



The Future Funding of the BBC

Report of the Independent Review Panel

Chairman: Gavyn Davies July 1999

To The Rt Hon Chris Smith MP, Secretary of State for Culture, Media and Sport.

We have completed our review of the future funding of the BBC and now have the pleasure of submitting our report.

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28 July 1999

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Chairman's Foreword - A Better BBC for the Digital Age

The Panel has concluded that -

- the BBC should retain a central role in the provision of public service broadcasting in the early years of the digital age, at least up to Charter Review in 2006;
- in order to accomplish this, the BBC will need to improve its overall provision of services on analogue and digital platforms somewhat faster than it has during the 1990s;
- the status quo option of uprating the licence fee in line with inflation after 2001 should therefore not be adopted;
- the prime source of new funding for extra services should be self-help by the BBC, in the form of efficiency savings, commercial revenues and privatisation revenues;
- the secondary source of new funding, amounting to about £150 - 200 million a year, should come from additional licence fee revenue;
- the main licence fee is a feasible route for this extra funding, but it is not the preferred route, because it is unfair to charge analogue households for the development of digital services which they cannot receive;
- the preferred route is to charge a digital supplement on the licence fee, amounting to an average of £1.57 a month over the seven years to 2006, and falling to 99p a month at the end of the period (see footnote on page 87);
- the digital licence supplement needs to be phased out over time, so as not to preclude an early date for analogue switch-over;
- the BBC should seek a significant injection of private capital into BBC Worldwide, and should sell the bulk of BBC Resources (see footnote on page 103);
- the BBC should seek to accelerate the growth of its commercial services, which need not conflict with its role as a public service broadcaster, provided that new measures are introduced to ensure that the fair trading commitment is enforced strictly, and with full transparency;
- the concessionary licence fee scheme for people in sheltered accommodation and residential homes should be retained;
- a new half price licence fee should be introduced for blind people, and the BBC should urgently step up its targets for subtitling;
- the role and financing of the BBC should be subject to a root-and-branch re-assessment at the time of Charter Review in 2004-6.

A complete list of our recommendations appears on pages 32-35.

Context of the review

Everyone cares about the BBC. With the possible exception of the National Health Service, it is the organisation that most fosters a sense of common ownership among British citizens. We spend longer in its company than we do with any other organisation in our lives, other than schools and workplaces. We all own a piece of the BBC, and we feel almost personally affronted if our Corporation lets us down.

Fifteen years ago, the future of the BBC did not seem assured. The political climate was hostile, the private broadcasting market was expanding, and it was hard to escape the suspicion that the Corporation had indeed let us down. Through excessive inefficiency, it was wasting public money. It was snooty about the need to generate commercial revenues. Its producers resented the necessary intrusion of market forces into their private fiefdoms. It was the last unreformed nationalised industry. It seemed a sitting duck for radical Thatcherite change.

The Government established the Peacock Committee in 1985 with the hope that it would recommend in favour of advertising on BBC television. For good or ill, the end seemed to beckon for Lord Reith's BBC. Then, three things happened.

First, Alan Peacock wisely rejected the advertising option. He said that it would trigger head-to-head competition for audience share with ITV, and that this would be ruinous to the UK's broadcasting "ecology". Instead, though, he predicted that technological advance would end the problem of spectrum scarcity, and with it the issue of market failure in broadcasting would largely disappear. Accordingly, he recommended that the BBC should become more dependent on subscription revenue in the new world of plentiful supply. This recommendation fell by the wayside, for various technical and political reasons (though it may easily re-emerge as an option, with a 20 year time lag, at the next Charter review). Nevertheless, a key watershed had been passed - the forces of radical change got bogged down, so the status quo was granted a last minute reprieve.

Second, the supporters of the BBC re-asserted themselves. Some of these, in the private broadcasting industry, were alarmed by the threat of advertising on the BBC, and therefore rallied behind the licence fee. But more generally, the public's respect and affection for the organisation proved deep-seated. There was no evidence of particular affection for the licence fee itself (in fact, the reverse), but nor was there any great pressure for change. Even Mrs Thatcher, increasingly irate about the BBC, never felt able to overcome this silent force.

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Third, and most important, the BBC embarked on a process of internal reform. Efficiency was raised until it reached levels at least compatible with those in the private sector. A commercial motive, subject to strict regulation, was injected (albeit very slowly) into the organisation through BBC Worldwide. The BBC maintained its share of the broadcasting market to a much greater extent than had been expected. And, with the political winds becoming less hostile to the concept of the licence fee, the status quo has remained the status quo. So far.

The role of the licence fee

In our terms of reference, we were asked to assume that the licence fee would remain as the main source of BBC funding until 2006, and to consider ways of extending funding for public service output from other sources. This is a clearly restricted task, but as it happens we would not have wished to recommend a radical change in the concept of the licence fee in any event. We considered various options for funding the BBC against a wide set of criteria - including access, universality, service quality, diversity, fairness, choice and transparency. We were not convinced that any of the most obvious alternatives to the licence fee were markedly superior to it on these criteria. Indeed one of our main recommendations - the digital supplement on the licence fee - relies squarely on the British tradition of amending the licence fee so that those who benefit from new technology are the ones who bear the major costs of development. We hope that this will sustain public service broadcasting on new platforms by the BBC up to 2006, without pre-empting the big decisions which will be taken then.

The longer term future of the licence fee is territory for the Charter review and we believe that it would be premature, given the pace of technological change in broadcasting at the present time, to rush to a definitive judgement now. Nevertheless, we outline in Chapter 5 some reasons for believing that the principle of the licence fee may be more sustainable after Charter review than many people currently believe.

The fact that we are recommending some additional revenue for the BBC over the next seven years implies that we think they deserve it. We do - though, in exchange, we propose measures to ensure that the BBC keeps up and accelerates the momentum for reform which it has attained in the 1990s. We believe that the incentives for self-help, whether in the form of efficiency improvements or extra commercial revenue, must be maintained. We believe that the Corporation needs to become more transparent and accountable to the public, and that the regulation of its fair trading commitment must be strengthened. We believe that some parts of the BBC - for example, the bulk of BBC Resources - should be privatised, and that BBC Worldwide would benefit from a significant injection of private capital.

BBC management will perhaps bridle at these recommendations, and may be disappointed too by the fact that we have rejected the bulk of the Corporation's ambitious bid for extra funds. But a guiding principle of our review has been that, while the licence fee is a good way of financing public service broadcasting, it is a very bad way of taxing the public. And, with the single exception of a recommendation concerning blind people, we have joined several previous committees in failing to identify ways of making the system obviously fairer. The current concessionary scheme for those who live in residential homes and sheltered accommodation has many glaring drawbacks - notably that the scheme is arbitrary, implying that the people who pay for it are sometimes poorer than the recipients of the benefit - but overall we became convinced that phasing out the scheme would in itself be a regressive change.

So we are stuck with a conundrum. We have been asked to assume that the licence fee remains in place, and anyway we agree that it remains the best way of funding the BBC. But it is important not to place too much extra weight on a regressive charge which bears most heavily on those with the lowest incomes in our society. We have handled this conundrum in two ways:

- First, in suggesting a digital supplement to the licence fee, we respect the principle that it is fair to charge only those who benefit from the digital roll-out for the BBC's services in this arena.
- Second, rather than funding the maximum amount that the BBC can usefully spend (a sum almost without limit), we aim to fund the minimum level of BBC output which is needed to maintain a critical mass of public service broadcasting in the changing marketplace. Sufficiency without excess has been our watchword.

Defining that minimum is no easy task. It is more of an art than a science. In deciding how much extra BBC activity to fund, we have had to come to grips with many issues - the role of public service broadcasting, the impact of technological change, the BBC's need for more money to discharge its public service role as the world changes, the BBC's recent performance, the scope for raising money from BBC internal sources, and the options for raising money from external sources. Much of our report is concerned with grappling with these issues, but it is useful to summarise the main considerations here.

The role of public service broadcasting

Many people who gave evidence to the Panel said - quite logically - that we could not decide how much extra money the BBC might need without first attempting to define what the BBC should do. They added, almost as a throwaway, that this would mean establishing a new definition of the role of public service broadcasting.

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We have not managed anything so ambitious in the six months we have had at our disposal. When we each tried to define public service broadcasting, some very familiar words started to appear - information, education, extension of horizons, impartiality, independence, universal access, inclusivity, service of minorities, lack of commercial motivation, etc., etc. We decided that we may not be able to offer a tight new definition of public service broadcasting, but we nevertheless each felt that we knew it when we saw it. And not only did we all share some basic conceptions of what it meant, but we believed that these would be common to many people, probably the majority, in our society. Here are some broad principles :

The first is that, while the BBC is a public sector broadcaster, this does not mean that everything it does is public service broadcasting. Still less does it mean that the output of other broadcasters falls outside the definition of public service. To support the continued existence of the BBC as the recipient of a universal compulsory charge, we need to believe both that a large share of the Corporation's output falls into the public service category, and also that by no means all of the private sector's output does so.

The second principle is that some form of market failure must lie at the heart of any concept of public service broadcasting. Beyond simply using the catch-phrase that public service broadcasting must "inform, educate and entertain", we must add "inform, educate and entertain in a way which the private sector, left unregulated, would not do". Otherwise, why not leave matters entirely to the private sector?

The third principle is that, in order to believe in a full-scale BBC, we need to accept that a combination of the private sector's profit motive, plus regulation, is insufficient to repair the market failure and deliver what we want. After all, the existence of public service broadcasting on ITV, and the success of Channel Four, shows that a fair ration of public service output can be generated from the private sector. In order to argue in favour of maintaining an expensive organisation dedicated to public service television, we need to be satisfied that regulation of the private sector is not, on its own, enough.

The Panel unanimously believed that the adoption of these three principles today would make out a strong case for a comprehensive public service broadcaster like the BBC in the UK market. The present outcome in the broadcasting market seems broadly satisfactory. We were cautioned several times by our witnesses against claiming that the UK has the best television in the world, but we would claim that it has the best television **for a British audience** in the world. This may not be saying much. But since the alternative might be to import even more American television, designed for American tastes, it is probably an argument in favour of the present structure. The Panel would go further and say that, in the present state of technology, it would be a very risky act to try to do without a full-scale BBC, since it has proven itself able to condition the whole marketplace (the broadcasting "ecology") for the better.

But the key question for the next decade is whether this state of affairs will persist in the new world. If we think that it will persist - or even that it may - then there is a case for funding the BBC sufficiently to allow it to pursue, through the use of new technology, its long-standing purpose.

The fourth broadcasting revolution

The core of the BBC's case to the Panel for extra funding is that the Corporation currently stands at a cross-roads. Either it receives additional funds to compete in the digital arena, or it is in effect consigned to a slow demise, trapped in a world of disappearing old technology. In the course of our work, we were exposed to many examples of how technology will alter the experience of broadcasting for almost everyone in the next couple of decades. It is quite striking, though, that there is still an almost complete lack of awareness among the public of what is about to hit them.

Digital television, even in its current fairly primitive state, is not widely understood by most potential buyers, which is perhaps why the take-up of the new medium was initially rather sluggish. If it is understood at all, it is seen as a means of acquiring some new channels, the content of which is unproven. People are increasingly beginning to realise that the quality of picture and sound will improve under digital technology, and are dimly aware that widescreen sets may represent a significant enhancement in viewer experience.

But we doubt whether many people have yet had their horizons lifted to the full potential of digital technology - limitless numbers of channels, full access to massive archives of programmes, the creation of "virtual channels" to suit individual tastes, total portability of equipment, convergence between the web and broadcasting, convergence between both of these and personal communications, interactivity between households, programme makers and the commercial suppliers of all manner of consumer products, and no doubt a myriad of new applications which are as yet barely a glint in their inventor's eye.

This qualifies without any doubt as the Fourth Broadcasting Revolution, coming after the invention of radio, monochrome television, and colour television. There are still a large number of people who believe that all the hype about the digital world will prove over-done, and that this latest advance will go the same way as quadrophonic sound. They are overwhelmingly likely to be proved wrong. Indeed, the Fourth Broadcasting Revolution may be as profound as any or all of the previous three - if only because it is far from confined to what we now define to be "broadcasting".

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In their evidence to us, the BBC conjectured that an ordinary family in the year 2010 might be able to use their “television sets” to do all of the following in the same day:

- To allow the children to watch selected specialist children's TV programmes of the parents' choice, downloaded into the set-top box, over breakfast;
- To watch a Delia Smith cookery programme in mid-morning, and order all the ingredients of a preferred menu to be delivered to the home via a single click on the remote control;
- To consult the website family doctor about a nagging illness, and get a prescription from an online chemist;
- To participate in a live TV hook-up with granny's 70th birthday party in Australia;
- To catch-up with recent episodes of their favourite soap on the train home from work;
- To come home to find an e-mail from the BBC reminding them to download and watch the final episode of the family's favourite wild-life series.
- To help the kids revise for their exams in a fully-interactive history series available from BBC Knowledge
- To watch Southampton play Manchester United on pay-per-view, deciding exactly where to sit in the “virtual stadium”, and replaying Southampton's winning goal at will, from 8 different angles.

The Panel, no doubt like the rest of our society, differed on whether this vision of the future was an appealing one. Some thought that it described an isolationist world, lacking in community values and seriously missing the unifying force which network television has exerted on our lives since the 1950s. This group regretted the fact that each family member would soon want their own personal TV set (or personal computer) to use according to their own particular whims. Others thought all this represented a welcome return to the pre-television world in which we were forced to rely on our own individual resources for entertainment to a much greater extent than we are today. One of us thought that everything would turn out for the best as long as Southampton really did beat Manchester United. But whatever we all thought about the desirability of this new world, we were united in believing that it was approaching us with unstoppable momentum.

Technology goes in jumps, and we are clearly in mid-jump at present. Past efforts to forecast the effects of such jumps do not encourage us to be dogmatic about where this jump may finally end. But we do think that in about 10 years time, UK society will find itself precariously poised in something we call “the 80/80 world”. We need to sketch out the main features of this world before we can decide what role the BBC should play in it.

The 80/80 world

Ten years ago, almost all households were equal in a broadcasting sense. Virtually everyone had access to four television channels, and that was it. Now, about 30% of households have access to multiple channels via cable or satellite, and there is already widespread resentment that the majority of the British population now lacks live access to many sports events, including the Premier League, and cannot get first run movies on television. Greater choice has so far been a huge bonus, but only for a minority of the population. The majority probably have much less choice in some crucial types of programming, than they had a decade ago. With greater choice has come far greater inequality of experience. Quite surprisingly, this seems to have been taken with remarkable equanimity by the losers.

In about ten years time, it seems likely that households will be split into many different technological states, as the box on page 14 shows. Inequality will be a much more complex issue than it is today. Some will benefit massively from greatly enhanced choice, while others may acutely feel that they are missing out. Eventually, as national income grows, almost everyone will benefit from the new technology, just as everyone benefits today from colour television, but there may well be an awkward transitional period during which some people actually experience a deterioration in their broadcasting experiences. The BBC has an important and continuing role in addressing these issues.

It is obvious that no two households will be exactly alike in this transitional stage. Nevertheless, it is useful to characterise the multifaceted world of 2010 in the following way:

- 80% of the population may well have access, at home or at work, to digital media broadcasts, and/or access to huge television archives via the web. They will therefore be occupying the new digital world;
- 80% of the population may well still be using the main terrestrial channels, accessed on TV sets scattered throughout the home. They will therefore be occupying the old analogue world.

The point is that there will be a large proportion of the population who will neither be occupying the new world nor the old world. They will be occupying both.

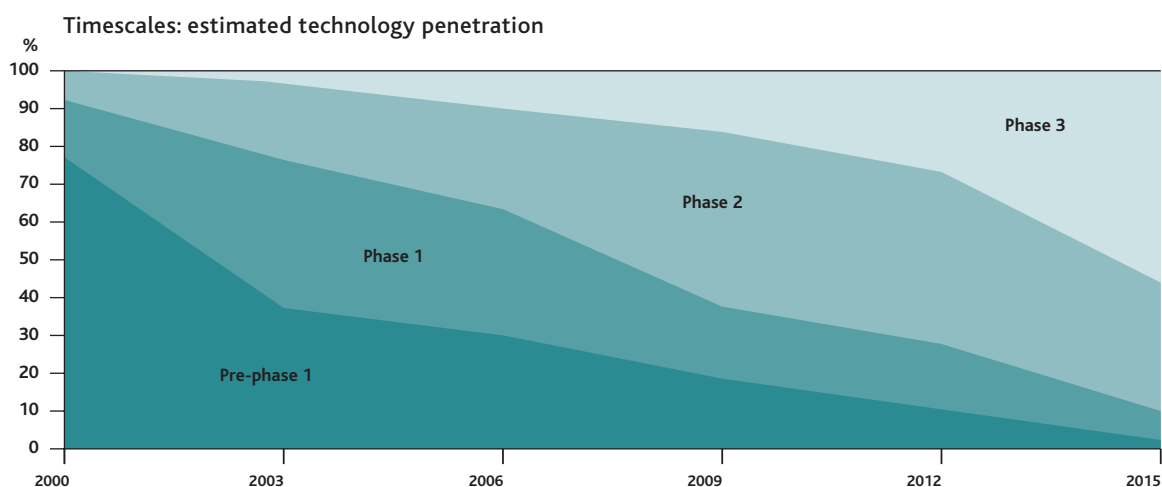
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The digital revolution

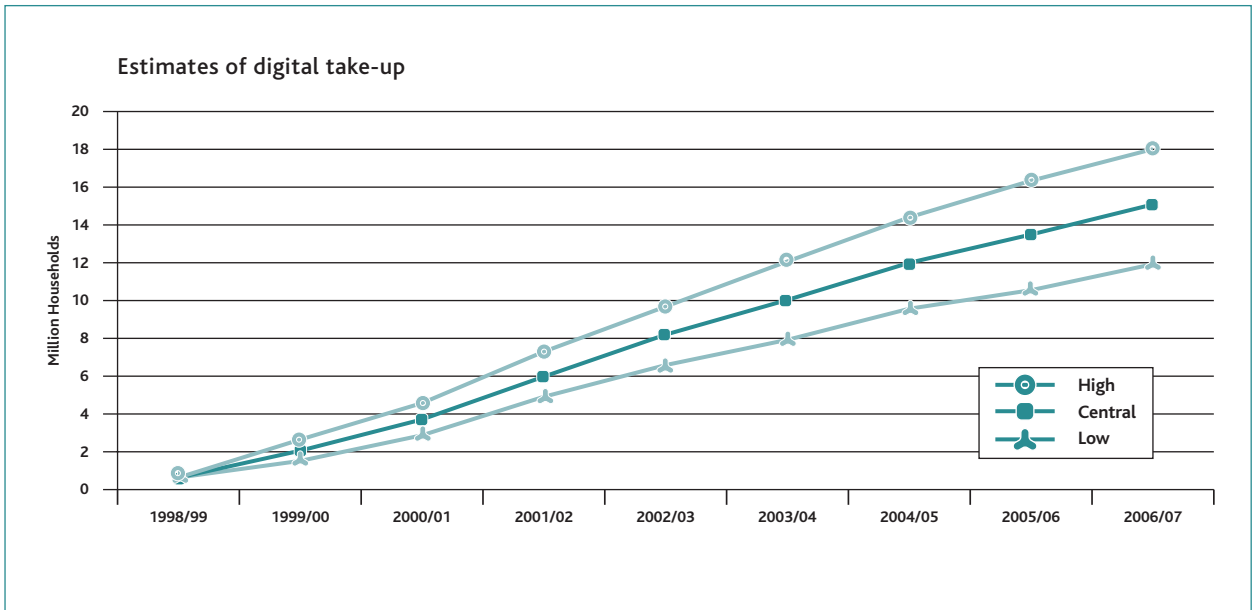
The fully digital environment will encompass multiple services, devices and distribution channels. Today's Electronic Programme Guides, search engines and web guides are likely to converge, creating flexible 'media navigators' able to access all kinds of content. The digital revolution will probably happen in three stages defined by technology and functionality:

- Phase 1:** Set-top boxes with over 200 digital channels. Widescreen TV increasingly available. Some near-video-on-demand (NVOD) and other limited interactive services. Downloadable low quality video.
- Phase 2:** Second generation set-top boxes, offering storage and a return path. Improved interactive services and improved access to archives. Reasonable quality downloadable video.
- Phase 3:** Fully converged digital TV and web devices, with integrated media navigators. Full portability and mobility. Full interactivity and archive access.

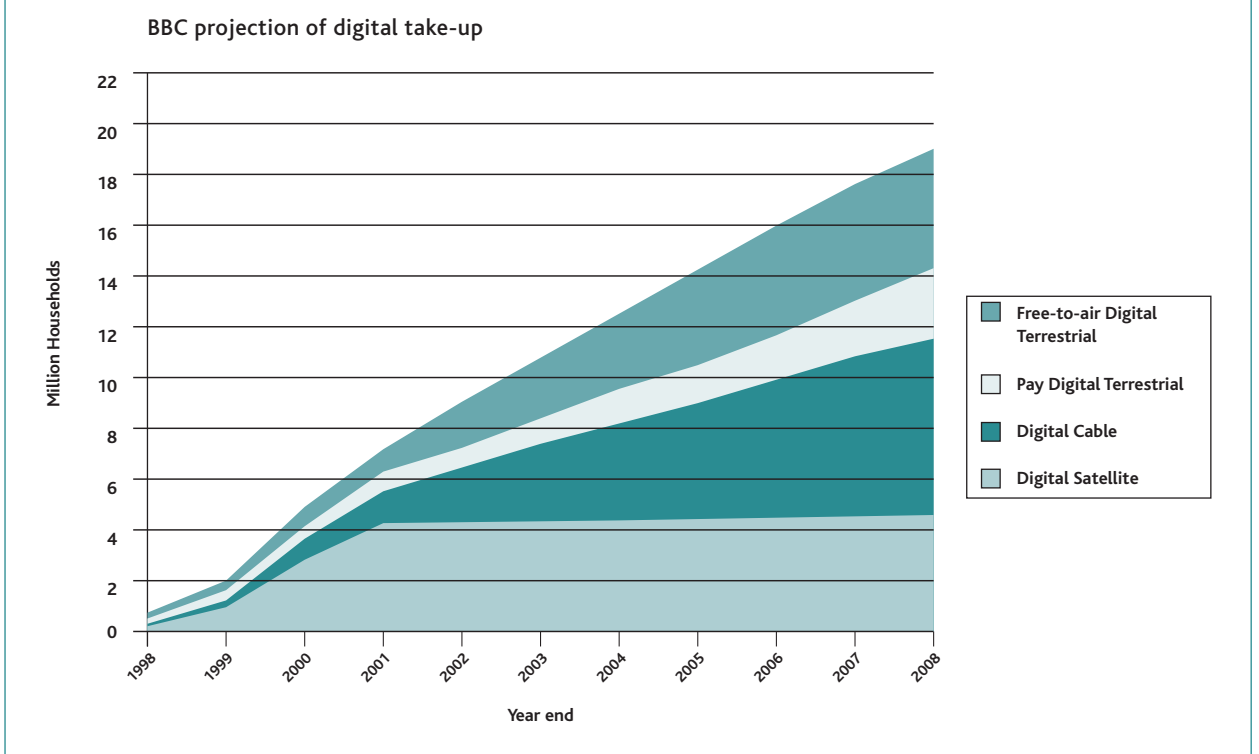
The BBC's estimate of the penetration of these new technologies is illustrated in the following chart. A gradual take-up of the new services implies that by perhaps 2008 households will be split into many groups with differing levels of digital functionality.



Stepping back from the undoubted future potential of the digital revolution, it is important to remember that digital television is still an infant industry. There is great uncertainty about the speed of digital take-up. Since the advent of 'free' set-top boxes it is thought that BSkyB have been signing perhaps up to 60,000 subscribers, and ONdigital 40,000 new subscribers, per week. Current subscriber numbers stand at around 1.2m, but many consumers remain confused and ignorant about what digital television offers.



In terms of digital television platforms, there will be four different types of digital user, all in place simultaneously. It is expected that initial take-up will be driven most strongly by satellite subscribers, particularly those converting from analogue to digital equipment.



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This will clearly make analogue switch-over something of a political problem. But it is important that we solve this problem, since it is economically desirable to free-up that part of the spectrum which is currently occupied by the analogue TV channels. Even if this spectrum proves of only modest value in a Government auction, which is unknowable at present, the UK will not want to fall behind other EU countries when they make the spectrum available for new economic uses. We have therefore designed our recommendations to ensure that they do not conflict in any way with the possibility of analogue switch-over in about ten years' time. (Only small amendments in our plan would be needed to bring this date forward if desired.)

After switch-over, everyone will have access to digital services, but the main feature of the 80/80 world may still survive - ie 80% of the population will be economically and computationally able to take advantage of large swathes of the new technology, while 80% will still be exposed to the traditional channels for prolonged periods each week. It is an open question whether the traditional channels will be more or less important than they are today when we get to the 80/80 state. On the one hand, they will be watched for much less time each week than they are now. On the other hand, they will be the one and only way that really large audiences will be accessible to programme providers, advertisers, politicians and sporting entities.

What does all this mean for the present and future role of the BBC? We believe it is quite conceivable that the world will develop in the direction envisaged by the Peacock Report, with enough people being able to access and pay for enough individual programmes or channels to make broadcasting tolerably close to a perfect market. If the broadcasting market were ever to approach the condition of the book publishing market, it would be much more dubious whether the BBC and the licence fee could be justified in their present role. This again is natural territory for the Charter Review.

However, for the moment, we would make the following points:

- We are not yet in the 80/80 world. Our present condition is a 5/100 world - i.e. 5 digital, 100 analogue - which is still dominated by the main five terrestrial channels. Therefore nothing much has changed yet. The old reasons for market failure in broadcasting still apply.
- Even when we enter the 80/80 world, 20% of the population will be wholly trapped in a state no different from today, while 80% will still be accessing large amounts of broadcasting exactly as they do today. Hence some of today's market failure problems will persist.
- Even when we enter a 100/0 world in favour of the new technology, it is highly debatable whether all the causes of market failure will disappear in the manner expected by Peacock. Annex VIII discusses in detail which of the sources of market failure will get worse, and which will get better, in the new world.

The upshot of these arguments is that there are still good reasons to believe that the traditional role of the BBC is justified in the current state of the broadcasting market. Furthermore, this role still seems likely to be justified in the transitional state which we will have reached in 10 years time. Even in 25 years, the market could develop in ways which make the BBC still necessary, though we are more agnostic on this question. What seems clear for now is that it would be premature to suggest major changes in the BBC's role, and that - if we want to retain the option of having the BBC operating in the new world into the indefinite future - we need to allow it to develop its digital platform today.

The BBC on a diet

The BBC has, of course, already spent heavily in the digital and internet spaces, and about £10 in everyone's licence fee today goes in the direction of the new media. This has given the Corporation a foothold in digital television and websites, but it must be said that some of the BBC's digital offerings have been distinctly threadbare, and they have also taken vital funds away from the analogue services, which have suffered as a result. All this has occurred because the BBC has been on a strict financial diet for many years. During the 1990s, the licence fee income of the BBC has risen by only around 1% per annum, while the income of the private sector in total has risen roughly ten times as fast. Admittedly, the growth in the private sector has come almost entirely from subscription services, with ITV showing little or no growth relative to the BBC. This is significant, since ITV remains by far the BBC's main single competitor.

Nevertheless, the BBC has clearly been put under pressure as its own income growth has dwindled (thanks to the fact that colour television has now fully saturated the marketplace, so the switch from lower-cost monochrome licences is virtually complete), and private subscriptions have grown rapidly. As a result, the BBC's licence fee revenue as a share of private television income has fallen from 42% in 1993 to 31% in 1998. The growth of licence fee revenue over the next seven years is likely to be only around 0.45% per annum, before taking account of improved methods of collection. Meanwhile, private revenues are likely to expand at 4.5-7% per annum. This means that the BBC's share of broadcasting income could fall to only about 20% by 2008.

Of course, some diets can be healthy, and the BBC diet has resulted in a much leaner and fitter institution than existed a decade ago. Efficiency savings have been running at a remarkable annual rate of 8-10% of the relevant cost base for several years. The Corporation has also maintained the value of the BBC brand in a manner which many private companies might envy. Indeed, it has been suggested to us in evidence that the three initials "BBC" represent Britain's most respected brand. Its reach is extraordinary - for example we have been told that the weekly reach of the BBC far exceeds the annual exposure of the population to such brands as Heinz, Kelloggs and Coca Cola. Furthermore, the BBC has managed to maintain its share of the audience to a much greater extent than was expected some years ago.

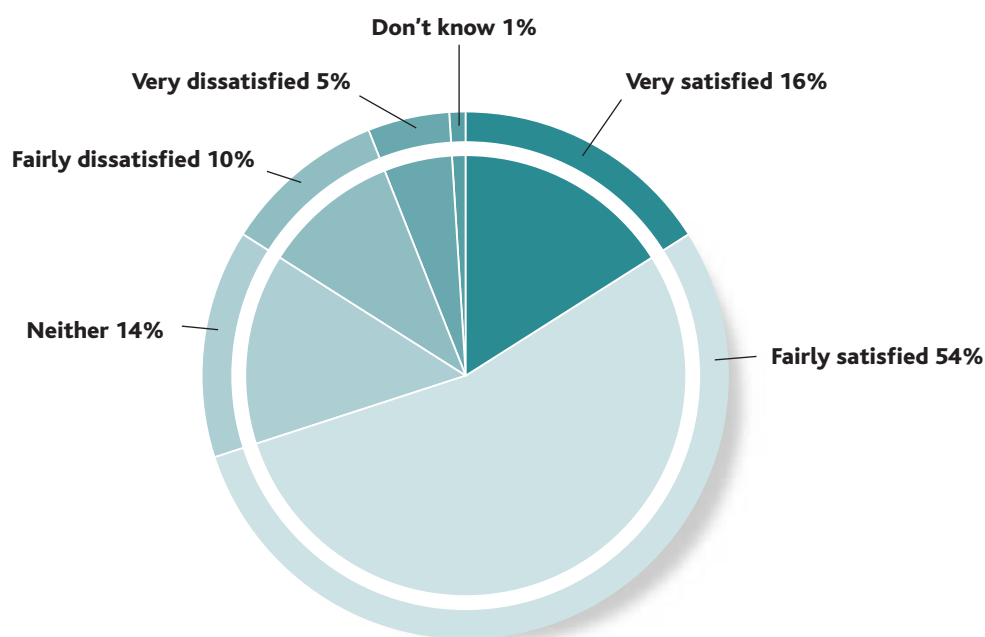
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It is hard to avoid the suspicion that this has been done by cheapening or “dumbing down” the product - a process which the BBC assures us will now be reversed. Nevertheless, our opinion poll results show strong customer satisfaction with the BBC and demonstrate that the Corporation continues to be perceived as being particularly good at delivering television genres which fall squarely into the public service category - notably, national events, news, education and the like. Encouragingly, the BBC is not thought to be particularly good at daytime chat shows and games shows, genres which are well provided by the private sector. An extraordinary fact is that two-thirds of the nation's GCSE students used the BBC website last year to aid their revision.

Up to now, the BBC's diet has been a successful one. But diets can also be taken to excess and the BBC believes that this one has started to eat into the muscle of the Corporation.

Satisfaction with the BBC

Q Overall, how satisfied or dissatisfied are you with the BBC?



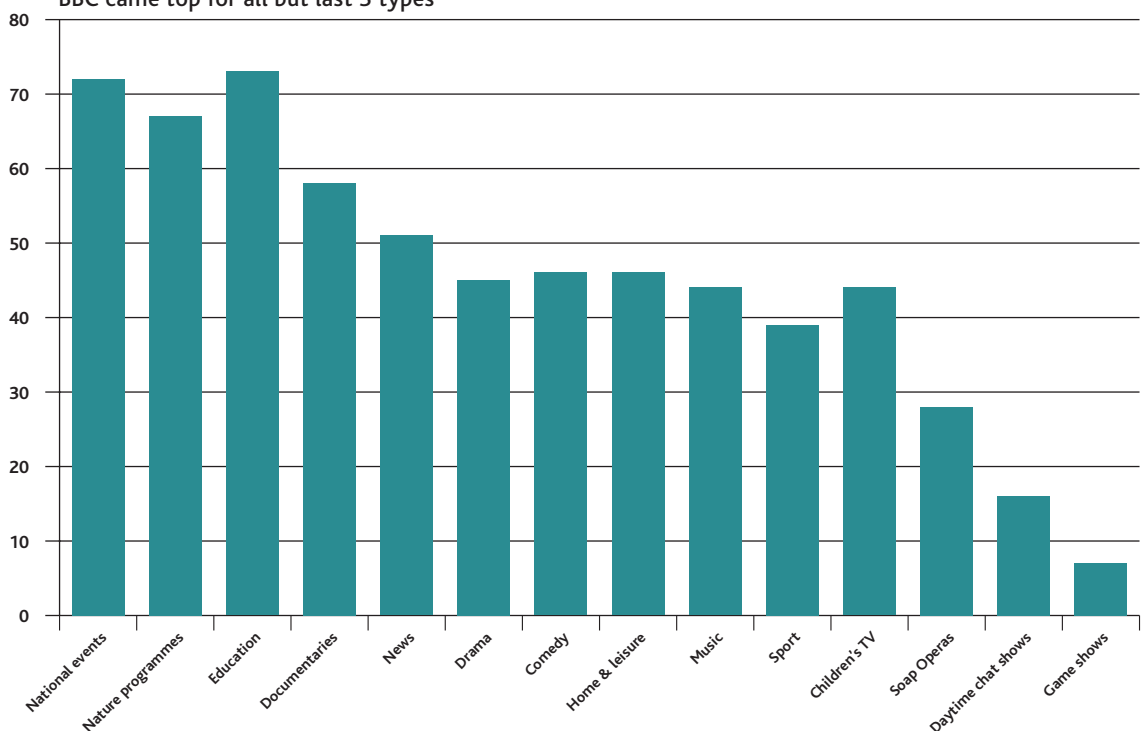
Base: All (1,051)

Source: MORI

Programme quality

Q. "Which broadcaster best provides the following types of programme?"

Chart Shows proportion of those offering an opinion who responded 'BBC'.
BBC came top for all but last 3 types



The BBC's vision for its future

The BBC's has put to the Panel a set of exciting proposals for developing its services in the digital age. If fully funded they would clearly offer a major enhancement to the provision of public service broadcasting in the UK. But cost is a key issue. The full BBC vision for 2006 involves an increase in programme provision of 57% in an eight year period, implying real growth of about 5% per annum in spending from 1998 to 2006. By the end of that period, the BBC would be spending around £700 million on new digital services, in addition to the £200 million spent now. In order to make this possible, the Panel would need to propose measures designed to enhance BBC income by about £650 million in 2006.

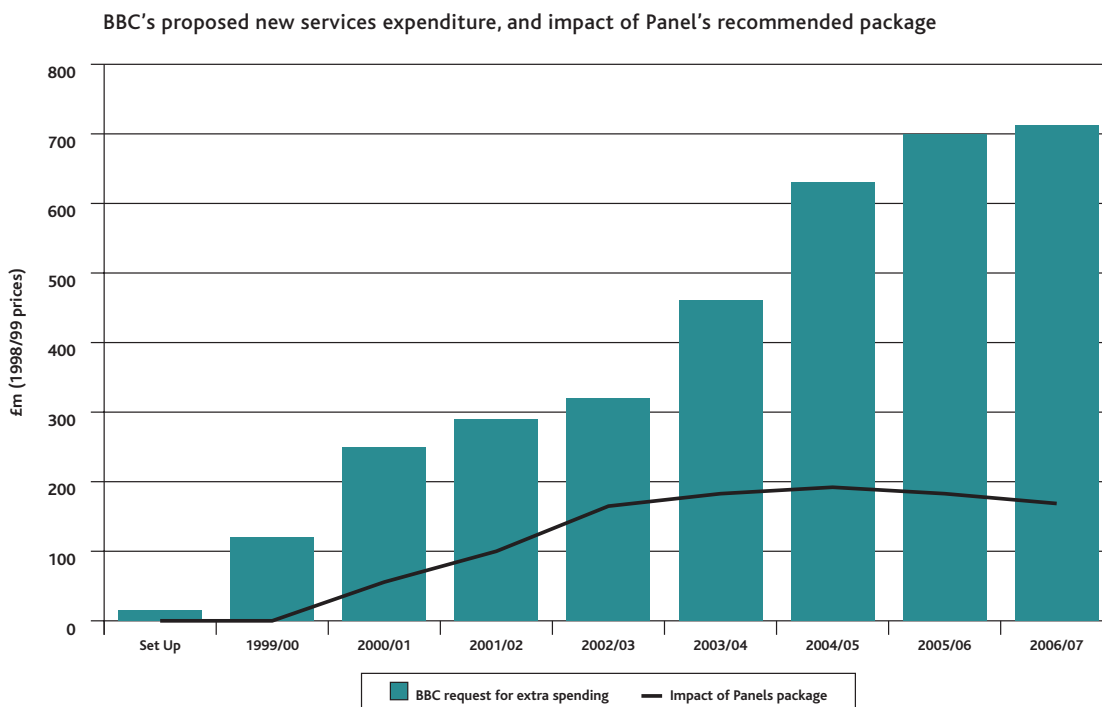
The question is whether the benefit is worth the cost. Even with a 30% market share the BBC would still be by far the dominant player in the UK. And the option of increasing licence fee revenue, in any of its possible forms, is a costly one. The licence fee is a regressive charge, with the payer having no effective choice about the scale of services which the BBC is providing. In these circumstances, we do not feel justified in asking the licence fee payer to incur still higher

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costs, unless we are absolutely convinced that this is necessary to maintain a healthy broadcasting ecology in the UK.

Of course, turning these principles into hard figures requires judgement. After considerable debate, the Panel was not convinced by the case made by the BBC for £650 million extra funding by 2006. For the reasons spelled out in Chapter 1, we consider that a sensible plan would be to implement measures designed to increase BBC revenues by around £150-200 million a year between 2002 and 2006. This would produce growth in BBC real revenue of about 2 - 2.5% per annum, which is roughly in line with real GDP. This would imply growth in real spending of around 3.5% per annum, with the gap being filled by further efficiency gains and other forms of self-help.

Our recommendation would fund around one third, or a little less, of the annual increase in spending that the BBC has proposed in the last few years of the Charter period, but would fund a much higher proportion in the next few years. We believe this should be sufficient to enable the BBC both to improve the quality of its established services and to invest in digital. But it will also mean that the BBC will have to prioritise its activities in the digital world and not seek automatically to expand into every new area of activity. And it will mean that faster gains in efficiency and commercial activities will be needed if the BBC is to come closer to its full service vision.



Options for extra funding

In principle, it would be possible to generate the necessary revenue by turning the BBC into something closer to a commercial broadcaster, for example by raising revenue from advertising, sponsorship and subscription. But each of these courses of action would damage the BBC as a public service broadcaster, or set in train undesirable head-to-head competition for scarce revenue with private broadcasters, or both. As explained in Chapter 2, we think that these options would be profoundly damaging for the broadcasting ecology in the UK.

This leaves two possible ways forward - an increase in the basic licence fee, or a digital licence supplement. We prefer either of these options to the “status quo” of doing nothing. However, on balance, we think that a digital licence supplement has clear advantages over the basic licence fee, and fits in better with the British tradition of introducing new technologies in the broadcasting market.

A digital licence supplement would have compelling advantages:

- it would continue the established practice that people should pay more when there is a major change in the technical capabilities of their main receiver - analogous with the introduction of television, and later the colour licence fee;
- it would reduce resentment among those who have not adopted digital technology that 10% of their licence fee was being spent on something from which they do not benefit;
- it would provide buoyancy for BBC revenues as digital take-up increases; and
- once the initial decision was taken by Government, it would remove the BBC licence fee from the arena of political controversy for many years to come.

Against these, some disadvantages have to be weighed:

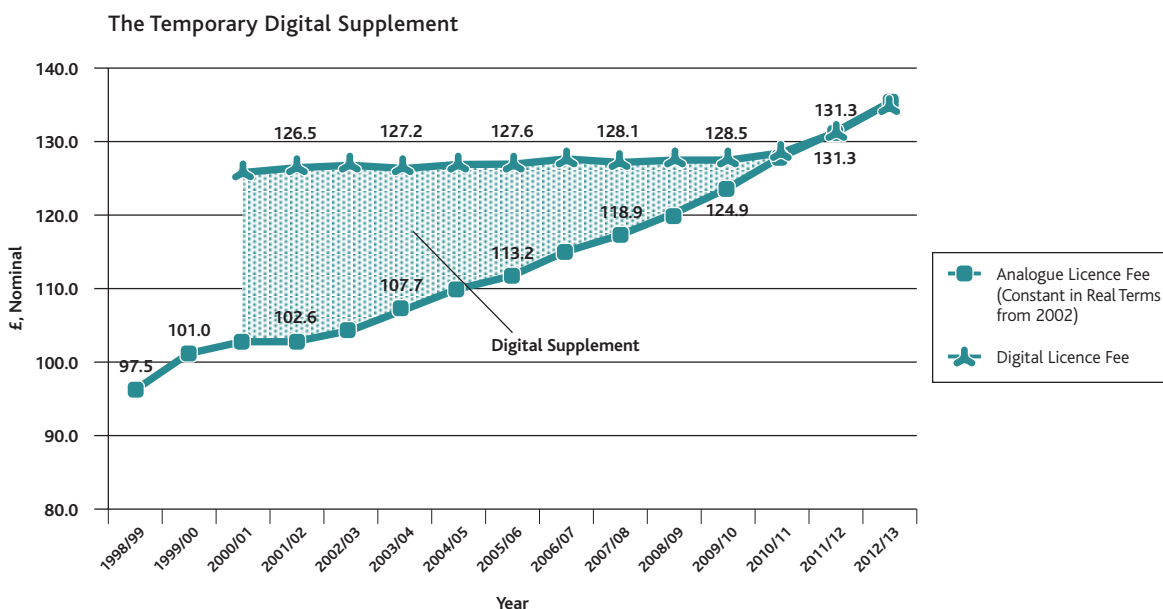
- there would be concerns among manufacturers, the platform operators, ONdigital and BSkyB, and others, that a higher licence fee for digital televisions might deter take-up of digital systems;
- it would add to the barriers to digital transfer faced by the poor;
- there may be enforcement difficulties, especially if many digital receivers were already in use before a digital licence supplement was introduced; and
- there would be uncertain effects on BBC revenue, dependent on the rate of digital penetration.

Chairman's Foreword - A Better BBC for the Digital Age

The fundamental argument against a digital licence supplement concerns the disincentive to digital take-up. It would be foolish to pretend that this does not exist but, at the level we consider appropriate, we do not believe that the damaging effect - measured over a period of years - will be large. This is particularly the case as the BBC will be given a huge incentive to promote the rapid take-up of digital. We have examined evidence from all sides and would not contemplate recommending this course of action if the delay to digital take-up seemed likely to be large. A digital licence supplement will not kill the digital revolution any more than the colour licence killed colour television.

The specific package we propose is designed to avoid creating problems concerning analogue switch-over by gradually phasing out the supplement by 2010. Therefore:

- A digital licence supplement of £ 1.99 a month would be introduced from April 2000. This would decline to 99p per month in April 2006, and would be planned to disappear altogether by 2010.
- This means that the total licence fee for digital subscribers would be fairly static at about £ 126-£ 128 per annum in nominal terms throughout the period up to 2006 (assuming the Government hits its 2.5% per annum inflation target).
- The analogue licence fee would follow a path unchanged from the baseline - ie it would fall by 3.5% in real terms in the next two years, and thereafter it would be raised in line with inflation.
- The effect of this is that the analogue licence fee would rise gradually to meet the digital fee as the date of analogue switch-over is approached.



This option has enormous advantages:

- The average digital licence supplement charged from now to 2006 would be £1.57 per month, and people would know in advance that the supplement would drop to only 99p a month by the end of the period. We do not believe that this would be a large disincentive to digital take-up.
- Parity between the digital and analogue licence fees would be achieved in 2010. If the Government wished to go for analogue switch-over before that date, it would be easy to adjust either the analogue fee upwards, or the digital licence supplement downwards, to achieve parity at an earlier date.
- Unlike the analogue option, this option does not increase the BBC's income in perpetuity, since the overall licence fee is the same when convergence occurs as it would be under the status quo or baseline option. (The easiest way to see this is to realise that the digital licence supplement eventually disappears altogether, while the analogue licence fee is uprated by exactly the same amount as in the baseline.)
- This means that this package does not pre-empt decisions about BBC funding which will need to take place at Charter review. At that time, the BBC will need to make out an entirely new case for extra funding. We see this as an advantage.
- The digital licence supplement declines through time. This has the disadvantage that the disincentive to digital take-up appears larger in the early years, but this pattern is unavoidable once we have decided to eliminate the supplement by 2010. There are also offsetting advantages to this pattern - it means that the higher charges fall on the early adopters (who presumably attach the most value to the new technology), and it means that the per head charge for digital services falls as the number of digital users increases, thus enabling the cost of the service to be spread over a higher number of users.

Despite these advantages, we recognise that there may be some people who would prefer simply to increase the analogue licence fee, so we set out an alternative analogue option which would raise the same amount of money for the BBC in the years up to 2006. This involves increasing the licence fee by £5 in both 2000 and 2001, instead of increasing it by only £1.60 in the two years, as intended under the 5-year settlement which ends in 2001.

On balance, the Panel prefers the digital option to the analogue option, mainly because it better meets the principle that the digital user pays for the digital services. We see this as inherently fairer than loading all the costs of digital onto the analogue viewer.

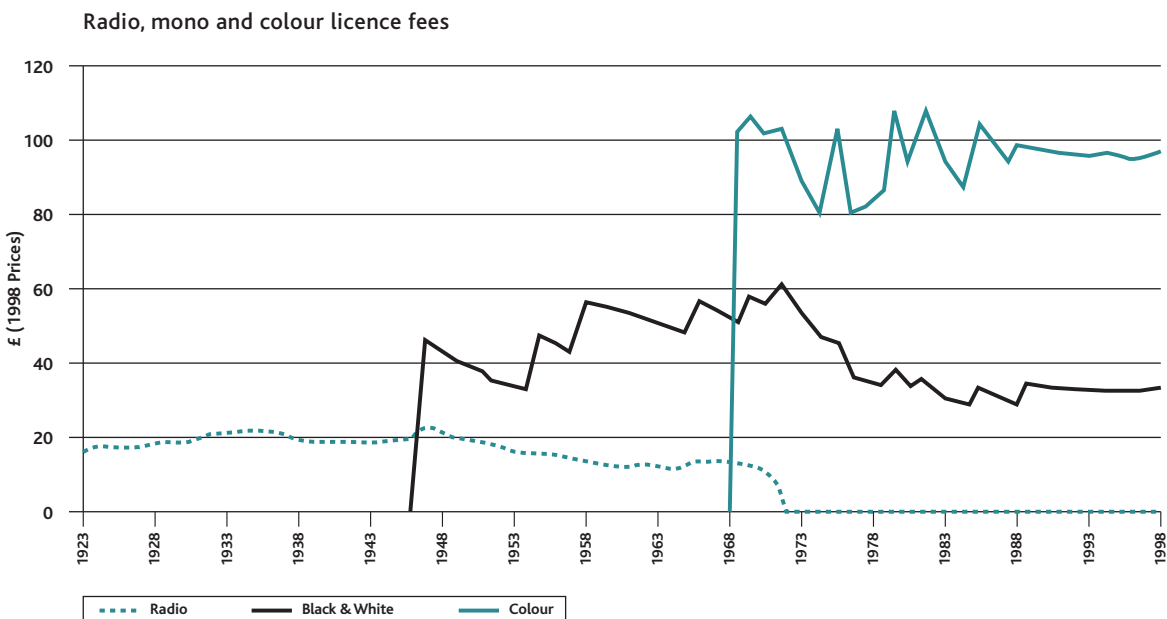
Chairman's Foreword - A Better BBC for the Digital Age

However, we recognise that the digital option creates a disincentive for the take-up of the new technology. Although we do not believe this will be large, neither is it entirely negligible. The Panel believes that if the Government decides against the digital option, the analogue option is preferable to doing nothing.

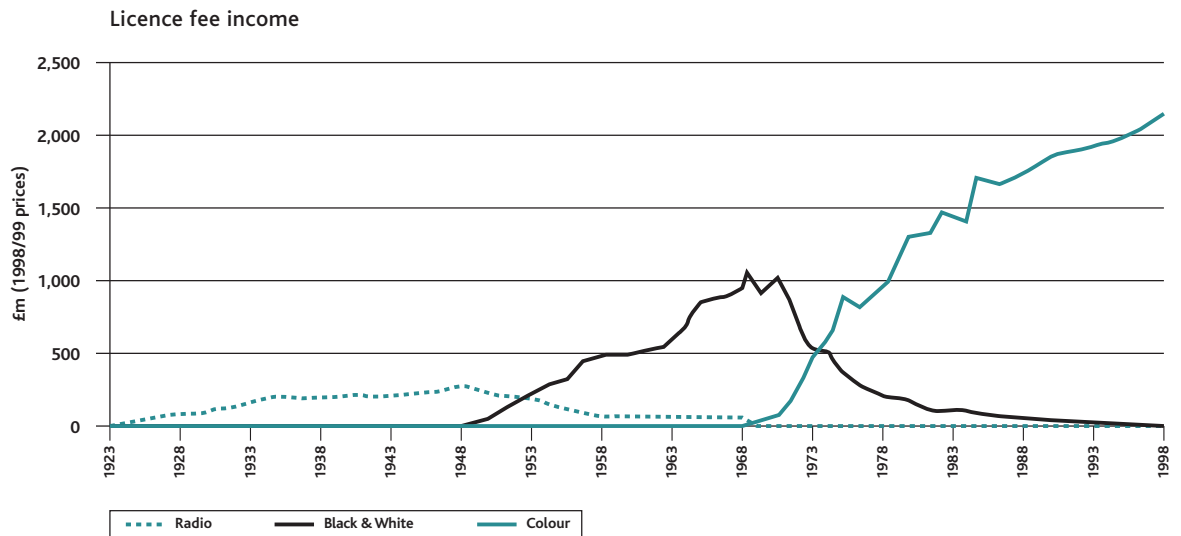
Technological shifts and the licence fee

It is important to view our proposal for a digital licence supplement in the context of how the UK has handled previous technological shifts in the broadcasting market. We view our proposal as building on a British tradition which has had a successful track record on previous occasions.

Historical data shows that each major technological development in broadcasting over the last 50 years has been supported by the introduction of new licence fees, which have each been introduced at a substantial premium. The black and white and colour licence fees were both introduced at a level 100% higher than the prevailing licence fee (£1 to £2 in 1964 and £5 to £10 in 1968). The digital licence supplement we recommend would represent a premium on the main licence fee of only about 13% on average in the period from now to its disappearance in 2010.

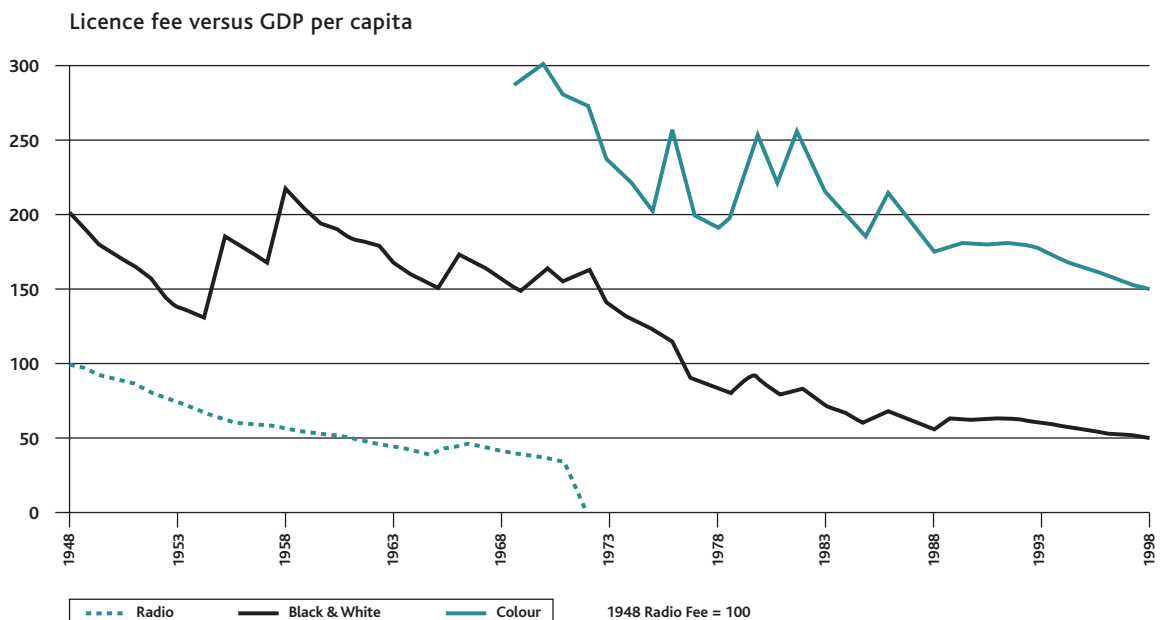


Over time, the licence fee premia associated with the new technologies have driven strong growth in the BBC's revenues, and the newly introduced licence fee has quickly become the major source of BBC licence fee income in each case. The development of BBC services, funded by the licence fee, has been a strong force encouraging the spread of the new technology.



Although the step changes in the level of the licence fee have initially led to a sharp increase in total spending on broadcasting by consumers, in each case this percentage has declined relative to GDP per capita over the life of the technology.

Eventually the proportion of income absorbed by spending on the new technology has dropped back to the same level as was previously enjoyed by the old technology. Such is the cumulative process of economic growth that we now enjoy colour television for the same real cost (in terms of hours worked) as we had to incur to enjoy black and white television in 1970.

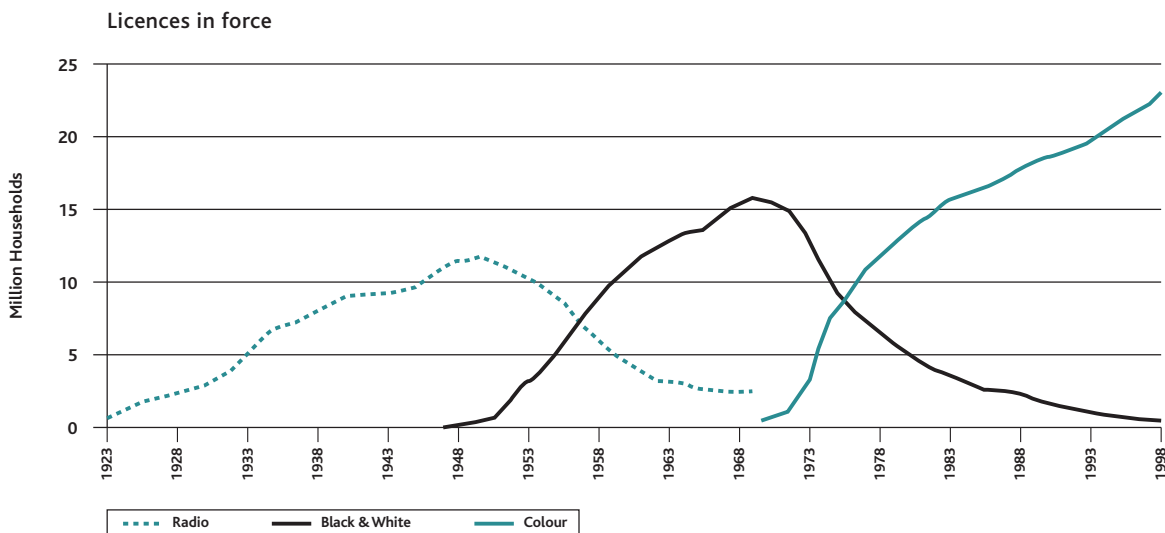


Chairman's Foreword - A Better BBC for the Digital Age

Furthermore, in spite of the increases in the licence fee, take-up of the new technologies has followed a steep upward curve and has resulted in eventual market penetration of close to 100%. The powerful appeal of the services available in the new technology has more than offset the disincentive effects of the higher costs, including the higher licence fee.

For the introduction of digital television, we do not see why the outcome should be any different. Some people may argue that the advantages of digital television are less obvious than those of colour and admittedly this may seem the case today to many consumers. But potential customers for digital television are still at a very early stage in their understanding of what the new technology will eventually offer. Explaining to someone today what the digital world will be like in 20 years time is somewhat like trying to explain the wonders of television to someone in 1937. Furthermore, the prospect of analogue switch-over, which did not exist in previous technological shifts, is likely to speed the transfer.

The private sector broadcasters who are opposed to a digital licence supplement are in the position of arguing simultaneously that the new technologies will open a new world, offering a compelling uplift in service provision and that a supplement of £1.57 on the licence fee will kill the new technology. We are more inclined to believe the former than the latter.



Commercial activities and fair trading

It is often argued that the BBC's objectives as a public service broadcaster are directly in conflict with its declared aim to raise additional revenue from commercial activities. We do not believe that this need be the case. In fact, we see the commercial exploitation of the BBC's archive as wholly desirable from the point of view of the licence fee payer and likely to further the aims of broadcasting policy more generally. The archive has been under-exploited for too long.

The strategy of the BBC in this context should be to maximise revenues from commercial activities, subject only to two constraints:

- that the BBC as a whole preserves its public service ethos; and
- that it meets its fair trading commitment.

In doing this, additional safeguards are necessary, not only to ensure that the BBC competes fairly in the private broadcasting market, but also to ensure that the BBC is clearly seen by the public to do so. Many of those who have submitted evidence to the Panel have described the BBC as non-transparent, and there is considerable concern that the BBC might abuse its dominant market position in the course of expanding its commercial activities. Again, the BBC has moved a long way in recent years both to develop fair trading safeguards, and to make its accounts and governance more transparent to the public. Nevertheless, more progress is needed on both these fronts.

With these considerations in mind, we make proposals designed both to inject a new climate of entrepreneurship into the BBC (for example by taking private capital into BBC Worldwide at holding company level), and also to make the commitment to fair trading more transparent (for example by asking the National Audit Office to review the BBC's compliance with fair trading policy).

We accept that there is some tension between these recommendations, since the commitment to fair trading already limits the ability of the BBC's commercial bodies to earn profits. It would of course be far easier to earn enhanced revenues if there were less concern about fair trading. Alternatively, there would be less concern about fair trading if the BBC downplayed its commercial objectives. But this tension is the inevitable price to be paid for commercial activity in an organisation which is primarily funded by the licence fee. In the right circumstances, we think that this can become a creative tension.

Chairman's Foreword - A Better BBC for the Digital Age

Concessions

We probably had more evidence on concessions than on any other subject. However, with the exception of recommending a half-price licence fee for blind people, along with urgent new measures to increase sub-titling, we have no recommendations to make in this area. A full review of the thorny issues surrounding the current concessions scheme appears in Chapter 4. While we believe that the scheme has many disadvantages, abolition would hit a group of generally poor and vulnerable people very hard, and hand extra money to the average licence fee payer. We do not recommend doing this for obvious reasons. However, nor do we believe that the BBC should be used as a surrogate social security department, so we do not recommend widening the scheme from the pockets of the licence fee payer.

Conclusion

Any package which gives the BBC more money through the licence fee carries with it disadvantages, which we have weighed fully in coming to our recommendations. If it is to be implemented, it must be accompanied by new measures to enhance efficiency, transparency, accountability, privatisation and a commitment to fair trading at the Corporation. Measures to achieve all of these objectives appear in abundance in the Panel's recommendations.

But at the end of the day, it will be for the Government to decide whether they buy into the BBC's digital vision. Basically, we think the BBC deserves to be given a chance to succeed in the digital world - though a much more limited chance than they themselves have requested.

To confine the BBC to its traditional analogue services in the next five years will be to sign its death warrant, just as assuredly as confining it to black and white television in 1970 would have done. As always in the past, we should give the BBC the chance to grow with the new technology.

Gavyn Davies
Chairman

The Review: Terms of reference and methodology

Genesis of the review

We were requested to carry out the review against the following background.

The BBC's Royal Charter guarantees the future of the Corporation until 31 December 2006. A separate formal Government Agreement with the BBC guarantees the licence fee until 31 March 2002 and provides for a review, before that date, of the funding arrangements between 2002 and 2006 in the light of technological and other developments.

The Government said its aim for the review was to ensure the BBC's continuing ability to meet its public service obligations effectively, while at the same time ensuring that it retains the ability to operate effectively in a competitive marketplace.

The Government decided that the review should be a closely defined one. It did not consider that the time was right for an extensive review of the BBC's purpose and governance; that would more appropriately be carried out in 2003-04, when the issue of Charter renewal was approached.

The Government also decided that it was not appropriate at this stage to consider alternatives to the licence fee as the main source of BBC funding. While acknowledging that the licence fee is an imperfect funding mechanism, the Government considers that it is the best means of providing the BBC with sufficient security to continue to meet its obligations. The Government decided therefore that the review would start from the position that the licence fee is sustainable, at least until Charter review.

The Review Panel was, therefore, required to focus, within the existing framework, specifically on a number of closely defined issues, as set out in the terms of reference. We were requested to take a strategic, high level look at these issues.

Terms of reference

"The review panel will:

- i) Against an expectation that the licence fee will remain the principal source of funding for public services for the Charter period:*
 - consider ways in which funding to support public service output can be extended from other sources; and*

- *take a forward look at other possible mechanisms for funding the BBC in the longer term, particularly in the light of technological development*
- ii) consider how to secure an appropriate balance between the BBC's public and commercial services, and review the mechanisms under which the fair-trading commitment as to commercial services is delivered;*
- iii) consider the current structure of the concessionary licence scheme and whether a suitable alternative structure could be available.*

The Review Panel will report no later than the end of July to the Secretary of State, who will then consult on the Panel's findings."

Membership of the Review Panel is set out in Annex ii.

A wide-ranging consultation exercise to inform the Review was initiated on 27 January 1999 with a letter from the Panel's secretary and a press notice issued by the Department on the Panel's behalf (Annex iii). The Panel received 187 responses and these were considered individually by the Panel and the Secretariat. An analysis of the responses is at Annex iv. The Review Panel also took oral evidence from the BBC, the ITV Network, the Commercial Radio Companies Association, BSkyB, Granada Media Group, United Broadcasting and Entertainment, Cable and Wireless, Carlton Television, Channel 4, NTL, ONdigital, the National Consumer Council, the Consumer Association, Age Concern, the Royal National Institute for the Blind, the Royal National Institute for Deaf People, the Office of Fair Trading, the Broadcasting, Entertainment, Cinematograph and Theatre Union and the Federation of Entertainment Unions. The Review Panel also commissioned an attitude survey from MORI. The results are at Annex v.

The Review: Terms of reference and methodology

Summary of conclusions and recommendations

Chapter 1 - Achieving Sufficiency Without Excess - The BBC's Funding Needs Until the Charter Review

We recommend that:

- the BBC should be funded sufficiently to remain a full service public service broadcaster across the UK's rapidly-developing broadcasting market;
- the "status quo" option of simply implementing an inflation-linked supplement for the licence fee after 2001 should not be adopted, because this would effectively freeze the BBC out of the digital world, which will probably be the future of broadcasting;
- the BBC's core revenue should increase by 2-2.5% per annum in real terms up to 2006, roughly in line with GDP;
- the BBC should be permitted to retain additional efficiency savings and commercial revenues which together should enable programme provision to rise by some 3-3.5% per annum. Any efficiency gains and commercial income in excess of these targets should also be retained for extra programme provision;
- the BBC's efficiency savings should periodically be assessed by outside consultants, appointed by the Secretary of State for Culture, Media and Sport; and that
- the Director-General should ensure that expenses for the central management and bureaucracy of the BBC are commensurate with those of equivalent private sector organisations.

Chapter 2 - Achieving a Healthy Broadcasting Ecology - Good and Bad Options for Extra Funding

We* recommend that:

- there should be no introduction of advertising, sponsorship or subscription on the BBC's public services;
- BBC Online should be extended to new non-UK services, which should accept advertising and e-commerce revenues;
- consideration should be given to the further development of beeb.com, including a possible injection of private capital into the venture;
- in future the licence fee, and any digital licence supplement, should be expressed in monthly form;

- the existing five year settlement for the licence fee should not be re-opened;
- the main (analogue) licence fee should be updated in line with inflation after 2002;
- a digital licence supplement should be levied on the same basis as the current licence fee (ie on a per household basis, payable when a household has installed its first digital receiver or set top box);
- the digital licence supplement should be introduced from 1 April 2000 at a level of £1.99 a month, and that the supplement should fall to 99p a month in 2006;
- this should be seen in the context of a plan to announce a firm date for analogue switch-over (subject to penetration thresholds being reached for digital systems);
- revenue from the digital licence supplement should broadly cover the costs of services to digital licence fee payers and that the BBC should account, in its Annual Report, on how it has implemented this intention;
- an increase in the analogue licence fee of £5 in each of 2000 and 2001 is a preferable option to doing nothing, if the digital licence supplement is rejected; and that
- the BBC should allocate part of its enhanced revenue from the digital licence supplement to build on its campaigns to inform and educate the public about digital broadcasting and the Internet, and to make its digital and online services available in more public spaces on a permanent basis.

*See page 87 for the reason why James Gordon is unable to support the digital licence option

Chapter 3 - Achieving a Level Playing Field - Commercial Activities, Fair Trading and Privatisation

We* recommend that:

- the BBC should sell a stake in BBC Worldwide sufficient to take the effective private involvement in its total external operations to 49% with the objective of better exploiting its assets and increasing the return to the licence fee payer;
- the BBC should sell the bulk of BBC Resources Ltd;
- proposals for new BBC public services should be published and debated in full, along with the criteria used by the Secretary of State in deciding whether to permit the launch of such services;
- the Charter Review should consider whether new BBC services continue to fulfil a public service remit;

The Review: Terms of reference and methodology

- the BBC should demonstrate annually, in its Annual Report, for each of its established services, that it is continuing to fulfil its public service obligations;
- the BBC should ensure that BBC Worldwide's aims are consistent with the objectives of the BBC and the BBC should make programmes, formats and rights available to BBC Worldwide at market prices;
- there should be clear organisational and accounting separation between the BBC and its commercial subsidiaries and there should be greater transparency in the BBC's accounting arrangements;
- the Government should request the Office of Fair Trading to review, within the next twelve months, the adequacy of the BBC's documents: *Fair Trading Commitment* and the *Commercial Policy Guidelines*;
- the Government should request the National Audit Office to carry out, within the next twelve months, two separate reviews of the BBC's accounts and processes:
 - the first should concentrate on how the BBC ensures compliance with fair trading policy, both internal and external; and
 - the second should examine the transparency of the BBC's financial reporting culminating in its Annual Report and Accounts;
- the BBC, in consultation with the Secretary of State, should appoint a separate commercial audit firm for fair trading purposes from that which carries out the BBC's financial audit and the audit firm's full report on compliance and risk should be published by the BBC; and that
- the BBC should publish a quarterly complaints bulletin on fair trading and transparency issues.

*See page 103 for the reason why Helen Black is unable to support the first two recommendations

Chapter 4 - Achieving Fairness - Concessions

We conclude that:

- the current Accommodation for Residential Care concessionary scheme should be retained, despite its obvious drawbacks, since no superior alternative, funded from the licence fee has been found; and

We recommend that:

- licence fee revenue, or broadcasting money generally, should not be used to fund any extension to the current arrangements for pensioners;
- on subtitling for new digital services, including BBC Choice, BBC News 24 and BBC Knowledge, the BBC should aim to achieve 50% of programmes being subtitled in the next five years and 100% by 2009;
- the current discount for blind people should be uprated to 50% of the full colour licence fee, that the discount be restricted to registered blind people and that it should not be restricted to blind-only households; and that
- the current Cash Easy Entry scheme should be put on a similar payment schedule to the Monthly Cash Plan, thus reducing the payments for its users during the second six months of its licences.

Chapter 5 - Achieving Sustainability - BBC Funding After the Charter Review

We recommend that:

- in planning its public service provision, the BBC should define clearly the purposes of each service;
- new public services should be tested through wider consultation, particularly with consumers;
- the Board of Governors should insist on clearer criteria for what the BBC is doing and continue to shift its focus towards its distinctive strength;
- when the Charter is reviewed, consideration should be given to providing a clearer definition of the BBC's public service obligations in a way that can easily be translated into performance criteria for assessment under whatever regulatory arrangements apply post-Charter review;
- the Government should amend the Royal Charter to give the National Audit Office inspection rights to carry out periodic financial audits of the BBC's accounts and its fair trading arrangements; and that
- it should be made clear in the terms of reference for the periodic inspections by the National Audit Office that the NAO should focus only on administrative efficiency and on proper financial management and accounting and not question policy objectives and programming issues and matters of editorial or artistic judgement.

Chapter 1 - Achieving Sufficiency Without Excess

Overview

The BBC has put to the Panel an ambitious vision which would substantially increase its service provision on both analogue and digital platforms in the remainder of the present Charter up to 2006. In total, this would increase annual BBC spending on programmes by £1250 million a year in 2006, a jump of more than 50% on present spending levels. About £550 million of this would be needed to maintain and enhance existing services (allowing for superinflation in the costs of talent, sports rights, etc.), while about £700 million would be devoted to new services. Essentially, the BBC expects to fund about £600 million itself from self-help in the form of extra efficiency savings and higher commercial revenues. The Panel is therefore being asked to find the remaining £650 million from new measures.

The Panel has little doubt that the BBC could make effective use of this extra money in making high quality programmes. But we are not convinced that the benefits would be worth the extra cost, remembering that the licence fee is a regressive charge. We do not feel justified in asking the licence fee payer to incur still higher costs, unless we are absolutely convinced that this is necessary to maintain a healthy broadcasting ecology in the UK. In a sense, the inherent disadvantages of the licence fee system imply that we should fund the minimum BBC services necessary to do this, not the maximum amount that could be usefully spent.

Nor do we believe, however, that the BBC can properly fulfil its responsibilities in the new broadcasting era without some additional sources of funding. The status quo - with the licence fee being uprated in line with inflation after 2001 - is not an attractive option. We agree with the BBC that the broadcasting system stands at an important cross-roads. Without any extra funding, it will be very difficult for the BBC to provide important public sector offerings in both the analogue and digital worlds in the next five years.

We therefore propose that new measures are put in place to ensure that BBC real revenues grow at about 2-2.5% per annum, roughly in line with GDP, in the period up to Charter Review. This would add about £150-200 million a year to BBC spending on programmes in the years running up to 2006 - about a third or less of what the BBC has requested for the last years of the present Charter period. From 1998-2006, taking account of efficiency savings and other additional sources of funds, BBC spending on programmes could increase by 3-3.5% per annum under the Panel's proposals, compared with growth of over 5% per annum needed to fulfil the BBC's full service vision. If the BBC can achieve higher efficiency savings, and more commercial revenue, than assumed in our main case, then we would happily recommend that these extra resources should be devoted directly to further enhancements in service provision.

The BBC's view of its funding needs

All proposals to supplement BBC funding over the period up to the Charter Review must start from an assessment of the quantum of funding that the BBC might need to maintain its contribution to public service broadcasting over that period. In its evidence to the Panel, the BBC stated that:

"The BBC stands at a crossroads. If it can achieve buoyant revenues it can continue to condition the UK media market. Without such buoyancy it will diminish slowly but inexorably."

The BBC went on to paint for the Panel essentially two pictures. The first assumed buoyancy in revenue growth, and allowed the Corporation significantly to increase its service provision - in both quantity and quality - over the next seven years. The second assumed that revenue would continue to grow at the subdued rate seen in recent years, in which case the BBC argued that it would face a struggle to improve the main terrestrial channels while at the same time expanding its digital services.

Although this problem had been disguised, or avoided, in the 1990s by the growing impact of efficiency savings, the BBC believed that it was inevitable that this source of funding for programmes would be harder to realise in future. By contrast, the need for additional funding would simply increase, because of explosive growth in the new digital media, and the rising costs for talent and rights.

It was crucial, the BBC argued, for public service broadcasting to be given a major role in the new digital marketplace, while simultaneously being able to maintain and improve its traditional services. Furthermore, the BBC argued that there is likely to be a substantial "first mover" advantage in the digital space, so any significant delay in providing extra funds for the BBC would greatly disadvantage the development of public service broadcasting in the media of tomorrow.

Chapter 1 - Achieving Sufficiency Without Excess

The opportunity

With buoyant licence fee revenue, the BBC says it would fulfil its “services vision” by aiming to:

- remain the major investor in UK-originated, high-quality content that serves the needs of the diverse range of people and communities;
- maintain a benchmark of quality in every genre - from music and arts, to news, science and history, to sport, comedy, children’s and drama;
- provide licence payers and audiences with access to that wealth of creativity and content in a wider variety of ways, so that the licence fee will provide greater value to them personally even if they use those services a little less in a world of greater choice;
- ensure that there will always be something on they want to access.

In its evidence the BBC says it would aim to provide access to this investment in content in a range of ways.

- The main national networks would aim to offer the best in UK-originated content in all genres in peak-time for both analogue and digital audiences. They would also be strengthened year-on-year with more first-run programmes and higher value content in order to provide a competitive alternative to commercial networks. BBC Choice would become a genuine third network for digital audiences, which would aim to serve a younger audience than BBC One and Two. This would also enable BBC Two to devote more time to arts, music, history and science programmes.
- Properly resourced, specialised public channels would enable digital audiences to access more of the BBC’s distinctive output when they want it rather than when a mixed-schedule network allows it. On television, this would include important new developments for BBC News 24, BBC Knowledge, BBC Parliament, and possibly the launch of new public service channels in other fields. Importantly, BBC Knowledge would become a fully-interactive service to enhance lifetime learning opportunities for all. On digital radio, extra money would support development of the BBC Asian Network, BBC Black Music and BBC Sports Plus. These services would be made available to digital audiences across the whole of the UK.
- Digital TV audiences would be able to access the benefit of multiple repeats of programmes in key genres aired over the last fortnight or in a particular current series - eg BBC Science, BBC History, BBC Home, BBC Natural History. Over time, individuals would be able to build their own “personalised channels”, concentrating on their own particular interests, rather than relying on the BBC’s schedulers.

- BBC Online would continue to provide access into the creative and information resource at the heart of the BBC. The greater capability of PCs would enable better access to current TV and radio services for online audiences at home, school, office and on the move. Meanwhile the ability to offer interactive and online services alongside or attached to traditional broadcast programmes would significantly improve the value of those programmes to digital audiences.
- Public access to the BBC's digital services in libraries, schools, supermarkets etc would ensure that everyone can benefit from what digital can offer, even if they do not have the receivers at home.

Overall, the implementation of the BBC's vision for its services in 2006 would increase its annual spending on programmes by about £1250 million a year by the end of the present Charter period. Of this, around £550 million would be devoted to existing services. (£250 million would be eaten up by "superinflation" of rights and talents costs, leaving £300 million for genuine enhancements to core analogue services.) In addition to this, the BBC has proposed that the Panel should seek to fund the bulk of around £700 million per annum of additional spending on new services by 2006.

The Panel was provided with further information on the specific costs of enhancements to various services which the BBC would like to undertake. (We are not publishing these costs in detail because of necessary commercial confidentiality.) In total, the specific proposals by the BBC amounted to a spend of some £300 million per annum by 2006. This obviously implies that the remaining £400 million per annum on new services would be spent in a manner to be determined at a later date.

Chapter 1 - Achieving Sufficiency Without Excess

Funding needed to fulfil the BBC's vision

(1998/99 prices)	£ million
Spending in 1998	2,200
Suggested Spending in 2006	3,450
Extra spending	1,250
Of which	
- Enhanced Existing Services	550
- New Services	700
Of which	
- Specified in Detail to Panel	300
- Unspecified in Detail	400

Overall, then, the BBC's service vision would increase its annual spend on services by 57% in real terms over 8 years. This represents compound annual growth of 5.1% per annum in service provision over this period.

We asked the BBC what effect this amount of extra spending might have on their weekly reach, and on their audience share. We also asked whether the BBC would be able to continue to exercise an important influence on the rest of the marketplace if their full vision for additional services were met.

The BBC said that if it is given the ability to set public service benchmarks in every genre and to deploy the resulting content in ways which actually enhance the value people receive from their licence fee investment, it will continue to influence the competitive market in which it operates. On this basis, the BBC is confident that around 90% of UK households will access at least some BBC content each week by the time a new Charter starts in 2007. Although the BBC's share of audience time will continue to decline over this period towards 35% (compared to 42% now) the Corporation believes this remains well above the threshold for retaining influence in the marketplace.

Audience share and reach of the BBC

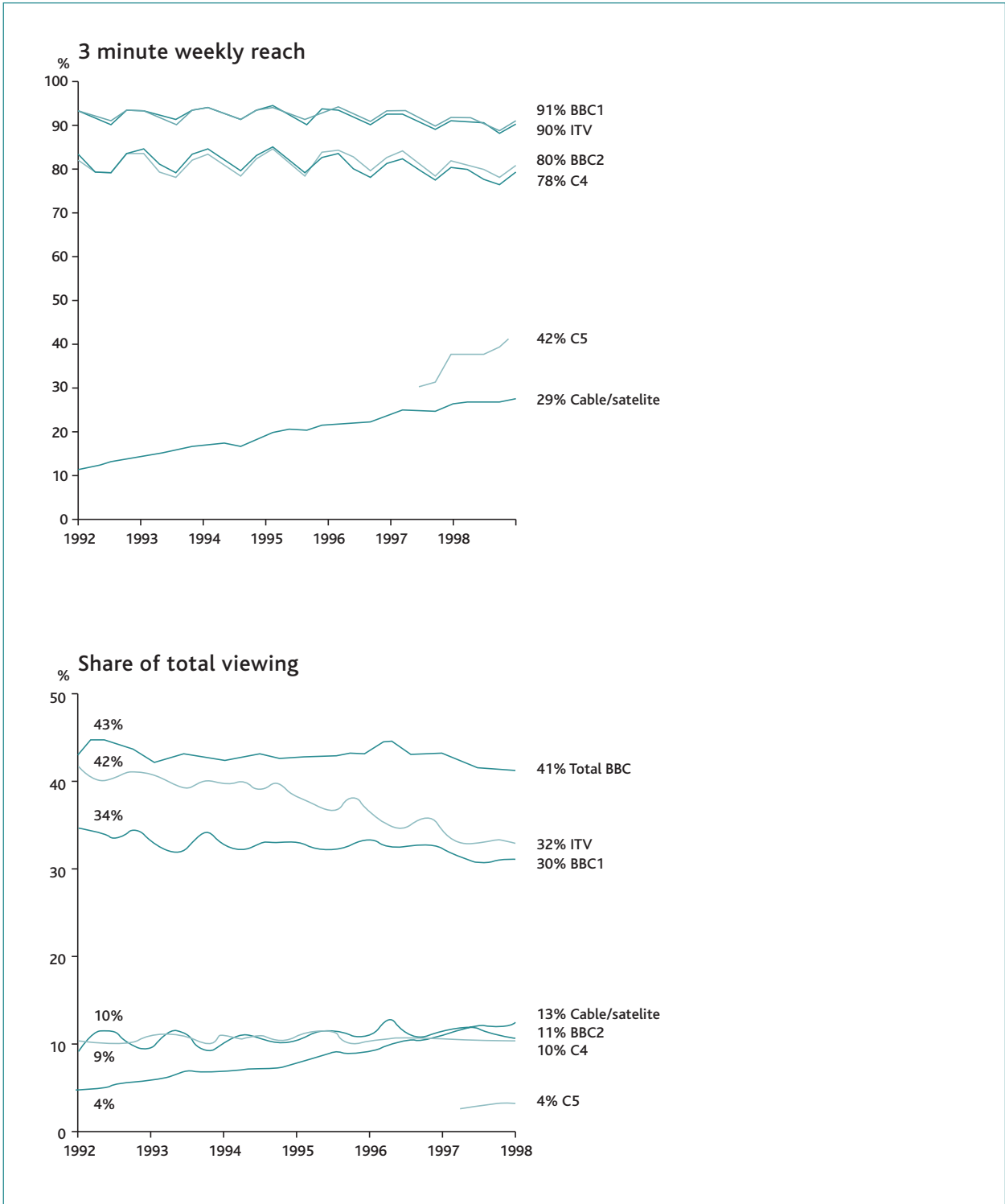
- **Audience share** is simply the proportion of total viewing or listening accounted for by a particular television channel or radio station. The BBC's share of adult viewing and listening in 1998 was 42%.
- **Audience reach** measures the proportion of the potential audience who have spent some (non-negligible amount of) time viewing or listening to a particular service during a given period. In 1998 the BBC achieved a weekly reach of 93% of adults, this being driven mainly by TV viewing which in itself had 92% reach.

In the digital age, audience reach may become a considerably more important concept for the BBC than share. With a large increase in the number of television channels available, a decline in BBC audience share seems inevitable. Evidence for this is the fact that the BBC's share of viewing in homes with access to satellite and cable television is 29%, compared with 41% for all households. In this more competitive environment, audience reach will measure how far the BBC continues to offer something of value to every licence payer.

The level of audience reach achieved in the future, therefore, can be considered an important indicator of the BBC's relevance, and its success in serving the needs and wants of a diverse audience. The BBC Governors' Assessment in the latest Annual Report recognises this, stating, "The overall reach achieved by BBC services is a more significant indicator of success than market share."

The graphs on page 44 illustrate the BBC's and other broadcasters' performance in terms of television reach and share over recent years. It can be seen that while BBC reach has remained fairly constant, there has been a slight fall in its share, following the growth in programming available on cable and satellite and the arrival of Channel 5 (although the main impact has been on the share held by ITV).

Chapter 1 - Achieving Sufficiency Without Excess



The consequences of less buoyant revenue growth

If, on the other hand, the BBC is not provided with any additional revenue buoyancy, the Corporation would simply be able to do less in many fields than it would like, especially in the development of new services. In its evidence, the BBC told us that it would aim to:

- continue as the UK's major investor in high-quality broadcast content for both radio and TV, though it would fall behind the commercial sector in the quality of its online offering. It would continue to serve the majority of UK audiences but not everyone;
- continue to be the benchmark for quality in those genres in which it is still able to compete effectively, but it would only fill in the gaps in market provision of sport, drama and children's programming such that its output makes little impact on that offered by the commercial sector;
- ensure access for licence payers to the wealth of BBC investment in a variety of ways, with the core TV and radio networks remaining relatively strong offerings. The current digital services would not be developed to what the BBC calls "their full potential". They would not be able fully to match the pay offerings from commercial competitors, and would therefore not enable the BBC to build its digital audiences to the extent necessary to condition the development of the marketplace;
- BBC Choice would not be a genuine third network serving younger audiences and audiences in the nations, but would be a catch-up service of the best on BBC One and Two each week;
- BBC Knowledge would remain a limited-hours service that would fail to make the same use of the interactive capabilities of digital receivers as the commercial shopping and games channels will;
- BBC Parliament would cover the Westminster parliament effectively but would not be able to provide anything more than perfunctory coverage of the devolved assemblies; and
- The BBC would not be able to provide a service for children which would provide a real alternative to a diet of imported programming, dominated by cartoons.

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Under these circumstances, the BBC believes that its reach would still remain relatively high (around 90%), but its audience share would fall to just over 30% in 2006, perhaps nearing the threshold required to have real influence in the marketplace. The fear is that this could call into question the case for universal funding through the licence fee at the next Charter renewal. By that time, the commercial sector may take little account of the BBC's offering in its service decisions, so audiences will be polarised between (a) those willing and able to spend the considerable sums needed to access premium content, and (b) the rest, who will have to rely on an under-funded portfolio of BBC programmes and thin free-to-air commercial offerings. If true, this would obviously be unsatisfactory for the broadcasting ecology of the UK.

Summary of the BBC's case

In summary, the BBC would like to increase its annual programme provision by £1250 million between 1998 and 2006 to ensure that a full service public service vision could be implemented in both analogue and digital media. Fortunately, not all of this needs to come from additional funding from external sources. In order to understand how much needs to be raised from external sources, we need first to examine the likely growth of the BBC's licence fee income under the current regime, and then add the amount that the BBC can reasonably be expected to raise from self-help (ie improved licence fee collection, efficiency savings and commercial revenues). Only after doing this can we estimate how much money needs to be raised by the Panel's proposals.

The outlook for licence fee revenue

The first question is how to interpret "the existing funding regime". We interpret this to mean that the final two years of the current settlement are left untouched, and that the licence fee is increased in line with inflation thereafter. This means that over the period from 1998-2006, the baseline assumption is that licence fee income **per household** falls by about 0.4% per annum, reflecting the 3.5% real cut in the licence fee which is due to take place in the next two years (following two years of above inflation settlements). The number of households continues to grow by 0.85% per annum, so licence fee income in total should rise by 0.45% per annum, before taking account of any measures to enhance revenue collection. This would represent an increase of £80m in annual licence fee income by 2006.

This figure should be seen in a historical context. In the past three decades, BBC licence fee revenues have enjoyed a degree of natural buoyancy due to the steadily increasing penetration of colour televisions in UK households. As a consequence, licence fee receipts rose by 4% per annum on average, in real terms, between 1970 and 1986. By 1986, however, the rate of increase in colour television ownership had slowed significantly. In that year the Government pegged the

licence fee to the Retail Price Index (RPI), and real licence fee revenue has grown relatively slowly (less than 2% per annum) since then. Excluding improvements in the system for licence fee collection, the overall revenue from the licence fee would have increased by only about 1% per annum during the 1990s.

Commercial and licence fee revenues

1970 to 1992

It is interesting to compare BBC licence fee revenues with commercial revenues. In 1970, BBC income from the television licence fee was £99 million. The same year, UK commercial television companies received about £95 million in net advertising revenue. Between 1970 and 1992, BBC revenue from the licence fee grew by just over 3% per year on average, in real terms. Much of this natural buoyancy stemmed from the increasing penetration of colour televisions. Commercial television revenues - from advertising, and latterly also sponsorship and subscription payments - grew slightly faster over the period at around 4.5% per year in real terms. Commercial advertising revenues displayed strong cyclicalities, reflecting developments in the wider economy.

1992 to 1998

Between 1992 and 1998 commercial revenues enjoyed rapid growth, virtually doubling in real terms over the period. The principal factor behind this growth was the expansion in subscription income paid to satellite and cable broadcasters. BBC licence fee income continued to grow in real terms, but at a rate below its previous trend. From 1986, the Government pegged increases in the licence fee to the RPI, and the process of colour penetration was virtually complete. Growth in the number of households and reduced TV licence evasion provided the means for incremental real revenue expansion. Nevertheless, commercial revenues in total grew at about ten times the rate of BBC revenue from 1993-98. The only mitigating factor for the BBC during this period was that ITV revenues also stagnated relative to the explosion in subscription channels.

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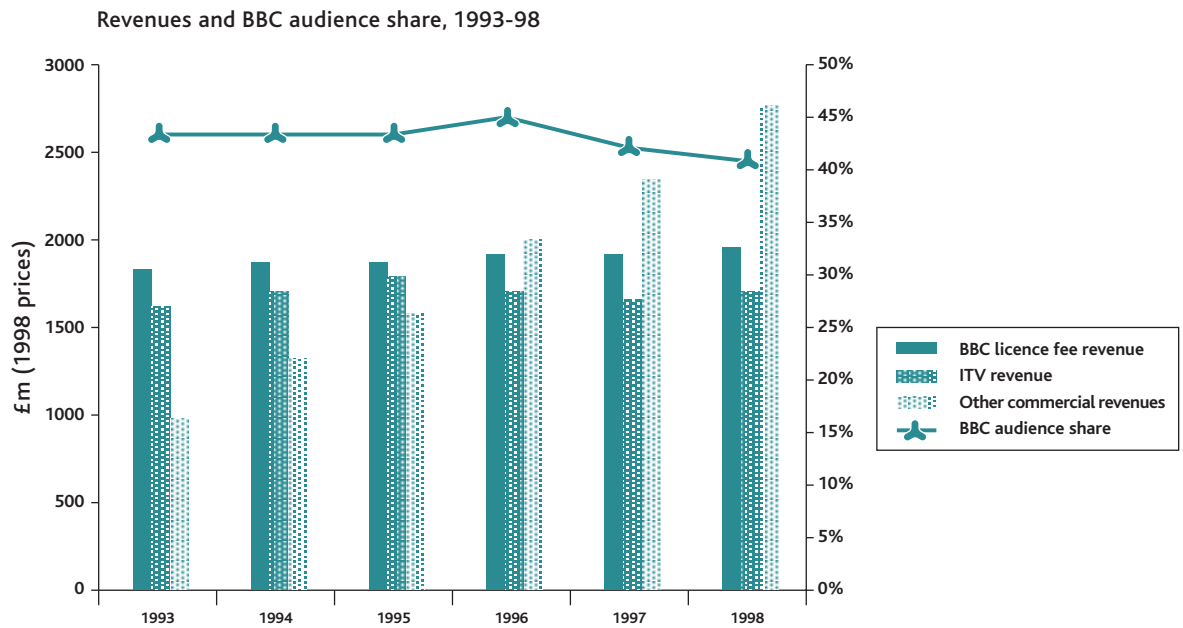
	1993	1994	1995	1996	1997	1998
Commercial revenues from advertising, sponsorship & subscription (£m, 1998 prices)	2585	3030	3410	3830	4157	4579
<i>annual real growth</i>		17%	13%	12%	9%	10%
BBC licence fee revenue (£m, 1998 prices)	1848	1902	1913	1940	1980	2010
<i>annual real growth</i>		3%	1%	1%	2%	1%

Revenue shares and market shares

Despite its rapidly declining share of revenues over recent years, the BBC's share of viewing appears to have largely held up. Gains in share by satellite/cable channels and Channel 5 were mostly at ITV's expense. However, it is questionable whether the BBC's share can remain robust in the face of expanding numbers of channels and further increases in the penetration of multichannel TV.

	1993	1994	1995	1996	1997	1998
<i>BBC share of revenue</i>	42%	39%	36%	34%	32%	31%
<i>Viewing shares (BARB, %)</i>						
BBC	43	43	43	45	42	41
ITV	40	39	37	35	33	32
C4	11	11	11	11	11	10
C5	-	-	-	-	2	4
Others (Cable/Satellite/RTE Ulster)	6	7	9	10	12	13

Note that in this table and the chart opposite, it is licence fee and commercial television revenues that are being compared rather than programme expenditure. Hence the BBC figures include funds used for overheads and radio services, whilst a proportion of commercial broadcasters' revenues will be required for overheads, tender payments and profits. Nevertheless, the main trend is clear, with the BBC shrinking relative to the total market.



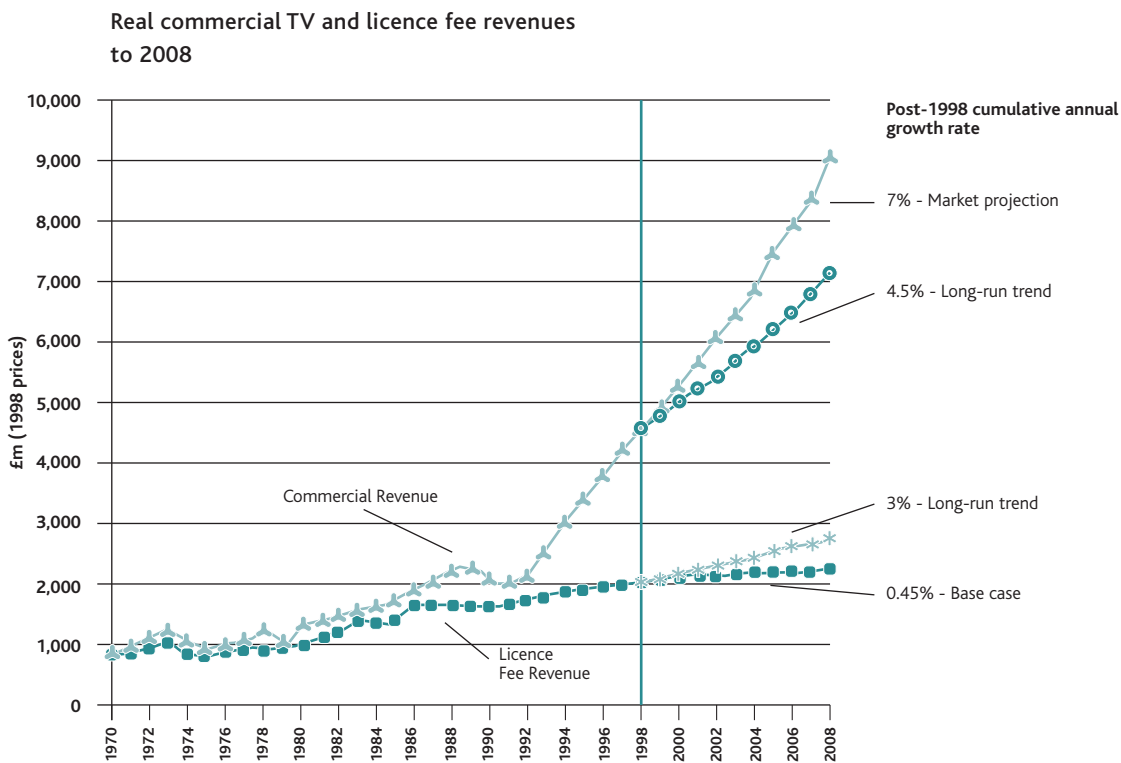
Projected revenue

The chart overleaf shows the paths of commercial and licence fee revenue, in real terms, from 1970 to 1998, showing the explosive growth in commercial revenues after 1992. The last part of the chart displays projected growth over the next ten years, under alternative assumptions. For commercial revenues, there is uncertainty over the extent to which recent growth rates can be sustained. A return to the long-run trend growth rate of 4.5% would see commercial revenues reach £7 billion (1998 prices) by 2008. However, the consensus market forecast is for real annual growth of about 7% (with subscription and pay-per-view revenues the driving factor), implying revenues of £9 billion by 2008.

As we have seen, licence fee income under current arrangements might be expected to grow by about 0.45% per year on average, in real terms, assuming annual upratings in the licence fee in line with inflation after 2002, and taking into account the expected growth in the number of households. This would provide about £2.25 billion (at 1998 prices) of licence fee income in 2006.

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The implication of the projected growth rates shown is that the BBC's licence fee income (note that this includes both radio and television) could account for as little as 20% of television revenues by 2008 (£2.3 billion out of £11.3 billion). This substantiates the BBC's concern that, with relatively stagnant real revenues, the Corporation might be unable to both maintain its standard-setting role in television programming and play an influential role in the development of digital services.



The problem of increasing costs

We have seen that, in the absence of measures to reduce licence fee evasion, and assuming no further "self-help" from the BBC, the BBC's licence fee income would grow by only 3.5% from 1998-2006. The whole of this growth and more is likely to be absorbed by "superinflation" in the costs of talent and rights.

The growing competition for skilled broadcasting staff which has occurred following deregulation of the television industry seems unlikely to diminish with the onset of digital services, implying that the BBC will face continued increases in the cost of recruiting and retaining key staff. Since

labour costs are a major component of the BBC's total costs, this has implications for funding if the BBC is to maintain its market position. An equally important consideration is the increasing cost of acquiring programme rights and securing talent, given the expanding numbers of broadcasters and channels, and the forecast growth in industry revenues.

There is also the issue of inflation in the costs of acquiring talent and programme rights. In the pre-satellite environment, spectrum scarcity allowed existing broadcasters to exert significant purchasing power. However, growth in the number of delivery mechanisms and channels has caused market power to gravitate away from broadcasters and towards key talent. Competition between broadcasters for talent and programme rights causes their prices to escalate.

In the UK this process has been most obvious in the competition for major sports rights, such as Premier League football, Formula One, and Test Match cricket. However, in an environment of expanding numbers of channels, competition between broadcasters is likely to drive up the price of acquiring rights to popular programming and key talent across a range of genres. Equally with the BBC accounting for a large share of the market for such talent, it should not take this inflation as a 'given', but should seek to keep down such costs by, for example, refusing to enter into excessively expensive bidding wars.

Whether the BBC needs a particular share of industry revenues in order to maintain high levels of audience share and reach is not clear. As the industry becomes more fragmented the BBC's level of guaranteed revenue makes it seem certain to remain a major player. What seems clearer is that where talent and rights costs are escalating, a degree of revenue buoyancy will be required if the BBC is to secure and retain the rights and talent necessary to be able to play the quality setting role that is required.

All of these factors have been included in the BBC's calculations of the extra money they will need to fulfil their services vision in the next few years. Essentially, more money will be needed simply to produce and deliver the same quality of programming, because the costs of talent, foreign programmes, sports and gateways (ie delivery across new platforms) will prove increasingly expensive. This "superinflation" of BBC costs could add around £250 million a year to total BBC costs by 2006.

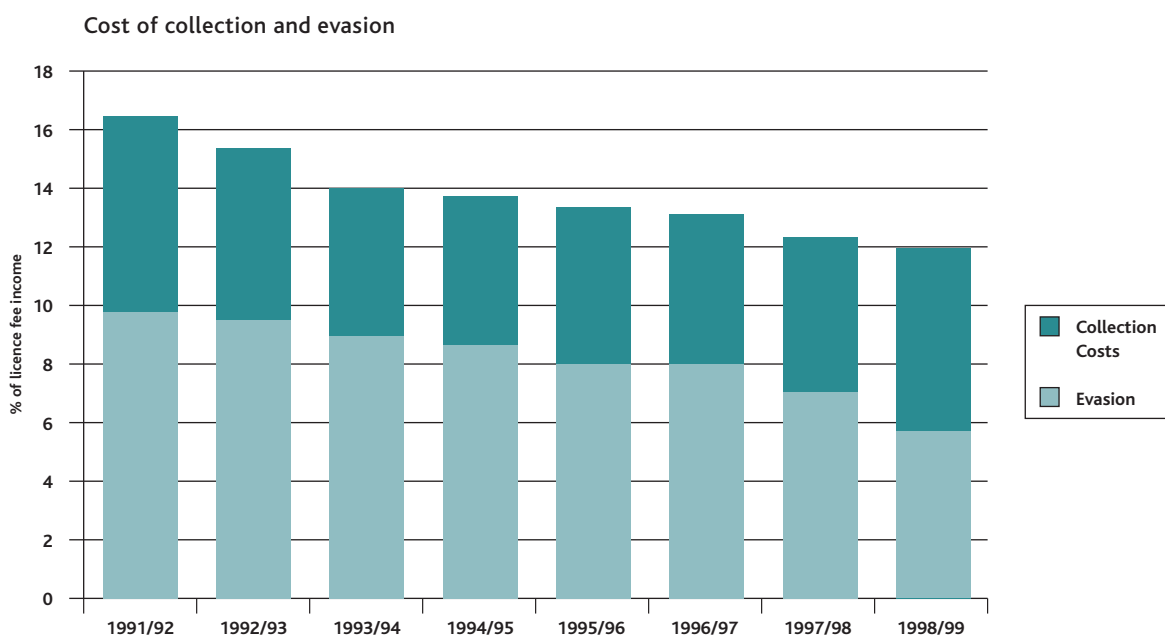
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BBC self-help

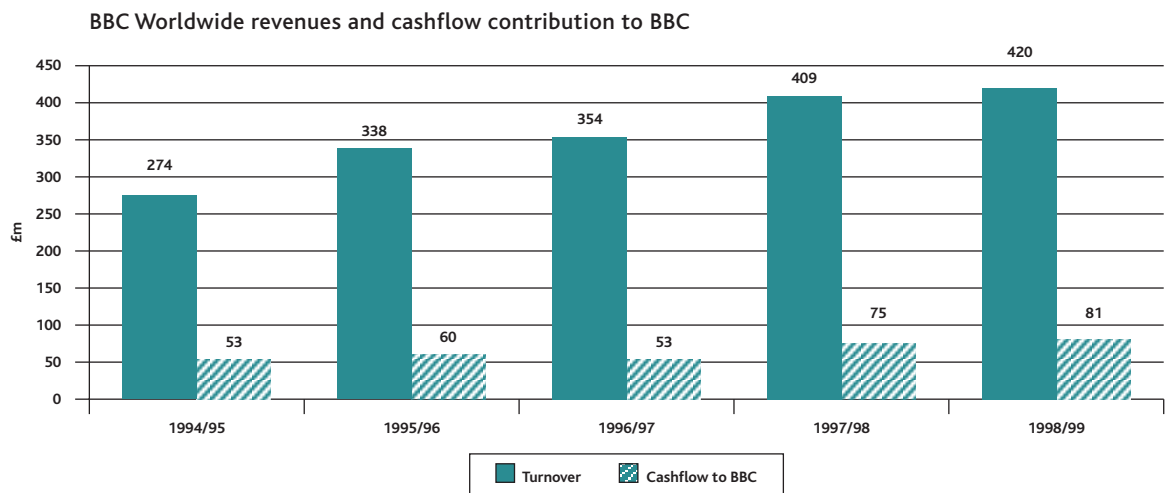
In addition to the base case increase in licence fee revenue, the BBC should once again be able to generate extra revenue from self-help, including:

- improved licence fee collection;
- improved returns from BBC commercial businesses; and
- improved efficiency.

On licence fee collection, the total cost of evasion and collection has dropped by nearly 5 percentage points since 1991 from over 16% to around 12% now. The BBC is aiming further to reduce licence fee evasion through better marketing of easy payment methods, more effective detection technology, and a new collection contract with Envision from April this year. The Panel has been impressed with the recent improvement in licence fee collection, which has stemmed from a more organised and imaginative approach to the collection process in recent years, and believes that the current 12% figure for combined collection and evasion costs can be reduced to 9-10% by 2006. This alone would generate around £50-£70 million in annual savings by 2006.

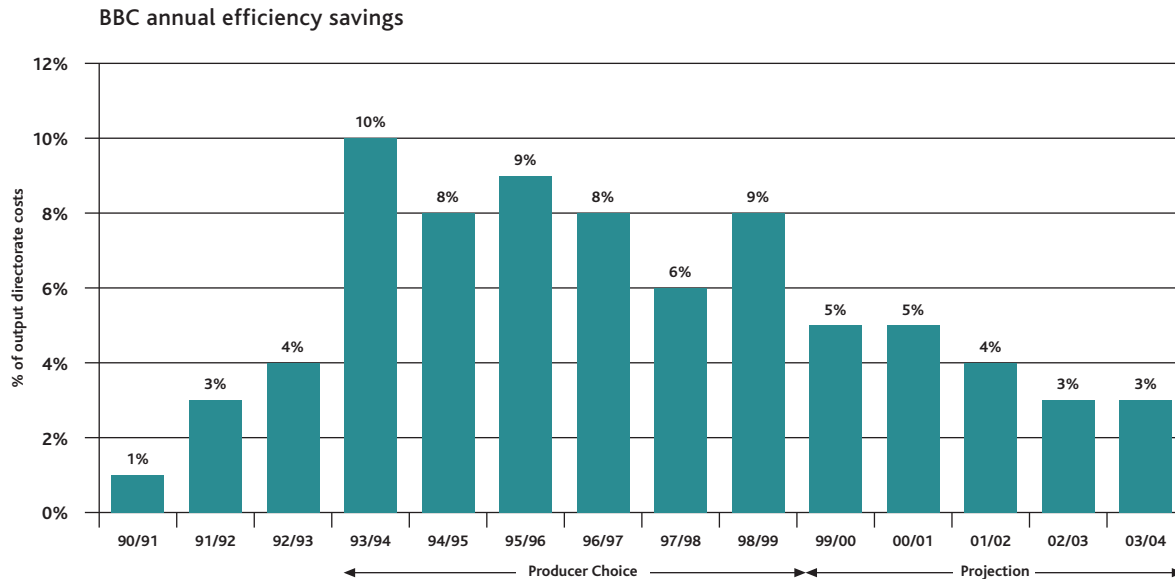


BBC Worldwide has increased its contribution from £53 million in 1996/97 to £81 million in 1998/99, and aims to achieve a target of quadrupling its cashflow to the BBC (to £212 million by 2006/7) through improved exploitation of cross-media brands, by growing the established programme sales and publishing businesses, and through the development of its domestic and international channel portfolio. This would generate £120 million of extra cash for public service programmes by 2006. In order to achieve these targets, BBC Worldwide will need to increase its sales by 13% per annum from 1998 to 2006, substantially faster than the 10% growth expected in the market as a whole, as well as improving its profitability. These are demanding targets, and it will be difficult to exceed them by any substantial amount, even if the culture of the BBC gives greater emphasis to commercial activities in future. Nevertheless, we suggest ways of doing this in Chapter 3.



Since Producer Choice (the BBC's internal market) was introduced in 1992/93, programme prices have been reduced by an average of 35%, generating £550 million of annual savings at the present time. In the last six years, with the full implementation of the internal market, annual efficiency savings have been running each year at about 7-8% of the costs incurred by the BBC's output directorates. Efficiency savings at the BBC have so far come in two waves, as the accompanying graph shows. The build-up to Producer Choice saw relatively small savings, while the last six years have seen much larger savings. In future, it may be much more difficult to cut costs at the rates seen since 1993, since the BBC has told the Panel that its programme costs have now fallen below those in the private sector. (We are reassured by the BBC's figures, but have treated them with some caution, as they have been criticised by independent producers. Nevertheless, they are indicative of the Corporation's welcome determination to improve its performance). The BBC's strategy for delivering continuing efficiency savings year on year includes a major project to deliver management and administrative activities more effectively, greater use of digital production technology, and smarter approaches to purchasing. We assume that these measures can generate £350 million in extra efficiency savings per annum by 2006.

Chapter 1 - Achieving Sufficiency Without Excess



Many observers have suggested that there should be massive cuts in the costs of “bureaucracy” at the BBC, whether in the form of consultancy costs, the costs of running the internal market, or the costs of the Corporate Centre. This needs to be kept in context - total costs of the Corporate Centre are 3% of annual turnover, a significant sum, but insufficient to come close to solving the BBC’s funding problem, even on the impossible assumption that these costs were eliminated altogether. We note that the BBC plans to reduce the staff employed in the Corporate Centre from about 400 now to roughly half that amount when the present reorganisation is complete in April 2000. Many of these will be redeployed in shared services (such as IT and technological support for the whole organisation), but there will also be increased out-sourcing to reduce costs. We have not found any firm evidence that the costs incurred by the BBC in these areas is particularly high compared to private sector businesses, but we do not claim to have made a major study of this question. No doubt the Director General, given the degree of public discussion which has arisen in this field, will wish to satisfy himself that costs are being minimised in these managerial activities.

Since none of these efficiency savings result in measurable revenue increases to the Corporation, it is difficult to prove conclusively that they have taken place. However, in 1996, Braxton Associates, an independent consultancy firm, prepared a report for the Secretary of State for Culture, Media and Sport on the BBC’s efficiency savings. This broadly confirmed that the efficiency savings claimed by the BBC were genuine, and that the Corporation’s efficiency levels were at least in line with those in the private sector. It would be a useful discipline to repeat this exercise before the Panel’s funding recommendations are implemented.

Summary of the funding outlook

The table below summarises the potential growth in the BBC's ability to fund additional programmes between 1998 and 2006, making the "base case" assumption that the licence fee is uprated in line with inflation after the current licence fee settlement ends in 2001. It shows that the BBC is in effect requesting the Panel to find around £650 million of extra money by 2006, assuming that the self-help measures are implemented as intended by the BBC.

Sources of additional funding, 1998-2006

(at 1998/99 prices)

£ million

In baseline

Licence fee income	80
Of which	
• Licence fee uprating*	-60
• Household growth	140

Self Help

Improved collection of licence fee	70
Efficiency Savings	350
Growth in Commercial Revenue	100
Total from self help	520
Total from baseline licence fee income and self help	600
Total required to fund full services vision	1,250
Remainder requested from Panel	650

* this represents the impact of the cut of 3.5% in licence fee revenue due to take place in the final two years of the present settlement period.

Panel's view

Where the BBC has spelled out its proposals for developing its services in a digital age, they would offer a major enhancement to the provision of public service broadcasting in the UK. But cost is a key issue. As we have seen, the full BBC vision for 2006 involves an increase in programme provision of 57% in an eight-year period, implying real growth of about 5% per annum in spending from 1998 to 2006. By the end of that period, the BBC would be spending around £700 million on new digital services, in addition to the £200 million spent now. In order to make this possible, the Panel would need to propose measures designed to enhance BBC income by about £650 million in 2006.

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The question is whether the benefit is worth the cost.

The Panel sympathises with many of the crucial arguments in the BBC's case.

- We agree that the BBC should aim to remain a full service public service broadcaster, with a sufficient foothold in all segments of the media to exercise influence throughout the market place.
- We agree that technology is changing rapidly, and that the BBC needs to expand its services in the digital space if public service broadcasting is to be maintained in the new world.
- Furthermore, we agree with those who believe that additional spending is needed both on the established channels, and on the radio networks, in order to retain the BBC's position in the marketplace without additional reductions in public service quality.
- We are concerned that if the BBC's share of the overall television and radio market falls towards 30%, it would be harder to maintain a standard-setting role in the broadcasting ecology.
- The option of doing nothing, other than to fall back onto the usual "RPI uprating" formula for the licence fee after 2001 is therefore not sustainable.

However, it must be remembered that even with a 30% market share the BBC would still be the dominant player in the UK. An important mitigating factor in the BBC's loss of revenue share in the market during the 1990s has been the similar decline in the relative share of ITV. On most forecasts for advertising revenue over the next decade, the BBC seems set to gain revenue share relative to ITV, even if no new funding measures are adopted. It should also be recalled that the growing revenue of the commercial sector will be spread over a dramatically increased number of channels, so that the BBC's revenue *per broadcasting hour* will remain relatively high. So there is no imminent danger of the BBC becoming a peripheral player in the UK marketplace.

We also need to recognise that the option of increasing licence fee revenue, in any of its possible forms, has serious disadvantages. The licence fee is a regressive charge, with the payer having no effective choice about the scale of services which the BBC is providing. In these circumstances, we do not feel justified in asking the licence fee payer to incur still higher costs, unless we are absolutely convinced that this is necessary to maintain a healthy public service broadcasting ecology in the UK. In a sense, the inherent disadvantages of the licence fee system imply that we should fund the **minimum BBC services necessary to do this**, not the maximum amount that could be usefully spent.

Turning these principles into hard figures is more of an art than a science. After considerable debate, the Panel was not convinced by the case made by the BBC for £650 million extra funding by 2006. We found most of the Corporation's proposals for future services attractive in themselves - in fact, we found many of them compelling (including, for instance, the expansion of BBC Knowledge into a truly interactive service providing learning for all the different groups wanting education at home). Other proposals, however, seemed vaguer and more sketchy, and we were not happy to pre-fund services which had not yet been fully identified and specified.

We also wish to incentivise the BBC to look for more efficiency savings and commercial revenues over time. It would be a very bad signal to management if the Government were to "take back" any of the BBC's past efficiency savings by using them as an excuse to reduce future funding, and we have been very careful not to do this. We would like the BBC to be reassured by the Government that every penny they can squeeze from these sources in the future will be permanently available for spending on improved services. But at the same time it is advisable to keep a strong funding discipline so that the BBC is not tempted to relax in these areas in future.

Balancing all these considerations, we consider that measures should be taken designed to increase BBC revenues by around £150-200 million a year between 2002 and 2006. This would produce growth in BBC real revenue of about 2 - 2.5% per annum, which is roughly in line with real GDP. We note that Sir John Birt, in his recent New Statesman lecture, argued that the BBC should not be allowed to shrink inexorably relative to national income; our suggestion broadly achieves this objective up to Charter Review.

If BBC real revenue grows in line with GDP at 2-2.5% per annum, this would imply growth in real spending of around 3.5% per annum, with the gap being filled by further efficiency gains and other forms of self-help. This would take the BBC more than halfway to the growth rate in spending required from 1998-2006 to fulfil its full services vision. Looked at a slightly different way, our recommendation would fund around one third, or a little less, of the annual increase in spending that the BBC has proposed for the last few years of the Charter period, but would fund a much higher proportion in the next few years. We believe this should be sufficient to enable the BBC both to improve the quality of its established services and to invest in digital. But it will also mean that the BBC will have to prioritise its activities in the digital world and not seek automatically to expand into every new area of activity. And it will mean that faster gains in efficiency and commercial activities will be needed if the BBC is to come closer to its full service vision.

Chapter 1 - Achieving Sufficiency Without Excess

Recommendations

In summary, taking into account the arguments presented in this Chapter, the Panel recommends that:

- *the BBC should be funded sufficiently to remain a full service public service broadcaster across the UK's rapidly-developing broadcasting market;*
- *the "status quo" option of simply implementing an inflation-linked settlement for the licence fee after 2001 should not be adopted, because this would effectively freeze the BBC out of the digital world, which will probably be the future of broadcasting;*
- *the BBC's core revenue should increase by 2-2.5% per annum in real terms up to 2006, roughly in line with GDP;*
- *the BBC should be permitted to retain additional efficiency savings and commercial revenues which together should enable programme provision to rise by some 3-3.5% per annum. Any efficiency gains and commercial income in excess of these targets should also be retained for extra programme provision;*
- *the BBC's efficiency savings should periodically be assessed by outside consultants, appointed by the Secretary of State for Culture, Media and Sport; and that*
- *the Director General should ensure that expenses for the central management and bureaucracy of the BBC are commensurate with those of equivalent private sector organisations.*

Chapter 2 - Achieving a Healthy Broadcasting Ecology

Good and Bad Options for Extra Funding

"Against an expectation that the licence fee will remain the principal source of funding for public services for the Charter period ... consider ways in which funding to support public service output can be extended from other sources"

Chapter 2 - Achieving a Healthy Broadcasting Ecology

Overview

In the previous Chapter, we established that the BBC's internal sources of funding would not be sufficient to generate the recommended growth in services up to 2006. In this Chapter, we consider the main options for generating significant extra revenue for the Corporation from external sources. In principle, it would be possible to generate the necessary revenue by turning the BBC into something closer to a commercial broadcaster, for example by raising revenue from advertising, sponsorship and subscription. But each of these courses of action would damage the BBC as a public service broadcaster, or set in train undesirable head-to-head competition for scarce revenue with private broadcasters, or both. We think that these options would be profoundly damaging for the broadcasting ecology in the UK.

This leaves two possible ways forward - an increase in the basic licence fee, or a digital licence supplement. We prefer either of these options to the "status quo" of doing nothing. However, on balance, we think that a digital licence supplement has clear advantages over the basic licence fee, and fits in better with the British tradition of introducing new technologies in the broadcasting market.

Options for supplementary funding

There is no reason in principle why all the BBC's services should be financed exclusively by the licence fee or by any other means. Already, the BBC obtains part of its income through BBC Worldwide, trading commercially, and BBC World Service radio is funded by a direct Government grant. While some options, such as advertising or subscription, could finance BBC services as a whole, others such as sponsorship and co-production, could meet only a small proportion of the BBC's total costs. Any of these options might be useful to supplement BBC income in the period ahead of Charter Review, though overseas experience suggests that mixed funding tends to lead over time to further cuts in the licence fee, creating pressures to take more advertising and forcing compromises in the scheduling and balance of programmes. Furthermore, there can be deleterious effects on the nation's broadcasting ecology - notably via a scramble down-market to attract advertising revenues. (See Chapter 5, which suggests that competition for commercial revenues with private sector broadcasting can trigger a downward spiral towards mediocre broadcasting, and presents evidence that a licence fee funded mechanism is superior to advertising in producing significant and distinctive public service broadcasting.)

Other than the income from BBC Worldwide, the BBC currently supplements its funding in three ways: **co-production**, co-funding and cost recovery. **Co-productions**, the most significant of the three, involve the provision of funding in exchange for broadcasting and other rights in conjunction with other broadcasters, programme and film distributors, independent producers, record and video companies and audio publishers. In 1997/98, they contributed around £50

million to the BBC's total TV origination investment of £614 million, compared with £37 million out of £590 million in 1995/96. **Co-funding** is currently restricted to schools programming by BBC Education and Regional Broadcasting, certain programmes in Gaelic and Welsh, and educational and "lifeline" broadcasting by the World Service. **Cost recovery** from audiences is considered appropriate where additional non-broadcast services are offered by programme makers in support of core free-to-air services, for instance, additional services produced by BBC Education in support of school broadcasting.

These forms of supplementary funding generate, however, relatively limited resources compared with the licence fee itself and they would not be sufficient to give the BBC the financial buoyancy it requires. We have, therefore, considered a number of other options for supplementing licence fee revenue.

Advertising on BBC public services

The introduction of advertising on BBC public services is superficially appealing. There is little doubt that it could generate very significant extra funds for the Corporation, making possible either a substantial cut in the licence fee, or comfortably funding the entire extra spending suggested in the BBC's new service vision in the previous Chapter. A recent study for the BBC by London Economics suggests that advertising on both BBC One and BBC Two, restricted only according to the rules which currently apply to ITV, could raise around £1.7 billion a year, once fully phased in. If restricted to outside peak time only, this revenue flow would fall to £0.6 billion, while if restricted to new channels only, it would fall to about £80 million. The Incorporated Society of British Advertisers, in its evidence to the Panel, reckons that the BBC could raise around £250 million for every minute per hour of advertising taken, so 7 minutes of advertising per hour would produce similar total revenue to the London Economics calculation. Similarly, the Billett Consultancy has told us that 2 minutes of advertising per hour on BBC One and BBC Two would raise about £500 million per year for the BBC. So all of our evidence is consistent in suggesting that the sums raised would be massive.

Chapter 2 - Achieving a Healthy Broadcasting Ecology

Nevertheless, the Panel believes that the introduction of advertising on BBC public services is neither desirable nor practicable:

- introducing advertising on some or all of the BBC public services would be likely to alter the range and quality of BBC programmes, leading inexorably to a more populist and less distinctive schedule. The programmes would have to attract large or high-spending audiences, which advertisers pay to reach. This could force the BBC to cut back on challenging and innovative programming, programming of interest to older or poorer people who may spend less, or to reschedule minority programmes out of peak times;
- commercial pressures can also threaten the freedom and independence of programme makers and schedulers;
- advertising on BBC programmes would be intrusive into programming content, reducing viewer satisfaction;
- allowing the BBC to take advertising would reduce the revenues of Channel 4 and existing and prospective commercial television and radio services, and of the press. London Economics reckons the amount would be around one-fifth if the BBC accepted 7 minutes of advertising per hour. (The entire UK TV advertising market is around £2.6 billion, ie not much more than the BBC's licence fee income);
- advertising becomes a less certain source of finance as the number of competing services grows;
- in a number of European countries, reliance by public service broadcasters on advertising has resulted in ratings wars, falling audiences and reduced revenues and there is some evidence of an adverse correlation between the extent to which the public service broadcaster is funded from advertising and the proportion of output dedicated to factual, children's and cultural programming, even when advertising is restricted to certain times (eg in the case of ZDF and ARD in Germany); and
- experience elsewhere in the EU suggests that taking advertising generates complaints from commercial broadcasters and raises regulatory queries about the legitimacy of public funding.

We have also considered the possibility of recommending the introduction of advertising only on the new public services, such as BBC Choice and BBC News 24, which are at present only accessible to the minority of licence fee payers. However, over time, it would be hard to prevent seepage of advertising from the new services to the established ones. If advertisements around "Glastonbury" on BBC Choice, or news bulletins on BBC News 24 is acceptable, there is no obvious logic as to why they should not also be allowed during similar programmes on BBC One and BBC Two. As the new channels grow in the new environment, the BBC would slowly become an advertising-financed broadcaster.

BBC programmes shown on UKTV with advertisements around them are acceptable, since viewers are well aware that the UKTV channels are subscription services which show only material which has already been seen on the main free-to-air channels. The basis of funding is entirely different, and the channels are not BBC branded.

BBC Online

We considered whether advertising should be allowed on the BBC's public service website, BBC Online. (Of course, it already is allowed on beeb.com, the commercial website run by BBC Worldwide.) This again is superficially attractive for several reasons:

- First, the Website is distinct from the BBC's main broadcasting services, which limits the risks of confusion about the BBC's objectives.
- Second, BBC Online is probably the most successful indigenous site in Europe, with over 100 million hits last month. This should make it a valuable medium for advertising and e-commerce revenues.
- Third, around half of the "hits" attained by Online are from non-UK residents who do not pay the licence fee, so there is a case for covering their share of the total costs of Online through advertising. (The total costs of Online are around £23 million a year, but it can be argued that most of this would need to be incurred in order to provide a UK service anyway. Distribution costs amount to about £1.5 million, of which about £750,000 involve distribution to non-UK residents. Of this, 70% is covered by a direct grant from the Government, so the licence fee payer is directly out of pocket by about £224,000 a year as a result of non-UK residents accessing the site.)
- Fourth, it can be argued that advertising and e-commerce windows on websites do not intrude much into editorial content.
- Fifth, given the very high valuations currently available for online businesses in the stockmarket, it can be argued that full conversion of the BBC site into a commercial business, followed by a flotation, would be attractive.

Despite these arguments, the Panel is not recommending that Online should be converted into a commercial service which would accept advertising or e-commerce revenues. This is for the reason that we expect Online to become a core part of the BBC's public service in the next few years. We also expect that closer convergence will take place between websites and broadcast services, so that the BBC's domestic audience will increasingly access BBC output via the website. If Online were to become a commercial service, it would need to be moved into BBC Worldwide, and its development as a public service would be stunted. (For example, the website

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could not be aggressively promoted on BBC channels.) We believe that this would carry substantial costs for the development of public service output in the UK. It is better to follow the model which has now been successfully developed for broadcast services - ie a public service website, funded by the licence fee, should co-exist with commercial services in BBC Worldwide, with the latter paying for BBC content at fair market prices

This still leaves scope for money to be raised from commercial website activities. We would point to the following in particular:

- Consideration needs to be given to the further development of beeb.com, including the possibility of taking some private capital into the venture, as suggested to us by Peter Ainsworth MP, the Shadow Secretary for Culture; and
- BBC Worldwide should launch separately-branded non-UK websites (eg BBC Online America) aimed directly at overseas users of BBC Online. The content of these sites might be similar to BBC Online, but we have been assured that it should be possible to direct most non-UK users to the sites specified for them. There is no reason why these international websites should not be run on a commercial basis, accepting both advertising and e-commerce revenues. We believe that, over time, international website revenues might cover a large proportion of BBC Online costs. That should be the aim.

Sponsorship

Sponsorship is another form of advertising limited to a statement in a programme that it is being financed by a particular organisation. Sponsorship would be less intrusive than advertising, but we would not recommend this for the following reasons:

- association with the BBC brand name could be attractive to sponsors, but there would be a risk that income from programme sponsorship might alter the balance of the BBC's programming, by putting pressure on the BBC to make more programmes which are attractive to sponsors;
- it would be unlikely to provide sufficient revenue to finance more than a small proportion of programmes and would cover only a fraction of the BBC's programme costs;
- it would inevitably draw advertising or sponsorship revenue away from Channel 4 and commercial broadcasters, or the arts and other sponsored events. The pot is not big to begin with: the sponsorship market in the UK is around £45 million; and

- sponsorship might also be an unsuitable method of financing some kinds of programme. The EC Directive on Broadcasting already forbids sponsorship of news or current affairs programmes, but there may be other programmes, for example, educational programmes, which should not be sponsored.

Subscription

Subscription could take several forms, ranging from a single fee for certain BBC services to paying to watch individual programmes. One advantage of subscription is that it could make a direct link between the providers and users of the services. Unlike the licence fee, subscription need not oblige television set owners to pay the same amount regardless of how many programmes or services they use. However, the downsides of subscription are:

- it would by definition be available only to those willing to pay and would therefore negate the fundamental public purpose of free-to-air services and universal access for the nation as a whole;
- if programmes or services were encrypted to ensure payment of the subscription, this would discourage people from sampling a wide range of programmes and could reduce the availability of programmes for those less able to pay.
- there would be a financial incentive for the BBC to place its best offerings on pay channels, or single programme pay-per-view, which would further undermine the licence fee concept.

The Peacock Committee envisaged that the BBC would one day become a subscription service. As our final Chapter shows, this option may become more attractive if technology develops to permit individual charging for virtually all television services in the distant future, but we are nowhere near there yet.

Other options

We have also considered the possibilities of **direct funding** by Government either through taxation or grant and **mixed funding** systems. The former has, however, tended to create broadcasters that are inextricably linked to political moods and have the potential to lose management or editorial independence, while the latter undermines the principle of fixed and independent funding and would be vulnerable either to reductions in mandatory funding or eventual transformation into a full commercial broadcaster.

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Our view is that each of these forms of supplementary funding, even if only providing funding at the margin, could change fundamentally the purpose and nature of the BBC's public services, both broadcast and online.

Changes to the licence fee system

We have considered several relatively minor options relating to the licence fee system itself for extending the BBC's funding. These include abolishing the black and white licence and changing the licensing requirements for pubs and clubs, hotels, businesses.

Black and white licences

The abolition of the black and white licence fee (which currently stands at £33.50) would in effect require all viewers to pay the colour fee of £101 and would generate about £20 million per annum for the BBC. However, the scheme is effectively abolishing itself: the number of black and white licences is declining rapidly (from 584,000 in April 1996 to 274,000 in June 1999 - down 90,000 from July 1998). Abolition would be onerous for the relatively small number of households who retain the monochrome option for financial reasons, and we do not think that this should be changed.

Business licences

It is estimated that there are around 80,000 pubs and clubs in the UK, 23,000 hotels or other forms of overnight accommodation, and 1.5 million other registered businesses. Currently, pubs, clubs and businesses pay the full licence fee in the same way as a domestic household. Hotels are obliged to pay one single colour licence fee which covers the use of television in up to 15 guest rooms, with a further fee payable for each additional five rooms with television.

To start with pubs and clubs, it has been suggested to us that there is a case for levying an extra licence fee because television events are often used to attract custom at these establishments. However, most of the viewers in pubs and clubs have probably already paid a licence fee at home, and anyway they are nowadays likely to be watching sporting events on channels other than the BBC. We do not think they should be charged for this.

Turning to hotels, the Panel has considered the possibility of shifting the regime so that one licence is charged for every five television sets, without any waiver for the first 15 sets. This would increase the number of hotel licences from the current 73,000 to at least 88,000, assuming that every hotel room has a television set. However, this would hit small hotels, and we recommend against the change.

Finally, there is the treatment of businesses. One option would be to increase the licence fee for business holders - for example, a £10 business levy in addition to the the existing licence fee would raise about £15 million in extra receipts from those premises. An alternative is to build on the existing hotels scheme, and charge all businesses one extra licence fee for every five licensable sets above 15 in number. This might be a fairer way of licensing businesses than a universal extra levy. However, in practice, many businesses will not have licensable sets and will only use televisions to promote their own products showing recorded material on a continuous loop basis. Their monitors are not therefore licensable as television receivers in use. The number of non-hotel businesses having more than five licensable sets is likely to be small. It is difficult to estimate how much such a scheme might raise, but it is unlikely to be significant, and the collection costs could be considerable.

In any case, the Panel questions whether it would be right in principle to charge businesses a higher fee than domestic households, when they receive the same level of service. This could be seen as changing the basis of the licence fee from a universal flat rate fee for services into a form of business taxation which would fall particularly heavily on small businesses. We do not recommend any changes to the business scheme.

A site licence

We have considered the possibility of recommending the introduction of an additional “site” licence for households with more than one television set. This would have the advantage of linking additional cost to potential consumption, and the structure of the charges could be designed to give a significant boost to BBC revenue (75% of households have more than one set). The disadvantages of this approach are that it would cause a sudden jump in licence fee expenditure for three-quarters of the population. It would particularly hit lower-middle income groups, and families with children (60% of children have a television set in their bedrooms). There would also be significant enforcement problems in view of the large installed base of second and third television sets, which might well encourage more widespread evasion. Effective monitoring of the continued existence of second sets would be likely to involve unacceptable invasions of privacy. Moreover, many households would simply choose to jettison old sets which they currently use to avoid paying a higher licence fee. They would lose the benefits they get from those sets, to no advantage to anyone.

We recommend against this option.

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Packages to reform the licence fee

As we set out earlier in this Chapter, we consider that a sensible plan would be to produce growth in BBC real revenue of about 2 - 2.5% per annum, which would imply growth in real service provision of around 3.5% per annum, if there are further efficiency gains. We would also like to increase BBC funds by around £150-200 million a year in the period between 2002 and 2006 - ie from the end of the current licence fee settlement period to the end of the present Charter period. This would give the BBC almost £1 billion extra to spend on investment and services over this 5-year period.

We have now rejected all of the means of raising this money, other than changing the structure of the licence fee. By process of elimination, we are therefore now left with only two realistic options for achieving buoyancy in the BBC's revenues:

- an increase in the basic licence fee; and
- a digital supplement on the basic licence.

Before we examine these options in detail, we have one simple recommendation to make about how the licence fee should be expressed. In the past, it has been conventional to express the licence fee as an annual amount, but nowadays people are becoming more accustomed to thinking about payments for television in monthly terms. We therefore recommend that in future the licence fee be expressed as a monthly sum. This would not affect collection methods, which are discussed later in the report.

Although we favour the digital licence supplement for the reasons set out below, we recognise that the recommended amount of extra revenue for the BBC could be raised simply by increasing the main licence fee, and that some observers might prefer that option in order to minimise the disincentive to digital take-up. We have therefore modelled two possible funding packages which would exactly achieve the funding objectives. The first involves an increasing real analogue licence fee with no digital licence supplement and the second, our recommended option, involves the analogue licence fee increasing in line with inflation, with a digital licence supplement introduced in April 2000. The two packages assume that around £20-40 million of additional investment spending is financed each year through the use of privatisation proceeds, and both assume that a licence fee concession is introduced for blind people, costing some £15-20 million a year. Thus, in order to achieve our funding targets, we need to raise about £150-200 million a year from the licence fee system, either analogue or digital. We now turn to a specific discussion of how this could be done.

The “analogue” option

For all of its obvious faults, the licence fee system in the UK has been a remarkably durable arrangement. It is reliable, relatively uncontroversial in political terms, and is an accepted feature of the landscape. Even the private broadcasting industry seems to accept that the licence fee has considerable merits.

In recent years, it has become accepted that the licence fee should rise in line with retail price inflation each year - or at least over each 5-year settlement period. This unwritten convention has had the advantage of further removing the licence fee from the political arena. However, the disadvantage of this arrangement is that BBC income will tend over time to fall as a share of nominal GDP, as we noted in the previous Chapter. For example, if the Government's inflation target is attained over time, then the licence fee will grow at 2.5% per annum, while national income is likely to grow at around 5% per annum.

The simplest way of avoiding this difficulty and increasing BBC income is to raise the licence fee. One way of proceeding would be to uprate the real licence fee faster than inflation after the current settlement ends in 2002. For example, if the Government were to allow an increase in the real licence fee of 1.3% on top of inflation from 2002-2006, this would raise £150 million of extra revenue from the licence fee in the final year. This would approximately achieve our funding targets by the end of the period, and would allow the compound growth of BBC revenue from now to 2006 to hit our 2-2.5% growth target. However, because the extra licence fee income would build up slowly over time, we would not even come close to our target for extra funding in the early years - for example, in 2003, we would be adding only about £60 million to BBC funding. Over the whole period from 2002-2006, we would raise about £440 million in licence fee income, which is only about half the desired total. We therefore need to front-load the increase in the licence fee in order to increase revenue in the early years.

In order to achieve the funding requirements discussed above, we would in fact need to do the following:

- eliminate the planned cut in the licence fee of 3.5% in real terms in the next 2 years, since it would be incoherent to cut the real licence fee in 2000 and 2001, and then increase it sharply in 2002. Instead, we would need to increase the licence fee by £5 per annum in both 2000 and 2001. Thus the licence fee would increase by 4.5% in real terms in the next two years, instead of falling by 3.5% as currently planned. The difference of about 8-8.5% is worth roughly £185 million to the BBC each year.
- increase the licence fee in line with inflation from 2002-6.

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This pattern of front-loading is necessary to (a) increase BBC funding by the required amount over the whole period, and (b) constrain the level of funding at the end of the period to the appropriate figure. The option would appear to the public as reasonably straightforward, centring around an increase of £10 in the nominal licence fee in 2000 and 2001 taken together. The package would raise an average of about £165 million a year in extra funding over the whole period up to 2006, and would achieve real compound growth in BBC funding of 2-2.5% from 1998 to 2006.

Impact on BBC revenues of the analogue option							
Licence fee levels			Impact on BBC revenue (£m)*				
Under existing arrangements (Nominal £)	Under New Package (£)		Licence fee	Privatisation	Concession for blind people	Total	
	Nominal	Real*					
1998/99	97.5	97.5	97.5	-	-	-	-
1999/00	101	101	98	-	-	-	-
2000/01	102.6	106	100.2	73	-	-15	58
2001/02	102.6	111	102.4	180	20	-16	184
2002/03	105.1	113.8	102.4	182	20	-17	185
2003/04	107.7	116.6	102.4	183	20	-18	185
2004/05	110.4	119.5	102.4	185	20	-19	186
2005/06	113.2	122.5	102.4	187	20	-20	187
2006/07	116	125.6	102.4	189	-	-21	168

* at 98/99 prices

Note: We assume inflation at 2½ % p.a. throughout

A problem with this approach is that it breaches the present licence fee settlement, which runs until April 2002. Under this settlement, the BBC was granted a real increase of 3.5% in the real level of the licence fee in the first three years, ending in April 2000. After that, there are scheduled to be two years in which the real licence fee will drop by 1% and 2.5% respectively, thus ensuring that the real level of the fee is the same at the end of the 5-year period of the settlement as at the beginning. The intention of this plan was to give the BBC some extra money up front to boost its digital services, but the BBC was expected to organise its cash balance appropriately, in anticipation of the drop in real revenue in the final two years. The Panel considers that the five year settlement should not be re-opened, which is one reason why we prefer the option of a digital licence supplement. However, if the analogue option is chosen, then we would probably have to accept this disadvantage in the interests of coherence.

An alternative, which would give the BBC less money over the next seven years, would be to introduce the jump in the licence fee in 2002 and 2003, accepting that the pattern of change in the real licence fee from 1999-2002 would be rather odd.

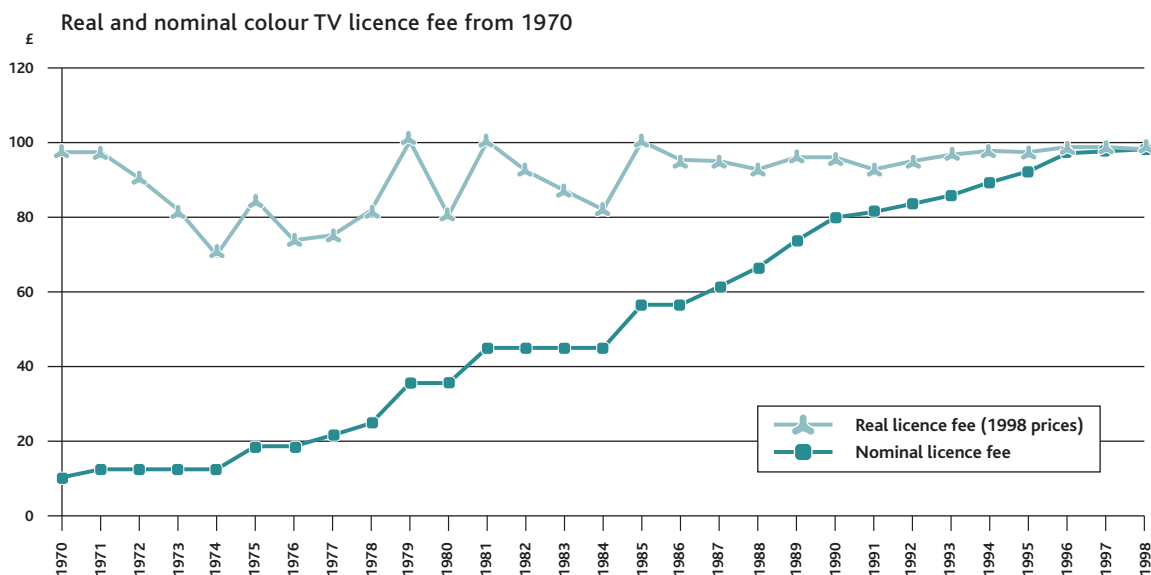
Another disadvantage of raising the main licence fee is that it would make the regressive elements of the licence fee even more noticeable. For instance, those on RPI-related benefits would not keep pace with the jump in the fee, which would form a larger proportion of the expenditure of such households. Analogue-only households would also be seen to subsidise extra choice for early adopters of digital and online. At present, these services cost around £200 million a year, so roughly £10 out of every £101 paid in the licence fee is used to fund these new services. At the latest count, digital TV can be accessed by only 1.2 million households (5% of the total), while only about 25% of the population access Online on a regular basis.

If the licence fee were increased by £10 in the next two years, analogue television households would have to continue bearing the costs of the digital roll-out for the minority of licence fee payers with digital receiving equipment. It will not be until 2005 that the majority of households will be able to receive digital services, and for some time after that (until analogue switch-over), the remainder of analogue households will be subsidising the digital services.

While it is common for the licence fee payer to fund investment in new services which will one day be accessed by the vast majority of the population, it seems to us to be very unfair that licence fee payers should fund additional services for owners of digital televisions for so long. Until recently, the take-up of digital televisions has probably been concentrated mainly among groups who have been above-average in the income scale, so this arrangement has meant that relatively poor households have been subsidising the better off. This may now be changing, since the arrival of free set-top boxes has changed the income mix of digital subscribers, but as yet we have no firm evidence on this.

Another problem with increasing the analogue licence fee is that we are dubious whether the political system will in fact be able to deliver and sustain any significant increase. It is certainly true that, in the past, the licence fee has tended to remain constant in real terms, with any short-term increases or declines being eliminated by subsequent decisions. Thus it seems quite likely that any increases in the real licence fee announced in the near future would fall by the wayside in subsequent settlements. The only way that the BBC has been able to achieve and maintain revenue buoyancy in the past has been for a higher licence fee to be charged on an emerging new technology.

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A higher licence fee for digital television

The final option for extra funding, which is firmly in the tradition of how previous technological changes have been handled in the UK, is the introduction of a digital licence supplement for digital televisions, levied on the same basis as the current licence fee (ie on a per household basis, payable once a household had installed its first digital receiver or set top box). We have been informed by the BBC that this would raise no insuperable difficulties with collection and evasion, particularly if retailers are required to inform the BBC when digital receivers and set-top boxes are sold or rented. In the meantime, collection would be on the same basis as for the colour licence fee today.

A digital licence supplement would have compelling advantages:

- it would continue the established practice that people should pay more when there is a major change in the technical capabilities of their main receiver - analogous with the introduction of television, and later the colour licence fee;
- it would reduce resentment among those who have not adopted digital technology that 10% of their licence fee was being spent on something from which they do not benefit;
- it would provide buoyancy for BBC revenues as digital take-up increases; and
- once the initial decision was taken by Government, it would remove the BBC licence fee from the arena of political controversy for many years to come.

Against these some disadvantages have to be weighed:

- there are concerns among manufacturers, the platform operators, ONdigital and BSkyB, and others, that a higher licence fee for digital televisions might deter take-up of digital systems;
- it would add to the barriers to digital transfer faced by the poor;
- there may be enforcement difficulties, especially if many digital receivers were already in use before a digital licence supplement was introduced; and
- there would be uncertain effects on BBC revenue, dependent on the rate of digital penetration.

The **fundamental** argument made in the evidence presented to the Panel against a digital licence supplement is that it will slow down the take up of digital television because of:

- the general proposition that the higher the price of any normal commodity or service, the lower the demand;
- findings from research carried out by the platform operators that there is a price sensitivity at subscriptions of £6-10 a month, where a digital supplement would particularly bite; and
- a recent NOP poll, which found that the two-thirds of Britons who say they are likely to take up digital television within the next 12 months would be less likely to do so if there was to be a charge of £30 to £35 per annum.

If the Panel believed that a digital licence supplement, of suitable size, would significantly slow the take-up of the new technology, then we would not consider recommending that it be introduced.

The impact on digital take-up

Whether or not a digital licence supplement would in fact severely slow down take-up is an empirical matter. The main evidence we have received is a report from London Economics (commissioned by the BBC) on the elasticity of demand for digital. We have had this reviewed by an independent economist who confirmed the methodology and concluded that, on the whole, the analysis produced sensible and credible results.

To summarise, London Economics argue that:

- the main obstacle to take up is the initial cost of the hardware and installation. On-going costs are less important.

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- take-up is determined more by the attractions of the technology than by its cost. Moreover, this will be heavily reinforced by the prospect of a firm date for analogue switch-over.
- a digital licence supplement at the levels suggested (averaging £1.57 per month over the next seven years) is small compared with the cost of commercial subscription packages which range up to £29.99 a month;
- people regard the BBC licence fee as a “cost of living”, a “must-have” and this would apply to a digital licence supplement too. In support of this, around half of those currently getting digital TV think they pay extra on the licence fee for it already;
- improved BBC digital services, and the marketing of these services on other BBC channels, would greatly add to the attraction of the digital package; and
- in Europe, there is no correlation between the cost of subscription packages and take-up. A subscription package in France is much more expensive than one in Germany, yet take-up in France is 9.8% of households, in Germany 1.1%.

The case London Economics makes is a strong one. Certainly the view that take-up of new technologies is affected mainly by the price of hardware would appear to be borne out by the platform operators’ decisions to make hardware and installation essentially free, while adding £2 per month to the cost of subscription to anything but the basic channels. Since this new pricing package was announced, the take-up of “free” set-top boxes has soared. (Incidentally, we would not be surprised if this represented a surge of pent-up demand, with the rate of new sales tending to fall once this surge is over.)

It must also be true that few people will buy a new analogue TV if they know they are going to have to throw it away in a few years time, which is why a firm date for analogue switch-over is an important part of the package. Furthermore, to the extent that the revenues from a digital licence supplement would allow the BBC to develop and improve its current digital offering, this would increase the overall attractiveness of the digital offering. Certainly a substantially improved free-to-air digital offering - with the BBC at the forefront - is likely to be necessary to achieve the final migration from analogue of those not attracted to multi-channel television.

Clearly a digital licence supplement is only one of several factors influencing take-up. Others include the price of hardware and the cost of minimum subscriptions. Quality of the service must also be an important driver of digital take-up and we consider that an increase in the quality of the BBC’s digital services may partly compensate for the price effects.

The impact of a digital supplement on the price of digital tv services

London Economics noted that colour television penetration grew rapidly to its current level of 99% of the population, despite the fact that the cost of a colour television licence represented a large and increasing cost relative to the price of the television set. In 1968, when the colour television licence was introduced (at £10 it was twice as expensive as a black and white television licence at £5), the net present value of colour television licence payments over the expected lifetime of colour television sets was almost 50% of the cost of a colour television set. Yet, by 1977, more than half of the UK population was watching colour television. By 1990, the NPV of a colour licence was almost twice as large as the average cost of a television set.

By estimating the present value cost of licence fee payments and payments for digital television services, it is possible to assess the relative cost impact from the introduction of a supplementary digital licence set at the proposed rate. The table below sets out the present value impact of the proposed digital licence supplement on the 10-year costs (at 1998/99 prices) of an illustrative range of digital service levels, assuming that subscription rates remain similar to current levels in real terms.

Reflecting the advent of 'free' set top boxes (which require consumers to take out a subscription to the service provider), most of the examples include only ongoing subscription and licence fee payments in the present value calculation. The exception is for free-to-air digital, where an up-front hardware cost of £200 in the year 2000 is assumed (representing either the cost of a set top box purchased without a subscription, or the price premium payable for an integrated digital TV over its analogue equivalent).

Present value of payments over 10 years ¹ (£, 1998/99)				
Analogue licence fee		699		
Digital licence fee		804		
	Pay TV Subscription	TV costs inc. analogue fee	TV costs inc. digital fee	%increase due to digital supplement
Basic pay TV (£7 per month)	618	1317	1423	8.0%
Mid pay TV (£15 per month)	1325	2023	2129	5.2%
Full pay TV (£30 per month)	2650	3348	3454	3.2%
Free-to-air digital (assume £200 hardware cost ²)	0	899	1004	11.8%

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The relative impact of a digital licence is greatly dependent on the equipment and subscription choices of individual consumers, but unsurprisingly bears most heavily on those who want access only to free-to-air digital services, without subscription channels. If the additional costs of access to free-to-air digital services fall, through cheaper set top boxes and and/or digital televisions, the increase in present value cost attributable to the proposed digital licence rises towards 15%. However, it is important to recognise that the number of free-to-air digital households is expected to grow far more slowly in early years than digital pay TV subscribers. Hence the bulk of free-to-air consumers would not be paying any digital licence supplement until the later years of the proposed scheme, by which stage the digital licence supplement, and the consequent increase in TV costs, would have fallen considerably below their initial levels.

Compared with the precedent of the introduction of the colour licence fee (at double the black-and-white fee), the incremental effect of a digital licence supplement on household licence fee payments would be considerably smaller. For digital pay TV subscribers the relative impact would be further diluted when their substantial ongoing subscription payments are taken into consideration.

¹ Assumes 6% real discount rate.

² For set top box, or price premium for integrated digital television.

Analogue switch-over

Even if the digital licence supplement puts some people off going digital, the effects will be swamped by the knowledge that analogue services will eventually be switched over. Once the Government has decided and announced a date for analogue switch-over, purchasers of new television sets will be aware that any analogue television they buy will soon be redundant. Though the average replacement time for a set is eight years, replaced sets will often become an additional set for the household. The knowledge that this use will not be available for new analogue sets seems likely to make purchasing them a less attractive option immediately. And, if consumers know that they will in time have to replace their analogue sets, or use them in conjunction with set-top boxes, they are more likely to conclude that they might as well upgrade sooner rather than later. The introduction of a digital licence supplement ought therefore to be seen in tandem with a decision on switch-over, which will be a new and powerful incentive likely to more than outweigh any additional costs of a digital licence supplement for the BBC.

We have considered the effect of the introduction of a digital licence supplement on the ultimate date for analogue switch-over. Analogue switch-over will be difficult in any case, since it will involve poor people incurring the costs of upgrading their television sets. A digital licence supplement could exacerbate the problem for these people by forcing them to pay a higher licence fee when switch-over is implemented. However, this problem can readily be overcome by ensuring that the digital and analogue licences cost the same in the period immediately before switch-over, thus entirely eliminating the disincentive at the critical time. We return to this in the specific proposals outlined below.

The information poor

We would be extremely concerned if a digital licence supplement added to the barriers faced by the “information poor”. Unfortunately, we do not have data on the actual spread of expenditure on digital television by income group, but it is noteworthy that higher licence fees associated with previous, fundamentally new, broadcast technology have eventually declined to a similar level, relative to GDP per head, to the licence fee level for preceding technology. In that sense, the higher licence fee becomes more “affordable” to all households over time.

However, the possibility that a section of society might be excluded from the information age gives cause for concern. The “information poor” might be so because of an inability to afford the hardware, because of an unwillingness to learn how to use the new technology or simply because it is not seen as being in any way relevant. In the vision of a digital future posited by the industry - where banking, shopping and education take place over the Internet - lack of access to these services will mean that a part of the population cannot function on the same level as the rest, with implications for their ability to meet the most fundamental needs.

Convergence will in itself go some way to addressing the problem, since the essential services which we envisage the Internet providing will be available not only through a PC, but also through the familiar household television set. Affordability will obviously still be a factor, although the price of digital receiving equipment will fall significantly, as has happened with all new technology, and perhaps the availability of equipment at a low cost should be a pre-condition for analogue switch-over. Perhaps also the Government should look at whether to require Internet access in the basic package of services offered by the three digital platforms after the analogue signal is switched over.

There are also current Government initiatives aimed at increasing access to and exploiting better the opportunities offered by IT. £200 million from the National Lottery has been set aside over the next few years to fund a network of computers in our public libraries, to create some of the content for that network and to train librarians in its use so that they in turn can

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train new users. The National Grid for Learning and the University for Industry are Internet-based learning tools covering education - from the earliest school age to lifelong learning - and vocational training.

From the perspective of digital television coverage is a key factor in ensuring the widest possible access. The commercial broadcasters and the BBC have achieved 90% coverage with digital terrestrial and aim to reach 95% in the next five years and 99.4% (equivalent to analogue coverage) subsequently. The availability of digital television through satellite and cable as well means that near universal coverage is likely to be possible through the three platforms taken together. Another factor is, of course, programming. The BBC is the principal public service broadcaster, but the ITV companies have specific public service obligations, while Channel 4's remit requires it to offer output for tastes and interests not generally served by other broadcasters. This framework offers a diverse range of public service programming.

Role for the BBC

It is inevitable that a digital licence supplement will be proportionately a larger disincentive to poor people than to the better off. This may exacerbate the problem which is already caused by the expense of the technology itself. Therefore, the BBC should allocate part of its enhanced revenue from the digital licence supplement to specific action to increase access to digital services, and to make them more understandable and approachable for people who might be intimidated by this new technology.

The BBC has already achieved much in this area:

The BBC's trails for digital television, running since the summer of 1998, have promoted the benefits of digital itself, as much as their own services. They have emphasised that consumers do not need to take out a pay-TV subscription to access the BBC's digital services. It is vital that the BBC's public services remain free at the point of use. It is also a duty of a public sector broadcaster to be a pioneer in new technologies and to educate people about them. This role should continue even after the large majority of the population have access to digital broadcasting at home.

In addition, BBC Education has been active in making computers and the Internet more accessible for everyone through a series of public campaigns over the last three years. They have worked with a network of public and private partners throughout the UK to improve the effectiveness of their campaigns.

The longest-running campaign has been *Computers Don't Bite*, first launched in 1997. It has introduced hundreds of thousands of people to IT through TV series, magazines and taster sessions (using a BBC CD-Rom) in local libraries, colleges, supermarkets and in many major employers. Even when the campaign is not actually running on BBC services, the network of partnerships remains, with BBC materials still available for people to take taster sessions.

More recently, in Spring 1999, the BBC's *Webwise* campaign aimed to introduce people to online and the Internet. It also enabled people who had only dabbled in the Internet, to explore the greater range of opportunities it offers. Over 5,000 different sites around the country hosted taster sessions and 350 public and private organisations have used the CD-Rom and materials for in-house training. About 144,000 people called the help-line in the first three weeks of the campaign and over 2 million magazines have been distributed.

More needs to be done, however, to inform and educate the public about the benefits of digital broadcasting and the Internet. We recommend, therefore, that the BBC allocates part of its enhanced revenue from the digital licence supplement to build on these important campaigns and initiatives, and to make its digital and online services available in even more public spaces on a permanent basis. This will enable those people who do not have access to these technologies at home, in school, college or work, to see at first hand the BBC's portfolio of services. Moreover, the BBC must be prepared to work in even more ambitious partnerships - with public, not for profit and private organisations - to ensure wide public access to its services. The development of a community-service television channel in conjunction with the charitable sector merits attention.

Why we favour the digital licence supplement

Clearly a digital licence supplement has advantages and disadvantages. We recognise the disincentive effect of a digital licence supplement, but at the level we consider appropriate (outlined below), we do not believe that the damaging effect on take-up - measured over a period of years - will be large. This is particularly the case as the BBC will be given a huge incentive to promote the rapid take-up of digital.

Moreover, of all the options considered by the panel, it is the most likely both to create sufficient buoyancy for BBC income to enable it to fulfil its role in the digital age, and to safeguard the healthy aspects of the UK's broadcasting ecology. Revenues from existing sources, including commercial revenues and efficiency savings, will not be sufficient to do this; and as we have argued, new sources such as advertising, while potentially large in scale, all have decisive disadvantages. An increase in the analogue licence fee, while capable of generating the necessary

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resources for a time, will be politically difficult to sustain for a long time, and involves lengthy subsidisation of the digital minority by the rest of the population. Surely, those who are prepared to devote a higher proportion of their income to digital television should also pay for the enhancements offered by the BBC

The advantage of the digital licence supplement is that it will give the BBC a source of revenue that is buoyant for about a decade. It is relatively secure from political interference. It is the option with the fewest disadvantages and the greatest advantages.

Eliminating cross-subsidy

The Panel has placed a great deal of weight on the undesirability of cross-subsidy of digital users by the analogue licence payer. We recognise that this is a contentious issue, since it has been common in the past for new technologies or services to be used by only a small proportion of licence payers in the early years. It is probably legitimate for all to bear some of the costs of investment in services which will one day become universal. But if this goes on for too long, or becomes too onerous, then the basic concept of fairness which underlies the licence fee will be undermined. This is why higher licence fees have been levied in the past when television was added to the radio service, and when colour television replaced monochrome.

As a broad principle, we believe that the BBC should ensure that expenditure on programmes which are available only to digital viewers should be no higher than the funds generated by the digital licence supplement. The BBC should, in its Annual Report, give an account of how it has implemented this intention.

Timing

We recommend that the digital licence supplement is introduced from 1 April 2000. This will have the advantage of giving the BBC increased revenue at a time when the Corporation needs to gain an effective foothold in the digital world. The sooner the new digital licence supplement comes in, the less will be the volume of complaints from those who have bought digital without realising that they may have to pay an extra fee to the BBC as a result. It will also ease potential enforcement difficulties, which would be more likely to occur if a significantly sized installed base of digital receivers has already been created before a digital licence supplement is introduced.

The “digital” option

The specific method we suggest to raise the recommended amount of extra funding would be to introduce a digital licence supplement in April 2000, while leaving the main analogue licence fee being uprated as in the baseline projection. As the number of digital users increases, this will obviously attain revenue buoyancy for the BBC, just as the spread of colour television did in the 1970s.

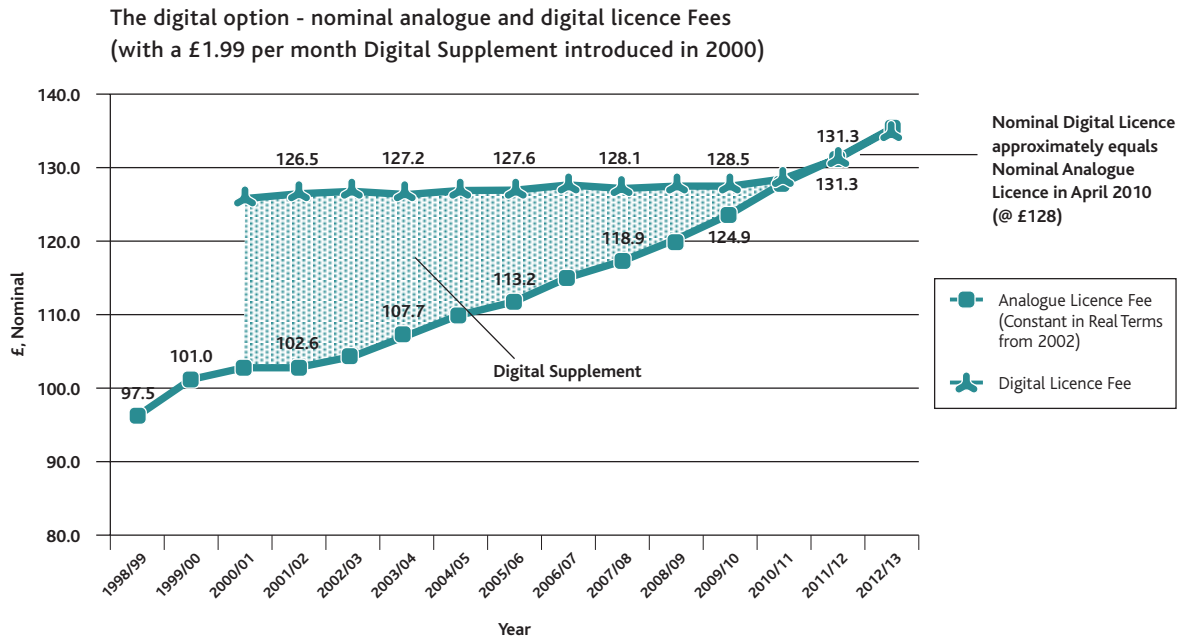
However, there is one complication in this package also, which relates to analogue switch-over. As noted above, it would be very difficult to achieve political consent for switch-over if people were being forced to pay an extra licence fee for digital services when switch-over occurs. We therefore need to design the digital licence supplement to avoid this problem. (Note that this is the one area where the analogy to the introduction of colour television breaks down. Since we never switched off monochrome services, people were never forced to pay the colour licence fee against their will.)

In order to eliminate the problem concerning switch-over, we have designed the digital licence supplement to decline over time, until it disappears completely in 2010. Specifically, we recommend the following:

- A digital licence supplement of £1.99 a month would be introduced from April 2000. This would decline to 99p per month in April 2006, with the intention that it should disappear altogether by 2010.
- This means that the total licence fee for digital subscribers would be fairly static at about £126-£128 per annum in nominal terms throughout the period up to 2006.
- The analogue licence fee would follow a path unchanged from the baseline - ie it would fall by 3.5% in real terms in the next two years, and thereafter it would be raised in line with inflation.

The effect of this is that the analogue licence fee would rise gradually to meet the digital fee as the date of analogue switch-over is approached.

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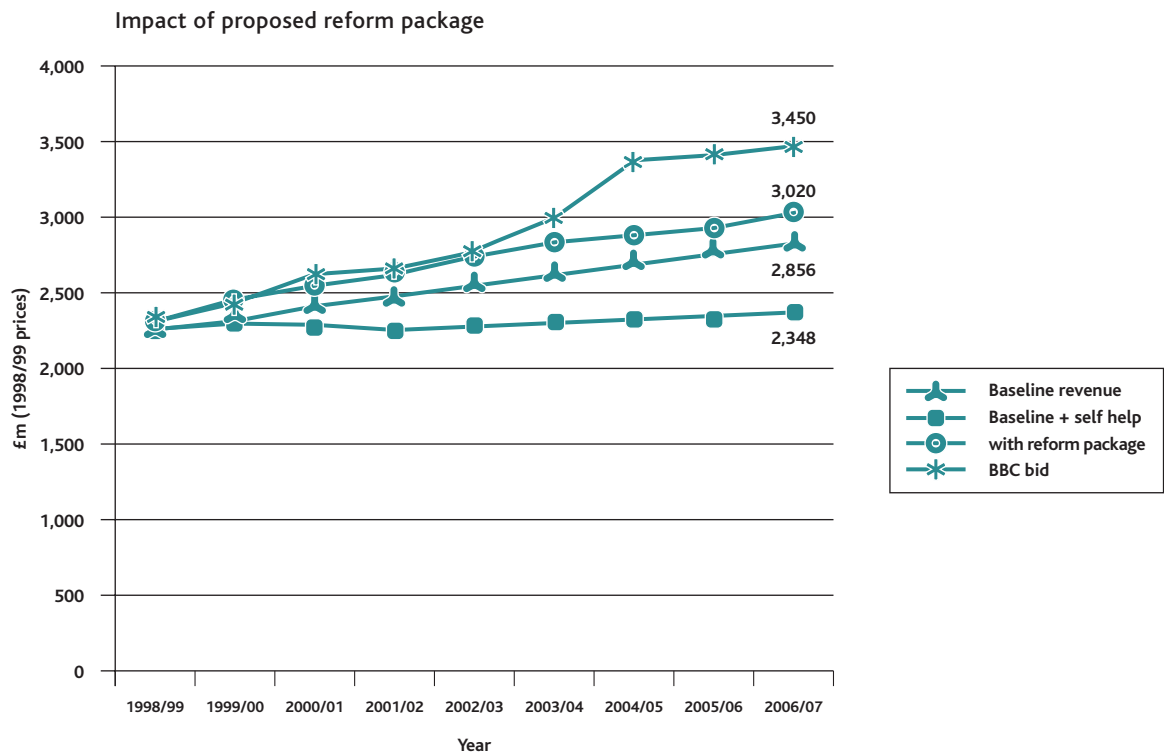


The impact of this scheme on the BBC's revenue base is broadly the same as in the analogue option. Specifically, the whole package would raise an average of £158 million per annum up to 2006, and the growth rate in BBC funding from now to 2006 would be of the order of 2-2.5% per annum.

Impact of digital option on BBC funding							
Analogue licence fee* (£)	Digital supplement		Digital licence fee (£)	Impact on BBC funding (£m, 1998/99 prices)			
	Annual (£)	Monthly (£)		Licence fee	Privatisation	Concession for blind people	Total
1998/99	97.5	-	-	-	-	-	-
1999/00	101	-	-	-	-	-	-
2000/01	102.6	23.9	1.99	126.5	84	-	69
2001/02	102.6	23.9	1.99	126.5	135	-	119
2002/03	105.1	21.9	1.82	127	160	40	183
2003/04	107.7	19.5	1.62	127.2	171	40	193
2004/05	110.4	17	1.42	127.4	174	40	195
2005/06	113.2	14.4	1.2	127.6	162	40	182
2006/07	116	11.9	0.99	127.9	145	40	164

*Unchanged from status quo

Note: we assume inflation at 2½% p.a. throughout



This option has enormous advantages:

- The average digital licence supplement charged from now to 2006 would be £1.57 per month, and people would know in advance that the supplement would drop to only 99p a month by the end of the period. We do not believe that this would be a large disincentive to digital take-up.
- Parity between the digital and analogue licence fees would be achieved in 2010. If the Government wished to go for analogue switch-over before that date, it would be easy to adjust either the analogue fee upwards, or the digital licence supplement downwards, to achieve parity at an earlier date.
- Unlike the analogue option, this option does not increase the BBC's income in perpetuity, since the overall licence fee is the same when convergence occurs as it would be under the status quo or baseline option. (The easiest way to see this is to realise that the digital licence supplement eventually disappears altogether, while the analogue licence fee is uprated by exactly the same amount as in the baseline.)

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- This means that this package does not pre-empt decisions about BBC funding which will need to take place at Charter review. At that time, the BBC will need to make out an entirely new case for extra funding. We see this as an advantage.
- The digital licence supplement declines through time. This has the disadvantage that the disincentive to digital take-up appears larger in the early years, but this pattern is unavoidable once we have decided to eliminate the supplement by 2010. There are also offsetting advantages to this pattern. It means that the higher charges fall on the early adopters (who presumably attach the most value to the new technology), and it means that the per head charge for digital services falls as the number of digital users increases. Thus the cost of the service would be spread over a higher number of users.

Conclusion

On balance, the Panel prefers the digital option to the analogue option, mainly because it better meets the principle that the digital user pays for the digital services. We see this as inherently fairer than loading all the costs of digital onto the analogue viewer.

However, we recognise that the digital option creates a disincentive for the take-up of the new technology. Although we do not believe this will be large, neither is it entirely negligible. The Panel believes that if the Government decides against the digital option, the analogue option is preferable to doing nothing.

Recommendations

In summary, the panel recommends that:

- *there should be no advertising, sponsorship or subscription on the BBC's public services;*
- *BBC Online should be extended to new non-UK services, which should accept advertising and e-commerce revenues;*
- *consideration should be given to the further development of beeb.com, including a possible injection of private capital into the venture;*
- *in future the licence fee, and any digital licence supplement, should be expressed in monthly form;*

- *the existing five year settlement for the licence fee should not be re-opened;*
- *the main (analogue) licence fee should be uprated in line with inflation after 2002;*
- *a digital licence supplement* should be levied on the same basis as the current licence fee (ie on a per household basis, payable when a household has installed its first digital receiver or set top box);*
- *the digital licence supplement should be introduced from 1 April 2000 at a level of £1.99 a month, and that the supplement should fall to 99p a month in 2006;*
- *this should be seen in the context of a plan to announce a firm date for analogue switch-over (subject to penetration thresholds being reached for digital systems);*
- *revenue from the digital licence supplement should broadly cover the costs of services to digital licence fee payers and the BBC should account, in its Annual Report, on how it has implemented this intention;*
- *an increase in the analogue licence fee of £5 in each of 2000 and 2001 is a preferable option to doing nothing, if the digital licence supplement is rejected; and that*
- *the BBC should allocate part of its enhanced revenue from the digital licence supplement to build on its campaigns to inform and educate the public about digital broadcasting and the Internet, and to make its digital and online services available in more public spaces on a permanent basis.*

*James Gordon is opposed to the introduction of a digital licence fee on the grounds that it will provide a significant disincentive to the early take-up of digital. He believes that those considering a switch from analogue will be tempted to wait until the digital licence supplement has reduced before actually switching. James is, however, prepared to support an increase in the general licence fee of between £5 and £7. He says it is recognised that the RPI indexation settlement needs review every five to ten years, to take account of developments in broadcasting. Although it is a bad idea in principle to disturb the current licence fee settlement, an increase in the general fee would be more palatable if phased in, particularly over the next two years. In James' view, the assumption must be that the current settlement is sufficient to fund the BBC's existing services, otherwise the new digital services would not have been introduced. This extra funding should be used to further improve all BBC services and to speed the introduction of digital by a more rapid expansion of the digital terrestrial network. James considers that if the BBC now claims to need more substantial further funds, it may be evidence of the Corporation wishing to do too much, including things which could be provided by those channels in the commercial sector which are regulated to ensure the provision of public service broadcasting.

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Commercial Activities, Fair Trading and Privatisation

"Consider how to secure an appropriate balance between the BBC's public and commercial services, and review the mechanisms under which the fair trading commitment as to commercial services is delivered."

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Overview

It is often argued that the BBC's objectives as a public service broadcaster are directly in conflict with its declared aim to raise additional revenue from commercial activities. We do not believe that this need be the case. In fact, we see the commercial exploitation of the BBC's archive as wholly desirable from the point of view of the licence fee payer and likely to further the aims of broadcasting policy more generally. The archive has been under-exploited for too long.

The strategy of the BBC in this context should be to maximise revenues from commercial activities, subject only to two constraints:

- that the BBC as a whole preserves its public service ethos; and
- that it meets its fair trading commitment.

The first of these requirements takes account of the fact that, as commercial activities expand, there is a danger of an unintended feedback into the type of programmes which are made throughout the BBC. To put it simply, BBC producers may find it more attractive to make programmes with obvious commercial potential than to make programmes of a public service nature. The commercial tail might start to wag the public service dog.

However, we believe that there is little danger of this in the BBC of today. With commercial revenues accounting for under 4% of total expenditure, the public service culture remains overwhelmingly dominant. We are convinced that there is considerable scope to increase commercial revenues without threatening the public service culture of the BBC, and we would like to see greater emphasis being given to this aim by both the management and the Governors of the Corporation. Admittedly, much has been done in this direction in recent years. Nevertheless, the profit motive, correctly harnessed, could still be better used to raise extra funds for the public service.

In doing this, however, additional safeguards are necessary, not only to ensure that the BBC competes fairly in the private broadcasting market, but also to ensure that the BBC is clearly seen by the public to do so. Many of those who have submitted evidence to the Panel have described the BBC as non-transparent, and there is considerable concern that the BBC might abuse its dominant market position in the course of expanding its commercial activities. Again, the BBC has moved a long way in recent years both to develop fair trading safeguards, and to make its accounts and governance more transparent to the public. Nevertheless, more progress is needed on both these fronts.

With these considerations in mind, we make proposals designed both to inject a new climate of entrepreneurship into the BBC, and also to make the commitment to fair trading more transparent.

We accept that there is some tension between these recommendations, since the commitment to fair trading already limits the ability of the BBC's commercial bodies to earn profits. It would of course be far easier to earn enhanced revenues if there were less concern about fair trading. Alternatively, there would be less concern about fair trading if the BBC downplayed its commercial objectives. But this tension is the inevitable price to be paid for commercial activity in an organisation which is primarily funded by the licence fee. In the right circumstances, we think that this can become a creative tension.

The specific issues that have particularly concerned us are:

- Whether the BBC is organised in such a way that it can successfully exploit its commercial opportunities.
- Whether existing institutional arrangements are adequate to preserve the BBC ethos and to maintain fair trading.

We note that at the moment the BBC seems to experience the worst of both worlds. It is felt that it could earn far more revenue than it does today if it were better organised to do so; but at the same time it arouses great resentment from its commercial competitors who accuse it of unfair trading and there are fears about the destruction of its public service principles. This seems to us to raise particular questions about governance and we make a number of specific proposals.

Fair trading or foul

There are particular grounds for concern about the commercial activities of a broadcasting organisation which is primarily funded from the public purse. To see why this is the case, consider the following examples.

First, imagine a publicly funded broadcaster which makes a documentary about the solar eclipse, and shows it first on a free-to-air national TV channel. The programme is highly successful and, even after a repeat showing, there is a market for video sales, which are accomplished through the broadcaster's commercial arm. Later, it turns out that there is a demand to see this programme overseas, so it is sold to the broadcaster's joint venture in America. Finally, after several years, the programme reappears on History Gold, the broadcaster's domestic subscription channel. Each time the programme appears, the public service arm receives a fair market price for the programme.

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Later, it also receives the profits made by the commercial arm from the sales of the video, and the running of the programme on foreign and domestic subscription channels. The public service reinvests all this money in a new programme, "Mythology and Astronomy", which runs on the free-to-air national channel.

What is wrong with this process? The answer is absolutely nothing. Provided that the public service arm has genuinely received a fair market price for the programme, there has been no subsidisation of the commercial activities of the broadcaster by the licence fee payer. Therefore, no issue of unfair trading arises. Licence fee payers have clearly benefited overall from this series of transactions, even though some domestic viewers have paid a fee for the second showing of the solar eclipse programme on History Gold, or to buy the video. Not only does this enable them to view material which would otherwise be unavailable, but it also generates revenue from which all licence fee payers can subsequently benefit. In short, everyone gains.

Now consider a second example in which a less scrupulous public service broadcaster notices that there is a booming commercial market for sales of programmes about golf. This broadcaster uses public money to make a show featuring the wonders of new technology in golf club design. The show is a success, and the broadcaster now sells it at a suspiciously low price to its specialist sports channel, UK Golf. Not surprisingly, UK Golf finds it rather easy to sell advertising from golf manufacturers in the breaks during this programme. This and similar activity proves highly profitable. But unfortunately the leakage of advertising revenue greatly damages the private sector subscription channel, UK Fairways, which runs on cable TV. Booming profits from UK Golf are now remitted to the public service broadcaster which, flush from its golfing success, decides to repeat the dose with a brand new series called "Amazing New Tennis Racquets".

What is wrong with this second example? Obviously, just about everything. Licence fee money is used to make programmes of a type which could perfectly well be left to the private sector, so there is no "market failure" case for public funding. Not only that, but public money is used to subsidise programme sales to the broadcaster's commercial arm, which then clearly engages in unfair competition with a private sector channel. No doubt this sort of behaviour increases the dominance of the "public service" broadcaster in the television market, making various types of uncompetitive behaviour more likely in the future.

Now let us turn to a third example, which is more difficult. This time the public service broadcaster decides to launch a new service, a free-to-air digital channel, "Digimusic", covering all types of classical music. It applies to the Secretary of State for permission to use licence fee money to do this. After carefully considering whether this can be defined as a public service channel, the Government allows the venture to proceed. The channel is only a moderate success in artistic terms, but, because it is free-to-air, it drives out of business an already-existing private sector digital service, "Classics on Subscription". This channel was slightly lower-brow, but had been a popular success until "Digimusic" came along. Actually, its audience ratings were rather higher than those subsequently mustered by the public service alternative.

What is wrong in this third example? It is far from clear. Classical music is usually seen as a public service genre, so there is nothing obviously mistaken in the Government's decision to allow "Digimusic" to be funded by the licence fee. The public broadcaster is adamant that it must be allowed to deliver classical music to its licence fee payer in the way best suited to new digital technology. But the market was already providing something reasonably close to the public service alternative, and actually more popular than "Digimusic" proved to be. The shareholders of "Classics on Subscription" are obviously outraged that their risk capital has gone up in smoke because the public service broadcaster has been allowed to launch into its field.

The point of these examples is twofold. First, very similar-looking activities by the public service broadcaster - making programmes, showing them first on public television and then selling them in the private marketplace - can either be wholly compatible with the tenets of public service broadcasting, or wholly inimical to them. Second, it can sometimes be very difficult to draw the line between what is a legitimate public service channel, and what is an unwarranted (and apparently "unfair") incursion into private sector activity.

In any event, it is obvious that very real issues arise whenever a public service broadcaster enters the commercial arena and, as usual with competition matters, the devil is in the detail. In the real world - unlike in our first two examples - there are few open-and-shut cases. The route to success is based on a transparently fair regulatory regime, and we make appropriate proposals in this Chapter.

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The current regime

Successive Governments have supported the Corporation's involvement in its commercial ventures, while stressing that the BBC's primary mission is - and must remain - one of public service. Such ventures should enable the BBC to exploit its considerable assets and are an important means of securing new income for its public service remit. The BBC Charter and Agreement, therefore, set out a framework for ensuring that commercial activities are funded, operated and accounted for separately from the public services; that they are subject to specific Ministerial approval; and that the BBC should report on its compliance with fair trading requirements, including arrangements to avoid cross-subsidy between the public and commercial services.

The BBC has in fact engaged in commercial activities since the launch of the *Radio Times* in 1923, and the object has been to support the Corporation's public purpose. The commercial activities aim to do this by:

- helping maximise the value of licence fee funded programme assets;
- generating extra income to reinvest in core programming; and
- extending BBC services into new markets.

The activities are based around three key principles (set out in the *BBC's Commercial Policy Guidelines* - revised version published May 1999). These are that:

- commercial activities must be consistent with, and supportive of, the BBC's core purposes as a public service broadcaster;
- the BBC must always trade fairly; and
- the respect in which the BBC brand is held must not be diminished.

The BBC aims to ensure that commercial activities reflect the Corporation's core values, through their quality, distinctiveness and integrity.

Scope for commercial activity is currently restricted by various mechanisms. The principles outlined in the *Commercial Policy Guidelines* are echoed in the *Fair Trading Commitment* which also requires commercial activities to arise from and support BBC programmes, to comply with legal and regulatory requirements, and to offer the prospect of generating significant funds for reinvestment in BBC programmes.

Commercial activities

Most of the BBC's commercial activities are carried out by BBC Worldwide Ltd, a wholly owned subsidiary of the BBC. BBC Worldwide was established in 1994 to operate the Corporation's range of commercial media interests. The rationale is that BBC Worldwide provides the best means of maximising long-term value for the licence fee payer by:

- building equity over time, rather than losing assets for short term gain; and
- protecting BBC editorial standards, and with them brand value.

Three main steps have been taken to maximise long-term value. First, BBC Worldwide has established jointly owned channels with the intention of contributing to building greater long-term value. These channels, in the UK and abroad, are intended to enable the BBC to exploit the full commercial potential of BBC programmes which have been shown first on the BBC's free-to-air channels. In the UK, BBC Worldwide joined forces with Flextech in October 1997 to launch the UKTV channels - UK Gold, UK Horizons, UK Style, UK Arena and UK Play. The BBC hopes that as digital television encourages more UK viewers to adopt multichannel TV, the UKTV channels will both enable greater access to the BBC archive and increase commercial returns for licence payers.

Second, internationally, BBC Worldwide has established joint venture operations with Discovery Communications Incorporated to develop global channels - Animal Planet and People and the Arts. The DCI deal also enabled BBC Worldwide to launch BBC America in March 1998 (the BBC's first wholly owned channel in the US, marketed and distributed by DCI).

The third step taken by the BBC to improve commercial exploitation of its assets was the incorporation last year of some of BBC Resources into a wholly owned subsidiary of the BBC called BBC Resources Ltd. The subsidiary is allowed to trade externally, whereas previously, Resources was only allowed to trade at the margin, ie to sell externally temporarily underutilised capacity. As a wholly-owned subsidiary, BBC Resources Ltd is now able to increase its non-BBC business, invest in new production technologies and aim for growth.

BBC Worldwide's Annual Report (1997/98) stated that the Company "will increase the rate of growth in the business through ever greater market focus and the development and exploitation of branded properties around the world, developing them across different media where the market demands it. At the same time, we will focus hard on improving efficiency of our business processes. The result, I [the then Chief Executive, Peter Teague] believe, will be a **quadrupling** of the cash that BBC Worldwide returns to the BBC by 2006." In order to deliver cashflow back to the BBC in excess of £200 million by 2006/07, BBC Worldwide will

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need to increase sales by 13% per annum to a level in excess of £1.2 billion, in addition to significantly improving profitability. BBC Resources Ltd is charged with providing an increased financial contribution and, like BBC Worldwide, a positive return to be invested in public service programmes. Its target is to generate an additional cash flow of £82 million over the next five years.

Concerns arising in evidence

Considerable concern has been expressed to the Panel about the BBC's commercial activities. A number of organisations, including the ITV Network, the Independent Television Commission, the British Internet Publisher's Alliance, United News and Media, BSkyB, the Radio Authority, the Producer's Alliance for Cinema and Television, the National Consumer Council, the Advertising Association and the Commercial Radio Companies Association, are concerned that the procedures introduced by the BBC for ensuring clear separation and transparency between its public and its commercial activities are inadequate. Some organisations, including the British Internet Publisher's Alliance, United News and Media, Teletext and the Producer's Alliance for Cinema and Television believe that the BBC's commercial activities are unfairly subsidised from the licence fee and that the BBC is not trading on fair terms.

On the other hand, there are those who believe that the BBC is not exploiting its assets sufficiently. In 1993, the National Heritage Select Committee (HC 1993-94, 77-1, para 96) urged the BBC to institute "a restructured system to support a more aggressive strategy for the sale of material, facilities, services and expertise at home and abroad". In its 1997/98 report, the Committee said it supported "the continued expansion of the BBC's commercial activities."

Panel view

The Panel fully supports the expansion of the BBC's commercial activities to generate additional income for UK public services. Such activities must not, however, detract from the BBC's core purpose as a public service broadcaster. It is possible to take two views on this issue. The first is that the slightest involvement in commercial activities will damage the integrity of a public service broadcaster. The second is that there need be no conflict between the two. Provided that the system of governance maintains the quality of programmes shown on the licence fee funded services, commercial exploitation of these activities can only benefit the BBC.

We believe that, under proper arrangements, it should be possible to increase commercial revenue significantly so providing extra money with which to enhance the quality of public service broadcasting. The BBC should pursue this aim more ambitiously than in the past.

Restructuring of BBC Worldwide

The BBC should and could do more to exploit its assets and to generate more income from its programmes. But we believe that unless BBC Worldwide is restructured, the BBC will fail to take full advantage of the commercial opportunities available to it, both domestically and internationally.

At present, as we have seen, BBC Worldwide's portfolio of businesses can be split into two components:

- channels developed from the secondary use of BBC programmes, either in joint ventures with commercial partners or wholly owned by the BBC; and
- non-channel based activities such as programme sales, the exploitation of BBC books, videos and magazines and merchandising.

Channel based businesses	Non-channel businesses
BBC Prime BBC World BBC America	International programme sales
Joint venture channels:	Magazines (UK)
UKTV Flextech	Consumer publishing (UK)
People and Arts } Animal Planet } Discovery	Overseas publishing
UKTV (Australia) Pearson and FOXTEL	New Media (CD Rom/online)

We consider that there is potential for BBC Worldwide significantly to increase commercial revenues, but that its present structure is holding it back. In 1993, the Select Committee said the BBC needed to adopt a more "aggressive strategy", but BBC Worldwide's progress since then does not indicate that it has been sufficiently aggressive or entrepreneurial.

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Cash flow to the BBC from BBC Worldwide, 1994-95 to 1998-99

1994-95	1995-96	1996-97	1997-98	1998-99
£53 million	£60 million	£53 million	£75 million	£81 million

Growth has not been spectacular, though we recognise that the partnerships with Flextech and Discovery may greatly increase the BBC's commercial revenues and that the net benefit to the BBC might reach £200 million by 2006. However, we share the Select Committee's view that the growth potential could far exceed that figure.

So long as BBC Worldwide remains a wholly owned subsidiary of the BBC (it has no non-executive directors and the Chief Executive reports to the Director-General), it will not be able to compete as effectively as it could and should in the developing multi-media markets. This could be a real lost opportunity, particularly as the BBC has such a powerful media brand, which is recognised throughout the world for the quality and diversity of its programmes and the independence and accuracy of its news coverage.

As BBC Worldwide is organised now, it has distinct disadvantages. It does not depend for its survival on the exercise and reward of entrepreneurial skills, although some competitive stimulus is being provided by its increasing links with private sector partners. It has a necessary aversion to financial risk, because the licence fee cannot underwrite any losses by BBC Worldwide. It is also constrained by the Public Sector Borrowing Requirement and a lack of marketing expertise. We have also been told that its senior executives lack influence within the BBC. How, therefore, can such an organisation compete effectively in a market which is increasingly dominated by aggressive and very large enterprises? These multi-media groups have the advantages of commercial experience, economies of scale and synergies, and they are prepared to invest large sums in high risk ventures. Currently the BBC does not have the capital itself to develop major new markets, nor would it be desirable to use licence fee revenue for this purpose. However, an injection of private sector entrepreneurial skills and commercial expertise, and private sector finance at holding company level, could make a significant difference to BBC Worldwide's outlook and its performance and possibly bring complementary products to the BBC's services.

BBC Worldwide is currently involved in about 30-40 ventures with other partners and we estimate that the private value of these partnerships might be equivalent to a significant proportion of the total value of BBC Worldwide, perhaps as much as 20%. It can, therefore, be said that private funding is already contributing to the activities of the BBC. We would like to see a significant increase in the scale of private funding to reach a level of 49%. Over time, this could be done through additional joint ventures, but it would be preferable to do this more

rapidly through an injection of private capital at holding company level. This, plus the introduction of some external directors (which we see as essential), will bring more commercial expertise to the board of BBC Worldwide and access to private finance, while ensuring that the BBC keeps editorial control over its programmes in order to protect its brand name.

How such a sell-off is structured requires detailed work and professional advice. It may be that the sale of minority stakes to business investors is more appropriate than a stock market flotation. Furthermore, we accept that the joint-venture and branded channels may be best excluded from the sale. The joint-venture and BBC branded channels have been structured in a way that both insulates the BBC from all risk and guarantees a pay-back direct to current licence fee payers in return for the investment they are currently making in the programmes available for secondary exploitation. All risk or loss is carried by the joint venture partners.

We have not been able to get an accurate valuation of the suggested privatisation of a portion of BBC Worldwide's business. This can only be done after much detailed work. However, as an illustration, a 49% stake in the non-channel business of BBC Worldwide could be worth about £200 million. This represents the present value of the future net revenues of 49% of the relevant businesses.

After privatisation, the BBC will continue to receive the proceeds of sales of programmes to BBC Worldwide, as under the present arrangements, but will lose a share of future profits. This means that the short term loss of funds to the BBC will be very minor, amounting only to the share of profits owned in future by the private sector. This may be no more than a few million pounds per annum - a sum which could be quickly made up by the increase in the activities of BBC Worldwide which private involvement would bring about. If BBC Worldwide wishes to raise additional capital at the time of its sale it could do so; but the proceeds of the privatisation should accrue to the BBC.

We hope that the changed ownership of BBC Worldwide will enhance its future profitability. This should be reflected both in the sale price and in the future profit stream attributable to the BBC's remaining majority ownership.

BBC Resources

We have seen that in August 1998 those parts of BBC Resources that were considered to have earning potential outside the BBC were incorporated into a new wholly owned subsidiary of the BBC, BBC Resources Ltd. The company was set a target of generating an additional cash flow of £82 million over the next five years. BBC Resources Ltd's Annual Report (1998/99) noted

Chapter 3 - Achieving a Level Playing Field

that although the company maintained its share of BBC Production's work during the period - and lost only a little of BBC Broadcast's - its external revenue was below forecast. On an eight month trading turnover of £223.3 million, the Company made an operating loss of £4.8 million, after charging £6.5 million against restructuring. The BBC's current expectations are that BBC Resources will move into profitability in the financial year 2000/01.

BBC Resources Ltd operates in a growing but very competitive UK broadcast facilities market which the BBC estimates at over £800 million. BBC Resources Ltd has also begun to operate in the wider market of multimedia, interactive, advertising, corporate and film making. BBC's research suggests that the market size could be some £1.5 billion and growing rapidly overall. On a global basis, the larger channel delivery market - broadcast communications, technical operations, channel branding etc - could be as great as £10 billion.

The question must be asked whether BBC Resources Ltd, as presently structured, is best placed to develop its commercial potential and capitalise on these opportunities. Incorporation meant that BBC Resources Ltd moved from being a public service organisation to a commercial one to enable the Company to trade beyond the margin, while being consistent with EU and UK competition law, State aid rules and BBC Charter constraints. These prevent the use of licence fee revenues to guarantee or cross-subsidise commercial activities. While necessary at present, the fair trading rules must be a major constraint in terms of developing commercial potential, for instance, the prohibition on cross subsidy between contracts or between business units.

Most of BBC Resources Ltd's business units are now in mature "commodity" industries (for instance conference facilities, outside broadcast units and television studios) and a market exists with a number of competitors that are likely to be interested and who have the ability to realise synergy and develop the commercial potential for BBC Resources Ltd. Moreover, the value of BBC Resources Ltd and the BBC's ability to realise that value should not be significantly constrained by sensitivities about brand control, as BBC Resources' Annual Report makes clear that the Company trades on the basis of its technical expertise. BBC Resources Ltd is unlikely to derive significant value from its association with the BBC brand. If sold, it would not, therefore, suffer from loss of the brand association. It would also be freed from fair trading constraints.

We see no strong reason for BBC Resources Ltd remaining a wholly owned subsidiary of the BBC and consider that steps should be taken to realise the value of the business for investment in improving the quality of BBC services. We recognise, however, that realising the value of Resources' assets will require detailed work, as the BBC's important craft base and therefore its creative capacity must not be undermined. And it is essential that any sale does not detract from the BBC's role as the UK's primary investor in core broadcast skills.

A 100% stake in BBC Resources Ltd could be worth in the region of £230 million.

The use of the proceeds

We recommend the sale of a stake in BBC Worldwide and the bulk of BBC Resources Ltd primarily as a means of improving the profitability of their activities and their ability effectively to exploit BBC assets on behalf of the licence fee payer, while safeguarding the BBC ethos and observing the fair trading requirements. The proceeds of the sale could be of the order of £400 million and our recommendation is conditional on this being retained by the BBC, rather than remitted to the Exchequer.

As with any privatisation, these sales would replace a flow of revenue by a single capital payment. As mentioned earlier, we would hope that the enhanced profitability would produce a larger sum than the present value of the revenue flows under current payments (and the BBC would continue to benefit from its retained majority share of BBC Worldwide). However it would clearly be wrong to treat these capital receipts as if they were revenues available to finance current expenditure; the correct use would be to finance investment. The BBC has argued that it requires additional funding to develop the technology of digital programme-making. Much of this activity is in effect investment since it will provide continuing benefits to future viewers of digital television. (This activity is typically described as “investment” by those in the industry.) We therefore believe that it would be appropriate for the BBC to use the proceeds to finance it and we have included an allowance for these proceeds in our projections of the funds that will be available (under our proposals) to finance the BBC’s activities over the coming years. Any funds surplus to those needs could be held in a fund available to meet the Corporation’s future capital needs

Ensuring that there is an appropriate balance between the BBC’s public and commercial services

As we said earlier, there need be no conflict between the BBC’s public and its commercial services. Provided that the system of governance maintains the quality of programmes shown on the licence fee funded services, commercial exploitation of these services can only benefit the BBC.

It is also important that the commercial services are clearly separated from the public services. However, although they should operate separately, there should be a common approach between them. The BBC’s long-term objectives and values as a public service broadcaster should underpin all its other activities. The BBC must, therefore, continue to adhere to the principles set out in its *Commercial Policy Guidelines*, including ensuring that BBC Worldwide’s aims are consistent with the objectives of the BBC, that revenues raised by BBC Worldwide are used to supplement income from the licence fee and that commercial returns are invested primarily in making new programmes to be shown first on free-to-air licence fee funded services.

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The BBC should continue to need the Secretary of State's approval before it establishes commercial subsidiaries or takes a stake in a private sector company. There should also be wide consultation with both the public and the broadcasting industry before such proposals are submitted to the Secretary of State.

As already noted, a particular problem arises with the launch of entirely new public services by the BBC in the UK market. These services will typically be free-to-air, and therefore do not directly impact on the BBC's commercial revenues. Nevertheless, precisely because they are free-to-air, they are often seen as grossly unfair competition by private broadcasters. Indeed, the launch of such services by the BBC can call into question the economic viability of similar services which have already been launched by the private sector. The risk that this may happen could be a disincentive to the future development of private sector broadcasting services.

There is at present one safeguard against the BBC abusing its privilege to launch free-to-air services at public expense. The Secretary of State for Culture, Media and Sport is required to grant permission to the BBC to launch such services, and these decisions can subsequently be challenged in the courts. We are assured that these decisions are not taken lightly, and that careful criteria are followed before the Secretary of State forms a view in each individual case. However, we believe that this process, like so many others discussed in this Chapter, can be improved and made more transparent. We have three proposals to make.

- First, we would suggest that each application for a new public service approval by the BBC should be published in full, and that adequate time for a comprehensive public debate should be allowed before the Secretary of State reaches a decision. In some cases, it may be that the private sector might be able to argue persuasively that the market is already able to provide such a service, making duplication by the BBC unnecessary.
- Second, we suggest that the criteria used by the Secretary of State in reaching such decisions should also be published in full, and that the eventual decision should be justified in detail to the public.
- Third, we suggest that at the time of the Charter Review, a comprehensive review should take place of the services recently launched by the BBC, in order to decide whether such services continue to fulfil public service criteria. If they do not, they should be closed.

Indeed, the BBC should continue to specify, clearly and critically, in its Annual Report, how it has fulfilled its public service obligations (as set out in the Charter and Agreement), for all its established services (radio and television). This will enable licence fee payers better to judge whether the BBC's public service purposes are being maintained, as well as, more generally, whether they are receiving value for money from the licence fee.

In the longer term, when the Charter is reviewed, consideration should be given to providing a tighter definition of the BBC's public service obligations (see Chapter 5). In particular, we consider that the BBC's public purposes should be specified in terms which can readily be translated into performance criteria for assessment under whatever regulatory arrangements apply post-Charter review.

Finally, it is essential to ensure that there is no risk to public funds by a clear organisational and accounting separation between the BBC and its commercial subsidiaries and by greater transparency of accounting arrangements. We return to this below.

In summary, the Panel* recommends that:

- *the BBC should sell a stake in BBC Worldwide sufficient to take the effective private involvement in its total external operations to 49%, with the objective of better exploiting its assets and increasing the return to the licence fee payer;*
- *the BBC should sell the bulk of BBC Resources Ltd;*
- *proposals for new BBC public services should be published and debated in full, along with the criteria used by the Secretary of State in deciding whether to permit the launch of such services;*
- *the Charter Review should consider whether new BBC services continue to fulfil a public service remit;*
- *the BBC should demonstrate annually, in its Annual Report, for **each** of its established services, that it is continuing to fulfil its public service obligations;*
- *the BBC should ensure that BBC Worldwide's aims are consistent with the objectives of the BBC and that the BBC makes programmes, formats and rights available to BBC Worldwide at market prices; and that*
- *there should be a clear organisational and accounting separation between the BBC and its commercial subsidiaries and that there should greater transparency in the BBC's accounting arrangements.*

* One of the Panel's members, Helen Black, is unable to support the recommendations to sell a 49% stake in BBC Worldwide Ltd and to privatise BBC Resources Ltd. In the case of the former, Helen considers that unsustainable tensions would arise between the private shareholders' desire for maximum profits on the one hand and, on the other, the licence fee payers interests, and the Governors' need to ensure fair trading, the protection of standards and the integrity of the BBC brand. On the latter, Helen considers that it would lead to the BBC becoming a publisher - broadcaster only, because privatisation would erode the craft and skills base within the BBC, and that ultimately the BBC would end up paying more for programmes than it currently does. Furthermore, Helen does not consider these recommendations to be the best way to maximise net income to the BBC in the longer term.

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Regulation of the BBC's fair-trading commitment

As already mentioned we regard the question of balance between the BBC's public service and commercial activities as directly related to the question of governance.

Current arrangements

The structure and operation of the BBC's commercial services are designed to ensure that they:

- are operated and funded separately from public services;
- compete fairly in the markets in which they operate; and
- are subject to scrutiny to at least the same level as other UK companies.

Currently, the BBC aims to achieve this in six ways:

i. separate commercial subsidiaries

Trading between BBC Worldwide and BBC Resources Ltd and the rest of the BBC is carried out at arm's length, without recourse to public funds.

ii. published annual reports

Both BBC Worldwide and BBC Resources Ltd publish annual reports and accounts to plc standard levels of disclosure.

iii. OFT scrutiny

The BBC's commercial activities are subject to domestic (and European) competition law.

iv. Fair Trading Commitment and Commercial Policy Guidelines

The *Fair Trading Commitment* (required under the Royal Charter and Agreement) sets out the trading standards the BBC will maintain for its commercial activities, focusing on three principles:

- clear criteria for commercial activities;
- fair competition;
- no use of, or risk to, public funds.

In addition, the BBC publishes *Commercial Policy Guidelines*, which set out how BBC subsidiaries and departments should operate their commercial activities in order to comply with the terms of the *Fair Trading Commitment*.

v. **Governors' Fair Trading Audit Committee**

We understand the Committee meets regularly throughout the year to monitor compliance with the *Fair Trading Commitment* and with the statutory fair trading requirements and that it receives reports directly, and without the intervention of management, from the BBC's Chief Adviser, Commercial Policy; from the Head of Internal Audit and from a firm of external auditors, currently KPMG. The BBC's *Annual Report and Accounts* includes a statement from the Committee.

vi. **External audit**

KPMG is charged with reviewing the operation of the BBC's commercial activities during each financial year and, specifically, giving a formal opinion on compliance with the *Fair Trading Commitment*. KPMG publishes a free-standing formal opinion in the BBC's *Annual Report and Accounts*.

Despite the BBC's efforts to put in place procedures intended to achieve transparency and separation of public service and commercial operations, these procedures have not yet inspired public confidence. Whilst hard evidence that the BBC is trading unfairly has not come to light, many organisations have expressed their concerns to the panel. For instance, the British Internet Publishers' Alliance is concerned about the channelling of audiences from the public internet service, BBC Online, to the commercial service, beeb.com, through hypertext links and other cross-subsidies and promotions. The Alliance argues that these elements drain potential viewing from competitors and adversely affect the potential advertising and sponsorship revenues that might be earned by private sector operators. United News and Media and Teletext are similarly concerned about what they describe as the BBC's use of licence fee funded services to promote its commercial internet service.

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The Producers Alliance for Cinema and Television is concerned about the BBC selling the programmes it controls cheaply to its own commercial channels and securing programmes without competition for BBC Worldwide. The Image Industry Alliance expressed concern about anti-competitive behaviour by BBC Resources Ltd. The Alliance claims that in an essentially fixed cost business, BBC Resources Ltd's ability to "marginal price" additional work because BBC contracts underpin the business, is a serious threat to the sector, especially when that goes with the spare capacity that exists in various BBC facilities. The Commercial Radio Companies Association and Capital Radio expressed concern about the extent and cost of cross-promotion of BBC services.

Clearly there is considerable concern that the BBC is not sufficiently transparent about how it spends the licence fee and that the procedures for ensuring clear separation and transparency between public and commercial services are inadequate. ITV sees the fundamental problem as being that the Governors - who are ultimately responsible for monitoring the separation between the BBC's public service and commercial operations - do not have their own secretariat; they are advised by BBC staff. Until there is a greater degree of distance between those who oversee the BBC's adherence to its remit, and the staff of the BBC, ITV believes there will be continuing doubts as to its transparency. As an example, ITV questions the validity - without external scrutiny - of the BBC's internal market testing procedures in the Rights Agency of the programmes it sells to BBC Worldwide. Since BBC Worldwide effectively has the right of first refusal on a majority of BBC programmes, and the BBC's Rights Agency only sporadically market tests the price of programmes, ITV says it is unclear how the Rights Agency knows that it is receiving a proper market price. Hence there will be lingering suspicions about cross-subsidy which would only be properly addressed by greater external regulatory scrutiny, and/or by making the programmes available on the open market so that competitors could bid alongside BBC Worldwide.

The solution proposed by ITV and the Independent Television Commission among others is for independent regulatory scrutiny of the fair trading commitment to ensure that there is no cross-subsidisation of the BBC's commercial activities by the licence fee taking place.

The BBC points out that it is subject to the full force of domestic and European competition law, in exactly the same way as any other British company but that, because of its special position as a publicly funded organisation, it has embraced the further arrangements outlined earlier in this Chapter. The BBC also points out that it has an excellent record of trading fairly, with not a single complaint upheld by the Office of Fair Trading since it adopted the *Fair Trading Commitment* and published the *Commercial Policy Guidelines* in 1995. The BBC considers that the regulatory regime to which its commercial activities are subject has a proven record of being effective, and that disclosure and external scrutiny goes beyond that of any other UK media company.

Panel's view

It is essential that the BBC's commercial activities are conducted in ways that are fair to its competitors. This means that they must not be subsidised by the licence fee or the grant-in-aid which finances the World Service. The Panel acknowledges that the BBC has gone to some length with its arrangements on fair trading, but is not convinced that these are wholly adequate. The licence fee is to all intents and purposes public funding and, as such, not only must the arrangements be effective, they must be seen to be effective. Otherwise they will fail to inspire public confidence. We do not believe that this is possible without some form of external scrutiny. Moreover, we consider that the need for this will become ever more important as the BBC expands its commercial enterprises in the coming years. The role of the Board of Governors is outside our remit, though the governance of the BBC, in particular the sustainability of self-regulation generally, will clearly be an issue at Charter renewal. However, we believe that some steps should be taken both in the short term and on a slightly longer time-scale, to provide the necessary assurance that the BBC's accounts are sufficiently transparent and that the Corporation's fair trading commitment is adequate.

Recommendations

As a first step, we recommend that the Office of Fair Trading carries out, within the next twelve months, a paper exercise to consider the adequacy of the relevant BBC documentation: *Fair Trading Commitment* and the *Commercial Policy Guidelines*. We do not consider it is necessary to recommend an ongoing monitoring role for the Office of Fair Trading, largely because of the strengthened powers given to the Office of Fair Trading in the Competition Act 1998 (which comes into full effect in March 2000). The legislation will prohibit anti-competitive agreements that do not meet the criteria for exemption, and will also prohibit abuses of dominant position (for which no exemptions are available). Moreover, section 2 of the Fair Trading Act 1973 (which will remain in force) requires the Director-General of Fair Trading, so far as appears to him practicable, to keep under review commercial activities in the UK, looking for, among other things, monopoly situations and uncompetitive practices. When he finds them, he may take action under the powers given to him by Part IV of the Fair Trading Act (which empowers him to make monopoly references to the Competition Commission).

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We believe that greater transparency would help to give the public greater confidence in the existing arrangements and recommend that, within the next twelve months, the National Audit Office, carries out two separate reviews of the BBC's accounts and processes. One of these should concentrate on how the BBC ensures compliance with fair trading policy (external and internal). The other should examine the transparency of the BBC's financial reporting culminating in its *Annual Report and Accounts*.

We also make a further recommendation involving the National Audit Office, necessitating an amendment to the Royal Charter, in the final Chapter

We recommend that the BBC, in consultation with the Secretary of State, appoints a commercial audit firm for trading purposes which is separate from that which carries out the Corporation's financial audit. Currently, the same firm of external auditors carries out both the annual financial audit and also the audit of the fair trading commitment. A separate commercial audit firm for fair trading purposes should therefore ensure that any issue of conflict of interest does not arise. We also recommend that the separate auditors' **full** report on compliance and risk is published by the Governors as part of the Annual Report.

Finally, we recommend that the BBC publishes a quarterly complaints bulletin on fair trading and transparency issues, as it currently does for programme complaints.

In summary, the Panel recommends that:

- *the Government should request the Office of Fair Trading to review, within the next twelve months, the adequacy of the BBC's documents: Fair Trading Commitment and the Commercial Policy Guidelines;*
- *the Government should request the National Audit Office to carry out, within the next twelve months, two separate reviews of the BBC's accounts process:*
 - *The first should concentrate on how the BBC ensures compliance with fair trading policy, both internal and external; and*
 - *the second should examine the transparency of the BBC's financial reporting culminating in the BBC's Annual Report and Accounts;*
- *the BBC, in consultation with the Secretary of State, should appoint a separate commercial audit firm for fair trading purposes from that which carries out the BBC's financial audit and that the audit firm's full report on compliance and risk should be published by the BBC; and that*
- *the BBC should publish a quarterly complaints bulletin on fair trading and transparency issues.*

Chapter 4 - Achieving Fairness

Concessions

"Consider the current structure of the concessionary licence scheme and whether a suitable alternative structure could be available."

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Overview

This is a thorny subject. The current concession scheme is valued by those who benefit, while being widely resented by those who do not. The controversial nature of the scheme is reflected by the fact that we received more correspondence on concessions than on any other subject, and the majority of correspondents highlighted the imperfect and unsatisfactory nature of the present arrangements. Previous attempts to reform the arrangements have done nothing to tackle the underlying faults of the concession arrangements, and have only seemed to give them wider scope. Unfortunately, we have done no better than these earlier studies in identifying an easy solution to the problems raised by the existing scheme. In fact, we have become satisfied that such an easy solution does not exist within the confines of broadcasting finance.

We recognise that the licence fee is a regressive charge, since it falls equally on all households, whatever their income. It therefore bears more heavily on the poor than on the rich. There is consequently a case for considering ways of alleviating the burden of payment on poor households.

However, the Panel takes the view that the BBC's funding mechanism is not well suited to solving problems of income distribution, and that the BBC should not be used as a benefits agency. The fact that everyone pays the same amount for the same service from the BBC has probably been an important element in maintaining political acceptability for the licence fee, and those responsible for collecting the fee have forcibly informed us that this is crucial in minimising evasion. They believe that additional concessionary schemes are likely to undermine the willingness to pay among those groups who do not benefit.

The current concessionary scheme (Accommodation for Residential Care, or ARC) does not depend on an income or wealth criterion, but instead depends on a qualification based on the type of accommodation experienced by qualifying individuals. This means that there is inherent unfairness in the scheme, since many very poor pensioners fail to benefit, while a few relatively well-off pensioners do benefit. Furthermore, the cost of the scheme essentially falls, through the licence fee, on the rest of the population, many of whom are poorer than the ARC recipients. Finally, the line which separates qualifying accommodation from the rest is inevitably arbitrary.

For all these reasons, we considered recommending that the ARC scheme should be phased out for future recipients, though we never considered removing the benefit from those individuals who currently qualify. In the end, we came down against the phase-out option, even though we recognise many problems in the ARC scheme.

Why did we come to this view? Essentially, because the ARC scheme, for all its faults, does succeed in helping a group of people which is much poorer than the average for the population at large, and is slightly poorer than the rest of the pensioner population. Consequently, phasing out the scheme - with other licence fee payers picking up the benefit - would widen income disparities in this country. This was not something which any of us was willing to do.

Another option was to attempt to reduce anomalies by widening the scope of the ARC scheme. We outline an attempt to do this in Annex VI. It has two main drawbacks. First, it would not entirely eliminate a sense of unfairness, since many extremely poor pensioners living independently would still not benefit. Second, it would cost an extra £36 million a year, which represents a considerable burden on other licence fee payers, many of them very poor. One possibility we considered was to finance the £36 million by raising an extra levy on business, but we felt that this breached our principle of not using the broadcasting system as a surrogate social security department.

The final option was to remove the unfairness element by widening the concession to cover all pensioners, or to cover all those over a certain age (such as 75). A study by the IFS confirmed to us that if this proposal were funded by an increase in the general licence fee it would reduce a crude measure of income disparity, in the sense that each of the poorest five deciles in the income distribution would gain, and the rest would lose. However, there would be some very odd and undesirable effects within decile groups. For example, if the licence fee were abolished for all pensioners, the rest of the population would incur a 39% increase in their licence fee levels. This would hit many people in the poorest two income deciles very hard. In fact, according to the IFS, 57% of households in these bottom income groups would lose, while only 32% would gain. Thus there would be many more low-income losers than gainers as a result of this reform.

The final area we considered was concessionary arrangements for blind and deaf people. In both cases, we strongly urge the BBC to move more aggressively to provide enhanced services such as subtitling and audio description. Access, it seems to us, is an essence of public service broadcasting and enabling access for those with sensory impairment should be a priority for the BBC. In addition to improving these services, it is obvious that blind people in particular do not receive the same service from the BBC as the sighted population and the £1.25 per annum reduction in their licence fee is insulting. We believe that from now on registered blind people should pay only half the general licence fee.

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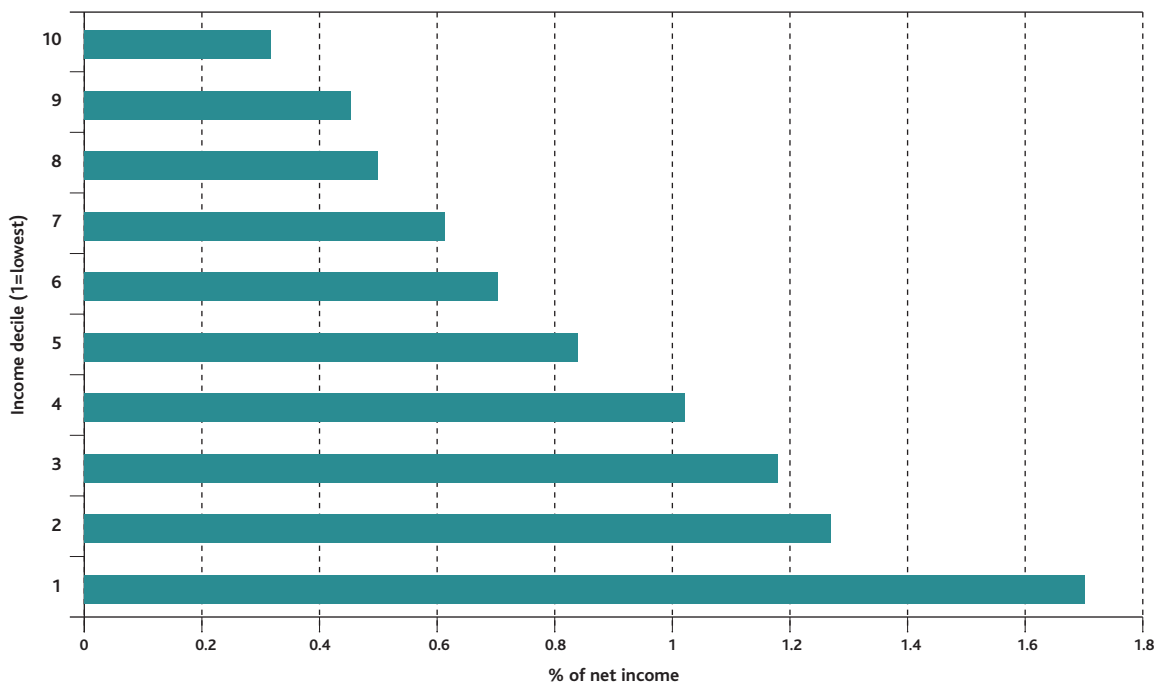
Results from the IFS study

The review panel asked the Institute for Fiscal Studies (IFS) to estimate the distributional effects of the television licence fee, and of various options for the reform of concessionary arrangements. The IFS used their tax and benefit model (TAXBEN) and data from the Family Expenditure Survey.

Distributional effect of the licence fee

The distributional effects of the licence fee were examined by splitting UK households into income deciles, from the poorest 10th (decile 1) up to the richest 10th (decile 10). This was done using a measure of equivalised net income - income after taxes and benefits, adjusted for differing needs of families of different sizes and ages. As would be expected of a flat rate charge, the licence fee is highly regressive, representing 1.7% of the net incomes of the poorest decile but just 0.28% of the income of the top decile.

TV licence fee as proportion of net income



ARC scheme recipients

The panel asked the IFS for an analysis of how ARC scheme recipients compare with pensioners in general, in terms of income, age, and other characteristics. Despite some data limitations, it appears from the evidence that compared to the pensioner population as a whole, ARC recipients are:

- poorer than other pensioners;
- older than other pensioner households; and
- much more likely to be single.

Estimated proportion of ARC recipients and non-ARC pensioners with each characteristic

	ARC recipients*	non-ARC pensioners
Single	84%	42%
Income less than £100 per week (single pensioners only)	65%	49%
80 and over	43%	15%

* These figures refer to householder ARC recipients only, and not people in institutions.

Options for reform of concession arrangements

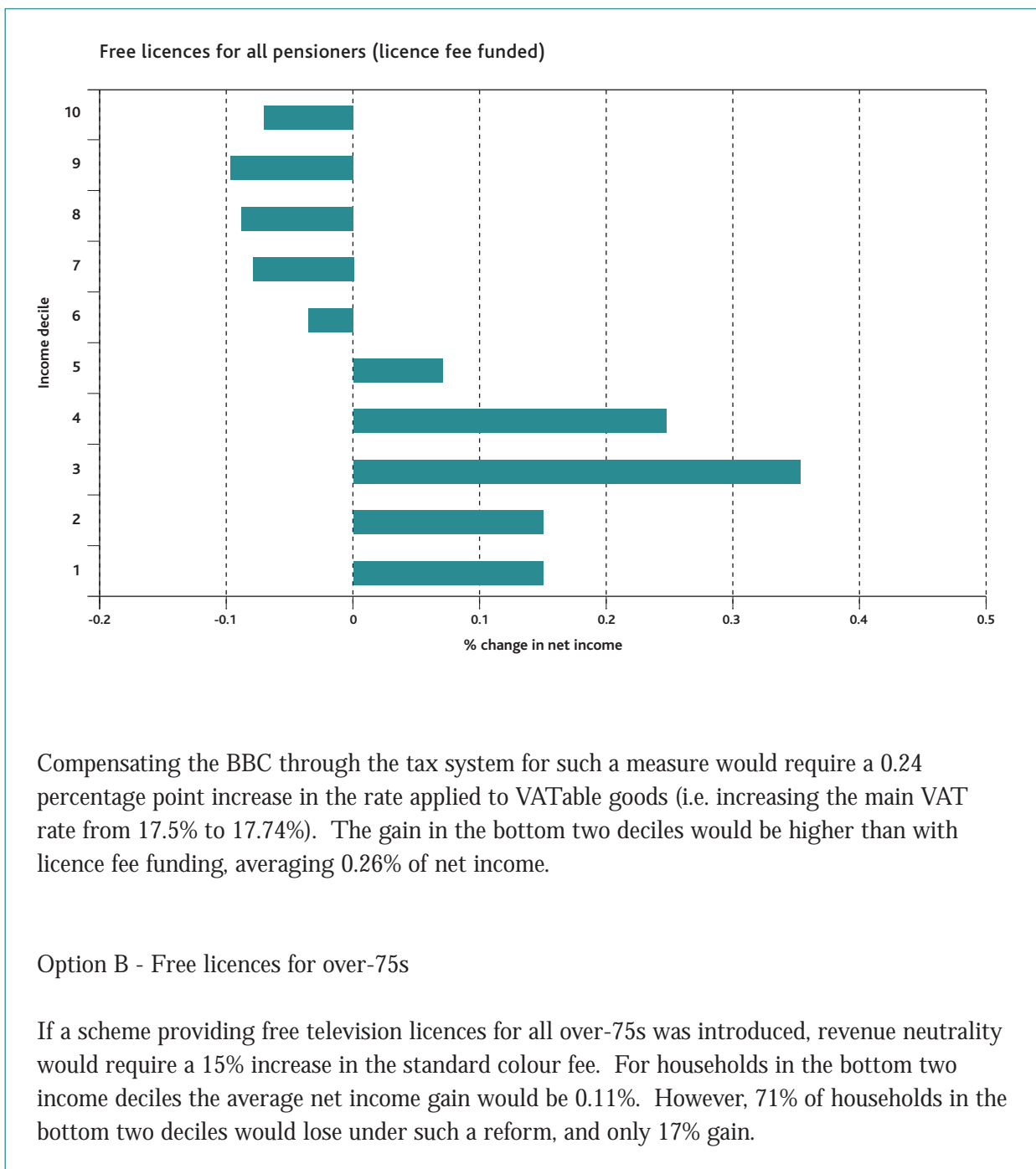
Several possible reforms to the licence fee system, involving concessions for particular groups, were modelled for their distributional effects. For each reform, alternative methods of ensuring revenue neutrality for the BBC were examined, these being:

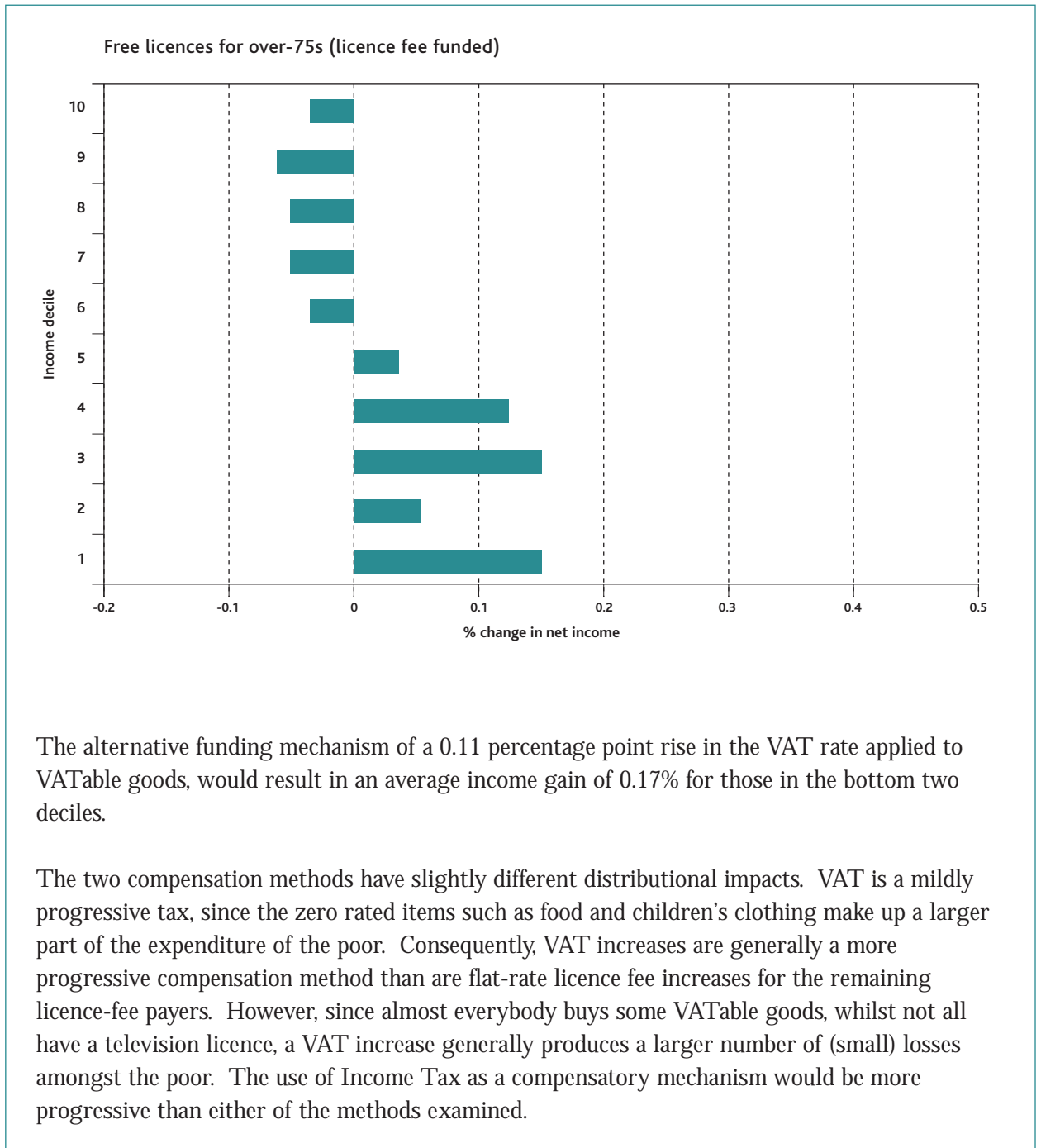
- (a) an increase in the standard licence fee;
- (b) compensation raised via the tax system (specifically an increase in the rate of VAT).

Option A - Free licences for all pensioners

If free licences were issued to all households containing a state pensioner, then ensuring revenue neutrality for the BBC would require a 39% increase in the standard colour fee. The average net income gain in the bottom two income deciles would be 0.14%. However 57% of households in these bottom two deciles would lose (since the majority of those in the poorest deciles are not pensioners), while only 32% would gain.

Chapter 4 - Achieving Fairness





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Current structure of the concessionary television licence scheme

Though BBC funding is based on the requirement for households and commercial premises to pay a flat-rate licence fee for the right to receive television services, some departures from that requirement have been permitted. The main departure has been for specific types of accommodation (those in residential care and qualifying sheltered housing, hotels, caravans, boats etc) and a small reduction for blind people. It is important to note that these concessions are not based directly on income or wealth criteria, which is why they are often perceived to be unfair.

Special types of accommodation

The arrangements for licensing special types of accommodation, including hotels, hospitals, caravans, boats, etc., are based on the principle that it would be wrong to treat these premises as ordinary households, except where they are being lived in as such. For instance, a caravan used only for holidays does not need a licence, but one used as a home does, and a hospital does not need a separate licence for each television set, but members of staff living in the hospital need a licence for the televisions they use in their own accommodation. A feature of these arrangements is that while hotels pay one licence for the first fifteen of their television sets, they then pay one per five thereafter, and other businesses are treated in the same way as domestic households.

Accommodation for Residential Care concessionary scheme

The Accommodation for Residential Care scheme (ARC) is the main accommodation-based concessionary scheme and it attracts most criticism and concern. Entitlement is linked to the kind of accommodation occupied and the way it is provided or managed. This linkage appears to have been designed to target the concession on a clearly identifiable group of people in need of sustained support, and therefore particularly reliant on television for social access.

The £5 concessionary licence is available to people living in:

- i Residential homes; or
- ii Sheltered accommodation which
 - forms part of a group of at least four dwellings within a common and exclusive boundary (though up to 25% of units in a scheme can be purchased under the “right to buy” legislation); and
 - is specially provided for occupation by disabled people or retired people of pensionable age; and
 - is provided or managed by a local authority, a housing association or a development corporation; and
 - has a person (eg a warden) whose function is to care for the needs of the residents and who either lives on site or works there for at least 30 hours a week.

Concessionary licences granted under ii. are available only if all four qualifying criteria are met.

According to figures provided for the BBC by Subscription Services Ltd (the agency contracted by the BBC to collect the licence fee), the current estimated breakdown of recipients of the ARC concession is:

Residential care homes	150,000	23%
Sheltered housing	413,000	64%
Preserved rights ¹	83,500	13%
Total	646,500	100%

¹Individuals with preserved rights are those failing to qualify under current regulations who qualified under the pre-1988 change in regulations and whose schemes still qualify under those regulations. Schemes retaining preserved rights are sheltered housing.

Subscription Services Ltd's estimate for the breakdown of recipients is:

Pensioners	615,000	95%
Disabled people	21,000	3%
Mentally disordered	10,000	2%
Total	646,500	100%

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The estimated cost to the BBC of the current ARC scheme is £60 million.

This concessionary scheme has been much criticised for the anomalies to which it gives rise. There are several reasons for this. The absence of a clear statutory definition of sheltered housing has made it difficult to define the sort of accommodation that should be eligible for this concession. The scheme has also failed to keep up with changes in social housing policy which have often involved increasing the social mix in social housing units (ie not restricting their use to pensioners, disabled people and mentally disordered people) and changing the way in which warden cover is delivered. These changes have resulted in schemes which were once eligible losing their eligibility. This generates understandable complaints from those who see others, in accommodation which they feel is similar to their own, receiving a concession for which they are not eligible.

The changes to the Regulations in 1988 (following the “Kirklees” judgement) only seem to have increased these problems. For instance, anyone who had a concessionary licence before that date and who still lives in accommodation which would have qualified before that date, has had their right to receive the concession preserved. Over 160,000 people benefited from those preserved rights initially and around 83,000 continue to benefit today. The fact that these individuals generally live surrounded by people who do not qualify for the concession, even though their accommodation may be specially provided for elderly or disabled people, adds to the complaints which the scheme generates.

Moreover, as the £5 concessionary licence fee has not been uprated since 1988, it becomes an increasingly valuable concession every year the licence fee is uprated. This can add further to the perception that the concessionary scheme is inequitable.

Special arrangement for blind people

When the radio licence was abolished in 1971 its value (£1.25) was converted into an ongoing discount for blind people if they chose to have a standard television (as opposed to a sound only television receiver). Take-up of this concession is low: only around 30,000 people currently claim it, though there are over 194,000 registered blind people in the UK, with possibly a further 238,000 unregistered. Blind people do not have to pay any licence fee if they have a sound-only television receiver, but about 50% of blind people do not live alone and it may therefore be that many of those who claim the £1.25 discount have a receiver with pictures as well as sound because they live with sighted people. Eligibility for the concession is restricted to registered blind people and is not available to partially sighted people. The current concession costs the BBC about £40,000.

Attitude survey

The results of the Attitude Survey carried out on our behalf show that the majority of respondents (97%) feel that specific groups should receive a reduced licence fee. Four in five (79%) support a reduced fee for blind people, three-quarters (77%) for pensioners, and seven in ten (70%) support a reduction for deaf people. Two in five (43%) feel that those with disabilities should receive a reduced licence fee, and a third say those on income support should also receive a reduction. However, despite this high level of support for the concept of reduced licences for particular groups, when asked the simple question how much more they would be prepared to pay for the licence fee, three in five said they were not prepared to pay an additional fee to fund the scheme. Among those that were prepared to pay an additional fee, the average they would be prepared to pay is an additional £5.35 per year.

Responses to invitation to submit evidence

The panel has received many submissions drawing attention to the unfairness and anomalies of the current system. Some respondents, like Bromsgrove District Council, provided specific examples:

In one case, a sheltered housing scheme was formed in 1985 with the development of flats, bungalows and extensive community facilities for the elderly, adjacent to existing one-bedroom bungalows for the elderly. Prior to May 1988 the entire scheme qualified for a concessionary licence. However, the introduction of the new regulations in 1998 had the effect of restricting entitlement to the newly built complex, within which the Warden and Relief Warden reside, and adjoining bungalows. Though the remaining bungalows receive exactly the same services from the Warden and scheme facilities, they are deemed not to qualify for concessionary licences because they are segregated from the qualifying section by a road. Bromsgrove Council argues that it is unfair that these elderly residents, living within the same scheme as their neighbours and enjoying the services of the same warden and communal facilities, are penalised in this way.

Another example relates to dwellings, within a sheltered housing scheme, which are situated in five separate locations. None of the dwellings within the scheme qualify for concessionary licences because they do not share a common and exclusive boundary. A further anomaly is that the bungalows in one of the locations share a common and exclusive boundary with a sheltered housing scheme which does qualify for the concession, but the concession does not extend to the other bungalows because they are supervised by a different warden reflecting their different care needs. Bromsgrove Council regards this as being extremely unfair and divisive.

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The Local Government Association and many individual local authorities support Bromsgrove Council's views on the unfairness of the current arrangements, and the panel has also received representations from a number of Members of Parliament, including David Winnick, who recently tried to introduce a Private Member's Bill on the subject. Similar letters have also been received from the National Housing Federation, the Thame and District Housing Association and the Hanover Housing Association.

A letter on behalf of the Peverel Group of companies highlighted the perceived unfairness of the current scheme being limited to public sector housing places. The Peverel Group argues that the arrangements discriminate unfairly against the residents (up to 100,000) who currently live in private sheltered accommodation, which is not owned or managed by a housing association, local authority or development corporation. They also argue that the existing arrangements give housing associations an unfair advantage when competing for management contracts against private sector operators.

The solutions proposed vary. The Peverel Group considers that the scheme should be reformed so that entitlement to a concessionary licence is determined by reference to the individual characteristics of the licensees or their accommodation rather than by reference to who is managing the property. The National Housing Federation consider that the scheme should be retained, but improved by a number of modifications, for instance to both the warden and the boundary requirements. On the former the Federation proposes that a better indication of frailty would be that "care or support should be provided within the scheme for at least 30 hours per week by a warden, or by care, nursing, or medical staff" and on the latter, the Federation proposes an adjustment to allow split site schemes to be counted as a single scheme for the purposes of the tenants being eligible for the concession. The Federation also proposes that to avoid intrusive arguments over whether a pre-retirement age tenant is sufficiently disabled for the whole scheme to qualify, the rules should be operated more flexibly so that, for example, up to 10% of people could be under retirement age and not disabled (and therefore not personally eligible for the concession) without the whole scheme losing the concession.

Others, including Bromsgrove District Council, believe that the solution is to provide free television licences to all pensioners and disabled people, a view shared by David Winnick MP and Bill O'Brien MP. The Pensioners' National Campaign for Reduced Television Licenses favour a reduced licence for all pensioner households of £30, while Yours Magazine favours free licences for all pensioners. The British Film Institute is in favour of a concession at half the cost of a full licence for benefit recipients.

Opinions vary on how any revised arrangements should be funded. Bromsgrove District Council consider that future concessionary arrangements should be funded by the Government, possibly financed by a levy on satellite/cable television providers and/or pay per view or by BBC efficiency savings, an additional charge on those paying the full fee, Lottery funding or revised arrangements in relation to hotels, guest houses and commercial premises. The British Film Institute favours payments to the BBC from the Exchequer and David Winnick MP also favours Exchequer funding or a small increase in the licence fee. The Peverel Group considers that the cost should be covered by increasing the cost of the concessionary licence to about £20. The Pensioners' National Campaign for Reduced Television Licences believes that BBC efficiency savings should cover the cost.

However, not all respondents favour concessions. The National Viewers' and Listeners' Association point out that many pensioners are relatively well off with levels of disposable income higher than younger people who still have mortgages, children at school or university, and generally higher living costs. Age Concern says it is generally against concessionary systems because there is always an element of unfairness about them. Age Concern believes that older people should have an income that would be sufficient to allow them to lead a comfortable life and give them choice in how they spend it.

The National Consumer Council and the Consumers' Association were both critical of the present arrangements and consider that a more progressive way of helping groups in society is needed, for instance through the tax and benefits system.

Neither Age Concern nor the two consumer groups would like to see the present arrangements withdrawn without something more equitable being introduced.

Broadcasting industry respondents are generally agreed that whatever the outcome of the review, the BBC's funding should not be eroded by requiring it to bear the cost of any widening of the concessionary arrangements. The ITV Network and United News and Media, for instance, consider that an appropriate solution would be to ensure that any concession be linked to pension and disability payments, and provided by the Department of Social Security. They say this would have the advantage of linking the concession to the existing benefit structure.

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Panel view

We recognise that many people, particularly the elderly, are especially dependent on television for information and entertainment, and we are concerned about the continuing ability of these groups of people to have access to television services. However, the ARC concessionary scheme, which is intended to alleviate the regressive effects of the licence fee, is not particularly satisfactory. We have three main concerns about the ARC scheme:

- in principal, licence fee revenue, or broadcasting money generally, should not be used to fund any extension to the current arrangements for pensioners. The alleviation of poverty is not a broadcasting issue. Nor should the BBC be required to set itself up as a surrogate benefits agency to try to assess need.
- it does not meet the needs of individuals. It applies to some who are not in financial need and does not apply to others who are. An estimated 646,500 people currently benefit from the scheme and the great majority are pensioners (615,000). A substantial number of the latter will not be eligible for Income Support and in that sense will not be in financial need. By contrast, there are around 1.275 million households including at least one pensioner on Income Support. There will be some overlap between the two groups, but it is clear that the majority of pensioners receiving financial assistance through Income Support do not receive the concession. Financial considerations apart, the concession applies only to people in residential homes and qualifying sheltered housing who, by definition, are not isolated, and not at all to people who are living entirely by themselves. On the face of it, therefore, the scheme does not fully meet either financial or social priorities;
- it is divisive. The scheme is riddled with anomalies and interpretational difficulties and, because of this, many fine judgements have to be drawn about eligibility. The drawing of distinctions are meaningless to those affected because they are based on apparently arbitrary concepts. As Bromsgrove District Council (which supports concessions) pointed out in their evidence, the scheme creates a situation in which neighbours, in many cases living in identical accommodation with broadly comparable needs and financial resources, are treated very differently.

We have not been able to find a way of extending the current concessionary scheme that adequately addresses the various concerns which have been raised. The ARC scheme is not well targeted. Many people on the margins of the scheme, who are equally well entitled to a concession, do not benefit. Whatever changes are made to the criteria, there will be people who fall just outside. The problem is inherent in any scheme which demands detailed criteria of eligibility based on accommodation. Moreover, any widening of the current arrangements could potentially be very expensive (see table on page 102).

In particular, we have considered whether it would be possible to reform the scheme by seeking to alleviate some of the perceived anomalies. Such a reform would be possible for instance, by removing the restriction that the scheme must be a group of at least four dwellings within a common and exclusive boundary and also removing the hours limit on warden assistance (two of the most common complaints). Fuller details are at **Annex VI**. Though such changes might remove some of the perceived anomalies and reduce the number of complaints, the scheme would still be open to criticism because it would continue to be based on a specific kind of accommodation and not primarily on the needs of the occupants. Any changes would also of course increase the cost of the concession, possibly quite considerably.

We also considered the possibility of abolishing or phasing out the scheme (with the proviso that those people who currently benefit from the concession, including those who do so under existing preserved rights arrangements, should continue to do so). Such changes would however have the effect of widening income disparities in this country, since the recipients of the current ARC scheme are much poorer than the average licence fee payer. We note that none of those bodies who told us that the scheme should be phased out believed that this should be done without launching a better replacement, presumably using other sources of public money.

We share Age Concern's view that unless concessionary schemes have universal application, there will inevitably be a boundary between those who qualify and those who do not; and equally inevitably, schemes of this nature are bound to give rise to difficult cases from time to time, as well as complaints of unfairness from those who narrowly fail to qualify for the concession. But to fund a universal concession from the licence fee would be a mistake, since this is inevitably a very regressive form of funding.

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Estimated cost of concessionary television licences

Type of concession	Estimated cost (£millions)	Increase for other licence payers to offset the cost
Current concessionary scheme	61	
Free licences for all pensioner only households	494	£29
£5 licences for all pensioner only households	470	£27
Half price licences for all pensioner only households	247	£14
Free licences for households where all members are aged 75 or over	173	£8*
Free licences for households which include a person aged 75 or over	283	£15*
Free licences for households where all members are aged 80 or over	89	£4*
Free licences for households which include a person aged 80 or over	148	£7*
Free licences for households with a pensioner in receipt of Income Support	115	£5
50% discount on licences for registered blind people	15	£1

* These increases assume that the cost of the concession would be borne by all other licence fee payers, including pensioners below the qualifying age. The alternative would be to exempt non-qualifying pensioners or pensioner only households from the increase. However, this would further complicate the licensing arrangements by creating a three-tier system.

NB It may be impossible in principle and practice to restrict concessions to pensioner only households. If all households with a pensioner were included, the figures would be significantly higher, eg a free licence for all pensioners would cost £698 million, an increase of £47 per licence fee payer.

Concession for deaf people

Evidence from the Royal National Institute for Deaf People (RNID) states that television offers a vital link to the outside world for the 8.7 million deaf and hard of hearing people in the United Kingdom. There are around 53,000 registered deaf people and around a further 620,000 unregistered. We do not know how many live alone. Currently there is no concession available to deaf people and RNID considers that this is appropriate. RNID believes however that there must be adequate provision of subtitling on digital as well as analogue transmissions.

The BBC's targets for subtitling on the two simulcast digital services (BBC One and BBC Two) match those for the analogue versions of those channels:

Year	1998/99	1999/00	2001/01	2001/02	2002/03	2003/04
Target	55%	60%	66%	72%	76%	80%

The targets for the new BBC Channels currently carried on Digital Terrestrial Television (BBC Choice, BBC News 24 and BBC Knowledge) are:

Year from launch of service on DTT

1	2	3	4	5	6	7	8	9	10
5%	10%	15%	20%	25%	30%	35%	40%	45%	50%

Recommendation

Digital needs to be inclusive of all members of society and it has huge potential for improving services to those with sensory disabilities. The BBC must, therefore, take the lead in ensuring that the potential for digital to increase accessibility is maximised. Our view is that the above targets for subtitling the new services are wholly inadequate - only 50% ten years from now - and we recommend that the BBC aims to achieve 50% by year five and 100% by year ten. We recognise that this will have cost implications, but the BBC, as the nation's primary public service broadcaster, should not simply be aiming to match the targets set in the Broadcasting Act 1996, but to surpass them. We would hope that the other public service broadcasters would follow the BBC's lead.

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Concession for blind people

Evidence provided by the Royal National Institute for the Blind indicates that broadcasting also plays a very important role in the lives of people with a serious sight problem (1.7 million in the United Kingdom), with 94% watching television. RNIB research also shows that 90% of visually impaired people are over the age of 60; that 54% of visually impaired people live alone (62% for those over the age of 75) and that 63% of visually impaired people aged 75+ are unable to go out. RNIB makes the following recommendation:

"As from April 2000 the concession for registered blind people is increased to £50. The reduction is increased, thereafter, in the same proportion as future increases in the television licence fee."

Only around 30,000 blind people claim the current concession which costs the BBC about £40,000 a year. A 50% concession would cost about £9-10 million and up to £22 million if the estimated 200,000 blind people who are currently unregistered were to seek the concession.

We are mindful of the increased access that will be available to blind people through audio description of television programmes, but this technology is still in development. In the absence of reliable information about when decoders will be available to consumers, the BBC has not published targets for the provision of audio description. However, the BBC says that, once the technology is available, it will at least match the targets established for other broadcasters under the Broadcasting Act 1996:

Year from launch of service on DTT

<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>
	2%	2%	4%	4%	6%	6%	8%	8%	10%

We understand the Secretary of State for Culture, Media and Sport will be reviewing these targets in November 2000 in the light of technological developments. Though we would like to see this process speeded up, we do not recommend any increased target for the BBC on audio description. But we would expect the BBC to aim to exceed any fresh targets that are set following the Secretary of State's review. The BBC should be at the forefront in introducing this service when technology permits.

Recommendation

The Panel understand the disappointment and frustration people with a serious sight problem face at not being able to get as full access as possible to television. It is also clear that even when blind people are able to benefit from audio description technology, which is some years away, they will not derive anything like the full benefit of television. We therefore support the RNIB's case for an increase in the discount available to blind people. We recommend that the current discount of £1.25 is increased to the equivalent to 50% of the full colour (or digital) licence fee, thus allowing automatic uprating. We also recommend that the discount should be restricted to registered blind people and that it should not be restricted to households with blind-only people.

Payment methods

The Panel has noted that the BBC allows licence fee payers to pay their licences in a variety of different ways. The majority of licence fees are currently paid in a lump sum at the beginning of the licensed year. Around 48% of licence holders pay by cash or cheque in a single lump sum at the Post Office, 7% pay by post with a cheque, 1% pay by credit card over the telephone and a further 4% make a single annual payment by direct debit

It is essential that the BBC makes available as wide a range of options as possible, tailored to the needs of different households, which make it as easy as possible for all to pay their licences. In particular, that there are options for less well-off households. Currently there are five instalment based payment schemes:

- the **Quarterly Budget Scheme** (used by around 23% of licence fee payers and involves four quarterly payments by direct debit with a £1.25 surcharge each quarter since payments are all in arrears);
- the **Monthly Budget Plan** (used by 16% of licence fee payers and involves six monthly direct debit payments of 1/6 of the full fee initially but then 12 payments of 1/12 of the full fee thereafter. No surcharge is payable since the scheme involves six payments in advance of the renewal date balancing six payments in arrears);
- **Cash Easy Entry** (introduced in 1998 and is available to licence fee payers on income related benefits. It involves licence fee payers making weekly cash payments - £3.90 for the first 25 weeks then one week at £3.50 for the £101 fee - designed to pay for the first licence in six months. They then pay for their second licence over the next 26 weeks. Then, in the second year of the scheme, they have a full 52 weeks to pay for their third licence. After the first six months, all payments are therefore being made in advance);

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- **Monthly Cash Plan** (currently being piloted - licence fee payers make cash payments on the same basis as the Monthly Budget Plan above);
- **Savings Stamps Scheme** (allows licence fee payers to save up for their licences in advance and the stamps are then accepted effectively as cash in whole or part payment for the full fee).

In every case the licence is issued as soon as the first payment has been made, although in the case of saving stamps, it is the cashing of the stamps as a whole or part payment of the fee which generates the licence and not the purchase of the stamps themselves. Payments can be made at 19,500 post offices and 7,500 retail outlets around the United Kingdom.

The BBC believes that these new payment schemes have greatly assisted licence fee payers to pay their licences. A recent BBC survey found that only three out of 1,400 people interviewed claimed that they could not afford to use any of these methods.

The most recently introduced schemes, Cash Easy Entry, which became available nationwide in April 1998 and Monthly Cash Plan, which has been piloted by the BBC in seven major cities since February 1999, seem to have proved popular. At the end of March 1999, there were over 273,000 people using the Cash Easy Entry scheme and nearly 5,000 using the Monthly Cash Plan after only one and a half months of its restricted operation.

Take up of Cash Easy Entry has been particularly rapid (from about 75,000 in April 1998 to 273,000 in March 1999), helped by the fact that there is no longer an insistence that those who use the scheme must be unable to use direct debit facilities.

The Panel has noted, however, that although Cash Easy Entry is in some ways more generous than other schemes, in that it allows for weekly and fortnightly payments, it does require its users to pay for two licences in the first year of operation, whereas the Monthly Cash Plan scheme only requires the user to pay for one licence in six months and then allows the user twelve months to pay for their second licence. Moving the Cash Easy Entry scheme on to a similar payment schedule to the Monthly Cash Plan scheme would therefore reduce payments for its users during the second six months of their licences. This would put the scheme on a par with the monthly instalment schemes and be of real benefit to households paying via the scheme.

The Panel recommends therefore that the Cash Easy Entry Scheme should be put on a similar payment schedule to the Monthly Cash Plan.

Recommendations

The Panel concluded that:

- *the current Accommodation for Residential Care concessionary scheme should be retained, despite its obvious drawbacks, since no superior alternative, funded from the licence fee, has been found;*

and recommends that:

- *Licence fee revenue or broadcasting money generally should not be used to fund an extension to the current concessionary arrangements for pensioners;*
- *on subtitling for new digital services, including BBC Choice, BBC News 24 and BBC Knowledge, the BBC should aim to achieve 50% of programmes being subtitled in the next five years and 100% by 2009;*
- *the current discount for blind people should be uprated to 50% of the colour licence fee, that the discount be should restricted to registered blind people and that it should not be restricted to blind-only households; and that*
- *the Cash Easy Entry easy payment scheme should be put on a similar payment schedule to the Monthly Cash Plan, thus reducing the payments for its users during the second six months of the licences.*

Chapter 5 - Achieving Sustainability

BBC Funding After the Charter Review

"Against an expectation that the licence fee will remain the principal source of funding for public services for the charter period. . .take a forward look at other possible mechanisms for funding the BBC in the longer term, particularly in the light of technological development."

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Introduction

This chapter aims at responding to that last requirement in our terms of reference. But it can only do so by ranging wider. Once we look beyond the next few years, we cannot help but reflect more generally on the position of the BBC in an era where technology will be changing fundamentally.

Today's givens may not - indeed probably will not - be tomorrow's. Today distinctions between the television and the computer are broadly understood. Today the notion that there are things called programmes delivered through mechanisms called channels predominates. Today, though boundaries are already being blurred, it makes sense to talk of something called "broadcasting" and something else called "the Internet".

Tomorrow, however - and the BBC has been very early both to recognise this, and to act upon that recognition - all these divisions may be challenged fundamentally. We live in an era of consumer choice generally. We are moving into an era where choices in broadcasting are no longer driven by spectrum scarcity and where communications are no longer one way, from broadcaster to audience, but two way. In this environment, it is no longer sufficient to fall back on old saws. Fundamental rethinking is required - even if, at the end of that rethinking, it is concluded that more of the old-world way of doing things should be preserved than might immediately seem probable.

The BBC has sought to define the nature of the changes the new era will bring. It believes that it must be allowed to develop its services in the new media, or else it will ultimately decay as the old media fade away. It argues that there will remain a role for a full service public broadcaster, with a meaningful presence in all areas of the market. As the various ways of communicating with the audience multiply, and as broadcasting grows in relation to national income, the BBC's vision implies that its role will grow in importance, and also become more expensive.

In its evidence to us, it says it wants to "build on the strengths of the past", for example by nurturing the diversity of the UK's heritage, to engage people in debate on issues of national, regional and local significance, and to help people broaden their horizons through learning. It also sets itself new purposes: to "ensure that no-one is excluded from access to new kinds of service made possible by new technology" and to "use its ability to reach into every home to engage audiences in new experiences and to act as a trusted guide in a world of abundance." These are admirable statements of its general mission. However, their more specific meaning and their implications require more concrete definition. The public today is only vaguely aware of the digital revolution, and is confused about what changes it may bring. Neither it, nor its representatives, are ready to opine on whether the BBC's role will shrink or expand in the new

world. At the end of the day, this can only change when the nation has had more experience of what the digital era will really be like. Then it can decide if it really wants a full service public broadcaster and, if it does, whether it is prepared to pay for one.

This debate must be fostered in the run-up to Charter renewal. We do not claim to have completed it in the course of our short and limited review. However, we are clear that a longer look is required in the run-up to 2006. We recommend that the Government sets in place a mechanism for debating these issues, both inside and outside government, in the period ahead.

The nature of public service broadcasting

In his speech to the Royal Television Society on 14 October 1998, the Secretary of State for Culture, Media and Sport defined his view of what a public service broadcaster such as the BBC should be doing in a digital era. He envisaged that a BBC strongly committed to maintaining its traditional ethos, principles and purpose would have a key role in the digital era.

He set out five key principles:

- i the BBC should act as a benchmark for quality, driving up standards across the board;*
- ii it should provide something for everybody, making the good popular and the popular good;*
- iii it should inform, educate and entertain, expanding people's horizons with new and innovative programming;*
- iv it should operate efficiently and effectively and provide value for money for licence fee payers;*
- v it should stimulate, support and reflect the diversity of cultural activity in the United Kingdom, acting as a cultural voice for the nation.*

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The Secretary of State went on to say:

"The BBC must maintain and enhance its primary role as a high quality, comprehensive public service producer-broadcaster, delivering distinctive and creative programmes to the public. The BBC must also continue to nurture and support talent not only in the audio-visual field, but throughout the creative industries. These industries are a central concern of my Department and, accordingly, the BBC plays a central role in our aspirations."

We judge from the BBC's evidence to us that there is little in this with which they would disagree. The Government, apparently with BBC support, has committed itself to a broad definition of public sector broadcasting for a long period to come.

And yet the environment in which it does so is changing. Public service broadcasting was justified originally on the basis that only a small number of services should be provided, due to the scarcity of spectrum. With choice necessarily limited, those services should be used for the benefit of the public as a whole. And of course Lord Reith's BBC, conceived before the modern democratic era, defined the benefit of the public as a whole with relatively little regard to what that public might choose for itself.

Clearly that justification no longer exists. More services and greater choice have been made possible by developments in technology, particularly digital technology. Digital satellite and digital terrestrial television services have been launched and digital cable services will be launched later this year. The BBC has launched digital radio services and commercial companies will be doing likewise in the autumn. Hundreds of radio stations are available on the Internet, and television pictures are spreading rapidly on the same platform. Audiences already have a wider choice of programmes and services than ever before and this will increase further in the years ahead.

Some organisations believe that public service broadcasting has had its day and that the public will be well served by the growing number and diversity of television and radio channels. Others, including the Government, have argued that there will continue to be an important role for public service broadcasting, however defined.

Again, there are different views about how large that role should be. Some believe that public service broadcasting should concentrate on the types of programme which would not be provided by commercial broadcasters. Others believe that public service broadcasting consists of more than the provision of particular programmes, mainly for minority audiences. They regard public service broadcasting as an approach, which influences the choice of programme subjects, and how programmes are made and scheduled, as well as the scope of the services. Others again believe that public service broadcasters should compete in providing every form of broadcasting.

For there is a basic conundrum that puzzles everyone who looks at this subject objectively. The natural definition of public service broadcasting is that it is broadcasting which, for one reason or another is desirable, but which the market will not provide or will provide in insufficient quantity. As Annex VIII shows, it is impossible to argue for a public service broadcaster unless market failure can be shown. There are reasons for believing that the basic causes of market failure will persist in the digital age. Indeed, some of them may become more rather than less important. The best means of funding such broadcasting yet devised is a licence fee. However, broadcasting which the market will not provide may (almost by definition) be broadcasting that is not very popular. At least it will not necessarily be the kind of “lowest common denominator” which can command the largest audiences. And people naturally resist the proposition that they should pay for programmes that they do not wish to watch. Hence we have a debate which veers dangerously between the purist view of public service broadcasting, the so-called “Himalayas” view, which has it just producing programmes at the top end of the market, and the impure view, which interprets “public service” as potentially embracing any broadcasting, however populist, which a public broadcaster chooses to put on the air.

We have not resolved this conundrum, perhaps because it is unresolvable. We do believe that public service broadcasting, however defined, can play an important role in the competitive and complex broadcasting environment of the multi-channel, digital future. There is good reason to suppose that the market, left to itself, will not provide the broadcasting which our society wishes to foster.

Public service broadcasting exists to serve the community by providing distinctive programmes which inform, educate and entertain. It can help to ensure that the benefits of the information age are available to all at a reasonable cost and that viewers and listeners have access to quality services which cater for a wide range of interests. In all these respects, it can correct the tendency of the market to pull too far in the opposite direction.

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There is a continuing need to support the public policy aims of quality, diversity, choice and accessibility. Pluralism is not guaranteed in the multi-channel age, where the economics point towards fragmentation of audience and concentration of ownership. Public service broadcasting can act as a counterweight to private concentration of ownership and, provided that public service broadcasters are broadcasting distinctive schedules, this will exert pressure on commercial competitors to do the same. Many of our witnesses drew attention to what they described as the “ecology” of broadcasting, where a variety of institutions and funding mechanisms provide a mixed economy which is neither pure Reithian public broadcasting nor pure market, but which in a rough-and-ready kind of way, reconciles conflicting objectives.

It must also be said there are various means of attaining these objectives of public service broadcasting. It is a leap of logic to go from the premise that there is a role for public service broadcasting to the view that the BBC as we have it is the sole instrument for achieving them. Government regulation as now applied to ITV and Channel Four can contribute to achieving these aims. It could be extended. It is also possible to envisage models where public support goes not to particular institutions or particular publishers, but to particular programmes made to achieve particular objectives.

Whatever the role of such mechanisms, the BBC has strong claims, as an existing and highly reputed organisation, to a core place in the new environment. In the digital world more channels are available, but quality, choice and value may not be located easily. Free-to-air broadcast programming, as provided by the BBC, has a claim to remain a focal point for a shared and diverse culture and the quality benchmark for UK broadcasting. Moreover, viewers will continue to want high standards, impartiality and independence, all traditionally associated with the BBC.

What our society should be looking for is a public service broadcasting model, which combines creative and market pressures to achieve the public good. And this requires a balance: between giving public support to programmes which the market simply would not provide while sustaining programmes with a wider appeal in a way that seeks to maintain overall standards of broadcasting quality. It is not “either-or”. It requires a sustainable and defensible mix, just as it always has.

In striking this balance, the BBC's performance should not just be judged by ratings. It should also be linked to whether it offers something of real value to audiences not guaranteed elsewhere. Too often, the BBC in effect behaves as if public service broadcasting is everything the BBC chooses to put out. We welcome the BBC's remarkable success in more or less preserving the market share of BBC One and BBC Two in the face of increased competition. But we worry that this has to some extent been achieved by "dumbing down", in a way that has upset that balance.

We thus want to see the BBC continue to produce a mixed and varied output, developed with one eye on what the market is providing insufficiently or cannot provide. We do not necessarily believe either that the BBC should continue to provide all the services it currently provides, or the full range of programmes that it currently produces. But nor do we believe that it should be prevented from launching new services, particularly digital services, designed to further these objectives. Its optimal scale will no doubt change over time - indeed, it must, since the provision of services by the private sector will constantly change also. The fact that we are recommending that new resources be given to the Corporation in the near future implies that, for the moment, we believe that its scope needs to increase. If it uses these resources well, it will be in a stronger state than it is today to argue for further enhancements to its role in the next Charter period.

The striking of that elusive balance is, under current arrangements for the governance of the BBC, primarily a matter for its Board of Governors, though new services require the approval of the Secretary of State. What the Corporation does is also conditioned by the budgets essentially set for it by his decisions on the level of the licence fee. We welcome the recent emphasis of the Governors in the BBC's latest Annual Report on shifting the balance towards those programmes in which the BBC is providing something distinctive, rather than chasing ratings.

Following that, we should like to see a more cohesive effort from the Corporation in determining its priorities. Its competitors often describe the BBC as a power-hungry monopolist eager to extend its tentacles, under the guise of "public service", into each and every new medium which technology throws up. No doubt these competitors have more than one eye on their own interests in arguing this case. After all, there is nothing they would like better than to confine the BBC to the kind of irrelevant box which "public service broadcasting" occupies today in the US. Yet, we were sometimes struck, surveying the BBC's proposition to us, by an apparent lack of clarity in determining priorities. It is in this sense that most of us felt that the BBC failed to make out a decisive case for the whole of the ambitious spending programmes which it asked us to fund. If the BBC has to think harder in future about priorities, while still achieving critical mass in the new digital marketplace, then so much the better.

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Recommendations

For the present, we recommend that in planning its public service provision, the BBC should define clearly the purposes of each service. We also believe that all new public service proposals should be tested through wider consultation, particularly with consumers and that the Governors should insist on clearer criteria for what the BBC is doing, and will continue to shift its focus towards its distinctive strength.

For Charter renewal, there is a strong case that the BBC, because of its privileged position, should have a tighter remit than other broadcasters. Today, of course, its remit is much looser than that of ITV, with the “good behaviour” of the BBC being taken almost on trust. But the privilege of controlling £3 billion of public money after 2006 requires a more formal criterion than exists today. We think that the principles set out by Julian Le Grand and Bill New in *Public Purposes in Broadcasting - Funding the BBC*, would be a valuable starting point. Le Grand and New’s CORA principles (community, opportunity, responsibility and accountability) seem to lend themselves to a number of programme genres that serve each of the CORA principles. We are aware of the argument that regulation is by its nature negative and not susceptible to capturing and protecting the essential nature of the BBC’s public purposes, but good regulation can result in qualitative, as well as quantitative values, and it can have a positive as well as a negative function. When the Charter is reviewed, therefore, we recommend that consideration should be given to providing a clearer definition of the BBC’s public service obligations in a way that can easily be translated into performance criteria for assessment under whatever regulatory arrangements apply post-Charter review.

As we said in Chapter 3, we also suggest that at the time of the Charter review, a comprehensive review should take place of the services recently launched by the BBC, in order to decide whether such services continue to fulfil public service criteria. If they do not, they should be closed.

The future of the licence fee

From the BBC’s point of view, the licence fee is the best way to finance public service broadcasting. The security of this regular income allows the BBC to take a long-term perspective, nurturing creative and performing talent, carrying out research and development and investing in production skills and technology. However, the downside, as with all forms of guaranteed, tax-based revenue, is that it frees the BBC from the need to respond to changing consumer preferences. We do not accept the view, implied in the BBC’s current advertising campaign, that the licence fee is necessary for innovative programming.

As we have discussed in Chapter 2, all alternatives to the licence fee have major disadvantages.

Advertising and sponsorship provide an incentive for broadcasters to maximise audiences, particularly at peak times and, therefore, to concentrate on the most popular types of programming. Though popularity is no bad thing in broadcasting, the consequence is that more innovative and challenging programmes (such as education, religion and documentaries) are not likely to command high profile exposure on advertising funded networks. Commercial pressures can also threaten the freedom and independence of programme makers and schedulers.

Subscription television by definition is only available to those willing to pay. It therefore negates the BBC's traditional objective of providing free-to-air services which are universally accessible to the nation as a whole. Moreover, since some people who would like to watch particular programmes or channels will, under subscription, either not be able to afford to, or will choose not to at the full price, there will be a consequential loss of consumer benefit.

Direct funding, by Government through taxation or grant, gives government even greater power than the licence fee over the revenues enjoyed by the BBC. It creates broadcasters that are inextricably linked to political moods and cyclical economic factors with a consequential potential loss of managerial and editorial independence.

Mixed Funding systems (ie, licence fee + advertising or subscription) undermine the principle of fixed and independent funding and are highly vulnerable to either reductions in mandatory funding or eventual mutation into full commercially funded broadcasters. They are also vulnerable to attack by EU regulators.

Arguments in favour of the licence fee as the preferred form of funding are supported by substantial evidence from other countries that have suffered with alternative schemes, as a report on international experience prepared by McKinsey for the BBC shows.

For instance:

In the last ten years the **Canadian Broadcasting Corporation**, has lost 10% of its direct Government grant funding - with 22% of income now derived from advertising and sponsorship. In the same period the level of quality of Canadian drama, arts and children's programmes is widely reckoned to have declined. There has been an increase in US acquisitions - much of which duplicates content received via US channels. CBC is now wrestling with the issue of how to retain audience share while meeting its Canadian content obligations and aspirations.

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Portugal's public service broadcaster RTP is grant and advertising funded. RTP has faced strong competition since market liberalisation in 1992 and its share of the developing advertising market has declined markedly in recent years leading to an unstable overall revenue position for the broadcaster. As a consequence, RTP developed a more commercial programme mix in an attempt to compete head to head with advertising rivals. However RTP's divided purposes (public service and advertising revenue maximisation) led both to audience share erosion and evidence of a dilution of distinctive public service programming. Steps are now being taken to stabilise its share at a lower base and to refocus its channels around a more distinctive public service proposition.

Germany has a mixed funding system, including a licence fee, for the two state broadcasters ARD and ZDF. Around 30% of their income is derived from advertising and sponsorship. In the last five years, ARD and ZDF's joint share of total advertising revenue fell 39% due to increased competition for advertising - and restrictions on advertising slots (ie, not after 8pm). Subsequently, performance has suffered in key areas. Much cheaper and more mainstream programmes have been introduced to peak time schedules to drive up advertising revenues - leading to a higher overall proportion of repeats.

From a broadcasting point of view, therefore, the licence fee has much to recommend it. However, there is another side to the coin. The licence fee, correctly described, is a tax and a poor tax at that. It is levied on everyone who has a television set. It takes the same amount from every household, rich or poor. A wage-earner on the national minimum wage has to work for a week to earn enough to pay it, but pay it he or she must, whether they choose to watch the BBC or not.

Partly in consequence, there are no grounds for complacency about the sustainability of the licence. Our poll indicates that opinion is divided on whether the licence fee provides good value for money - 45% agree, while 42% disagree. There is a variation in opinion by social class - among ABs, 69% feel they receive good value for money, falling to 31% among DEs. Advertising, and not the licence fee, is the preferred way of funding the BBC amongst the public (see Annex V).

Because the licence fee is unpopular with the public, it tends to be unpopular with politicians. Over a number of years now, it has been demonstrated that few governments are willing to put up the licence fee over a period of years by more than the retail price index. Moreover this means that the BBC is constantly forced to pay great regard to the views of politicians lest they punish it by cutting back the licence fee. This in turn can lead to perceptions that the Corporation is more susceptible than is desirable to political pressures, in turn jeopardising its reputation for impartiality.

None of this means that the licence fee is unsustainable. It has been around for a long time. Licence fee payers take it for granted. They regard it as part of the cost of living. It has a crude but not unconvincing logic: everyone pays for what everyone can, if they choose, get. Its demise has been frequently predicted, but it has proved remarkably durable. However, the dawn of the digital age and the consequential multiplication of channels mean it faces its greatest test.

As the Peacock Committee predicted, the digital age is revolutionising broadcasting, bringing hundreds of new channels, services and innovative technologies and different ways of consuming and paying for media services. We are in the middle of a technological revolution, and, given the pace of technological change, it is impossible at this stage to predict how far if at all beyond 2006 the licence fee will be sustainable.

Technological progress will present both problems for existing methods of funding the BBC and opportunities for new methods. For example, our witnesses including the BBC have agreed that it is likely that there will be a rapid convergence between what we now think of as the PC and the television set. Indeed it is already possible to get television pictures, admittedly of poor quality, on a home PC and thus (for example) to get the latest news bulletins at any time through the Internet. Equally, television sets will be able to use e-mail and perform text-processing tasks. There will therefore be scope for argument as to where precisely the boundary of licensable TVs ends and that of unlicensed PCs begins, which could make enforceability of the licence fee harder.

Moreover, there will be huge changes in TV services themselves which may make different funding systems appropriate. At the moment, the licence fee is supposed to provide for first showings of all BBC programmes, but licence fee payers may have to pay for subsequent viewings showing on the BBC's commercial channels, such as UK Gold. Technology however may make the concept of a channel redundant because anyone will be able to watch whatever is available when they want. The "first showing" principle will not be easy to sustain if the second showing may follow it only a few minutes later.

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Another problem for the future of licence fee is that it is losing its buoyancy. Until recently, the licence fee has been a dynamic source of revenue for the BBC. Revenue was first boosted by the spread of radio, then by the spread of television, and then by the conversion from black-and-white television to colour. If our recommendation of a digital licence supplement is accepted, that will give a further period of buoyancy, until the time of analogue switch-over.

But after that, the next source of buoyancy is not immediately obvious. The BBC is likely to extract some more revenue from the licence fee, both because of a continuing growth in the number of households, and because of more effective anti-avoidance measures, themselves made easier by the new technology. But it will also face increasing demands to spend more: on maintaining and improving its existing services, on new digital programming and on developing the potential of the new technology. Unless the nature of politics also changes, however, it will struggle to get increases in the licence fee which exceed inflation.

So continuing reliance on the licence fee might well leave the BBC short of revenue. Either it would have to embrace forms of financing that it now eschews, or it would have to cut its coat to its limited supply of cloth. The latter choice could mean a weaker BBC, less able to remain an important factor in the ecology of broadcasting.

Finally, the digital age will increasingly be one in which many or most consumers of television pay for packages closely tailored to their needs. As they become more accustomed to choice, to subscription and to pay-per-view, it could be that the licence fee will come to seem an anachronism.

The implications of this changing environment are not easy to assess. Nor is the present the easiest time at which to try to make such an assessment. Technology goes in jumps, followed by periods of development and consolidation. At the moment, we are mid-jump, into the digital era. A glance at the record of previous efforts to forecast where such jumps will find their landing place does not encourage us to feel confident of our predictive abilities. A further and better assessment of the position will, we hope, be more easily achieved in the early years of the new millennium.

One central issue is, however, whether the BBC's role and purpose will endure in the digital world and whether, given the hundreds of channels available in a digital multichannel environment, the BBC will retain the kind of presence and significance in licence payers' lives necessary to sustain a compulsory universal licence fee. It will not be easy. As the number of channels increases, there is likely to be continued fragmentation of audiences, and a consequent reduction in share for network channels, including the BBC's. Multichannel households in the UK already watch less of the main network channels than the average household, and the share

of viewing of networks is in steady decline in the United States. Consequently, it will become more difficult for the BBC to reach on a daily basis those viewers who only rarely switch on to the BBC.

However the task is not hopeless. As the McKinsey report for the BBC notes, while the capacity may exist to launch very tightly focused channels, these channels will only be able to afford a relatively low programme cost per hour. These fees will not be able to fund the sort of high quality star-led programmes that are popular. Nor are they certain to cater for minority interests where production costs are necessarily very high: for example, in the broadcasting of opera. Producers are, therefore, likely to continue to need broad generalist networks to fund their programmes.

We should resist cultural or technological determinism in this field. Whether the licence fee is sustainable beyond 2006 will depend among other things on the BBC's own performance, not only the quality of its programmes, but the maintenance of its ethos and the accountability of its management.

The financial accountability of the BBC

The BBC is an institution with a strong ethos. The commitment of its senior managers to its public service vision has been evident in the course of our inquiry. Any organisation needs a powerful internal culture to chart a consistent course of success. The BBC assuredly still has one.

Clearly, the organisation also recognises that it has a duty to be accountable to those who fund its services and indeed to the taxpayer generally. It has taken a number of steps in recent years to strengthen that accountability. Its Annual Report is no longer the opaque document it used to be, and is reviewed by the House of Commons Select Committee on Culture, Media and Sport. It now produces separate Annual Reports for BBC Worldwide and for BBC Resources Ltd. It goes to some trouble to use opinion and focus group research to gauge public opinion; and holds open meetings, at which management can answer questions and take points from members of the public.

Still, in the course of our inquiry, we have found ourselves asking the question: to whom, exactly, should the modern BBC be financially accountable? We recognise that governance is not directly within our terms of reference, but we have been asked to take a forward look at funding arrangements, and we cannot do this without making some comments about future regulation, at least in so far as this relates to financial matters.

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Clearly, the BBC is subject to a number of outside controls. Its Charter is subject to periodic renewal, at which its structure and purposes are assessed. Its funding is dependent on the decisions of the Secretary of State on the licence fee, as is its ability to launch new services. Nevertheless, it is broadly a self-regulatory body. Its accountability is to the Corporation's Governors. They are appointed by the Secretary of State, but are not subject to his instruction. Senior management reports to them.

The position of the Governors is a problematic one. On the one hand, they are supposed to set the Corporation's general directions under the Charter, and to be the main instrument by which it is rendered accountable. On the other hand, they are often regarded very much as part of the management of the Corporation. The Governors are serviced by a secretariat which is part of the staff of the BBC, and which therefore has to reconcile dual loyalty to its management and to the Governors.

This is in sharp contrast to the arrangements that apply in commercial television companies, which are subject to external regulation by the Independent Television Commission. In regulation more generally, a certain tension between regulators and those they regulate is regarded as desirable, since their interests can diverge. It is not clear whether in the BBC such a divergence of interests can become transparent and effective.

The most serious lacuna that results from this structure concerns financial control. The BBC is disposing of a substantial sum of what is essentially public money. One part of that money is subject to normal parliamentary controls. The Comptroller and Auditor General, Parliament's spending watchdog, can audit the money paid to the BBC through the £170m annual grant to the BBC's World Service. But another and far larger part is not. The grant it gets from the Department for Culture, Media and Sport (which is equivalent to the money paid into the Consolidated Fund through the licence fee, less central government costs) cannot be examined by the Comptroller, nor by the Committee of Public Accounts to whom he reports.

In a letter to us included in our report at Annex VII, David Davis, the chairman of that Committee, argues that the BBC's spending should be brought within his remit. He says that "the Comptroller and Auditor General's inability to report to Parliament on the way the BBC uses the licence fee seriously weakens the public accountability of the BBC." We agree and, accordingly, recommend that the National Audit Office should be empowered (by an amendment to the Charter) to carry out periodic financial audits of the BBC's accounts and its fair trading arrangements.

The BBC is sensitive about external regulation, in particular that it might undermine the Governors' role as the primary regulators. The question then is: are there arguments against such accountability which mean that, despite this, the BBC's money should not be subject to Parliamentary audit. According to the BBC, there are. They fear that such audit would provide politicians with a handle with which to beat the Corporation, on its policy and even on its individual programmes. Rightly concerned for its independence, they oppose this. They also say that the knowledge that BBC executives might be second-guessed by politicians could result in timid and safety-first decisions by programme-makers.

If we felt these fears were justified, we would not recommend a change. But we do not. First, it has to be said that, even at present, independence is not pure. As already noted, the Culture Secretary has considerable power to influence the Corporation, even outside the Charter renewal period. Moreover, nothing protects the BBC against the ultimate threat that Parliament will legislate to control it. Independence therefore is not an absolute; it has to be balanced against other considerations such as accountability and affordability.

Moreover, we think that there is a misapprehension as to the nature of the Comptroller's work, and that of the Committee to which he reports. The Comptroller is appointed by Parliament, not by the Government. It is not his job to report on matters of policy and, in conducting its reviews, it should be made clear to the National Audit Office in its terms of reference that it must not cut across the proper independence of the BBC and, in particular, must not interfere in programming issues. The fact that the licence fee collection and enforcement arrangements are already audited by the National Audit Office, and the National Audit Office also audits the grant-in-aid for the World Service, demonstrates that it can have a legitimate role in ensuring due process in the BBC.

The Panel does not accept, therefore, that more scrutiny need mean more interference. There is nothing in the National Audit Office's remit which threatens the proper independence of the BBC.

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What, beyond that, needs to be done to resolve the problem of accountability and governance that we have identified? This is a matter for Charter renewal. We do however have a sense that the present situation is neither satisfactory nor defensible.

There is a range of possible solutions from (at the one end) the creation of a genuinely independent secretariat to service the governors to, at the other, the imposition of some form of external regulation. We believe that the construction of a more satisfactory model for the governance of the Corporation should be a priority for the Charter review process.

The BBC's ability to produce world-class programming is essential to its future, and we believe that our earlier recommendations will give it a base from which to do that in the digital era. But it is important to its future to underpin its public service ethos by improved accountability, achieved through a modernised system of governance.

For all organisations must adapt or die. That should be the mantra by which the new Director-General, like his predecessor, lives. We hope and expect to see the BBC flourish. We believe our proposals, taken in the round, will strengthen its ability to do so. Beyond that, the Corporation's future is in its own hands, to lose or to seize.

Recommendations

In summary, we recommend that:

- *in planning its public service provision, the BBC should define clearly the purposes of each service;*
- *new public services should be tested through wider consultation, particularly with consumers;*
- *the Board of Governors should insist on clearer criteria for what the BBC is doing and continue to shift its focus towards its distinctive strength;*
- *when the Charter is reviewed, consideration should be given to providing a clearer definition of the BBC's public service obligations in a way that can easily be translated into performance criteria for assessment under whatever regulatory arrangements apply post-Charter review.*

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- *the Government should amend the Royal Charter to give the National Audit Office inspection rights to carry out periodic financial audits of the BBC's accounts and its fair trading arrangements; and that*
 - *it is made clear in the terms of reference for the periodic inspections by the National Audit Office that the NAO should focus only on administrative efficiency and on proper financial management and accounting and not question policy objectives and programming issues and matters of editorial or artistic judgement.*

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