing new creative sector tax reliefs

- 6.83 Pact strongly welcomes the introduction of the new creative sector tax reliefs to high-end TV, animation and children's programming. Almost two years since their introduction, the high-end TV and animation reliefs have led to significant growth in these sectors.
- 6.84 The rationale for these interventions was that there was a market failure in these markets, which enabled the UK Government to receive state aid approval from the European Commission for these interventions.
- 6.85 Before introducing additional tax reliefs, the UK Government would require well-documented evidence that a market failure exists in another genre. At present Pact is not aware of any such issue in other genres of the TV market.

Exempting PSBs from any future AIP changes

- 6.86 Pact supports Ofcom's decision to postpone the imposition of administered incentive pricing (AIP) for spectrum on the PSBs until at least 2020. Before assessing whether to introduce any changes in the regime of spectrum pricing, it would be necessary for Ofcom to re-examine the market and the case for intervention. In our opinion, it is important that such a review takes into consideration the impact which the introduction of AIP pricing might have on the PSBs' ability to invest in original UK content.

Introduce contestable funding

- 6.87 Pact notes that Parliament could introduce contestable funding to address the under provision of certain types of programmes, such as nations and regions or children's programming. Whilst additional investment in these important and often under-invested genres is important, Pact does not consider that contestable funding is the most appropriate solution as it would most probably reduce other forms of content provision as PSB budgets are increasingly facing financial pressures.

Use new quotas to ensure at-risk genres

- 6.88 As outlined above and in the report which Communications Chambers has prepared for Pact and the Ragdoll Foundation, which has been submitted as a separate response to Ofcom's PSB review, Pact would support the introduction of a new quota for children's programming.

Transfer funds from other parts of the industry in to the PSB system

- 6.89 Pact has listened to a range of different opinions put forward by the broadcasters in recent months on the issue of balance of payments/retransmission fees.
- 6.90 We understand that the Department for Culture, Media and Sport will shortly be consulting on this issue, as announced by the Secretary of State, Sajid Javid, in his RTS speech in September 2014.²¹
- 6.91 Pact does not have a fixed view on whether or not changes should be made to the balance of payments between the public service broadcasting channels and the cable and satellite operators for the carriage of their channels on these platforms.

²¹ Sajid Javid speech to the Royal Television Society, 9 September 2014:
<https://www.gov.uk/government/speeches/sajid-javids-speech-at-the-royal-television-society-conference>

6.92 We do wish to highlight, however, that in continental Europe, where retransmission fees are paid by the cable and satellite operators to the PSB channels for carrying content, a payment must be made to Agicoa for this use. Agicoa is a collecting agency which then distributes appropriate payment to the underlying rights holders – producers, writers, directors, musicians etc – for the additional use of their work in this way.

6.93 Therefore should a system of retransmission be introduced in the UK, it will be necessary to consider how the underlying rights holders will be adequately compensated for the use of their content in this way. This is in addition to the considerations which Ofcom identifies in its report, as outlined below, which Pact also supports.

6.94 Should any reforms that might affect the balance of payments between PSBs and platforms in the UK, the following policy implications must be considered:

- How underlying rights holders will be adequately compensated for the additional use of the content;
- What impact this could have on the overall levels of investment in programmes by PSBs;
- What impact this would have on funding for specific genres;
- How this would impact competition between PSBs and other non-PSB broadcasters;
- The universal availability of PSB channels and programmes, who potentially risk losing their guaranteed position on the EPG if all regulation is removed in this area;
- The potential impact on pay-TV retail prices for consumers (and, in our opinion, on the ability of non-PSB channels to continue to invest in original UK content, given that they represent the only section of the UK TV market where investment in content is currently increasing);
- Other commercial negotiations between PSBs and platforms;
- The proportionality of as well as the costs and benefits associated with any regulatory change.

7 Concluding remarks

7.1 Having considered Ofcom's consultation questions in detail, Pact wishes to reiterate the important role which UK PSBs play in delivering high-quality, original content which viewers value. By investing revenues back into programme research and development – at the expense of their own margins – independent producers play a crucial role in supporting the PSB system.

7.2 We consider that the changes in both the supply and buyer sides of the market, together with the financial uncertainties facing the UK PSBs, means that the Terms of Trade are as important - if not more important - now than ever before. It is important that the diversity of supply in the sector is protected and promoted, and without the Terms of Trade the levels of vertical integration (whether of rights or of ownership) are likely to increase.

7.3 Furthermore, it is important that high-quality, innovative, hugely popular content made by UK producers is capable of widespread dissemination. This can only happen if producers retain the secondary distribution rights to the content which they create, rather than these rights being assimilated and consolidated within PSB institutions.

7.4 As a result of technological change and consumer demand, the PSB ecology in the UK is spreading onto new platforms and devices, and it is important that the associated IP rights are free to follow that evolution.