



Review of ITV Networking Arrangements

Cost sharing between licensees

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Consultation

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Section 1

Executive Summary

The requirements upon Ofcom

- 1.1 The ITV Networking Arrangements (the ‘NWA’) are a set of arrangements between the holders of the 15 regional Channel 3 licences ('the Channel 3 licensees').¹ The statutory purpose of the NWA is to enable the regional Channel 3 services, when taken as a whole, to be a nationwide system of services which is capable of competing effectively with other television broadcast services in the UK.²
- 1.2 Ofcom has a statutory duty to carry out a general review of the NWA from time to time under section 293 of the Communications Act 2003 (the ‘Act’). Essentially such a review is intended to assess whether the arrangements enable the licensees to meet the statutory objective to provide a competitive, regionalised Channel 3 service. If, following a review, we conclude that modifications to the NWA are necessary, we can require the Channel 3 licensees to give effect to any modifications that we propose.
- 1.3 In considering whether to propose modifications to the NWA, we are required under Schedule 11 of the Act to consider whether the NWA, as modified, would represent a satisfactory means of achieving their statutory purpose. We must also take account of the likely effect of a modified NWA on the ability of the Channel 3 licensees to maintain the quality and range of regional programming or other programming which contributes to the regional character of the services. We may not propose modifications if we consider they are likely to prove prejudicial to the ability of the licensees to comply with their public service or regional programming obligations or if they fail to satisfy certain specified competition tests.³

Background to the NWA

- 1.4 The requirement for Channel 3 licensees to participate in NWA originates from the Broadcasting Act 1990 ('the 1990 Act'). Prior to the 1990 Act, the regional television companies were in effect contractors providing services to the IBA, which was both the regulator and broadcaster. Under the terms of the 1990 Act, the successful applicants for the new regional licences became broadcasters in their own right, working together on the basis of new networking arrangements to provide a competitive network service.
- 1.5 In the guidance which it issued in February 1991 to applicants for the regional Channel 3 licences, the new regulator, the ITC raised a series of issues which it

¹ The 11 regional English and Welsh licenses are currently held by ITV Broadcasting Limited (a wholly owned subsidiary of ITV plc). The two Scottish licenses are held by STV Central Ltd and STV North Ltd, both subsidiaries of STV Group plc ('STV'). The licences in Northern Ireland and the Channel Islands are held by UTV Ltd ('UTV') and Channel Television Ltd ('Channel') respectively.

² Where the term ‘ITV1’ is used in this document, it refers collectively to all of the Channel 3 services, including those broadcast in Scotland and Northern Ireland.

³ We are required to consult the Office of Fair Trading ('OFT') on whether proposed arrangements meet the relevant competition tests. Further information about the respective roles of Ofcom and the OFT can be found in ‘A letter from the Office of Fair Trading setting out OFT/Ofcom Concurrency Arrangements’ at <http://www.ofcom.org.uk/about/account/oft/>.

expected the new networking arrangements to address.⁴ Among other things, the ITC proposed that contributions to the Network Programme Budget should be shared between licensees according to a formula which took account of the different earning potential of each licence area. The purpose of this proposal was to ensure that holders of the small licences could afford to meet their regional programme commitments in addition to contributing to the cost of the network schedule. The ITC's proposal was, with minor adjustments, accepted by the new Channel 3 licensees.

- 1.6 The 1990 Act also imposed restrictions on the ownership of licences; under the 1990 Act no company could hold more than two regional licences.⁵ A gradual loosening of the Channel 3 ownership restrictions during the course of the 1990s, however, allowed progressive consolidation to take place through a series of mergers and takeovers. This culminated in the merger of Granada plc and Carlton Communications plc in 2003 to form ITV plc, the company which currently holds 11 of the 15 regional licences. The cost sharing arrangements under the NWA have remained largely unchanged throughout this process of consolidation.

Background to the current review

- 1.7 During our second review of public service broadcasting ('PSB') in 2008-9, both ITV plc and the non-consolidated licensees ('NCLs')⁶ submitted reports from consultants containing assessments of the existing arrangements for sharing the costs of the Channel 3 networked service between the regional licensees. Those reports were used by both sets of licensees to suggest that the current cost sharing arrangements which lie at the heart of the NWA are inequitable, providing a significant net financial benefit to the other group of licensees.
- 1.8 In the PSB review statement, we noted that the NWA had since their inception in the early 1990s provided different degrees of benefit to the different licensees.⁷ We also recognised that the value of the regional licences was in decline. Given that it was unclear whether a negotiated agreement in the interests of all parties was possible, we acknowledged that unless all of the regional licensees were willing participants in the network, the existing arrangements would become unsustainable.
- 1.9 We said that we would consider the issues identified by the licensees as part of our next review of the NWA. We anticipated an assessment of relevant financial arrangements in that review would enable us to "work with [the licensees] to try and arrive at new arrangements which recognise the extensive financial inter-relationships between their businesses."⁸

⁴ See ITC, *Invitation to Apply for Regional Channel 3 Licences: Issued by the Independent Television Commission*, February 1991.

⁵ See Schedule 2, Part III, paragraph 2 (1) (a) of the 1990 Act. A further restriction was added in the Broadcasting (Restrictions on the Holding of Licences) Order 1991 preventing, among other things, any company from holding licences for any two of the specified 'large' regions, i.e. those whose share of the combined qualifying revenue of the network exceeded four per cent.

⁶ Throughout this document, STV, UTV and Channel are referred to collectively as the 'non-consolidated licensees' ('NCLs').

⁷ See Ofcom's *Second Public Service Broadcasting Review: Putting Viewers First – Annex 3: The networking arrangements and their impact on the Channel 3 licences at*
http://www.ofcom.org.uk/consult/condocs/psb2_phase2/statement/annex3.pdf

⁸ See *Putting Viewers First*, Annex 3, A3.28.

The current review

- 1.10 This consultation document includes an analysis of the issues raised in the consultant reports submitted to us by the licensees during the PSB review. We have used these reports, along with further information which we have gathered, both to build up a picture of the cost sharing arrangements which exist between the licensees and to evaluate the impact of those arrangements.
- 1.11 Our review powers are limited to the NWA themselves. However, in light of the many complex arrangements between the licensees and the licensees' different views about the status of those arrangements, we have first sought to make clear which costs we believe are directly related to the provision of the Channel 3 service. Building on the requirements for NWA set out in the Act, we have developed criteria to determine the relevance of those arrangements to the provision of a networked Channel 3 service.
- 1.12 The most significant cost sharing arrangement in the NWA is the Network Programme Budget,⁹ a cost which is clearly related to the provision of the network service. However, our initial analysis also suggests that certain other groups of costs, including those relating to transmission and operation of the Network Centre, are intrinsic (or common) to the provision of a national, networked broadcast service of the kind required by statute.
- 1.13 Conversely, we believe other types of intra-licensee arrangements are not relevant to our assessment of the relative costs and benefits to each party of the existing arrangements. In most cases this is because the agreement in question is the subject of a separate commercial agreement between two licensees and/or is unconnected to the provision of the Channel 3 service as stipulated within the terms of the Act.
- 1.14 In a few other instances – where parties have raised issues about revenue sharing – the status of the relevant arrangement is unclear and we have asked for further information.
- 1.15 Following our preliminary determination of the relevance of the various cost sharing arrangements, we have sought to evaluate the relevant cost allocation arrangements against a benchmark in order to assess their impact. There is no uniquely correct way of allocating common costs between the different licensees. Nevertheless, we consider, having assessed the suitable alternative options, that each licensee's share of Qualifying Revenue ('QR') is, in most cases, an appropriate benchmark from which to analyse the net impact of the existing arrangements on the licensees. Where costs can be attributed to the activities of particular licensees, we believe cost causation represents an appropriate starting point. Our preliminary analysis suggests that ITV plc's contribution to relevant common costs in 2009 could be up to £[<] more than would be the case using an appropriate alternative cost sharing mechanism, predominantly QR share. Of this, £[<] was incurred under the NWA.
- 1.16 We consider, however, that deciding whether changes to the cost sharing arrangements within the NWA are appropriate as a result of this analysis is less straightforward. There is no regulatory reason for ITV plc's licence ownership structure – and hence its cost burden – to have developed as it has; its costs are the result of a series of mergers voluntarily entered into by its licence holders during the late 1990s and early 2000s. Equally, some of the regional licences, which have been

⁹ The Network Programme Budget or 'NPB' is a fund to which all the Channel 3 licensees contribute. It is used to pay for programmes in the network schedule.

recognised since the inception of the NWA as having more limited revenue generating potential than others, might not be commercially viable if costs within the NWA were allocated on a QR basis. We are also mindful that under the provisions of Schedule 11 of the Act, we must consider a number of factors before modifying or approving NWA. Specifically, in addition to the competition tests specified in the Act, under Schedule 11 we are prohibited from proposing modifications to the NWA which would be likely to prejudice the ability of any of the Channel 3 licensees to fulfil:

- 1.16.1 their public service remits;
 - 1.16.2 the quotas set by us for programming made outside the M25 area (known as the ‘out of London quotas’); or
 - 1.16.3 their regional programming obligations.
- 1.17 Given these boundaries, we set out three possible ways to reflect our preliminary analysis within the NWA:
- 1.17.1 Option 1: we retain the existing system of cost allocation in the NWA;
 - 1.17.2 Option 2: we require amendments to the NWA to ensure that costs are allocated on the basis of QR share; or
 - 1.17.3 Option 3: we carry out further work to determine whether there is an option between the existing arrangements and a strict QR based system of cost allocation. Under this option we would seek to ascertain whether the smaller licensees could pay more towards network costs, by comparing the current level of payment with the maximum amount which a theoretical new entrant would be prepared to pay while still meeting its regional licence obligations.
- 1.18 For each of the options we identify in relation to the cost sharing arrangements in the NWA, we have considered:
- 1.18.1 whether it would provide a satisfactory means of enabling regional Channel 3 services (taken as a whole) to be a nationwide system of services which is able to compete effectively with other television programme services provided in the United Kingdom;
 - 1.18.2 its impact on the ability of individual licensees to meet their public service remits, regional programming obligations and the out of London quotas; and
 - 1.18.3 whether it might give rise to a prevention, restriction or distortion of competition.
- 1.19 As we have noted, in proposing these options, we have been mindful both of the statutory purpose of the NWA and our duty not to propose modifications likely to prejudice the delivery by the individual Channel 3 licensees of their public service remits and regional programming obligations. Given our concern that any increase in the contribution of the smaller licensees resulting from the implementation of option 2 or option 3 could prejudice the ability of the non-consolidated licensees to meet existing regional programming obligations, option 1 may be the only option which is compliant with the statutory framework for NWA.
- 1.20 We would, however, welcome the views of interested parties on all of the options for allocating network costs between the licensees. We are also seeking further

information on the impact of each of the options on the business models of the regional licensees to determine the extent to which further changes might be possible.

- 1.21 Finally, we are conscious that, although both the broadcasting environment and the ownership structure of the regional licences has changed significantly since the NWA were first developed, the framework within which we are required to assess the operation of those arrangements (and indeed their substantive structure) has not. There are considerable tensions in this system. The arrangements cover the single largest element in the licensees' cost base and, because any modification within the cost sharing arrangements that benefits one licence holder must negatively impact on another, it is difficult for the licensees to reach a consensus on change. Equally, while Ofcom has a statutory obligation to assess the continuing suitability of the NWA, we may only introduce amendments within the scope of a regulatory framework that was designed for an analogue world. Although we will retain our duties for as long as arrangements between the regional licensees are governed by statute, we consider that it would now be appropriate to remove the regulatory burden which formal annual reviews place on Ofcom and on the licensees.

Next steps

- 1.22 We invite interested parties to make submissions on the issues set out in this document by **5 October 2010**. We would make a particular request to respondents to structure their responses around direct answers to the questions asked in this document, which are listed together at Annex 4.
- 1.23 Following the consultation period, and after a full consideration of the responses that we receive, we will look to consult with the OFT and publish a statement as soon as practicable.

Section 2

Context of the Current Review

Statutory framework for review of the Networking Arrangements

- 2.1 Channel 3 is a free-to-air, commercially funded national television broadcast channel made up of 15 regional licensed areas. The 11 regional English and Welsh licenses are currently held by ITV Broadcasting Limited, a wholly owned subsidiary of ITV plc. The two Scottish licenses are held by STV Central Ltd and STV North Ltd, two subsidiaries of STV Group plc ('STV'). The licences in Northern Ireland and the Channel Islands are held by UTV Ltd ('UTV') and Channel Television Ltd ('Channel') respectively. Throughout this document STV, UTV and Channel are referred to collectively as the 'non-consolidated licensees' or 'NCLs'.
- 2.2 It is a requirement of the Communications Act 2003 (the 'Act') that each of the regional licences contains licence conditions to ensure certain specified outcomes. These outcomes include:
 - 2.2.1 fulfilment of the public service remit, namely the provision of high quality and diverse programming;
 - 2.2.2 securing that a certain proportion of programming is made outside of the M25 area (the 'out of London quotas');
 - 2.2.3 securing that the service includes a sufficient amount of high quality, regional programming;
 - 2.2.4 securing that regional news is broadcast at regular intervals; and
 - 2.2.5 securing that approved Networking Arrangements ('NWA') are in force.
- 2.3 The origins of the NWA date back to the Broadcasting Act 1990 ('the 1990 Act'), which required the Channel 3 licensees to conclude a set of arrangements, approved by the ITC, that would enable them to work together to produce a national television service. The relevant provisions in the Act were largely drawn from the provisions of the 1990 Act which they superseded.
- 2.4 Section 290(4) of the Act defines networking arrangements as arrangements that:
 - 2.4.1 apply to all the holders of regional Channel 3 licensees;
 - 2.4.2 provide for programmes made, commissioned or acquired by or on behalf of one or more of the Channel 3 licensees to be available for broadcasting in all the regional Channel 3 services; and
 - 2.4.3 are made for the purpose of enabling regional Channel 3 services (taken as a whole) to be a nationwide system of services which is able to compete effectively with other television programme services provided in the UK.
- 2.5 As part of our responsibilities under the Act, we have a statutory duty to carry out a general review of the approved NWA from time to time under section 293, and we may require the channel 3 licensees to modify the NWA as a result. In carrying out

such a review, we must consider a number of specific issues alongside our principal duty to further the interests of citizens and consumers. These duties include:

- 2.5.1 whether the NWA are a satisfactory means of achieving the purpose set out in paragraph 2.4.3 above;
 - 2.5.2 the likely effect of the NWA on the ability of the licensees to maintain the quality and range of regional programming or programming which contributes to the regional character of the services;
 - 2.5.3 whether the NWA would be likely to prejudice the ability of any of the Channel 3 licensees to comply with their public service remits; and
 - 2.5.4 whether the NWA satisfy the competition tests set out in Schedule 11 of the Act.¹⁰
- 2.6 Under the transitional arrangements in Schedule 18 to the Act, the approved NWA are those arrangements approved by the ITC under the 1990 Act and in effect immediately before the commencement of section 291 of the Act, as modified following reviews by Ofcom under section 293 of the Act.

Arrangements included in the NWA

- 2.7 The approved NWA currently comprise:
 - 2.7.1 Network Supply Contract ('NSC') – an agreement between ITV Network and each of the regional Channel 3 licensees in relation to the acquisition, commissioning and scheduling of network programmes. The NSC includes arrangements relating to the NPB, the fund used to pay for programmes in the network schedule;
 - 2.7.2 Statement of Principles – the principles by which ITV Network carries out its functions on behalf of the regional Channel 3 licensees, including the principle that ITV Network acts in the interests of all the licensees and independently of any production interests of any of them;
 - 2.7.3 Code of Practice – which provides guidance to programme producers on how ITV Network selects and commissions programmes for broadcast on the Channel 3 network and the terms on which such programmes are licensed for broadcast;
 - 2.7.4 Network Programme Licence ('NPL') – a standard form contract for programme commissions from a regional Channel 3 licensee made between ITV Network and the relevant licensee; and
 - 2.7.5 Tripartite Commissioning, Production and Compliance Agreement ('TA') – a standard form contract for programme commissions from independent producers made between ITV Network, the independent producer and the regional Channel 3 licensee carrying out compliance work.
- 2.8 There are a number of other contractual arrangements between the Channel 3 licensees. These range from matters closely related to the provision of a national networked service, such as transmission, to those not directly connected to it, such

¹⁰ Full details of the competition tests are in Annex 5.

as use by ITV plc of the ITV brand. A number of these agreements are described in detail in section 4 below.

ITV Network activities and governance

- 2.9 ITV Network Ltd ('ITV Network') is a company limited by guarantee, with a membership composed of the regional Channel 3 licensees. Under the terms of the NSC, each of the regional Channel 3 licensees grants ITV Network authority to "purchase, commission and administer a Network Schedule of Network Programmes to be available for inclusion... in its Regional Channel 3 Service." A Network Programme is defined as "films, programmes or other material for television broadcast."
- 2.10 ITV Network's board, which is known as the Network Council, agrees the network strategy and budget, which its executive, the Network Directorate, implements on behalf of the licensees. ITV Network, through the Network Directorate, also acts as the agent of the licensees in the purchase, commissioning and administration of a schedule of network programmes (i.e. programmes for broadcast across the Channel 3 network) which are made available to each of the licensees for inclusion in their regional Channel 3 services. Each licensee is a member of ITV Network and holds a seat on Network Council. However, because voting rights are determined by a combination of number of licences held and share of Channel 3's qualifying revenue ('QR'), ITV plc holds over 90% of the votes and has de facto control over Network Council decisions.

Development of the Channel 3 network

- 2.11 The regions comprising the Channel 3 licence areas are of very different population sizes and hence advertising revenue earning potential. The individual licence areas were subject to auction as a result of the 1990 Act. The bidders for each licence were required to meet a quality threshold and business plan test with licences awarded (in the absence of exceptional circumstances) to the highest qualified bidder in each region.
- 2.12 The 1990 Act included restrictions which prevented companies from holding regional licences in more than two areas. This restriction was supplemented in 1991 with a further proscription on any company holding two 'large' licences (i.e. licences for regions whose share of the network's total revenue exceeded four per cent).¹¹ Few companies chose to bid for multiple licences during the auction process and ultimately the licences were won by 15 separate bidders.
- 2.13 Subject to the statutory requirements in the 1990 Act, the form which the NWA were to take was initially a matter for negotiation between the successful bidders. However, in its guidance to applicants for those licences the ITC raised a series of issues which it expected the NWA to address. Among other things, the ITC proposed that contributions to the Network Programme Budget ('NPB') should be shared between licensees according to a formula which took account of the different earning potential of each licence area. Under the ITC's formula the holders of 'small' licensees (i.e. licences for regions whose share of the network's total revenue did not

¹¹ See the Broadcasting (Restrictions on the Holding of Licences) Order, 1991. The large licences specified in the order are those now known as STV Central, Central, Anglia, London (weekday), London (weekend), Granada, Meridian, Wales & West of England and Yorkshire.

exceed four per cent)¹² would make lower contributions to the NPB than their relative size would otherwise warrant, with the large licensees making proportionately higher contributions. The ITC's proposal was, with minor adjustments, accepted by the new Channel 3 licensees and included within the first NWA.

- 2.14 The cost sharing arrangements in the NWA were therefore originally devised in the context of fragmented network ownership, to ensure that each licensee could meet its regional programme obligations while also making a contribution to the costs of the network schedule.
- 2.15 Over the course of the 1990s the ownership restrictions on the regional Channel 3 licences were progressively relaxed in response to increasing competition and pressure from the licensees to allow consolidation. Secondary legislation in 1993¹³ allowed a company to own any two licences with the exception of the London weekday and weekend licences. The Broadcasting Act 1996 allowed further consolidation within the network, subject to a restriction preventing any company holding a combination of licences that would give it more than a 15% share of overall UK television audience viewing time. All restrictions on consolidation between regional licensees were repealed in the Communications Act, although separate rules were introduced under Schedule 14 preventing companies with other specific media interests from holding Channel 3 licences.
- 2.16 In response to this gradual relaxation of the ownership rules there was a consolidation of regional licence ownership by a series of mergers culminating in the 2003 merger of Carlton Communications plc and Granada plc to form ITV plc, holding 11 of the 15 licences. Separate consolidation means that the two Scottish licences are now owned by STV Group, while UTV and Channel are now the only holders of a single licence.
- 2.17 As a result of the consolidation process, ITV plc now owns all but one of the 'large' licences as well the Tyne Tees, Westcountry and Border 'small' licences. The NCLs between them own a single 'large' licence, STV Central, as well as the remaining 'small' licences (STV North, Ulster and Channel Islands).
- 2.18 The licensees agreed small increases to the level of contribution to the NPB by the small licensees and a consequential reduction in the contributions needed from the large licensees in 1995 and 1998. However, other than this, although the ownership of the Channel 3 licences has been consolidated from the original 15 companies, the cost sharing arrangements in the NWA have remained unchanged since 1991.
- 2.19 The lack of change in the past ten years is primarily due to the merger undertakings to which ITV plc is subject. In 2003, in order to secure regulatory approval for the merger of Granada plc and Carlton Communications plc, the merged group gave undertakings to the Secretary of State concerning the cost sharing arrangements for the NPB. The undertakings capped the individual contributions made by the NCLs to the NPB at their 2003 level increased in line with RPI, thereby limiting the possibility of further changes to the cost sharing arrangements in the NWA.

¹² The small licences are those now known as Border, Channel, STV North, Tyne Tees, Ulster and Westcountry.

¹³ See the Broadcasting (Restrictions on the Holding of Licences) (Amendment) Order, 1993.

Background to the current review

- 2.20 During our second review of public service broadcasting ('PSB'), both ITV plc and the NCLs submitted evidence (further discussed in section 3 below) suggesting that the approach used to allocate shares of network costs to the regional licensees was inequitable. Both sides argued that the existing structures provided for a significant net benefit to the other group of licensees.
- 2.21 ITV plc called for substantial amendments to the NWA. It argued that the difference between the existing arrangements and what it considered to be a more equitable sharing of network costs amounted to a transfer of over £25m per year from the ITV plc owned licensees to the NCLs.
- 2.22 For their part, the NCLs argued that ITV plc's calculations had failed to take account of the broader benefits which they argued ITV plc derived from membership of the network, and that – in their opinion – there was in fact a transfer of value from the NCLs to ITV plc of between £28m and £31m per year.
- 2.23 In *Putting Viewers First*, the statement with which we concluded our second PSB review we:
- 2.23.1 noted that the NWA had since their inception in the early 1990s provided different degrees of benefit to the different licensees;¹⁴
 - 2.23.2 recognised that the value of the regional licences was in decline;
 - 2.23.3 stated that it was unclear whether a negotiated agreement in the interests of all parties was possible; and
 - 2.23.4 acknowledged that unless all of the regional licensees were willing participants in the network, the existing arrangements would become unsustainable.
- 2.24 We proposed therefore to analyse the licensees' submissions as part of our next review of the NWA, in order to assess the nature of the financial arrangements between licensees and to "work with them to try and arrive at new arrangements which recognise the extensive financial inter-relationships between their businesses."¹⁵

Scope of the current review

- 2.25 We wrote to each of the regional licensees in August 2009 in order to invite comments on the scope of the present NWA review. We made clear that our intention was to use the review to look at the way in which network costs were allocated between licensees under the NWA. We also wanted to consider whether the cost-allocation mechanisms specified in the arrangements affect:
- 2.25.1 the ability of the licensees to meet their public service obligations; and
 - 2.25.2 the suitability of the existing NWA to meet the purposes specified in section 290 of the Act.

¹⁴ See Ofcom's Second Public Service Broadcasting Review: *Putting Viewers First* – Annex 3: *The networking arrangements and their impact on the Channel 3 licences at*

http://www.ofcom.org.uk/consult/condocs/psb2_phase2/statement/annex3.pdf

¹⁵ See *Putting Viewers First*, Annex 3, A3.28.

- 2.26 We made clear our view that an assessment of the cost sharing provisions which was limited to the existing NWA documents could prove insufficient for this purpose, given the complexity of the financial arrangements between the licensees. Instead, we said that we considered it was appropriate to evaluate the burden of the cost sharing arrangements specified in the NWA in the context of other relevant arrangements between the licensees.
- 2.27 Further, we invited the licensees to agree the factual basis that we could use to analyse the funding flows between the parties. We also asked them for their comments on the evidence submitted by the other set of licensees.
- 2.28 We received a series of submissions from ITV plc, STV and UTV during the autumn of 2009 and in early 2010. Towards the end of 2009 we confirmed our intention to proceed with the scope of the review outlined above.

Structure of this document

- 2.29 The rest of this document comprises the following:
- 2.29.1 In section 3 we summarise the submissions we have thus far received from the licensees about the cost sharing arrangements in the NWA.
- 2.29.2 In section 4 we explain the criteria that we have used to determine whether specific financial arrangements between the licensees have an effect on the ability of the Channel 3 network to meet its statutory aims. We then consider which of the financial arrangements are relevant to our assessment of cost sharing under the NWA.
- 2.29.3 In section 5 we discuss some of the economic issues involved in evaluating the existing arrangements for sharing the common costs of the ITV1 network. We then consider whether it is possible to develop alternative benchmarks against which to evaluate the impact of the current arrangements.
- 2.29.4 In section 6 we compare the current cost sharing arrangements against the relevant benchmarks identified in section 5 in order to evaluate the effect of the current arrangements.
- 2.29.5 In section 7 we consider whether, in light of the preceding analysis, changes the existing cost sharing arrangements in the NWA are appropriate.
- 2.29.6 Annexes 1-4 cover the consultation process, including details of how to respond.
- 2.29.7 Annex 5 describes the statutory framework for reviewing the NWA.

Section 3

Submissions by the Parties

- 3.1 During our second review of public service broadcasting ('PSB') in 2008-9 both ITV plc and STV/UTV submitted reports to us which assessed the distribution of cost and benefit between the regional Channel 3 licence holders. These reports offered markedly different approaches to and analyses of payment flows between the parties. Although both documents were confidential, both ITV plc and STV/UTV (now working in co-operation with Channel) have seen the other's submission in an unredacted form and have been invited by us to offer their comments. In this section, we briefly outline both of the main submissions made by the parties and their subsequent comments.¹⁶

Submissions to the Second PSB review

Spectrum Value Partners report for ITV plc

- 3.2 During the second PSB review ITV plc submitted to us a report it had commissioned from Spectrum Value Partners (the 'Spectrum report') examining the existing flow of payments between the companies controlling the regional Channel 3 licensees. The Spectrum report adopts a three step approach in its analysis.
- 3.3 Firstly, the report seeks to establish which "value flows" exist between ITV plc and the NCLs, i.e. what actual payments are made by one party to another (either directly or via ITV Network). The report explains that such payments are either the result of the allocation of network costs among the licensees or transactions between them for products or services.
- 3.4 Having identified ten broad categories of "value flow", in their second step the report's authors then seek to divide them into two types:
- 3.4.1 flows which are subject to regulation, such as contributions by licensees to the Network Programme Budget or the costs of transmission; and
 - 3.4.2 flows which are "based on arms length commercial terms", including the terms of use by ITV plc of the ITV brand or multiplex capacity not required by the NCLs.
- 3.5 In relation to the six arrangements in the "regulated" category, the Spectrum report notes that the flows primarily relate to the allocation of common costs between the licensees. The Spectrum report argues that, while costs which are directly incurred by or attributable to a licensee should be allocated to that licensee, common costs
- "...should be shared amongst licensees based on the proportion of the total value each licensee reaps in relation to the exploitation of the Channel 3 network schedule in their area... Accordingly, the proportionate approach... should be to divide the common costs in accordance with the licensees' share of Qualifying Revenue..."

¹⁶ We wish to make clear that this section constitutes a summary of what are in our view the key points made by the licensees and their agents in their submissions. We do not attempt to summarise each and every argument made to us thus far on these matters by the licensees.

The Spectrum report suggests that cost allocation on any basis that diverges from QR share results in “a net value transfer to one party”. Because within regulated agreements, the allocation of cost is not solely determined by a commercial negotiation, the report’s authors suggest “it is appropriate to classify that benefit as a subsidy”.

- 3.6 In relation to the four arrangements within the “commercial” category, the Spectrum report notes that these are primarily transactional, with ITV plc paying the NCLs “for the use of their share in a series of commonly owned ‘assets’.” As a result, and in contrast to the “regulated” arrangements, while a net value transfer to ITV plc may occur “if the payments made by ITV plc for these assets are materially lower than the current rational opportunity cost to the NCLs of allowing ITV plc to use”, the report’s authors argue the term subsidy would be inappropriate because:

“... at most a claim that there is a net value transfer in relation to commercial flows might intimate that one or other party may be benefitting / suffering from a good / bad deal.”

- 3.7 In the third and final step, the Spectrum report’s authors assess the actual value flows against the separate benchmarks for “regulated” and “commercial” arrangements they previously identified in order to determine whether these involve a “net value transfer” between the licensees. They conclude that in 2009 there was a total net value transfer of £[>] to the NCLs from ITV plc, of which £[>] resulted from regulated arrangements which they therefore class as a subsidy.

Ingenious Consulting report for STV and UTV

- 3.8 Following ITV plc’s submission of the Spectrum report, STV and UTV commissioned their own report from Ingenious Consulting (the ‘Ingenious report’) on the benefit flows between the regional licensees. The Ingenious report seeks to bring out the full range of benefits which ITV plc accrues as a “direct result” of membership of the Channel 3 network and so looks more broadly than

“... the benefits that are defined and established through the formal Networking Arrangements themselves... but also those which derive from the operating and commercial relationships between all network members.”

- 3.9 In contrast to the Spectrum report, the Ingenious report’s authors argue that because agreements (such as those for DTT capacity and cross-promotion of ITV plc’s digital channels on ITV1) which the former categorised as ‘commercial’ are:

- 3.9.1 “inextricably linked” to the NWA or directly flowed from them;
- 3.9.2 set out “both some of the principles... and detail... of how the Network operates on a day-to-day basis”; and
- 3.9.3 do not capture “fully and transparently” the “considerable developments in the businesses of many of the regional licensees” since they had been agreed,

it is appropriate to take account of their effects in an assessment of the value flows between the licensees.

- 3.10 As a result, the Ingenious report seeks to quantify the value which:

- 3.10.1 ITV plc's digital channels and other services derive from "support given by the network, either through access to programming or promotional support, or sharing costs for original programming"; and
 - 3.10.2 each of the licensees derives from "the way in which advertising, sponsorship and other revenue is generated and allocated".
- 3.11 In relation to both sets of benefits, the Ingenious report's authors consider that there is a direct flow of value from the network to ITV plc. Among other things, the Ingenious report argues that:
- 3.11.1 repeats of network programming on ITV plc's digital channels take viewers and therefore advertising revenue away from Channel 3;
 - 3.11.2 ITV plc continues to acquire network content for retransmission at "nominal" rates agreed a decade ago "in order to help the digital channels to grow";
 - 3.11.3 cross promotion of ITV plc's digital services in network programming, obtained by ITV plc "for free", would be worth almost £100m per annum if promotional references were paid for at advertising rates;
 - 3.11.4 the NCLs pay ITV plc approximately £[><] per annum to sell airtime on their behalf when it considers the incremental cost to ITV plc of doing so is likely to be minimal; and
 - 3.11.5 efficiency savings generated by the transfer of functions from ITV Network to ITV plc have not been reflected in the contributions to NWC costs made by the NCLs.
- 3.12 The valuations placed on these benefits in the Ingenious report are substantial. The Ingenious report estimates that over £227m of value flows from ITV Network (as a whole) to ITV plc. It argues that this represents a flow of between £28m and £31m from the NCLs.

Report rebuttals by the licensees

- 3.13 In August and November 2009, we wrote to the licensees inviting them to comment on the report submitted by the other group of licensees during the second PSB review. In particular, we asked the licensees to comment on the methodology, analysis and findings in the reports.

Rebuttal by the NCLs of the Spectrum report

- 3.14 The NCLs submitted their rebuttal of the Spectrum report in March 2010.
- 3.15 In their response, the NCLs question whether "there can be an unpicking of the financial arrangements in place before the expiry of the current licence period in 2014". The NCLs argue that the Spectrum report:
- 3.15.1 Relies on a concept of "net subsidy" which is flawed because it fails to take "all relevant financial relationships... into account";
 - 3.15.2 Makes "academic" distinctions between regulated and commercial arrangements ignoring the fact that most of the benefits resulting from the latter "can only exist as a result of... the 'regulated' NWAs"; and

- 3.15.3 Overlooks the fact that the purpose of the NWA is to “provide support to all licensees (including the NCLs) to allow them to provide part of the national Channel 3 service in less economically viable areas of the United Kingdom.”
- 3.16 In response to arguments within the Spectrum report about specific contractual relationships, the NCLs contend that:
- 3.16.1 Spectrum’s use of the concept of ‘opportunity cost’ is inappropriate as, without the NCLs’ agreement “we do not believe it would be possible for ITV to use ITV1 programming on its digital channels”. Instead, they consider the “value is what ITV should be prepared to pay if the alternative is for them not to have the rights, if they could be denied by the NCLs.” As it is, the NCLs suggest that “the arrangements agreed for the pricing of ITV1 content when it transfers to ITV’s digital channels significantly undervalues that content, to the disadvantage of the NCLs”;
 - 3.16.2 They have “no visibility over the operations of the Network Centre” and question why they continue to contribute at a fixed rate to Network Centre costs given the “considerable cost savings” made by ITV plc since 2005;
 - 3.16.3 Due to a lack of transparency by ITV plc, they are unable to assess whether ITV Network commissions programmes from ITV Studios “from a desire to place profitable production activity with ITV rather than based on what is best for the ITV1 schedule”;
 - 3.16.4 Spectrum’s suggestions that ITV plc’s digital channels “are scheduled in a way that is complementary to ITV1” is untrue as spin-off programming “is specifically designed to bring audiences across from ITV1 to ITV’s digital channels” with a clear financial benefit to ITV plc to the detriment of ITV1 and the NCLs; and
 - 3.16.5 Spectrum does not supply “evidence to support the assertions made” about the benefits to the NCLs of ITV plc’s national advertising sales offering. Indeed, UTV considers its agreements “do not take account [of] the dramatic fall in advertising revenue in recent years” with the result that it “now provides a subsidy to ITV plc”, while Channel describes the rate of commission it pays to ITV Sales as “unacceptable”.
- 3.17 The NCLs also used their rebuttal to argue that we should take a number of further areas into account in our assessment. They argue that “any consultation” which fails “to take account of all intra Licensee arrangements, whether they are strictly part of the NWAs, or not” would be “flawed”. In addition to their concern that the existing transfer pricing arrangements enable ITV plc’s digital channels to obtain access to ITV Network content at a discounted rate, the NCLs argue that:
- 3.17.1 in the absence of transparency by ITV plc over allocation of costs between ITV Network and ITV plc for spin-off programming, they believe that ITV plc’s digital channels “tend to bear far less than [their] fair share of the programme costs”;
 - 3.17.2 they have no visibility over rights “acquired by the Network and passed onto ITV entities.” As a result, the NCLs believe they do not have the “full understanding” they require of rights used on ITV.com; ITV Play and ITV Mobile;

- 3.17.3 ITV Network has been “slow to account” for costs allocated to activities involving PRS; they maintain that these deductions “require further investigation”. The NCLs also contend that PRS revenue is inappropriately allocated on the same basis as contributions to the Network Programme Budget;¹⁷ as opposed to share of qualifying revenue; and
- 3.17.4 in the absence of reports from ITV plc about back-end revenue received by ITV Network for shows commissioned under the Terms of Trade “it is not clear how or when ITV will account to the NCLs for their share of this revenue.”

Rebuttal by ITV plc of the Ingenious report.

- 3.18 ITV plc submitted its rebuttal of the Ingenious report in November 2009.
- 3.19 In its rebuttal, ITV plc states that it considers the Ingenious report to be “seriously flawed” because its analysis is “based on the misconception that the NCLs have some claim over the value that ITV plc adds to the assets it procures on arms length terms from the NCLs.” ITV plc argues that the Ingenious report:
 - 3.19.1 ignores the fact that there had been “no obligation on any party” to enter into the commercial agreements through which ITV plc acquires the use of network assets;
 - 3.19.2 focuses on the benefits derived by ITV plc without considering whether any realistic commercial alternatives for exploitation of those assets are available to the NCLs which would make them better off in “net terms”; and
 - 3.19.3 confuses opportunity cost “...with the value which ITV plc derives from the use of the assets procured from the NCLs/the Network”, ignoring “the value which ITV itself has added and the risks it has taken in building its digital channels”.
- 3.20 In response to arguments within the Ingenious report about specific contractual relationships, ITV plc contends that:
 - 3.20.1 although the NCLs “may now regret” the terms of the deal under which they waive their share of ITV Network’s exclusive rights to commissioned content, “in transactions not subject to regulatory influence, there would be no inherent reason to suppose that a commercial contract did not reflect the free will of the parties”;
 - 3.20.2 Ingenious gives no “meaningful consideration” to the opportunity cost of the existing transfer pricing arrangements to the NCLs, while erroneously basing benefit calculations on the suggestion that “virtually all the content on the digital channels is programming that is still in licence for ITV1”;
 - 3.20.3 Ingenious ignores the fact that network programmes “would be commissioned for ITV1 regardless of any arrangements [for spin-off programming] for [ITV plc’s] digital channels” and that all incremental costs of such programming are paid for by ITV plc;

¹⁷ See paragraph 4.8 ff.

- 3.20.4 Ingenious's calculation of the value of cross-promotional slots takes no account of the fact that such slots "cannot be sold on the market" or that the use of such slots is tightly limited by Ofcom's Cross-Promotion Code;
- 3.20.5 Ingenious's report "ignore[s] the choice to avoid risk made by the NCLs" in relation to Network Centre costs following the 2005 NWA review;¹⁸
- 3.20.6 Ingenious fails to consider whether "there is a market to any material extent for nation based DTT capacity... or whether the NCLs themselves could make more lucrative use of the capacity"; and
- 3.20.7 Ingenious's arguments about advertising sales ignore the "revenue benefit that the NCLs derive from being part of a network sale" and fail to take account of those aspects of existing sales contracts which are beneficial to the NCLs and which they would be "unlikely" to obtain from any other party other than ITV Sales.

Summary

- 3.21 The table below attempts to capture the positions of ITV plc and the NCLs on the issues discussed above:

Table 1: Summary of Licensee Viewpoints on the Relevance of Individual Arrangements to the NWA

ITV plc viewpoint	Issue	NCL viewpoint
Relevant to the NWA	Network Programme Budget	Relevant to the NWA
Relevant to the NWA	Network Centre costs	Relevant to the NWA
Relevant to the NWA	Network transmission costs	Relevant to the NWA
Relevant to the NWA	Payments for music performing rights	Relevant to the NWA
Regulated agreement but outside the scope of the NWA	Arrangements for advertising sales services	Relevant to assessment of ITV plc benefits
Commercial agreement outside the scope of the NWA	Arrangements for the use of spare multiplex capacity	Relevant to assessment of ITV plc benefits
Commercial agreement outside the scope of the NWA	Transfer pricing arrangements	Relevant to assessment of ITV plc benefits
Commercial agreement outside the scope of the NWA	Cross-promotion arrangements	Relevant to assessment of ITV plc benefits
Commercial agreement outside the scope of the NWA	Arrangements for the use of the ITV brand	Relevant to assessment of ITV plc benefits
Regulated agreement but outside the scope of the NWA	Carlton/Granada merger undertakings cap	No position stated
Commercial agreement outside the scope of the NWA	Arrangements for spin-off programming on ITV2-4	Relevant to assessment of ITV plc benefits
Commercial agreement outside the scope of the NWA	Acquisition by ITV plc of additional content rights	Relevant to assessment of ITV plc benefits
No position stated	Allocation of PRS revenue	Relevant to assessment of ITV plc benefits
No position stated	Allocation of back end revenue shares from commissioned programmes	Relevant to assessment of ITV plc benefits

¹⁸ See paragraph 4.19 ff below.

Section 4

Categorisation of Financial Arrangements

- 4.1 Ofcom's duty under section 293 of the Act is to review the approved NWA, taking account of the statutory objectives for networking arrangements as well as our general duty to further the interest of citizens and consumers and the specific duties described in section 2. The approved NWA currently comprise the five documents described at paragraph 2.7 above. Given its scope, the key document for the purposes of this review is the Network Supply Contract, and particularly the cost sharing arrangements in relation to the Network Programme Budget ('NPB'). This is the fund used to pay for programmes in the network schedule to which all the Channel 3 licensees contribute. In addition to the NPB, licensees also pay a "networking fee" which covers certain specified 'core functions' relating to the commissioning, acquisition and scheduling of programming carried out by ITV Network on behalf of the licensees as a whole.
- 4.2 Beyond the approved NWA, the licensees are also parties to a number of other arrangements connected to the provision of the Channel 3 licensed services, which confer costs on one or more of the licensees. We consider that any assessment of the costs which the approved NWA place on the licensees should be carried out in the context of other financial arrangements between them that are relevant to the provision of the Channel 3 network service.
- 4.3 As described in Section 3, ITV plc and the NCLs disagree as to which of these different financial arrangements are potentially relevant to our assessment of the cost sharing provisions under the NWA. As a first step, we have therefore considered the criteria we should use when assessing the relevance of each of the arrangements identified by the licensees to our assessment of the cost sharing provisions in the NWA.
- 4.4 In our view, the criteria set out in section 290 of the Act are appropriate for this purpose. The criteria, which define arrangements capable of being approved by Ofcom as networking arrangements, are as follows:
 - 4.4.1 the arrangements apply to all the Channel 3 licensees;
 - 4.4.2 the arrangements provide for programmes made, commissioned or acquired by or on behalf of the regional licensees to be available for broadcasting across the Channel 3 network; and
 - 4.4.3 the arrangements are made for the purpose of enabling the regional Channel 3 services (taken as a whole) to be a nationwide system of services which is able to compete effectively with other television programme services provided in the United Kingdom.
- 4.5 Any arrangement which satisfies these criteria is directly related to the provision of the Channel 3 network service. Our general position is, therefore, that such arrangements have a sufficiently close nexus to the approved NWA to constitute part

of the relevant context in which the cost sharing arrangements under the approved NWA should be assessed.¹⁹

- 4.6 In Summer 2009 we wrote to each of the licensees asking them to confirm that the way these agreements were described in the Spectrum report provided an appropriate factual basis for our analysis in this review. With some reservations and adjustments, this position has been accepted by all of the licensees; we have therefore used the description of payment flows in the Spectrum report as the basis of our assessment.
- 4.7 Below we describe each of the arrangements we have considered and, in relation to those arrangements outside of the approved NWA, our view as to whether or not they constitute relevant context for the purposes of our assessment. The arrangements in question are:
 - 4.7.1 the Network Programme Budget;
 - 4.7.2 the costs of running the Network Centre;
 - 4.7.3 the costs associated with transmission of the network service;
 - 4.7.4 arrangements relating to the acquisition of music performing rights;
 - 4.7.5 arrangements relating to advertising sales;
 - 4.7.6 arrangements relating to spare multiplex capacity;
 - 4.7.7 the Programme Pricing Agreement;
 - 4.7.8 arrangements for cross-promotion of other services run by the licensees;
 - 4.7.9 arrangements for the use of the ITV brand by the licensees;
 - 4.7.10 the Carlton-Granada merger undertakings cap; and
 - 4.7.11 additional arrangements highlighted by the NCLs.

Network Programme Budget

Description

- 4.8 As noted above, the NPB is the fund used to pay for programmes in the network schedule, i.e. programmes which may be shown by each Channel 3 licensee on its regional service. The licensees' obligation to contribute to the NPB is set out in the Network Supply Contract, which forms part of the approved NWA.
- 4.9 The starting point for determining contributions to the NPB is a licensee's Qualifying Revenue ('QR') share, that is, its share of the net advertising revenue and sponsorship income generated across Channel 3 in the preceding year. The contribution of licensees is then adjusted by reference to two formulae originally devised by Ofcom's predecessor the ITC and known as the C1/C2 mechanism.

¹⁹ We consider that there are particular reasons for taking a different view of one specific agreement, as set out in paragraphs 4.61 to 4.66 below.

- 4.10 The C1/C2 mechanism was explicitly designed so that the larger licensees bore a greater share of the costs of the provision of the networked service. The purpose of this was to ease the perceived burden of regional programming obligations on the smaller licensees, compensating those licensees for the relatively higher proportion of their revenue that would be subsumed by the fixed costs of regional production. By reducing the contributions made by the smaller regional licences to the NPB, the C1/C2 mechanism explicitly sought to reflect licensees' ability to pay.²⁰
- 4.11 The C1/C2 mechanism was proposed by the ITC in its *Invitation to Apply for Regional Channel 3 Licences* in 1991 and was adopted by the successful applicants and introduced into the first Network Supply Contract in 1993.²¹ Since then, there have been changes to the C1/C2 mechanism which have had the effect of increasing the overall contribution of the smaller (or 'C1') licensees. For instance, in 1995, the mechanism was adjusted to raise the payments of the smaller licensees by 8.5%. In 1998, the contribution of the Westcountry licensee further increased while that of Tyne Tees (the largest C1 licensee) was brought into line with QR.
- 4.12 The consolidation process within the Channel 3 network means that ITV plc now owns all but one of the large licences, plus Tyne Tees and two of the other small licences, Westcountry and Border. The NCLs between them own a single large licence, STV Central and all the rest of the licences owned by them (namely STV North, Ulster and Channel Islands) are classed as small.
- 4.13 In our 2005 NWA review,²² we noted that the arrangements for contributions to the NPB were not in line with the principle that costs should be shared in direct proportion to the benefits gained by a company from the service being purchased. Nevertheless, we considered that NPB arrangements did meet the overarching policy objective (enshrined within Schedule 11 of the Act) of enabling the smaller licensees to meet their regional licence obligations and consequently approved them as NWA.
- 4.14 In addition to the changes to the C1/C2 mechanism made by the licensees themselves, it is important to note that the contributions made by the NCLs to the NPB were further amended by the Carlton-Granada merger undertakings ('the undertakings'). Regardless of the C1 or C2 status of the individual licences held by the NCLs, the undertakings specified that their individual contributions to the NPB must not exceed their 2003 contribution as cumulatively inflated by RPI – known as the 'undertakings cap'.²³

²⁰ The smaller 'C1' licences are those covering the Border, Channel, STV North, Tyne Tees, Ulster and Westcountry regions. As will be apparent, the mechanism reduces the contributions of the smaller regional licensees regardless of ownership. In correspondence in 1998 with United Broadcasting & Entertainment, one of ITV's predecessor companies, the ITC made clear that it had "always taken the view" that the crucial consideration in determining contributions to the NPB "should be the characteristics of the licensed business and not the income and wealth of its shareholders."

²¹ Channel Television has since 1993 received a separate additional rebate on its contribution to the NPB as calculated under the C1 formula.

²² Our 2005 NWA consultation and statement can be found at <http://www.ofcom.org.uk/consult/condocs/itv1/main/itv.pdf> and <http://www.ofcom.org.uk/consult/condocs/itv1/statement/261207/>.

²³ In its report on the Carlton/Granada merger, the Competition Commission noted its concern that a merged ITV plc could exert power over the NWA to the detriment of the NCLs against the public interest. As a result certain undertakings were agreed between Carlton/Granada and the OFT to mitigate these adverse effects. This included the undertakings cap which was designed to prevent the merged ITV plc from artificially raising the cost of shows produced by its in-house production company for the network and therefore the Network Programme Budget to the detriment of the smaller licensees. See paragraph 4.75 ff.

- 4.15 Finally, licensee contributions to the NPB also include the cost of compliance for programming commissioned or acquired by ITV Network. All network commissions, with the exception of national and international news, are complied by a licensee.²⁴ In the case of programmes produced by a regional licensee, compliance is undertaken by that licensee's own broadcasting business. In the case of programming commissioned by the network from an independent producer, a licensee known as the compliance licensee supervises programme production, ensuring on the network's behalf that a programme is suitable for broadcast. Although the cost of compliance is included in the NPB and therefore shared among the licensees, only those licensees with a significant volume of production for the network or who provide a compliance service generate significant revenue from it. Because the revenue generated by compliance licensees is licensee specific, we do not consider it is appropriate to take compliance revenues into account when considering the cost sharing arrangements within the NWA.²⁵

Network Centre costs²⁶

Description

- 4.16 The ITV Network Centre ('NWC') is the executive body created as a result of the initial NWA to run the Channel 3 network on behalf of the licensees. The specific tasks undertaken by the NWC were described in depth in our 2005 review. In brief, however, the Network Directorate and the staff of the NWC are responsible for:
- 4.16.1 the commissioning, acquisition and scheduling of programming for the Channel 3 network;
 - 4.16.2 negotiation for network programme rights. Although rights are held individually by the regional licensees, it is the NWC that negotiates the terms on their behalf; and
 - 4.16.3 corporate affairs, finance, support services and marketing.
- 4.17 The costs incurred by the Channel 3 licensees in relation to the operation of the NWC are met by (i) the networking fee, payable by the licensees under the Network Supply Contract; and (ii) payments under the Services Agreement, which is described below and does not form part of the approved NWA.
- 4.18 Although the NWC operates on behalf of all of the licensees, a number of its functions are either shared with or sub-contracted to ITV plc. For example, the rights and business affairs staff will negotiate contracts for sports rights deals that are shared between the Channel 3 network and ITV plc's wholly owned channels, as well as content exclusively commissioned for the latter. The costs involved in negotiating joint deals are apportioned between ITV plc and ITV Network.

²⁴ National and international news is in effect self-complied by ITN. See paragraph 3.42 and 3.66 in our 2008 review consultation.

²⁵ Further information about the Channel 3 compliance processes can be found in our 2008 NWA consultation and statement at: http://www.ofcom.org.uk/consult/condocs/itv_network2008/.

²⁶ The Spectrum report groups contributions by the licensees to 'core network functions', 'non-core network functions' and 'relevant activities' together under the term 'contribution to network activities'. Because, as discussed in paragraph 4.25 below, we consider that all of these costs are relevant to our assessment of financial arrangements under the NWA, we have considered them together under the term 'network centre costs'.

- 4.19 In the 2005 review, we noted that NWC costs were informally shared between the licensees on a QR basis. We also stated that, while we did not believe a rigid set of arrangements was necessarily appropriate, it was our view that the existing undocumented arrangements created a lack of certainty for the NCLs. Although we made clear that the mechanism for sharing NWC costs was a matter for the licensees to agree among themselves, to assist the licensees we proposed two different cost sharing methods.
- 4.20 On the one hand, we suggested that ITV plc and the NCLs could agree to formalise cost sharing on a QR basis. Under this option we expected ITV plc to provide full details to the NCLs of the costs which it incurred on behalf of ITV Network.
- 4.21 Alternatively, and in recognition of the fact that the first option by creating an additional burden on ITV plc could lead to an increase in costs, the NCLs could choose instead to pay a fixed sum towards running costs. The NCL's annual contributions – after an initial discount to reflect the benefits of the merger – would then increase in line with RPI.
- 4.22 The licensees agreed to pursue the latter option. The Network Supply Contract was amended to specify the contributions to be made by each of the licensees to a group of 'core network functions' – commissioning and acquisition of network programming and responsibility for devising the network schedule.
- 4.23 In addition, further fixed payments, again increasing with RPI, were specified within a document called the Services Agreement ('SA'). The SA is an agreement between ITV Network and each of the licensees which sets out the basis on which ITV plc provides (and is paid to provide) certain 'non-core network functions' and 'relevant activities' to the network. The services included within these categories include the collection of BARB data, provision of network programme listings and IT, financial and engineering services.²⁷

Assessment

- 4.24 As compared against the three criteria for assessing whether an arrangement is a networking arrangement for the purposes of Part 3 of the Act, we consider that:
 - 4.24.1 NWC costs which are specific to the provision of the Channel 3 network – and not to ITV plc's other operations (such as its digital services) – fulfil the first criterion because they are contained within agreements entered into by all the licensees, namely the Network Supply Contract and the SA.
 - 4.24.2 NWC costs covered by the Network Supply Contract specifically relate to the commissioning and acquisition of network programming. NWC costs specified in the SA relate to IT and engineering services that enable the provision of programming across the Channel 3 network. As such the NWC costs in the Network Supply Contract and the SA fulfil the second criterion.
 - 4.24.3 The NWC costs included in the Network Supply Contract and the SA fulfil the third criterion, because they provide for key network services including commissioning and certain financial, broadcast support and platform services necessary for the provision of a nationwide system of services and other services, such as the provision of network programme listings and viewer

²⁷ In a letter to Ofcom dated 5 November 2008, ITV plc explained that "In practice... the Network Supply Contract and the Services Agreement work hand in hand..."

research, which are germane to the ability of the Channel 3 network to compete with other nationwide services.

- 4.25 Although the Network Supply Contract is one of the documents formally approved by us as part of the NWA, the SA is not. Nevertheless, the SA does set out a list of functions undertaken by ITV plc on behalf of ITV Network. As a result, we consider that payments made by all of the licensees in relation to NWC costs, whether under the Network Supply Contract or the SA, are relevant to our consideration of financial arrangements under the NWA.

Transmission costs

Description

- 4.26 The regional Channel 3 licensees are obliged under the terms of their licences to make their services available on both the analogue terrestrial television ('ATT') and digital terrestrial television ('DTT') platforms for reception by members of the public. Since 31 January 2010, they have also been under a licence obligation to offer their services on "appropriate networks" such as the cable television service provided by Virgin Media, and "satellite television services" such as that provided by British Sky Broadcasting ('Sky').²⁸
- 4.27 Both ATT and DTT make use of land-based transmitters to broadcast signals using part of the radio spectrum known as a frequency channel to viewers within range of that transmitter. Whereas each ATT service is transmitted as a single analogue signal occupying an 8MHz-wide frequency channel, DTT uses compression technology to stream a 'multiplex' of channels, combining a number of different services onto a single 8MHz frequency channel, increasing spectral efficiency.
- 4.28 Currently the DTT platform comprises six multiplexes, five of which are licensed by Ofcom under the Broadcasting Act 1996. Each multiplex carries between four and ten simultaneous television channels.
- 4.29 In relation to ATT, the licences held by the regional licensees oblige them to:
- 4.29.1 ensure that their Channel 3 service is "available for reception by members of the public" by procuring transmission services from a transmission operator;
 - 4.29.2 contribute to the costs incurred by the transmission operator "...in respect of the broadcasting for reception by members of the public of all Channel 3 services (taken as a whole) in analogue form..."; and
 - 4.29.3 contribute to the costs in distributing the Channel 3 services (taken as a whole) to transmission sites.²⁹
- 4.30 In relation to DTT, the licences held by the regional licensees oblige them to:
- 4.30.1 procure multiplex capacity from Digital 3 & 4 Ltd ('D3&4'), a joint venture between ITV Network and Channel 4 which holds the licence for Multiplex 2;

²⁸ See *The Communications Act 2003 (Commencement No. 4) Order 2009* at:
http://www.opsi.gov.uk/si/si2009/pdf/ksi_20092130_en.pdf.

²⁹ Details of each Channel 3 regional licence can be found at:
<http://www.ofcom.org.uk/tv/ifi/tvlicensing/c3/>.

- 4.30.2 contribute to the costs incurred by D3&4 “...in respect of the broadcasting for reception by members of the public of all Channel 3 services (taken as a whole) in digital form...”. These costs primarily involve multiplexing, which is the act of combining the content of the digital channels carried on the multiplex into a single digital signal; and
- 4.30.3 contribute to the costs in distributing the Channel 3 services (taken as a whole) to transmission sites.
- 4.31 Historically, programmes were submitted to the NWC via a private leased line or distribution network known as the contribution network. A network service was then assembled by the NWC and sent via a distribution network to each regional licensee’s transmission centre. At this point, advertisements were added into the regional or sub-regional streams³⁰ and distributed to the appropriate main transmission sites, which in turn feed a network of smaller ‘relay’ transmitters.
- 4.32 Following consolidation, the distribution aspect of this service has been simplified. ITV plc now has two regional distribution centres – one in London covering the London, Anglia, Meridian, ITV West, ITV Wales and Central South regions, and one in Leeds covering Granada, Border, Yorkshire, Tyne Tees and Central North – while each of the NCLs operates their own playout facilities. For DTT, the ‘clean’ ITV1 network feed (which is required by the NCLs and which does not include ITV branding) is sent via the same distribution network as the analogue stream.
- 4.33 Although the obligation to offer an ITV1 service via cable and satellite only came into force in 2010, a regionalised Channel 3 network service has been available via the digital satellite (‘DSat’) platforms operated by Sky and Freesat and the cable service operated by Virgin Media (and its predecessors) for several years.
- 4.34 For carriage on these platforms the regional streams are assembled as before at the regional distribution centres and carried via a telecommunications network (a process known as ‘backhaul’) to a national satellite ‘uplink’ centre. At this centre, the services are uplinked to those satellite transponders on which ITV Network has leased bandwidth. Twenty three ITV plc regional streams, and five NCL regional streams, are carried across four transponders.
- 4.35 Signals are broadcast from the satellite and received by a satellite dish, either belonging to an individual end-user (in the case of Sky or Freesat viewers) or by the cable operator, which makes the appropriate regionalised service available to its customers. ITV Network also buys a range of platform access services from Sky Subscriber Services Ltd (‘SSSL’), including a listing on its EPG.
- 4.36 Platform agreements with SSSL, transponder capacity agreements with satellite operators and programme distribution and satellite transmission agreements with transmission operators are all covered in separate contractual arrangements. These are known as ‘Relevant Ancillary Agreements’ and are entered into by ITV Network on behalf of the Channel 3 licensees on the basis agreed between them in the SA.

Assessment

- 4.37 As compared against the three criteria for assessing whether an arrangement is a networking arrangement for the purposes of Part 3 of the Act, we consider that:

³⁰ Although there are 15 regional licences, there are in fact 28 different regional or sub-regional variants of the Channel 3 network service.

- 4.37.1 Transmission costs which are relevant to the provision of the Channel 3 network service and not to ITV plc's other operations, such as transponder costs for its digital channels, fulfil the first criterion because they are contained within contracts entered into by ITV Network on behalf of all the licensees;
 - 4.37.2 Transmission costs, to the extent that they are incurred under the terms of the Relevant Ancillary Agreements included in the SA, fulfil the second criterion because they enable the broadcast across the Channel 3 network of programmes made, commissioned or acquired for that purpose; and
 - 4.37.3 Transmission costs, to the extent that they are incurred under the terms of the Relevant Ancillary Agreements included in the SA, fulfil the third criterion because in the absence of transmission services it is impossible for the regional Channel 3 services to be a nationwide system of services that compete effectively with other television programme services provided in the United Kingdom.
- 4.38 As discussed above, the regional licensees also have specific licence obligations to ensure that a regionalised Channel 3 network service is available across a range of platforms. In light of this obligation, we consider that the Relevant Ancillary Agreements included in the SA, and therefore the basis on which the costs of the services obtained as a result of those agreements are allocated, are relevant to our consideration of the financial arrangements under the approved NWA.

Music performance rights

Description

- 4.39 ITV Network has an agreement with PRS for Music (formerly the Mechanical-Copyright Protection Society and the Performing Rights Society Ltd) which gives the licensees the right to broadcast recorded music and live music performances on Channel 3. Rights for ITV1 are purchased together with those for ITV plc's digital channels in a single deal, with the cost per channel (after the cost of services to ITV Consumer³¹ and a discount from the MCPS have been excluded) allocated on the basis of share of viewing between ITV1 and ITV plc's digital channels. The shares of the ITV1 charge owed by individual licensees are then allocated on the basis of the C1/C2 formula.
- 4.40 The agreement between ITV Network and PRS for Music is one of the 'Relevant Ancillary Agreements' entered into by ITV Network on behalf of the Channel 3 licensees on the basis agreed between them in the SA.

Assessment

- 4.41 As compared against the three criteria for assessing whether an arrangement is a networking arrangement for the purposes of Part 3 of the Act, we consider that:
- 4.41.1 Performing and mechanical rights fees which relate to programming on the regionalised Channel 3 network and not to ITV plc's other operations, such as content on its digital channels or websites, fulfil the first criterion because they are contained within a contract entered into by ITV Network on behalf of all of the licensees;

³¹ ITV Consumer Ltd is the business responsible for ITV plc's interactive and mobile services.

- 4.41.2 As the agreement entered into by ITV Network on behalf of the licensees provides for programming containing music to be made, commissioned or acquired by or on behalf of the regional licensees to be available for broadcast across the Channel 3 network it fulfils the second criterion; and
 - 4.41.3 Because the purpose of the agreement is the efficient licensing of performing and mechanical rights for use in programming shown on the Channel 3 network in competition with other television networks, it fulfils the third criterion.
- 4.42 As a result, we consider that the Relevant Ancillary Agreement included in the SA, and therefore the basis on which the costs of that agreement are allocated between the licensees, is relevant to our consideration of financial arrangements under the NWA.

Advertising sales

Description

- 4.43 Each of the companies holding regional Channel 3 licences (with the exception of Channel) sells some of its own airtime on a regional basis.³² Airtime which is sold on a national basis – ie. by grouping together advertising slots made available by the individual licensees – is sold exclusively by ITV Sales, ITV plc's sales house formed from the separate sales operations of its predecessor companies – Carlton Communications plc and Granada plc.
- 4.44 Prior to their merger in 2003, Carlton and Granada had competed to sell advertising on behalf of the NCLs. As part of its assessment of the merger, and to address a concern that loss of competition in this area would adversely affect the smaller broadcasters, the Competition Commission concluded that the NCLs should be able to continue to sell airtime through the merged company's sales house on terms which were similar to those that the NCLs enjoyed pre-merger. This condition was agreed to by Carlton and Granada and formalised within the merger undertakings.
- 4.45 The NCLs have each taken advantage of this undertaking, albeit in different ways. STV and UTV entered into new airtime sales arrangements with ITV Sales at the point their previous contracts expired in 2006 and 2007 respectively. These agreements broadly reflected the terms previously enjoyed by both companies. Channel, meanwhile has not been able to agree a formal commercial agreement with ITV plc since 2004. Instead, it has rolled forward its previous terms on an annual basis.

Assessment

- 4.46 As compared against the three criteria for assessing whether an arrangement is a networking arrangement for the purposes of Part 3 of the Act, we consider that:
 - 4.46.1 Each of the licensees has an individual arrangement with ITV Sales in relation to the sale of network advertising slots and ITV Network is not party to any of these bilateral agreements. For example, each of the NCLs has a separate contractual arrangement with ITV Sales, each with different contractual terms. Accordingly, we do not consider that there are grounds for considering these

³² Channel's regional advertising is sold as part of a package with the Meridian region.

agreements collectively as an arrangement to which all the licensees are party. Therefore, the airtime sales agreements do not fulfil the first criterion;

- 4.46.2 Although Channel 3 is a free-to-air network reliant on its advertising revenue, the agreements do not, within the terms of the Act, provide for programmes to be made available for broadcast across the network. As a result the agreements do not fulfil the second criterion; and
 - 4.46.3 Although each of the Channel 3 licensees could sell all of their own advertising, such an arrangement would require investment by each company in a back-of-house operation. It is also likely that a nationwide offering provides benefits to each of the licensees because, as noted in the Spectrum report, it is valuable to advertisers who wish to roll out national campaigns through a single deal. Further, it remains the case, as the Competition Commission noted in its 2003 report, that “it would be difficult for [the NCLs] to contract with a third party, such as Channel 4, to sell their airtime, as this would require [the licensees to share] commercially sensitive information, such as ITV[1]’s schedule and breaks, if the third party sales house were to be effective.” In light of the above, we consider the agreements collectively meet the third criterion.
- 4.47 As a result, we do not consider the airtime sales agreements have sufficient nexus with the NWA to be relevant to an assessment of the cost burden which the NWA place on the licensees.

Spare multiplex capacity agreements

Description

- 4.48 As noted at paragraph 4.30 above, a proportion of the capacity on Multiplex 2 is reserved for the Channel 3 licensees³³ to broadcast the regionalised Channel 3 service and additional channels. Only one of the Channel 3 licensees – ITV plc – currently seeks to offer additional DTT channels in addition to the main ITV1 service. The NCLs instead lease the regional multiplex capacity not required for the network service to ITV plc, which in turn uses it to broadcast its digital channels ITV2 and ITV2+1 on a national basis.
- 4.49 The terms under which unused regional multiplex capacity is leased to ITV plc are contained within bilateral agreements entered into by each of the NCLs between May 2004 and September 2006. Although the terms of these agreements differ, they each provide ITV plc with the right to use the leased capacity to broadcast ITV branded channels in return for a specified annual payment.

Assessment

- 4.50 As compared against the three criteria for assessing whether an arrangement is a networking arrangement for the purposes of Part 3 of the Act, we consider that:
- 4.50.1 Each of the NCLs has an individual contract with ITV plc with different contractual terms for their respective leases of spare digital capacity.

³³ See the Television Multiplex Services (Reservation of Digital Capacity) Order 2008 (at http://www.opsi.gov.uk/si/si2008/uksi_20081420_en_1). Section 8 (3) (a) reserves 48.5% of the capacity on Multiplex 2 “for the holder of a Channel 3 licence... throughout the appropriate area” less the capacity required to broadcast Five throughout the UK.

Accordingly, we do not consider that there are grounds for considering these agreements collectively as an arrangement to which all the licensees are party. Therefore, the spare multiplex capacity agreements do not fulfil the first criterion; and

- 4.50.2 As the multiplex capacity leased by ITV plc from the NCLs is capacity which the latter specifically do not require for the broadcast of the relevant regional Channel 3 licensed service, the spare multiplex capacity agreements do not fulfil the second or third criteria.
- 4.51 Since the individual bilateral agreements between the NCLs and ITV plc, do not meet the section 290 criteria, we do not consider the spare multiplex capacity agreements have sufficient nexus with the NWA to be relevant to an assessment of the cost burden which the NWA place on the licensees.

Programme pricing agreement

Description

- 4.52 As discussed above, ITV Network commissions and acquires programming for the ITV1 networked service on behalf of the regional Channel 3 licensees. The general terms under which it obtains packages of rights are defined within the NPL and the TA, taking account of the principles specified within the Code of Practice. These principles state that ITV Network will “normally only... acquire primary rights”, which include, among other things and subject to conditions “the exclusive right to transmit the programme on Channel 3 via any broadcast media an unlimited number of times” during the period of the programme licence, usually five years.
- 4.53 During this licence window, ITV plc often purchases repeat transmissions of programmes commissioned by and previously shown on ITV1 for its digital channels. In order for it to do so, ITV plc is required to make two payments; one to ITV Network to waive its exclusive rights during the licence window and a separate payment to the producer, for “secondary broadcast rights”. Although the Code of Practice specifies an option for ITV plc to negotiate with the producer to acquire such rights, the producer is under no obligation to sell the rights to ITV plc.
- 4.54 The ITV1/Digital Channels Programme Pricing Agreement sets out a framework for the allocation of costs between the Channel 3 licensees, on the one hand, and ITV plc, on the other, in relation to the acquisition of broadcast rights for, respectively, ITV1 and digital channels owned by ITV plc. The agreement makes different provision for different situations, including:
 - 4.54.1 payment of a fee by ITV plc for the waiver by ITV Network of exclusivity to allow the transmission of network programming on the ITV plc digital channels. Where exclusivity is waived after the first ITV1 transmission, the agreement sets the waiver fee at [X] of the original ITV1 licence fee;
 - 4.54.2 allocation of costs between ITV Network and ITV plc for co-commissions and simultaneous commissions of Channel 3 programming and “brand extension” programming (eg spin-off programming or “uncut” versions) for the ITV plc digital channels;
 - 4.54.3 allocation of costs for joint acquisitions; and

4.54.4 allocation of costs where sports rights are acquired for broadcast on the Channel 3 service and the ITV plc digital channels.

- 4.55 In addition to the Programme Pricing Agreement, each of the NCLs has entered into bilateral agreements with ITV plc³⁴ in which they each agree to exercise their rights in ITV Network to support a resolution that the waiver fee and amounts paid by ITV plc to ITV Network under the Programme Pricing Agreement for sports rights and other acquired programming are “acceptable and sufficient and adequate”(in the case of UTV), “fair and reasonable” (in the case of STV) and “fair, reasonable and adequate”) in the case of Channel. In return, they each receive under these commercially negotiated bilateral agreements an annual payment from ITV plc.

Assessment

- 4.56 The Channel 3 licensees have differing views on these arrangements and in particular, the interaction between the Programme Pricing Agreement and the relevant terms of the bilateral agreements. ITV plc has argued that these are part of a set of “broadly discretionary arrangements which have been entered voluntarily by all parties and negotiated commercially without being subject to regulatory interference or pressure.”³⁵ In contrast, the Ingenious report submitted to Ofcom by the NCLs, while acknowledging that such agreements “are the result of negotiation, rather than specific regulatory requirements,” argues that they “nonetheless set out both some of the principles... and detail... of how the Network operates on a day-to-day business.”
- 4.57 In their rebuttal to the Spectrum report, the NCLs make a series of further points about aspects of the Programme Pricing Agreement. First, in relation to the exclusivity waiver, they state that:

“...[they] do not believe the agreed provisions are ‘commercial’ and do not reflect the balance of advantage as between ITV [plc] and the NCLs. Whilst a contract exists, it is highly likely that the NCLs will wish to renegotiate this...”

- 4.58 Second, the NCLs also question the allocation of costs between ITV plc’s digital channels and ITV Network for spin-off programming. They “believe that... [the spin-off programme] will tend to bear far less than its fair share of the programme costs” and go on to say that:

“...the NCLs’ cannot prove this without access to the financial data which has not been made available to them. The NCLs believe that there is a complete lack of transparency on the part of ITV Network in relation to the sharing of common costs, despite this being a contractual provision in the transfer pricing agreement.”

- 4.59 Third, the NCLs question the role of ITV Network in the acquisition of additional rights on behalf of ITV plc digital channels. In their rebuttal, they quote from the Ingenious report which states:

“From observation of the documentation surrounding ITV Network commissions, it would appear that there is often a conflation of ITV

³⁴ The specific dates are STV – May 2004, UTV – June – 2006, Channel – September 2006.

³⁵ From “*ITV plc response to the [Ingenious Consulting] report of 19 November 2008 on ITV plc and ITV Network Benefit Flows*”, submitted to Ofcom on 13 November 2009.

plc and ITV Network in many of the commissioning negotiations (and possibly those of acquisitions) for content for the Network.”

The NCLs go on to argue that they have no visibility over rights “acquired by the Network and passed onto ITV entities.” As a result, the NCLs believe they do not have the “full understanding” they are entitled to of rights used by ITV.com, ITV Play and ITV Mobile.

- 4.60 As compared against the three criteria for assessing whether an arrangement is a networking arrangement for the purposes of Part 3 of the Act, we consider that:
- 4.60.1 Because ITV Network, acting as an agent on behalf of all the Channel 3 licensees, is party to the Programme Pricing Agreement, it meets the first criterion;
 - 4.60.2 Because the Programme Pricing Agreement includes terms relating to co-commissioning and joint acquisitions including sports rights which are included to enable programmes to be broadcast across the Channel 3 network, it meets the second criterion; and
 - 4.60.3 Because the agreement enables ITV Network and ITV plc to acquire the rights to sporting events which the Channel 3 licensees would be unable to show on ITV1 alone, we consider it fulfils the third criterion.
- 4.61 On the analysis above, the Programme Pricing Agreement satisfies the section 290 criteria. However, we propose that it is appropriate to disregard the agreement in our consideration of the respective cost benefits and burdens under the approved NWA. This is for a number of reasons.
- 4.62 First, we consider that the terms of bilateral agreements between each of the NCLs and ITV plc to be highly pertinent to our assessment of the relevance of these arrangements to our review. While noting the submissions that the NCLs have made in relation to the fairness of these agreements and their expressed desire to renegotiate them, on an objective basis, each of the NCLs has unequivocally accepted in a commercially negotiated contract – signed after the merger of Carlton and Granada – the fairness of the waiver fee and other payments to ITV Network by ITV plc under the Programme Pricing Agreement. On that basis, those payments should be treated as neutral when considering the respective cost burdens of the Channel 3 licensees under the approved NWA.
- 4.63 Second, the Programme Pricing Agreement is concerned with the allocation of costs between ITV Network, acting as the agent for the Channel 3 licensees collectively, and ITV plc in relation to its digital channels, not the allocation of costs between the Channel 3 licensees *inter se*, the question with which this review is concerned.
- 4.64 Last, the NCLs have not produced objective evidence that the allocation of costs between ITV Network and ITV plc under the Programme Pricing Agreement is inequitable. Instead, they have complained about a lack of transparency both concerning the acquisition of rights by ITV Network for ITV plc’s wholly-owned channels and the sharing of costs in relation to spin-off programming.

- 4.65 The issue of rights acquisition was most recently addressed by us in our 2008 review of the NWA.³⁶ We do not consider that the NCLs have provided any fresh information which might provide grounds for revisiting this issue. Given their continued concerns, however, we would reiterate to ITV Network the point made in our 2008 review statement that if it is unable to obtain separate contracts for additional rights, it must on request disclose all terms to all licensees and make clear the principles by which costs are allocated.
- 4.66 Likewise, in relation to the transparency of cost allocation for spin-off programmes we do not consider the information provided by the NCLs to date provides grounds for further investigation into these matters by Ofcom. ITV Network has clear reporting obligations to the NCLs regarding the allocation of such costs within both the Network Supply Contract and the Programme Pricing Agreement. It is unclear, given this contractual right, why the NCLs consider that they are unable to obtain this information; we would certainly expect ITV Network to supply the NCLs with the relevant information if requested to do so. However, should the NCLs remain concerned about the allocation of these costs and the information made available to them by ITV Network, they should present their arguments and evidence to us for our consideration.

Cross-promotion agreements

Description

- 4.67 Cross-promotion rights give the Channel 3 licensees the opportunity to promote related services as part of the networked Channel 3 service, both inside and outside programme content. Promotional material generally relates to programming on ITV plc's digital channels (such as same-day programme repeats, spin-off programming or related sports content), but may also include commercial services and internet services run by the licensees.
- 4.68 There is an obligation within the merger undertakings for ITV plc to provide the NCLs with a clean broadcast feed.³⁷ However as noted above, each of the NCLs subsequently signed bilateral agreements with ITV plc which stated that, in return for an annual payment, they would:
- 4.68.1 carry a specified level of cross promotional material;
 - 4.68.2 carry additional cross-promotions "at no cost to ITV plc"; and
 - 4.68.3 not seek to "remove, obliterate or obscure" ITV branding in a range of network programming.

Assessment

- 4.69 As compared against the three criteria for assessing whether an arrangement is a networking arrangement for the purposes of Part 3 of the Act, we consider that,

³⁶ See our 2008 review statement, paragraph 5.51-5.53 at http://www.ofcom.org.uk/consult/condocs/itv_network2008/statment/nwa_2008.pdf

³⁷ This is defined in the Undertakings as "the provision of a broadcast transmission feed of the Channel 3 Network schedule of all programmes including end credits but free from all end credit promotions and end credit announcements, commercials, other promotions, interstitial material and continuity announcements not relevant to the regions served."

- 4.69.1 Because each of the NCLs has entered into separate contractual agreements with ITV plc over the use of cross-promotion on the regional Channel 3 network, the agreements do not fulfil the first criterion;
 - 4.69.2 As the bilateral agreements specifically apply to promotion of services which are not broadcast on the Channel 3 services, the cross promotion agreements do not fulfil the second or third criteria.
- 4.70 The individual bilateral agreements between the NCLs and ITV plc, do not meet the section 290 criteria for NWA. As a result, we do not consider the cross promotion agreements have sufficient nexus with the NWA to be relevant to an assessment of the cost burden which the NWA place on the licensees.

ITV branding

Description

- 4.71 According to the Spectrum report, the legal title to the ITV brand is held by ITV Network, with rights of use for each of the Channel 3 licensees on the regionalised network service.³⁸ In December 2002, Carlton and Granada entered into a Brand Licence Agreement with ITV Network. Under the terms of this agreement, ITV plc procures from ITV Network the right to use the ITV brand outside the Channel 3 service, for example in relation to its digital channels.
- 4.72 As with the cross-promotion and spare multiplex capacity agreements, use of the ITV brand is subject to a series of bilateral agreements between ITV plc and the NCLs, signed after the merger of Carlton and Granada. These agreements grant ITV pc the right to exploit the ITV brand however it wishes, provided it complies with the terms of use in the Brand Licence Agreement, on a royalty free basis.

Assessment

- 4.73 As compared against the three criteria for assessing whether an arrangement is a networking arrangement for the purposes of Part 3 of the Act, we consider that,
- 4.73.1 ITV Network, acting as agent on behalf of all the licensees, is party to the brand licence agreement with ITV plc. As a result the brand licence agreement fulfils the first criterion;
 - 4.73.2 However, the Brand Licence Agreement specifically applies to the use of the ITV brand by ITV plc outside broadcast Channel 3 services. As a result, the Brand Licence Agreement does not fulfil the second criterion; and
 - 4.73.3 Although the ITV brand is an asset collectively owned by the Channel 3 licensees, the Brand Licence Agreement exists specifically to enable one party – ITV plc – to exploit the brand within its own business interests outside of the Channel 3 network. As a result the Brand Licence Agreement does not fulfil the third criterion.
- 4.74 The Brand Licence Agreement does not meet the section 290 criteria for NWA. As a result, we do not consider the Brand Licence Agreement has sufficient nexus with the NWA to be relevant to an assessment of the cost burden which the NWA place on the licensees.

³⁸ STV and UTV do not use the ITV brand in their services.

Carlton-Granada merger undertakings cap

Description

- 4.75 Consolidation amongst the Channel 3 licensees during the 1990s meant that by 2002 two companies held eleven of the fifteen regional Channel 3 licences: Carlton Communications plc and Granada plc. In October 2002, Carlton and Granada announced a proposed agreed merger. This merger was then referred by the Secretary of State for Trade and Industry to the Competition Commission in March 2003.
- 4.76 In its report in October 2003, the Competition Commission recommended that the merger should be allowed, subject to undertakings intended to protect the position of the non-consolidated licensees in relation to the operation of the NWA and competition in the TV advertising market. Among the undertakings given by Carlton and Granada (ITV plc post-merger) was to 'cap' the contributions made by the NCLs to the Network Programme Budget at their 2003 levels, increasing annually by RPI.³⁹
- 4.77 ITV plc has argued that the merger undertakings cap represents a cost to it under the NWA because the terms of the undertakings increase its own contributions to the NPB.

Assessment

- 4.78 As compared against the three criteria for assessing whether an arrangement is a networking arrangement for the purposes of Part 3 of the Act, we consider that,
- 4.78.1 the merger undertakings were given by Carlton and Granada to the Secretary of State. As such, the merger undertakings do not fulfil the first criterion;
 - 4.78.2 the merger undertakings fulfil the second and third criteria because they include terms relating to the NPB, i.e. the fund used by ITV Network in order to commission and acquire programming to be shown by the regional licensees across the national Channel 3 service.
- 4.79 The undertakings do not meet the section 290 criteria for NWA. In addition, although the operation of the cap does have a financial impact on all of the licensees, we consider that it is a cost that arises from the Carlton-Granada merger and was designed to ensure that the merged ITV plc does not operate against the public interest. It is a cost specific to ITV plc, rather than being a common cost deriving from the operation of the network service. As a result, we do not consider the cost to ITV plc of the cap under the merger undertakings has sufficient nexus with the NWA to be relevant to an assessment of the cost burden which the NWA place on the licensees.

Additional arrangements

- 4.80 In their rebuttal to the Spectrum report, the NCLs argued that we should take a number of further areas into account in our assessment of the net effect of the inter-licensee financial arrangements. As discussed in paragraph 3.17 above, they argued that "any consultation" which fails "to take account of all intra Licensee arrangements,

³⁹ For a description of the merger undertakings see our 2005 review consultation, paragraph 3.20. The full text of the undertakings can be found at: <http://www.adjudicator-crr.org.uk/pdfs/undertakings.pdf>.

whether they are strictly part of the NWAs, or not" would be "flawed". In addition to the arrangements for the allocation of costs between ITV Network and ITV plc for spin-off programming and the acquisition of rights by ITV Network on behalf of "ITV entities" including ITV Play and ITV Mobile discussed above,⁴⁰ they have also raised the sharing of revenue derived from premium rate services and the allocation of back end revenue shares from programmes commissioned by ITV Network.

Revenue from premium rate services

- 4.81 The NCLs argue that ITV Network has been "slow to account" for costs allocated to activities involving PRS and maintain that these deductions "require further investigation". The NCLs also contend that PRS revenue is inappropriately allocated on the same basis of contributions to the NPB; the NCLs believe that revenue should be shared on a QR basis.
- 4.82 We have not seen and are unaware of the terms under which ITV Network allocates the revenue generated from PRS in network programming. As a result, we are unable to offer a view at this stage as to whether allocation of this revenue could be a matter which could be considered germane to the financial arrangements within the NWA, even though they are clearly not within the current NWA. As a result, we invite the regional licensees and ITV Network in their consultation responses to provide an account of the relevant processes and revenue sharing principles. We also invite the licensees to explain why either cost allocation or revenue sharing associated with PRS has sufficient nexus with the NWA to be relevant to an assessment of the cost burden which the NWA place on them.

Allocation of back-end revenue derived from network programming

- 4.83 The NCLs state that within the new Terms of Trade, ITV Network is entitled to receive a share of revenue from future sales of commissioned programmes, known as 'back-end revenue'. The NCLs argue that "it is not clear how or when ITV will account to the NCLs for their share of this revenue" and that although they believe back end rights are provided for in contracts with third party producers "they are not aware if it applies to long running series produced by ITV Studios."
- 4.84 We are unaware of the basis on which ITV Network allocates such revenue and are unclear as to how allocation of such revenue by ITV Network could be considered germane to the financial arrangements within the existing NWA. We invite the regional licensees and ITV Network in their consultation responses to provide an account of the relevant processes, to identify the programme commissions that they apply to and to set out the revenue sharing principles. We also invite the licensees to explain why this matter has sufficient nexus with the NWA to be relevant to an assessment of the cost burden which the NWA place on them.

Conclusion

- 4.85 In light of the preceding analysis, we propose that the agreements which are relevant to our assessment of cost sharing under the NWA are:
- 4.85.1 the Network Programme Budget;
- 4.85.2 the agreements relating to the allocation of Network Centre costs;

⁴⁰ See paragraph 4.59 ff.

- 4.85.3 the agreements relating to the transmission of the Channel 3 service; and
- 4.85.4 the agreements between ITV Network and PRS for Music for the licensing of performing and mechanical rights.

Q1: Do you agree with the basis on which we have determined which costs are relevant to an assessment of costs shared between the licensees under the NWA?

Q2: Do you agree with the assessments of relevance which we have made in relation to individual agreements? If not, please provide reasons to support your views.

Q3: Do you have any further information relating to the section on Additional Arrangements from paragraph 4.80 onwards which you consider to be relevant to our assessment of cost sharing under the NWA? In particular, we invite the Channel 3 licensees and ITV Network to submit further information on these issues.

Section 5

Economic Framework: Cost Sharing

Allocation of common costs

- 5.1 As indicated in Section 3 above, much of the debate between the licensees is couched in terms of whether or not there is a “subsidy” from one set of licensees to another and, if so, what is the scale of that subsidy.
- 5.2 ITV plc has argued that it subsidises the NCLs’ contributions to the NWA. That is, ITV plc argues that there is a net “transfer of value” in the financial arrangements which are subject to regulation from ITV plc to the other licensees and that this should be considered to be a subsidy from ITV plc to the NCLs. Where there is a net transfer of value within commercial arrangements (i.e. those financial arrangements which are not subject to regulation), ITV plc either argues that such transfers do not constitute a subsidy – such transfers being part and parcel of normal commercial relationships – or that there is no opportunity cost to the NCLs.
- 5.3 Conversely, the NCLs argue that we should take into account all of the various financial arrangements between the licensees and should not distinguish between regulated and non-regulated financial arrangements. The NCLs argue that, taking all the various flows into account, there is in fact a (significant) net benefit to ITV plc from being a part of the Channel 3 network. That is, the benefit that ITV plc derives is greater than the amount it pays to the NCLs.
- 5.4 Although the term “subsidy” may be a convenient, shorthand way to describe the outcome of these interactions, we consider that there is a need to be precise about how the net flows involved in the different types of financial arrangements are characterised and described.
- 5.5 Ofcom considers that the appropriate way to consider the impact of the various financial arrangements relating to the provision of the ITV1 networked service is in terms of the allocation of common costs between the licensees.

Common costs

- 5.6 As set out in the previous sections, the operation of the Channel 3 network and the creation of the network schedule requires a number of inputs. These inputs include activities such as commissioning and acquisition of programming, the transmission of the Channel 3 network service and the operation of the Network Centre.
- 5.7 In economic terms these inputs represent the *common costs* of the provision of the Channel 3 network service. In general terms, common costs are costs which are incurred by an organisation and which cannot be allocated directly to a specific activity or department within that organisation. In the case of the NWA, the costs of providing the Channel 3 network service are common across all the licensees rather than being attributable to individual licensees. This is in contrast to the costs of (say) regional programming obligations where the costs would be specific to the particular licensee. The key issue in relation to the financial arrangements that are relevant to the NWA is therefore one of common cost allocation i.e. how the common costs involved in the commissioning, scheduling and distribution of the service on a national networked basis should be shared between the Channel 3 licensees. Therefore, we discuss the financial arrangements that are relevant to the NWA in

terms of the sharing of common costs and not in terms of whether one party is “subsidiising” another or not.

- 5.8 We are also mindful that some of the Channel 3 licensees also own and operate other TV-related services e.g. other TV channels, websites etc. which make use of some of the same assets/infrastructure as Channel 3. This means that for the purposes of the review of the NWA there are a series of prior cost allocation issues that need to be taken into account to make sure that there is a clear framework for the identification and analysis of the common costs which are relevant to the provision of the Channel 3 network service. These issues include the identification of common costs which are relevant to the provision of the national networked service; the extent to which the common costs could be influenced by the underlying ownership structure; and the relationship between the costs/revenues that are common to the provision of a national networked service and those which relate to the provision of other TV-related services. We discuss this set of issues below.

Scope of analysis

- 5.9 For the purpose of this review of the NWA, we need to establish a clear framework for the identification and analysis of the common costs which are relevant to the provision of the Channel 3 network service. This involves distinguishing between costs which are specific to regional licensees and costs which are specific to the provision of the network service.

Licence specific costs

- 5.10 Each regional Channel 3 licence carries with it certain regional programming obligations (together with the authority to use certain broadcast frequencies and transmitter sites). The costs relating to the provision of these regional programming obligations are not common to the provision of a networked Channel 3 service in that they are licence-specific and are not shared between licensees. These costs would be incurred even if all the licensees were under common ownership because they are specific to the individual licences. They are not relevant to the review of the NWA.

Costs shared with other services

- 5.11 In a number of instances, there are costs that are relevant to the provision of a national networked service but which are also shared between Channel 3 and other ITV plc owned channels i.e. ITV2-4, itv.com etc. For example, in relation to the acquisition of some programme rights (e.g. sport, film, entertainment shows) ITV Network acquires rights for use across both the Channel 3 network service and also ITV2-4. In this situation there is an initial attribution of the costs of acquisition between Channel 3 and the other services that make use of those rights before the costs common to the Channel 3 network service can then be allocated between the different licensees. There are also functional activities which ITV Network and/or ITV plc carries out on behalf of Channel 3 and the channels wholly owned by ITV plc.
- 5.12 As set out in section 4, the basis on which those initial cost attributions between Channel 3 and other services are made has been agreed between ITV plc and the other licensees. Because that agreement is reflected in commercial contracts between ITV plc and the NCLs we do not propose to examine those allocation systems as part of the review.

Common Costs for ITV1

- 5.13 The starting point for our quantitative analysis is therefore the position after allocation of costs to the provision of a national Channel 3 service: we take the existing regional structure of licences as given. As part of considering the allocation of these common costs, we note that some aspects of these common costs could be influenced by the underlying ownership structure.
- 5.14 In most cases the level of certain categories of common costs is independent of the existing ownership arrangements. For instance, the NPB is a common cost of the provision of a national networked service and we assume that the level of the NPB is not related to whether the licensees were under common ownership or not. We have applied the same presumption to the NPB, the transmission costs of the Channel 3 network service and the PRS for Music licence.
- 5.15 In the case of the costs of the Network Centre itself, the level of the costs incurred is influenced by the fact that the licences are not under common ownership and the resulting need for mechanisms to ensure a degree of co-ordination between the licensees. The operation of a network centre is a function of the need to have a system for taking decisions and reporting in relation to the commissioning, acquisition and scheduling of programming for a national networked service across a set of licensees that are not under common ownership. That is not to say that all the costs of the network centre function arise solely as a result of the ownership structure. If the regional licensees were under common ownership, decisions would still need to be taken in respect of the commissioning, acquisition and scheduling of a national networked service. However, it would not require a separate entity to carry out these activities: they could be carried out in-house and so the actual level of costs is influenced at the margin by the underlying ownership structure.
- 5.16 The identification of these two different categories of common costs (i.e. those costs which are independent of the underlying ownership arrangements and those which are likely to be influenced by the ownership arrangements) is important in that it provides us with a framework for identifying relevant cost drivers. The focus of the review of the financial arrangements that underpin the NWA, however, is not on the level of these common costs (e.g. whether they are incurred efficiently) but on how the costs are shared between the licensees. As a starting point we assume that – given the existing licensing structure – these common costs have been incurred efficiently.

Approaches to cost allocation

- 5.17 It is important to be clear at the outset that there is no definitively correct way of allocating common costs between the different parties either at an initial allocation stage (say) between the Channel 3 network service and ITV2-4 or then between the regional Channel 3 licensees. However, in order to evaluate the impact of the existing cost sharing arrangements that are relevant to the NWA, we do need to consider alternative allocation methods which could act as a benchmark against which to compare the existing arrangements.
- 5.18 In terms of developing relevant benchmarks, we start by considering which economic principles are relevant to our evaluation of alternative cost allocation methodologies.

Economic principles of cost sharing

- 5.19 In this section we set out five principles of cost allocation that have been developed in the context of cost sharing within telecommunications networks. These five principles are designed to ensure cost recovery mechanisms promote efficiency, sustainable competition, and maximise consumer benefit.⁴¹ Although developed in the telecommunications sector, we consider that the principles are appropriate for a consideration of cost sharing mechanisms in other contexts, such as the NWA.
- 5.20 We first set out the five principles and the rationale behind them and then move on to evaluate the extent to which different cost allocation mechanisms might meet these criteria. The principles listed below should provide a firm foundation for the analysis of cost allocation mechanisms.⁴² However, it should be noted that not all of these principles will be applicable in all circumstances, and that the list is not in any order of priority.

Cost causation

- 5.21 To ensure an efficient outcome, costs should be recovered from those whose actions cause the costs to be incurred at the margin. This principle is derived from the economic analysis of cost allocation which is based on marginal analysis and which looks at the benefits and costs of the marginal unit (the next unit) of an input. For instance, in economic terms it would only be efficient to use an extra unit of an input if the benefit it produced was at least as large as the cost of that unit of input.
- 5.22 The cost causation principle ensures that the parties are provided with the correct price signals when making purchasing decisions and (in the absence of externalities)⁴³ will lead to an efficient allocation of costs.

Distribution of benefits

- 5.23 Here the underlying principle is that the costs of an input should be recovered from the parties that benefit from the use of that input. This principle ensures that the cost allocation mechanism is fair as the parties that benefit from an input will contribute to the cost of that input. The principle also aims to secure economic efficiency.⁴⁴ If this principle did not hold then the consumption of an input may not reflect its true cost and benefit to society.
- 5.24 One way in which this principle could be put into practice, for instance, would be to allocate costs in line with revenue.

⁴¹ For instance, see “Principles of Implementation and Best Practice regarding cost recovery principles”, IRG (ERG), 24 September 2003.

⁴² The guidelines contain a sixth principle of Reciprocity. This relates to situations where identical or similar services are provided reciprocally. In such situations this holds that the charges should also be reciprocal. We do not consider that the costs of providing the Channel 3 network service involve reciprocal arrangements and therefore do not think that this principle is relevant to this case.

⁴³ An externality is a consequence of an economic activity/choice that is experienced by unrelated third parties, it occurs when the external effect on third parties is not taken into account when making decisions. Externalities can either be positive or negative. For example, there would be a negative externality if in the network one licensee benefits from an input, which adversely affects the operations of another licensee.

⁴⁴ This is also known as allocative efficiency. When this holds, the value placed on a good or service equals the cost of resources used up in its production.

Effective competition

- 5.25 It is important that a cost recovery mechanism should not undermine or weaken the pressures for effective competition. Effective competition is desirable because it provides strong incentives for firms to increase productivity, reduce prices and to innovate, whilst rewarding consumers with lower prices, higher quality, and wider choice. This principle can provide a rationale for moving away from a cost recovery system that solely reflects cost causation and distribution of benefits.

Cost minimisation

- 5.26 The mechanism for cost recovery should ensure that there are strong incentives to minimise costs. When costs are minimised there is productive efficiency, which means that the highest possible production of goods/services is being obtained from the inputs being used.

Practicality

- 5.27 The mechanism for cost recovery should be practical and relatively easy to implement. Although this is an important factor to consider for implementation it should not be the dominant factor in considering the appropriate cost recovery mechanism. For example, while the easiest cost sharing mechanism may be for each party to pay its own costs, the practical difficulties in implementing another, potentially more appropriate cost recovery system may not be significant.
- 5.28 We now move on to consider how these principles might be used to evaluate different cost recovery mechanisms.

Alternative cost recovery mechanisms

- 5.29 In the Spectrum report which formed part of the ITV plc submission to the Second PSB Review,⁴⁵ Spectrum set out a comparison between the existing arrangements and an allocation based on the licensees' share of Qualifying Revenue ('QR') for each of the financial arrangements that was analysed. Spectrum described the share of QR approach as being "the proportionate approach" in the absence of a more directly attributable basis, on the grounds that it reflected the revenue generated by each regional service (in particular from advertising and sponsorship). Spectrum also pointed out that the share of QR approach was already incorporated into paragraphs 4.1-4.3 of the Services Agreement in the absence of agreement as to a more fair and reasonable method of allocating charges.
- 5.30 We note that the NCLs seem to accept that costs should be shared on the basis of qualifying revenue as well. In their rebuttal to the Spectrum report, the NCLs stated that:

"The underlying principle of the Channel 3 broadcasting licences was to ensure that arrangements are in place to provide a national Channel 3 service by bringing together a federation of regional Channel 3 services ... Any federal system of regional broadcasters, such as the regional Channel 3 service, which is to compete effectively (as a whole) must have a system of cost sharing which matches revenue entitlement. Any other system will fail to deliver the public policy objectives of regional television".

⁴⁵ See Section 3 above.

- 5.31 Thus a cost allocation mechanism based on licensees' share of QR is already contemplated and approved by the licensees. However, we consider that it is relevant to look at other cost recovery mechanisms as well.

Share of viewing

- 5.32 From our analysis of the various financial arrangements between the licensees, we note that the costs of rights acquired by ITV Network for use on both the Channel 3 network service and the ITV plc digital channels are shared between the different channels [X]. It may therefore be possible to use share of viewing for individual licensees to allocate costs of the ITV1 networked service between the different licensees. BARB audience data is compiled at the level of the different ITV regions and so it is possible to calculate the audience share for individual regions.

Willingness to pay

- 5.33 Willingness to pay is an economic concept and is a measure of the maximum that an individual or firm would be prepared to pay for a particular product/service or input. It is relevant to the concept of economic efficiency in that it is linked with the balancing of marginal benefits with marginal costs. In theory, the maximum a firm would be prepared to pay for an input is the full extent of the profit it expects to derive from being able to use that input. In that situation, it would be no worse off than it was before. If a consumer or firm obtains a product/service or input for less than the maximum it was prepared to pay then it derives a "surplus". If it were to pay more than the value that could be derived from use of that input that would be an inefficient use of resource.
- 5.34 Given that, in general terms, advertising revenue tends to be driven by audiences, we would expect there to be a close correlation between share of QR, share of viewing and willingness to pay. However, we consider that it is worth evaluating the different approaches separately to see if there are particular advantages to one approach or another.

Qualifying revenue

- 5.35 QR is a measure of advertising and sponsorship revenue derived from broadcasting the regional Channel 3 service in the licence area. Given the geographical nature of the licence areas each licensee has an exclusive right to this revenue.⁴⁶ This would imply that using this cost recovery mechanism, the common costs of the Channel 3 network would be allocated in proportion to each licensee's share of the QR earned from the ITV1 service. So if a licensee had a 50% share of the QR, then it would pay 50% of the common costs.
- 5.36 The use of QR has a number of clear advantages. Firstly, it is a clearly defined metric and it has already been used to allocate a number of network costs. QR is also an established measure as it has been used by the licensees since at least 1990 as the starting point for the calculation of payments to the NPB under the C1/C2 formulae. At the same time it is conceptually appealing in that it is a measure or proxy for the share of the benefit that each licensee derives from being a member of the ITV1 network (i.e. from the sale of television airtime). It can thus be regarded as a measure of the licensee's ability to pay.

⁴⁶ This excludes revenue streams from sources unrelated to the regional network broadcasting of Channel 3.

- 5.37 We recognise that there are some potential difficulties with using QR shares to allocate common costs. Historically, advertising and sponsorship revenue have been clearly derived from the ITV1 service. In the case of advertising revenue, the CRR mechanism requires there to be separate contracts for advertising on ITV1 compared to other ITV plc services. However, manufacturers/service providers seeking sponsorship deals are able to enter into agreements which cover not just Channel 3 but also ITV2-4 and itv.com. In those situations there needs to be a mechanism for allocating the revenue between the different services in the first place in order to arrive at a figure for the revenue to be attributed to the Channel 3 network service and which would form part of the relevant QR. While these sponsorship arrangements currently only represent a small proportion of the total QR for Channel 3 then the attribution methodology may not be significant. However, if such arrangements came to form a more significant proportion of the total revenue then there could be an argument for the parties to agree processes to ensure transparency of these arrangements to ensure that these attribution arrangements produce an appropriate distribution of revenue.⁴⁷
- 5.38 Given that the NWA relate to the provision of a national networked service and the costs relating to the provision of that service, we do not at this stage propose to consider the basis on which revenues generated by the networked service are shared between the licensees.
- 5.39 Ofcom is also aware that the NCLs have at various times raised concerns about the transparency of the underlying reporting requirements for revenue sharing but Ofcom considers that these are, in the first instance, contractual rather than regulatory matters. Where there is concern about the basis on which sponsorship revenues are shared, the NCLs should in the first instance have regard to their contractual rights of audit. Ofcom is aware that STV has gone down this route in relation to its airtime sales contract with ITV plc. We await the outcome of the current legal dispute between STV and ITV plc before considering whether separate contractual or reporting arrangements for sponsorship (or other revenue generated by the networked service) may be required.

Share of viewing

- 5.40 An alternative cost recovery mechanism could be based on each licensee's share of the total network viewing. As with QR, this metric could be applied each year based on each licensee's average share of viewing ('SoV') over the previous year. Under this allocation mechanism, if a licensee had, on average, a 50% share of the network's total viewing over the previous year, then it would pay 50% of the common costs for the following year.
- 5.41 On the assumption that there is a link between SoV and advertising/sponsorship revenue, SoV should be a proxy for the benefit that each licensee receives from the participating in the network. That is, as set out above, SoV would be expected to be strongly correlated with QR. However, the value of different geographical audiences across the UK is not homogenous. For instance, advertisers may place a higher value on reaching viewers in certain parts of the country than in others. SoV would not reflect this in the same way that (say) QR would. As a cost recovery mechanism, SoV would thus appear to be one step removed from the ability of QR share to capture a licensee's ability to pay.

⁴⁷ For instance, it is not clear that ITV plc's incentives are necessarily aligned to ensuring that the attribution of revenue as between the ITV1 service and the other ITV plc services is appropriate.

- 5.42 In practical terms, data on SoV for each licensee can be readily obtained from BARB data, so this mechanism should be easy to implement. However, there could be measurement issues around calculating SoV e.g. around incorporating non-syndicated programming and devolution opt outs.

Willingness to pay

- 5.43 In order to apply this concept in this case we could seek to equate willingness to pay for inputs with the profitability of the different licensees' broadcast businesses. One approach might be to seek to equalise the profitability of the different licensees (or at least bring profitability more into line) with the more profitable licensees making a higher contribution to the common costs. However, there are likely to be significant issues in developing a practical measure of profitability in this context.
- 5.44 We have considered the use of EBITDA ('Earnings before Interest, Tax, Depreciation and Amortisation') which would be reported in annual accounts as a proxy for profitability. However, we are aware of a number of practical issues with implementing such a measure on a consistent, robust basis. For instance, each of the Channel 3 licence holders are multi-product firms: UTV also operates radio stations, STV and ITV plc have production businesses and Channel provides compliance services. There are thus practical issues in ensuring that all the licensees identified the costs relevant to their broadcast licence on a consistent basis.
- 5.45 Even if it were possible to identify the costs of the broadcast licence there would be the need to consider whether those costs have been in fact been efficiently incurred. There would obviously also be an incentive for broadcasters to overstate their costs in order to reduce the scale of their contribution to the common costs of the Channel 3 network service and this could have an adverse effect on the other licensees. In order to avoid this concern, there would be the need to audit the cost allocation mechanisms used by the different licensees. Given the fixed cost nature of their businesses, it is also the case that relatively small changes in revenue can have significant impact on the profitability of the licensees. If there is a degree of volatility in operating profit then there is the possibility that contributions could fluctuate quite significantly from year to year. It is also possible that there could be a degree of volatility in QR between different licensees such that there could be volatility in relative profitability.
- 5.46 In addition to issues around cost allocation, there could also be issues in terms of the identification of revenue appropriate to the broadcast licences as well.
- 5.47 An initial evaluation indicates that, in terms of our principles for evaluating different cost sharing mechanisms, there are likely to be significant practical issues in seeking to apply a measure of "willingness to pay". This would tend to suggest that although we can discuss this as another potential benchmark, in practical terms QR share is likely to have a significant advantage.

Assessment of alternative cost allocation methods

- 5.48 In terms of determining which cost allocation mechanism to use as our benchmark, we have evaluated the three alternative approaches against the five principles identified above to assess consistency with those principles. A comparison of the three approaches against the five principles is set out in the table below:

Table 2: Comparison of Alternative Cost Allocation Methods

Economic Principle	Comment
Cost Causation	Dealing with allocation of common costs so it is not clear that any one mechanism has a particular advantage over another from the Ingenious of cost causation.
Distribution of Benefits	<p>Conceptually, “Willingness to Pay” would directly capture the benefits derived from the operation of the ITV1 networked service in that it would factor in both the revenues and costs associated with being a regional Channel 3 licensee.</p> <p>QR would be one step removed from willingness to pay in that it measures the revenue from airtime sales and sponsorship derived by individual licensees. It is thus able to take into account the relative advertising value of the audience in each region even if it does not factor in the costs in serving those audiences.</p> <p>SoV is one step removed from QR and so would not reflect the benefits as directly. It also assumes that audiences across the country have an equal value to advertisers whereas in reality audiences in one region of the country may be more valuable to advertisers compared to audiences in another region.</p>
Effective Competition	<p>None of the allocation methods would appear to have a particular advantage over another.</p> <p>We do recognise that the NCLs have raised issues about the arrangements by which itv.com gets access to content commissioned by ITV Network and the potential implications for competition between ITV plc services and their own services. However, we consider that the 2008 review put in place arrangements for addressing access to new media content.</p>
Cost minimisation	<p>Given the current ownership structure, the incentives for cost minimisation should be the same under both QR and SoV approaches to cost allocation. For instance, ITV plc as owner of eleven regional Channel 3 licences has both the largest QR and SoV and in so far as ITV plc carries out activities on behalf of ITV Network it should have a clear incentive to reduce costs given that it ends up paying the vast majority of those costs.</p> <p>If willingness to pay were evaluated using a measure of profitability then incentives to minimise costs could be affected.</p>
Practicality	<p>QR share is practical and easy to implement and its use should not inhibit the ability of the regional Channel 3 services to operate as a nationwide system. We recognise that there could be an issue in relation to the allocation of sponsorship revenues across ITV1 and ITV plc multi-channels.</p> <p>There are a number of potential implementation problems in relation</p>

	<p>to the use of SoV and willingness to pay.</p> <p>In relation to SoV there would be measurement issues with non-syndicated programming and devolution opt outs.</p> <p>In relation to willingness to pay there could be issues around the need to standardise the basis for revenue and cost reporting across the licensees and also the risk of volatility in payments from year to year.</p>
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- 5.49 As indicated in paragraphs 5.21 and 5.22 above, the cost causation principle (i.e. recovery of costs from those whose activities cause the costs to be incurred in the first place) is a precursor to an economically efficient outcome. As we've endeavoured to establish above, the costs of the ITV1 networked service are common to all the licensees collectively and so it is not always possible to use this mechanism to allocate costs to individual licensees. Where cost causation is not available, we consider that – as a starting point QR would appear to provide a better benchmark against which to evaluate the existing cost sharing arrangements that are relevant to the NWA than a mechanism based on SoV or willingness to pay, although it will be correlated with these two measures. This is because QR better meets the principles relating to the distribution of benefits and practicality.
- 5.50 We note that there is a potential issue in relation to the visibility that the NCLs have over the way in which ITV plc allocates sponsorship revenue between the ITV1 service and ITV plc owned channels and itv.com, where the revenue has been derived from a single contract which applies across all the different services. As indicated in Section 4 we would encourage the licensees to engage with one another to resolve these issues.

Q4: Do you agree with the alternative cost allocation methodologies and our evaluation of their suitability as benchmarks? Should we consider different benchmarks for different categories of costs?

Q5: Are there other potential allocation methodologies that should be considered? If so, please set out your proposed cost allocation methodology and also how it fits with the economic principles set out above.

Section 6

Evaluation of Financial Arrangements

Introduction

- 6.1 Section 5 established that – as a starting point – QR share would provide an appropriate benchmark against which to evaluate the existing cost sharing arrangements if direct cost causation is not appropriate. The purpose of this section is to seek to apply these approaches (cost causation and QR) as benchmarks against which to compare the cost sharing arrangements contained in the financial agreements identified in Section 4 as being relevant to the NWA. There are two important points to note.
- 6.2 The first is that, in a number of instances, the common costs incurred include costs of providing services in respect of ITV2-4 as well as ITV1. In such cases, there is a need for an initial cost attribution to identify those costs which are relevant to the provision of the ITV1 networked service. These initial attribution methodologies do not necessarily use a QR share approach. We do describe the initial attribution methodology where relevant but as set out in Section 5 we do not propose to examine the underlying methodologies.
- 6.3 We identified QR share as an appropriate benchmark to use for the allocation of common costs because it was not possible to identify a particular licensee as having given rise to a particular cost. Where it is the case that cost causation can be identified – see for instance some aspects of transmission costs below – we would propose then to use a cost causation approach instead on the grounds that this is likely to lead to a more efficient outcome (see Section 5 above).
- 6.4 As set out in Section 5, in evaluating the impact of different cost allocation mechanisms in the context of the NWA it is important to bear in mind that we are focusing on the allocation of the common costs incurred in relation to the provision of the ITV1 networked service. This means that we are concerned with the costs of the provision of a national networked service.
- 6.5 It is important to be clear about the implications of this for our analysis. It does not mean that we are concerned with the assessment of the incremental costs of providing a national networked Channel 3 service if there was already (say) a service covering England and Wales or England, Wales and Northern Ireland or some permutation of the existing Nations. Rather, the relevant increment is the provision of a national networked service *given* the existing regional structure of Channel 3 licences. It does mean that we are focusing on the allocation of (say) the costs of the NPB as a cost common to the provision of a national networked service but are not taking into account the costs of specific regional programming obligations. The regional programming obligations are clearly part of the provision of PSB but they are not relevant to the provision of a national networked ITV1 service which is the focus of the NWA. We note that the cost of ITV's regional programming obligations has already been considered in assessing the costs and benefits of ITV's PSB obligations as a whole.⁴⁸

⁴⁸ See for instance, *Sustainable, independent and impartial news: in the Nations, locally and in the regions. Ofcom's public response to the DCMS consultation.* (Ofcom: September 2009).

- 6.6 This approach would also mean that we would take into account the costs of the ITV Network Centre that relate to the provision of the ITV1 networked service as a common cost of providing a national service. It also means that in relation to various transmission costs we assume that the relevant costs are those in relation to the provision of a national Channel 3 service that has an obligation to achieve 98.5% coverage for analogue and digital terrestrial transmission and a must offer obligation to major platforms. We would not, for instance, be assessing the incremental transmission costs in providing a service (say) to Scotland and/or Northern Ireland in addition to providing a service to England and Wales.
- 6.7 These issues are discussed in more detail below.
- 6.8 The financial information used in this section is based on data contained in the Spectrum report. We have confirmed with the NCLs that they agree with the headline figures in that report so that it should provide a reasonable basis for evaluating the cost allocations mechanisms for the purposes of this consultation.

Financial arrangements specified within the NWA

- 6.9 In section 4 we identified four categories of costs which are relevant to the provision of the ITV1 networked service and so are directly relevant to the ITV NWA. In this section we compare the current cost sharing arrangements for these cost categories with a relevant cost sharing benchmark.

Network Programme Budget

- 6.10 Contributions to the ITV NPB are the payments made by licensees to meet the NPB after taking into account the impact of regional opt-outs. The NPB does not include the costs of licensees' individual regional programming obligations: these are separate costs which are specific to the individual licensees and are not common costs in relation to the provision of the ITV1 networked service.
- 6.11 Licensees' contributions to the ITV NPB are determined by the C1/C2 formulae which were originally devised by the ITC in 1991. The C1/C2 approach takes as its starting point QR shares as a basis for sharing the common costs of the NPB but then the two formulae arrangement reduces the contribution of the smaller licensees relative to the simple QR share allocation. The difference relative to the QR share allocation is made up through increased contributions from the larger licensees, shared in proportion to their size.
- 6.12 The rationale behind the introduction of the C1/C2 approach was that it should reflect licensees' "ability to pay". The ITC considered that the fixed costs imposed by the regional programming obligations weighed more heavily on the smaller licensees who tended to have a lower earning potential. As it happens, all the successful applicants in 1991 offered a higher level of regional programming than was required in the Invitation to Apply ("ITA") documents but the C1/C2 formulae were not adjusted to reflect that when introduced in 1993.
- 6.13 Since their introduction the formulae have been revised twice. The first revision in 1995 increased the contributions of all the small companies by 8.5%. The second revision was in 1999 when Tyne Tees TV and Westcountry TV (as smaller licensees) had their contributions further increased.

- 6.14 We note that there have not been any changes to the formulae to reflect the reductions in regional programming obligations over time.⁴⁹ The level of regional programming obligations across all licensees is now lower than the minimum requirements set out in the ITC's original ITA⁵⁰ but there have not been any other changes to the C1/C2 arrangements since 1998.
- 6.15 Over the period 1993-2008, the total contribution by the smaller licensees to the NPB has increased. This is due to a combination of increased QR shares for most of the smaller licensees and changes to the contribution formula (as set out above). This means that the overall extent of support implicit in the C1 formula has fallen – in percentage terms – since the mechanism was introduced.
- 6.16 In addition to the C1/C2 formulae the contributions of each NCL to the NPB is also subject to the cap imposed in the Carlton-Granada merger undertakings (the “merger undertakings”). The concern at the time of the merger was that the merged entity – with de facto control of ITV Network Centre - could increase the NPB against the wishes of the NCLs knowing that the merged entity would be liable for less than 100% of any increase – the NCLs would pay a proportion of any increase. In order to address this concern, the merger undertakings provided that the contribution of the NCLs to the ITV NPB should be capped at the level of their contributions to the NPB in 2003 uplifted in line with the change in RPI inflation.
- 6.17 Ofcom does not regard this cap on contributions to the NPB as being relevant to the consideration of the cost sharing arrangements within the NWA. The “cost” of the cap is a cost that is specific to ITV plc as a result of the 2003 merger and, notwithstanding that it is a regulated arrangement, it does not represent a common cost of the ITV NWA. On that basis, when comparing the current arrangements for sharing the costs of the NPB between the licensees, Ofcom will strip out the “cost” of the cap on contributions to the NPB.
- 6.18 Table 3 below sets out the position in respect of contributions to the NPB. Based on the discussion in Section 5 we consider that QR share is the appropriate benchmark to use in this case of common cost allocation.
- 6.19 The table sets out: the level of NPB against which contributions are calculated (i.e. taking into account where licensees (specifically the STV licensees) have opted out of the network schedule through devolution arrangements); the estimate of what the NCLs contributions would be without the merger cap; the actual level of the merger cap (taking the contribution to the NPB in 2003 and up-rating them in line with RPI inflation); licensees' actual contributions in 2009 based on the combination of the C1/C2 arrangements and the merger cap; and an estimate of what the licensees' individual contributions would be under a “pure” QR share approach.
- 6.20 Given that we propose to exclude the operation of the merger cap as a cost of operation of a national networked service, we focus on the difference between what the contributions would be under the C1/C2 mechanism (excluding the merger cap) and a pure QR share approach. We then calculate this difference for each licensee and also sum across all the NCLs.

⁴⁹ There has been the inclusion of specific devolution arrangements in respect of STV Central. We do not however propose to consider these in the context of this review as these arrangements are currently subject to litigation between STV and ITV plc.

⁵⁰ Directionally this would tend to lend weight to the argument that QR shares as a measure of ability to pay is an appropriate benchmark against which to consider the existing cost sharing arrangements.

Table 3: Licensee Contributions to NPB relative to QR benchmark (2009 figures) – £m

NPB Contribution	STV Central	STV North	UTV	Channel
NCL Specific NPB	[<]	[<]	[<]	[<]
C1/C2 formula allocation (excl. merger cap)	[<]	[<]	[<]	[<]
Merger Cap	[<]	[<]	[<]	[<]
2009 actual payment (i.e. taking account of merger cap)	[<]	[<]	[<]	[<]
Contribution under “pure” QR allocation.	[<]	[<]	[<]	[<]
QR share less current C1/C2 payment. A positive figure implies net benefit.	[<]	[<]	[<]	[<]
Combined impact across the NCLs (£m)	[<]			

Source: Based on estimates for 2009 provided by ITV plc in the Spectrum report.

- 6.21 Table 3 indicates that STV Central (as a larger licensee) would be better off under a pure QR share compared to the C1/C2 mechanism – by around £[<]. However, STV North as a smaller licensee pays only £[<] under the C1/C2 mechanism compared to £[<] under a QR share approach. Similarly, UTV and Channel as licensees with less than 4% QR also benefit from the C1/C2 mechanism compared to a QR benchmark: by around £[<] and £[<] respectively.
- 6.22 As discussed earlier the cost of compliance is treated as a component of the NPB and included within the figures above. Compliance is an administrative function which is undertaken on behalf of the ITV licensees in relation to Channel 3 network programming. It is an activity required to ensure that Network programming complies with Ofcom's Broadcasting Code and as such it is a common cost for the provision of the ITV1 networked service.
- 6.23 Taking into account the impact on the NCLs overall, the figures set out in Table 3 indicate that in 2009 the NCLs collectively paid £[<] less towards the ITV NPB under the current C1/C2 arrangements than they would have done under a QR share approach. Another way of expressing this is that in 2009 ITV plc paid nearly £[<] more under the C1/C2 arrangements than would be the case under a QR share approach.

Costs of Network Centre – contribution to network activities

- 6.24 ITV Network carries out a broad range of functions not just on behalf of the Channel 3 network service but also for the channels wholly owned by ITV plc (i.e. ITV2-4) and itv.com. The Spectrum report describes six main areas of activity:

- 6.24.1 Commissioning and scheduling: commission, acquisition and scheduling across ITV1 and the ITV plc channels
 - 6.24.2 Corporate Affairs: regulatory and corporate affairs
 - 6.24.3 Rights & Business Affairs: negotiation for network programme rights
 - 6.24.4 Finance: programme finance, Network Centre finance
 - 6.24.5 Operations and development: IT, technology, engineering, Network technology centre, HR and facilities
 - 6.24.6 Marketing: viewer marketing, customer communications, network promotions unit, Network continuity unit.
- 6.25 The costs of these activities are likely to be common to both the provision of the ITV1 networked service and the other ITV plc services. That means, as a first step, there needs to be a methodology for attributing the costs between the ITV1 networked service and ITV plc channels.
- 6.26 We understand that there is in place a series of cost attribution systems which depend on the nature of the cost to be allocated. For instance, in terms of staff costs where someone works on ITV1 and ITV plc issues the costs can be allocated between the services based on time sheet information. In other cases, rents and accommodation are allocated according to the office space used by ITV Network/ITV plc staff respectively. This enables there to be an initial attribution of costs as between ITV1 and ITV plc wholly owned services. However, as indicated above, we are not proposing to examine this initial cost attribution methodology but take the division of costs between ITV1 and ITV plc as given.
- 6.27 On the basis of data provided by ITV plc, it is estimated that the costs attributed to the Channel 3 network service represents [<X>%] of the total budget for Network Centre activities which equates to £[<X>] in 2009. The NCLs have confirmed that they understand this figure to represent the regional Channel 3 licensees' overall share of the cost of ITV Network Centre, although they qualified this by stating that they no longer had visibility of the overall costs of ITV Network Centre.
- 6.28 The current arrangements for allocating this common cost between the licensees stem from the 2005 review of the NWA. In that review, Ofcom proposed that the NCLs could opt to share costs on either a QR share approach (combined with greater transparency) or agree a fixed contribution which would then be uprated in line with RPI inflation combined with less onerous reporting obligations on ITV Network Centre. All the licensees chose to pursue the second approach and this is now embodied in the NSC and Services Agreement.
- 6.29 We compare the current allocation mechanism with a QR approach.
- 6.30 Table 4 below sets out the current amounts paid by the different groups of licensees; the amount that they would pay under a QR approach and also the difference between these two approaches. Where the difference is a positive amount, it means that the group of licensees is paying less than they would do under a QR share approach.

Table 4: Licensee Contributions to Network Centre relative to QR benchmark – £m

	ITV plc	STV	UTV	Channel
Current Allocation	[X]	[X]	[X]	[X]
QR Share	[X]	[X]	[X]	[X]
QR Share less current allocation	[X]	[X]	[X]	[X]
Combined Benefit for NCLs (£m)			[X]	

Source: Based on estimates for 2009 provided by ITV plc in the Spectrum report.

- 6.31 Table 4 indicates that in 2009 the NCLs collectively paid around £[X]⁵¹ less towards the cost of the Network Centre than they would do under a QR share approach. Again, another way of expressing this is that in 2009 ITV plc paid £[X] more under the current fixed contribution approach than would be the case under a QR share approach.
- 6.32 However, given that the parties agreed the new method of cost allocation for the costs of Network Centre following the 2005 review and in effect traded off lower payments in return for less detailed reporting about its operation, we do not see any reason to move away from what was agreed in 2005. The fact that this arrangement was agreed between the parties means that it has a similar status to the other commercial arrangements agreed between ITV plc and the NCLs and as a result we exclude the net cost/benefit of this arrangement from our evaluation of the costs and benefits to the different groups of licensees of the operation of the NWA.

PRS for Music licence

- 6.33 ITV Network negotiates a licence with PRS for Music (formerly the Mechanical Copyright Protection Society ('MCPS') and the Performing Rights Society ('PRS')) to allow the broadcast of recorded and live music performance on the Channel 3 service. This is therefore clearly a cost which is common to the provision of the network service.
- 6.34 It is our understanding that the [X] licence that was negotiated with effect from [X] covers not just the Channel 3 service but also services provided by ITV Consumer and the ITV plc family of channels (i.e. ITV2-4). We further understand that – for 2009 – there was a flat rate charge for ITV Consumer and then the remainder of the cost of the licence was allocated between Channel 3 and ITV2-4 on the basis of their share of total viewing. For 2009, this meant that ITV2-4 paid [X]. As before we do not propose to review this initial cost attribution methodology.
- 6.35 The result of this initial attribution exercise was that the cost allocated to Channel 3 was £[X] in 2009. This allocation of costs was then divided between the licensees on the basis of their C1/C2 shares. Again, the NCLs have confirmed that they accept the figures provided by ITV plc.

⁵¹ The difference between this figure and the £[X] shown in Table 4 is due to rounding.

- 6.36 We note the use of the Share of Viewing metric to allocate the share of costs between ITV plc wholly owned channels and Channel 3. ITV plc reported that PRS for Music costs were linked to the number of times music and performing rights are used in programming and the viewership/audience of that programming. As such the larger the audience of the channel, the greater the payment attributed to that channel. ITV plc therefore considered that Share of Viewing represented a fair/proportionate arrangement for the allocation of costs between ITV plc wholly-owned channels and the Channel 3 service.
- 6.37 Table 5 below sets out a comparison of the current allocation mechanism against a QR share benchmark. As before, Table 5 sets out the current allocation between the licensees (under the C1/C2 mechanism), the allocation under a QR share approach and the difference between the two approaches. Given that it is based on the C1/C2 mechanism we present results for each of the NCL licences separately.

Table 5: Licensee contributions to Cost of PRS for Music Licence relative to QR benchmark – £m

	ITV plc	STV Central	STV North	UTV	Channel
Current allocation	[X]	[X]	[X]	[X]	[X]
QR Share	[X]	[X]	[X]	[X]	[X]
QR Share less Current Allocation	[X]	[X]	[X]	[X]	[X]
Combined Benefit to the NCLs (£m)			[X]		

Source: Based on estimates for 2009 provided by ITV plc in the Spectrum report.

- 6.38 The data in Table 5 indicates that in 2009 the NCLs collectively paid just under £[X] less towards the cost of the PRS for Music licence under the current arrangements than they would do under a QR share approach. There was a small net benefit to STV overall (approximately £[X]), a benefit of £[X] to UTV and a small net benefit to Channel TV. Again, another way of expressing this is that in 2009 ITV plc paid nearly £[X] more under the current arrangements than would be the case under a QR share approach.

Costs of transmission

- 6.39 As indicated above, our starting point in evaluating the existing cost sharing arrangements has been to take QR share as a relevant benchmark. However, in the case of transmission, we consider that it may be possible to identify direct cost causation in some cases. Where that is the case, we would propose to use cost causation instead of QR share as the relevant benchmark.
- 6.40 There are currently separate cost sharing arrangements in relation to the costs of terrestrial transmission and the cost of satellite transmission. Under the terms of their existing PSB licences, the regional Channel 3 licensees are required to broadcast on

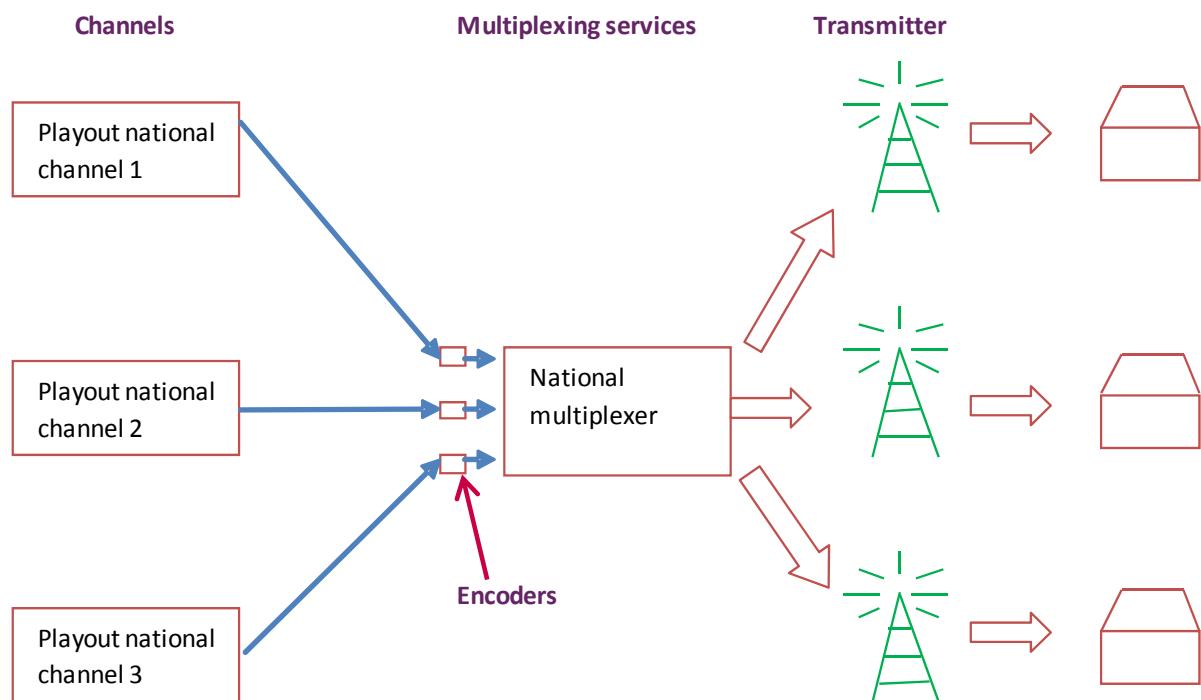
both the analogue and digital terrestrial platforms from specified transmitters and collectively the Channel 3 service has to achieve certain coverage targets. Historically the analogue terrestrial transmission network has reached approximately 98.5% of the population. At present the digital terrestrial transmission ("DTT") platform does not have the same level of population coverage. However, the process for Digital Switchover ("DSO") involves the switching off of the analogue terrestrial transmission platform on a region by region basis and at the same time the enabling of broadcasting in digital from a greater number of transmitters. By the end of DSO, the Channel 3 service will be required to achieve the same level of population coverage as was the case for analogue transmission i.e. 98.5%.

Terrestrial transmission

- 6.41 The process of DSO for television in the UK is underway, meaning that the costs of analogue transmission will fall to zero by 2012. In fact over the course of 2010, terrestrial television transmission in Scotland and the Channel Islands will be converted to digital and the analogue signal in Scotland will be turned off. DSO is scheduled to take place in Northern Ireland in 2012. Given that these payments are reducing and will fall to zero by 2012, we do not propose to evaluate the specific arrangements in relation to analogue terrestrial transmission.
- 6.42 For the digital terrestrial transmission network, the arrangements for cost sharing for "transmission" actually comprise costs relating to three separate activities: distribution, multiplexing, and transmission.
- 6.43 Distribution for the DTT network involves the costs of the distribution network carrying the Channel 3 service and the ITV plc digital channels from playout centres to the nationwide network of DTT masts.
- 6.44 Multiplexing involves the costs for multiplexing the regional DTT streams between the regional licensees for the C3 service and also the ITV plc wholly owned channels. At present the total cost relates to the multiplexing of a total of 31 streams for the Channel 3 service and the ITV plc digital channels taken together. 28 of the 31 streams relate to the Channel 3 service, the other three to the ITV plc wholly owned channels.
- 6.45 Currently, DTT Multiplex 2 is configured to broadcast across 28 regions so that Channel 3 can deliver regional advertising and programming across its different regions as a result of its PSB obligations.
- 6.46 Transmission for the DTT network involves the cost of running the DTT transmission masts which carry the Channel 3 service and the ITV plc wholly owned channels across the UK.
- 6.47 The diagrams below are stylised representations of differences between the equipment needed to provide national services and the equipment needed to provide regionalised services. What the diagrams illustrate is that the costs of multiplexing relate to the provision of multiplexing and encoding equipment and do not depend on the number of channels actually offering regionalisation – the capital and operational costs are incurred in configuring the Multiplex to broadcast each incremental regional variant.⁵²

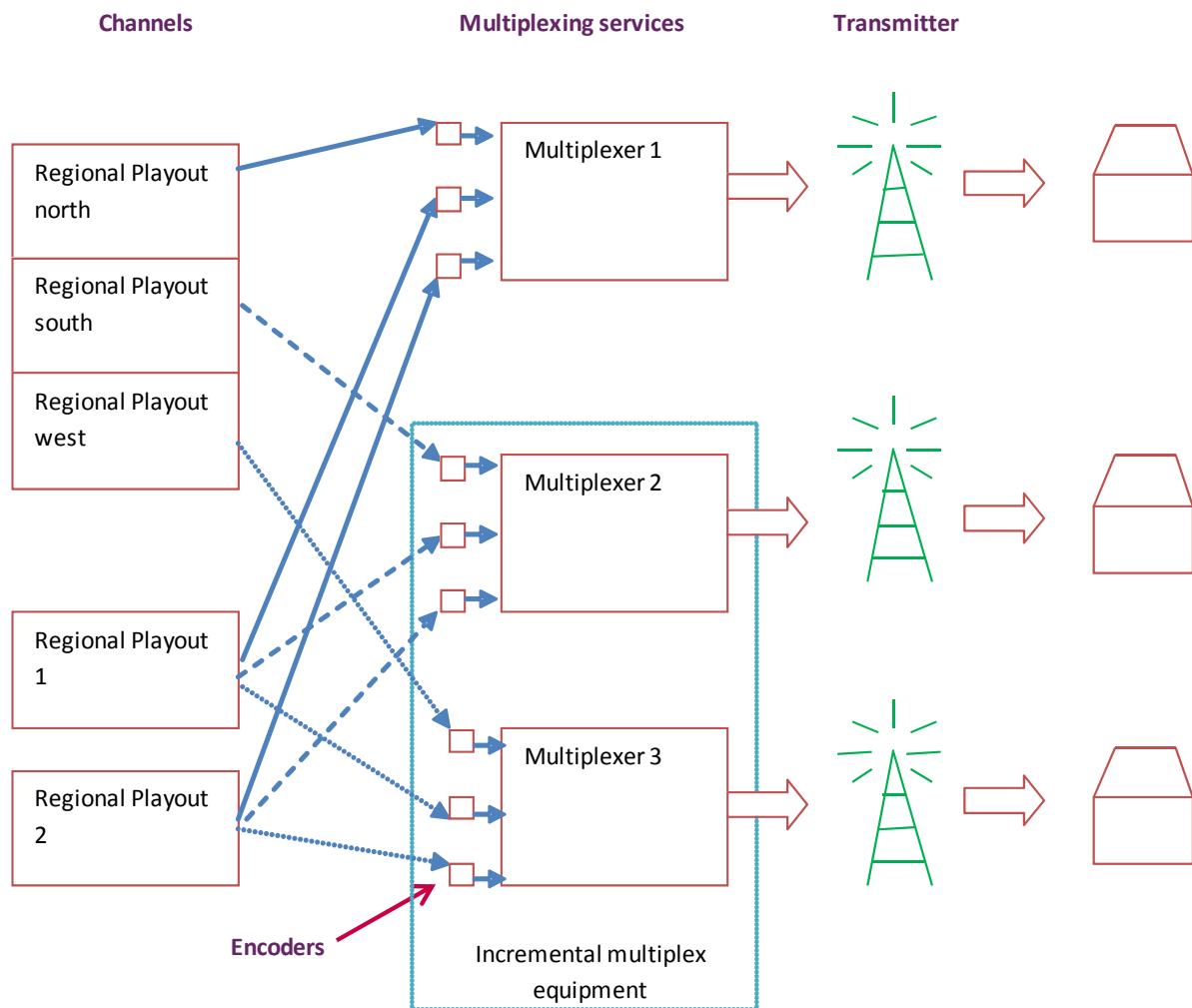
⁵² These diagrams have been derived from work carried out by Ofcom in the context of the Five-D3&4 Price determination. However, they do not rely on commercially sensitive information and were

Figure 1: National multiplexer arrangements with three channels



- 6.48 Figure 1 illustrates that to provide three channels on a national basis (without any regional variations), there could in theory simply be one encoder per channel and a single national multiplexer. In practice there is likely to be more equipment than this because there would be the need to build in a degree of back-up.
- 6.49 Figure 2 (below) illustrates how this position changes once regional variations are factored in. In the diagram we still have three channels but now one is broadcasting a series of regional variations (North, South and West) while the other two operate a uniform national service.
- 6.50 In order to provide the three regional variations there is now the need for three regional multiplexers (multiplexers 1-3) and also an encoder per stream at each multiplexer. Thus for the channel offering regional variations, it needs to deliver the "North" variant to multiplexer 1, the "South" variant to multiplexer 2 and the "West" variant to multiplexer 3. For the two channels offering a uniform national service they too now need to deliver their streams to each of the three multiplexers rather than a single multiplexer as in Figure 1. At each multiplexer there is still the need for an encoder per stream. The dotted lines in Figure 2 indicate the extra equipment needed to be able to offer regionalised variations for one channel.

Figure 2: Regionalised multiplex arrangements with three regions and three channels (incremental regional equipment shown)



- 6.51 The above diagrams indicate that some aspects of the costs of transmission are likely to be attributable directly to the services being provided. On that basis we consider that it may be relevant to depart from QR as the benchmark for cost allocation and instead consider the extent to which it may be possible to use cost causation directly i.e. which costs are relevant to the provision of a networked ITV1 service (and so are common to the licensees) and which are relevant to the provision of regionalised variants.
- 6.52 At present the costs of Mux 2 are split approximately equally between ITV Network and Channel 4 as the two partners in the D3&4 joint venture which holds the multiplex licence for Mux 2. There is then an initial attribution of ITV Network's share of the D3&4 costs between Channel 3 and the other channels that use ITV Network capacity on Mux 2. [><]. The costs of the three different components (distribution, multiplexing and transmission) that are attributed to the Channel 3 service are then allocated between ITV plc and the NCLs on the basis of "Transmission share within the Channel 3 stream".
- 6.53 Table 6 below sets out the current allocation of costs against the different cost categories that together make up the costs of "transmission".

Table 6: DTT Costs – Current Allocation among Licensees of each cost element (2009) – £000s

Cost Element	ITV plc	STV	UTV	Channel
Multiplexing	[X]	[X]	[X]	[X]
Transmission	[X]	[X]	[X]	[X]
Distribution	[X]	[X]	[X]	[X]
Other/Mgt	[X]	[X]	[X]	[X]
Total	[X]	[X]	[X] ⁵³	[X]

Source: Based on estimates for 2009 provided by ITV plc in the Spectrum report.

- 6.54 Table 6 indicates that the single largest component of the costs of transmission is the cost for multiplexing ([X]).
- 6.55 The current transmission share cost allocation mechanism means that the licensees are also contributing to these costs of transmission *broadly* in line with their QR shares. For instance, ITV plc paid just over [X]% of the total costs of transmission as well as just over [X]% of the costs of multiplexing.
- 6.56 ITV plc has, however, argued that the current allocation does not represent a fair and proportionate approach. It argues that the cost allocation should instead be based on use of infrastructure/identifiable costs. For instance, it argues that the multiplexing costs are driven by the number of streams rather than by transmission share i.e. the number of streams is the underlying driver of costs. Similarly it argues that the specific costs of transmission should be allocated on the basis of the actual running costs of the masts within the NCL and ITV plc regions since the running costs of the masts are clearly identifiable.
- 6.57 We consider the arguments for a different cost-based allocation mechanism in more detail below.

Multiplexing

- 6.58 For multiplexing, Ofcom understands that ITV has [X] multiplexers in each of its regions/sub-regions ([X]), and it has [X] encoders per multiplexer ([X] that use ITV's capacity on DTT Multiplex 2, plus [X]).
- 6.59 If there was no need to provide regional variations of Channel 3 then the provision of four national services on ITV Network's capacity on D3&4 would simply require [X]. However, given that there are 28 streams for the provision of the Channel 3 service, there are in fact [X] multiplexers, and [X] encoders. This indicates most of the costs of multiplexing are variable and relate to the provision of regionalised services.
- 6.60 In 2009 the allocation of the costs of multiplexing across the four services⁵⁴ [X]. Thus the total costs of multiplexing were divided by the total number of streams that

⁵³ We note that UTV has indicated that it thinks its share of the total costs of transmission in 2009 was [X]. Given that the difference is not significant we have continued to use the data set out in the Spectrum report on the grounds that it is a consistent data set.

were multiplexed (31 streams in total taking into account the other services on ITV's half of D3&4 capacity). ITV Network was allocated costs on the basis that 28 of the streams were for the provision of the Channel 3 service and its regional/sub-regional variations: 23 streams for ITV plc services and 5 for the NCLs.

- 6.61 Using the data in Table 6 above, this would imply that the *allocated* cost per stream was around £[<].
- 6.62 If the costs of multiplexing are indeed largely scaleable, as ITV plc has argued, then that would suggest that the costs of providing a networked national ITV1 service (i.e. the common cost of a national service) would be around £[<] in 2009 in total and the remainder of the multiplexing costs set out in Table 6 in fact represent the cost of providing regionalised services (and are therefore not directly relevant to the NWA). That is, of the 28 streams used by to provide the Channel 3 service, one is attributable to the provision of a national networked service and the other 27 are attributable to the provision of regionalised services.
- 6.63 If we adjust the cost allocation for multiplexing to allow for this we would expect each of the licensees to contribute to the cost of a single national stream on a QR share basis and then also pay for the cost of the provision of their own regionalised stream. This would suggest that (say) UTV should pay for the cost of its own single regionalised stream (at £[<] plus a contribution (based on QR share) to the common costs of a single national stream. Similarly, Channel would pay for the cost of its own regionalised stream plus a contribution to a single national stream.
- 6.64 We have attempted to re-allocate the costs of multiplexing on this basis and, as set out in Table 7 below, this suggests that the NCLs do derive a benefit from the current allocation mechanism and that ITV plc pays around £[<] more than it would do under the alternative approach.

Table 7: Revised Cost Allocation for Multiplexing – £000s

	ITV plc	STV	UTV	Channel
Current Allocation	[<]	[<]	[<]	[<]
Revised Allocation	[<]	[<]	[<]	[<]
Difference (revised allocation less current allocation)	[<]	[<]	[<]	[<]

Source: Ofcom, based on estimates for 2009 provided by ITV plc in the Spectrum report.

Transmission

- 6.65 In terms of the specific costs of transmission services we note that it is a condition of the regional Channel 3 licences that the licensee ensures that the network service is available on a DTT multiplex which achieves the same level of population coverage as the analogue service i.e. 98.5%. Given this requirement, we consider that the costs relating specifically to transmission as a whole should represent the cost of a national DTT transmitter network and thus be taken as a common cost of the provision of the Channel 3 network service. We therefore consider that ITV plc's argument that transmission costs should be allocated on the basis of the actual costs

⁵⁴ We recognise that Five transferred across to Mux 2 at the end of September 2009. As part of the reorganisation of Mux capacity one of the ITV plc channels transferred to Mux A.

to run the masts in the respective franchise area would not be appropriate in this instance.

- 6.66 Taking into account the above discussion and given that the different components of terrestrial transmission costs are already allocated in line with Transmission share (which is broadly the same as QR share), we do not consider that there is any particular transfer of benefit between the licensees.

Distribution

- 6.67 In terms of the distribution element, we note that there would need to be a core distribution network to provide a regional Channel 3 network. A comparison of Figures 1 and 2 also indicates that there are likely to be incremental costs specific to the provision of regionalised services compared to a single national service i.e. there is the need to distribute the streams to the various regional multiplexing sites. However, we also note that ITV plc has accepted that it would be difficult to isolate distribution costs by region.
- 6.68 A comparison of Figures 1 and 2 indicates that there will obviously be distribution costs in relation to the delivery of a national service – indeed it is likely to be the case that a majority of the costs of a distribution network would relate to the provision of a core national distribution network infrastructure. Given that ITV plc has not been able to isolate the specific regional distribution costs and the fact that its licensees account for 23 of the 28 streams needed to provide the Channel 3 service, at this stage we assume that refining this allocation to take account of the incremental cost of providing regionalised services would not make a significant difference compared to the current allocation mechanism. In addition, distribution accounts for approximately [X]% of the total costs of transmission so again seeking to refine the allocation mechanism is unlikely to make a significant difference to the current allocation. Therefore, we consider transmission shares are a reasonable benchmark for distribution costs (in that they are broadly the same as QR shares).

Provisional Conclusions

- 6.69 Taking into account the above discussion we consider that there is likely to be a benefit to the NCLs from the current DTT cost sharing arrangements in relation to the cost of multiplexing (in the order of £[X] in 2009). However, we also think that there is no specific benefit in relation to transmission costs and – as ITV plc itself has indicated – it is not possible to analyse distribution costs in a sufficient level of detail to be able to determine where any benefit might arise.

Satellite Transmission

- 6.70 In relation to satellite transmission, licensees require separate TLCS licences. From 2010 there has been a requirement for regional Channel 3 licence holders to offer their services to satellite platforms – under the so-called “Must Offer” provisions of the Act.
- 6.71 As with DTT ITV Network contracts for transmission services not just for the ITV1 service but also the ITV plc digital channels. ITV plc has indicated that there are the same number of streams on DSat as there are on DTT i.e. 31 overall, of which 28 relate to the provision of the Channel 3 service. ITV plc has indicated that the 31 streams together require a total of 6 satellite transponders.

- 6.72 Of the 28 streams used for the Channel 3 service, 5 are used for the NCLs and the remaining 23 for ITV plc. ITV plc has stated that of these 23, only 18 of them "are actually required by PSB regional news obligations and as such only 18 are required as part of ITV plc delivering on its contribution to the creation of a nationwide Channel 3 service."⁵⁵ ITV plc went on to explain that it broadcasts a further 5 services beyond regional news so that it can deliver regional advertising micros.
- 6.73 The information provided by ITV plc indicates that the number of streams is a key driver of the costs of satellite transmission. It argued that in 2009 the cost of a transponder was £[>] (including associated backhaul and uplink). On the basis that a transponder can accommodate 7 streams that would imply a cost per stream of £[>].
- 6.74 The current arrangements are such that the C3 service is treated as requiring 3 satellite transponders of capacity together with the associated backhaul and up-linking. The costs of these components are then shared between the licenses on the basis of QR share.
- 6.75 The current cost sharing arrangements are set out in Table 8 below.

Table 8: DSat Costs – Current Allocation among NCLs (2009) – £m

	STV	UTV	Channel
Current allocation of total DSat transmission costs	[>]	[>]	[>]

Source: Based on estimates for 2009 provided by ITV plc in the Spectrum report.

- 6.76 Following the implementation of the "Must Offer" rules, it is now a condition of their licences that the regional Channel 3 licensees make their services available to satellite operators. We consider that this is analogous to the 98.5% coverage obligation in relation to terrestrial transmission i.e. it is a requirement that applies to the networked ITV1 service as a whole and so is a common cost.
- 6.77 Taking into account the above discussion and given that the costs of satellite transmission are already allocated in line with their transmission share, we do not consider that there is any particular transfer of benefit between the licensees.

Preliminary conclusions

- 6.78 Our preliminary conclusion is that the ITV plc's contribution to relevant common costs is £[>] greater than would be the case if the licensees shared costs on the basis of the relevant benchmarks. Table 9 below sets out a breakdown of this figure:

⁵⁵ Spectrum report, page 39.

Table 9: Additional contributions to common costs by ITV plc compared to appropriate benchmarks

Arrangement	Additional amount contributed to common costs by ITV plc relative to the appropriate benchmark
Network Programme Budget	[>]
Network Centre costs	[>]
Music performance rights	[>]
Transmission costs	[>]
Total	[>]

Section 7

Implications for the Channel 3 Cost Sharing Arrangements

- 7.1 In section 4 we attempted to establish which sets of costs are common to the provision of a Channel 3 network service – and therefore relevant to the ITV NWA – using a set of criteria taken directly from the Communications Act. We then assessed those arrangements against a benchmark – either QR share or cost causation – in order to determine whether, based on the current cost sharing mechanisms applying in each case, it appears that any licensee or group of licensees bore a greater proportion of the costs than it would have if relevant costs had been allocated solely on the basis of the appropriate benchmark measure. Our analysis indicates that ITV plc's contribution to relevant common costs is £[>] greater than would be the case if those costs were shared according to those benchmarks.
- 7.2 Section 293(5) of the Act enables us to require the Channel 3 licensees to give effect to proposed modifications to the NWA if we consider that they are necessary. Any decision we take about proposed modifications must be informed both by our general duties and the specific obligations laid out in Schedule 11 of the Act.
- 7.3 In this section, given our statutory duties referred to above, we consider whether changes to the NWA reflecting our earlier findings about existing cost sharing practices are appropriate, in the light of the potential consequences of each option for the Channel 3 network as a whole and the licensees individually.
- 7.4 For each of the options we have identified in relation to the cost sharing arrangements in the NWA, we have therefore considered:
- 7.4.1 whether it would provide a satisfactory means of enabling regional Channel 3 services (taken as a whole) to be a nationwide system of services which is able to compete effectively with other television programme services provided in the United Kingdom;
 - 7.4.2 its impact on the ability of individual licensees to meet their public service remits, regional programming obligations and the out of London quotas; and
 - 7.4.3 whether it might give rise to a prevention, restriction or distortion of competition.
- 7.5 Although in this review we have sought to build up a comprehensive picture of the web of financial arrangements between the licensees in order to evaluate the burden which the cost sharing arrangements specified in the NWA impose on the different parties, the focus of this review concerns the costs incurred by the licensees within the existing approved NWA. It is worth noting, however, that while the licensees disagree about the relevance of certain costs outside the approved NWA, the Network Programme Budget ('NPB') clearly falls within the NWA and accounts for [>] of ITV plc's contribution above QR.⁵⁶

⁵⁶ It should be pointed out that [>] relates specifically to ITV plc's contributions above QR in 2009. Because the NPB is set by ITV Network Council and varies from year to year, it is possible that the level of ITV plc's contribution could change, although it is unlikely to do so drastically. Year to year

Options for amendments to the NWA

Option 1: Maintain the status quo

- 7.6 One option open to us would be to leave the NWA untouched during the remainder of the existing licence period ending in 2014.
- 7.7 We said earlier that the design of the NWA (and in particular the cost sharing arrangements for the NPB) have since their inception recognised the different revenue-generating potential of the licences within the Channel 3 network. As we stated in paragraph 4.10, the structure of licensee contributions to the NPB was intended to compensate the smaller licensees for the relatively higher proportion of their revenue subsumed by the fixed costs of regional production. Although the regional programming obligations placed on the licensees have declined in recent years, they are likely to remain proportionately a more significant burden for the smaller licensees; this should, arguably, continue to be reflected in the network's cost allocation structure.
- 7.8 On one view, it might be argued that ITV plc's cost burden derives from a series of commercial decisions made by its licence holders during the late 1990s and early 2000s. These led to its ownership of all but one of the larger licences and thereby conferred upon it in aggregate the heaviest cost burden under the NWA. Because there was no regulatory reason for ITV plc's licence ownership to have developed as it has, it could be argued that regulatory intervention should not be applied to offset the impact of those commercial decisions. This reasoning could be considered particularly relevant in the current situation, as modifications to existing cost sharing arrangements essentially represent a zero-sum game. That is, if the cost sharing arrangements are changed reducing the amount that ITV plc contributes overall, then the amount paid by the NCLs would have to increase.
- 7.9 Alternatively, as ITV plc has already suggested, it could be argued that
- “... the structure and economics of Channel 3 have changed profoundly in the past few years and whereas historically an intra channel 3 subsidy might have been possible consistent with (a) the provision of a competitive ITV1 network schedule and (b) the maintenance of a commercial return for licensees, that is clearly no longer the case...”⁵⁷
- 7.10 Ofcom has already stated it is mindful that with “the phasing out of the analogue signal in the period to 2012, the privileged access to analogue spectrum associated with the [Channel 3] licences, and previously seen as the primary driver of value for the licences, will cease within a few years.” Combined with a significant decline in television advertising revenue, we have acknowledged that the profitability of the Channel 3 licences may already have been reduced more rapidly than could reasonably have been expected by licence holders, even at the time of the last licence valuation in 2005.⁵⁸ An analysis submitted by ITV plc to Ofcom during the Second PSB review suggested that the costs to it of PSB status might exceed the

changes in licensees' QR share also impact their level of contribution to the NPB which is based on the prior year's QR share.

⁵⁷ Letter from Magnus Brooke (ITV plc) to Jonathan Porter (Ofcom), 4 September 2009.

⁵⁸ See Ofcom, *Reviews of the financial terms for the Channel 3 and Channel 5 licences*, paragraphs 3.32-3.37 at:

http://www.ofcom.org.uk/consult/condocs/review_c3_c5_licences/statement/Statement.pdf

benefits as early as 2010. While we do not accept that this is the case and reject some aspects of ITV plc's argument, we have already acknowledged that the value of the existing public service Channel 3 licences will decline as switchover progresses and that the current regulatory obligations will need further consideration in advance of 2014.⁵⁹

- 7.11 It is our preliminary view that option 1, when considered against the statutory framework for the NWA:
- 7.11.1 enables the regional Channel 3 licensees to offer a competitive network service. Although our analysis suggests that ITV plc pays more than it would do if costs were shared on an alternative basis, given the overall size of the NPB, we do not believe that the current cost sharing arrangements could be viewed as adversely effecting the continued provision of a nationwide, competitive service;
 - 7.11.2 enables the licensees to meet their public service remits, regional programming obligations and out of London quotas. We consider the current system of cost allocation mitigates the burden of the regional obligations for those licensees; and
 - 7.11.3 does not have any adverse impact on competition between the Channel 3 service and other competing national services, given that we do not consider that potential changes to the cost sharing arrangements within the NWA should affect the provision of a competitive nationwide service. Further, given that the cost sharing arrangements enable the licensees collectively to provide a nationwide service and individually to each meet relevant obligations, we do not anticipate any adverse impact on competition between the licensees.
- 7.12 Consequently we believe option 1 is both consistent with the statutory objectives of the NWA and, in light of the fact that it is currently used, practical for the licensees to implement.

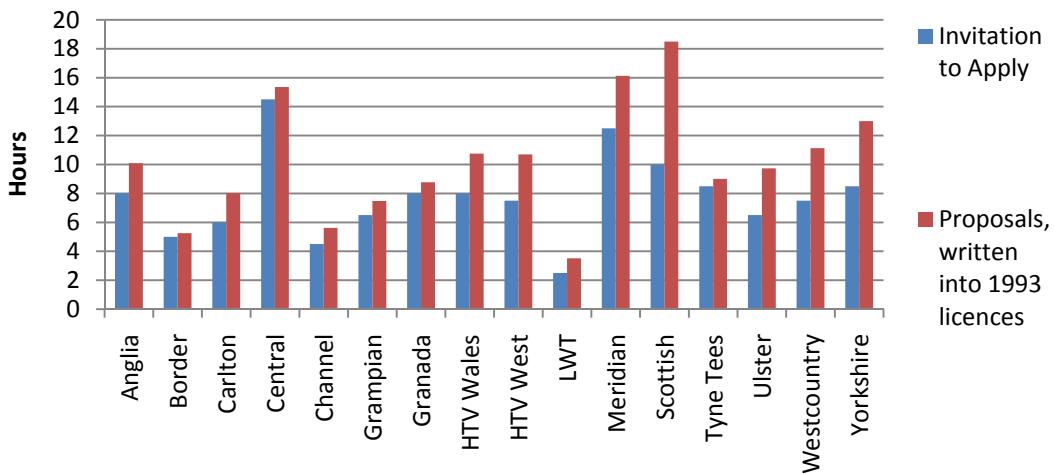
Option 2: Amend the NWA so that relevant network costs are allocated on a QR basis

- 7.13 As demonstrated in section 6, the contributions currently made by ITV plc licensees to the network appear to exceed the level that might be expected under an alternative common cost allocation mechanism, e.g. a licensee's share of qualifying revenue. Accordingly, it is reasonable to assess whether there are arguments for us to require modifications to the NWA to allocate costs between licensees on the basis of qualifying revenue.
- 7.14 QR share has provided a reference point on which to base the contributions of the regional Channel 3 licensees to network costs ever since the C1/C2 mechanism was first proposed by the ITC in 1991. Designed to take account of the 'burden' of regional production on the smaller licensees, the mechanism established a direct link between licence size and mitigating arrangements based on a licensee's QR share specified in the NWA.

⁵⁹ See Ofcom, *Putting Viewers First*, paragraph 8.30. Further details about this document are in footnote 7 above.

- 7.15 As we have already discussed, changes to the mechanism between 1993 and 1998, which were proposed by licensees and voluntarily agreed to by the network as a whole without reference to the regulator, served to bring the amount paid by some of the smaller licensees closer to (or actually in line with) their QR share. It is therefore appropriate to acknowledge that a process of bringing those contributions closer to QR share had been underway before the last round of consolidation in 2003, when the cap specified in the Carlton Granada merger undertakings effectively froze the contributions of those licensees not owned by ITV plc.
- 7.16 Further, although the mechanism has remained unchanged since 1998, the licensee obligations and therefore the costs it was intended to mitigate have altered significantly. Figure 3 below shows both the minimum level of regional programming required by the ITC and the amounts written into the original regional Channel 3 licences, based on the proposals made by the appointed licensees in their original bids.

Figure 3: Weekly regional programme obligations in 1992



- 7.17 Regional obligations now stand at four hours per week in the English regions and Channel Islands, five and a half hours in Wales and Scotland and six hours in Ulster following the recent “significant” reductions specified in the Second PSB Review.⁶⁰ Given the original purpose of the mechanism, and the fact that the process of acquisition and licence consolidation has not prevented us from reducing the burden of the regional programming obligations on some of the licences that ITV plc has acquired, it is clearly possible to argue that we might have already expected further adjustments in the C1/C2 arrangements towards QR.
- 7.18 Alternatively, it is possible to suggest that while changes have taken place both to the mechanism and the issue it was intended to resolve (i.e. the amount of regional programming each small licensee is required to produce), the necessity for contributions to the NPB to take account of the limited revenue-generating potential of the smallest licensees remains. Neither the fixed costs associated with running a licence-based business nor the greater profit making potential of the largest licence regions are recognised within a strict QR approach. Some licences would not be sustainable if network costs were allocated solely on a QR basis. For instance, if

⁶⁰ See Ofcom, *Putting Viewers First*, paragraphs 8.28 ff and our related *Statement on short term regulatory decisions* at http://www.ofcom.org.uk/consult/condocs/psb2_phase2/shortterm/.

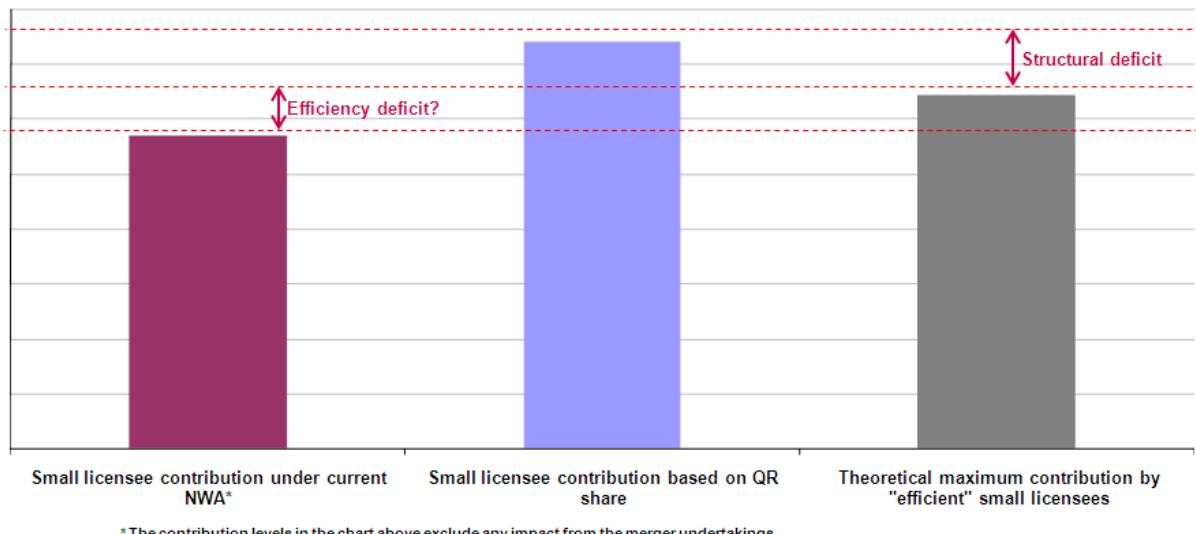
Channel were required to contribute to the current costs of the NPB in line with its full QR share, its broadcast operations would almost certainly no longer be commercially viable. STV North and UTV could be in a similar position.

- 7.19 As discussed above, in assessing the arguments for making such a change, we must take account of our duties under Schedule 11 of the Act. Among other things, Schedule 11 requires us, in reviewing the NWA, to reject arrangements which are likely to be prejudicial to the ability of licensees to continue to meet obligations to comply with their public service remit and their regional programming obligations. Beyond this, we are also mindful that our aim in significantly reducing licensee obligations during the Second PSB review was to safeguard those programmes which our research showed had the greatest public service value. It is unclear to us how approval for an amendment to cost sharing arrangements which could put much of that programming at risk would be in line with Schedule 11 or our general duties, including our duty to ensure the availability throughout the United Kingdom of a wide range of television services which are both of high quality and calculated to appeal to a variety of interests.
- 7.20 Finally, even leaving aside our obligations under Schedule 11, the cap currently in place on contributions to the NPB specified in the Carlton-Granada merger undertakings would continue to affect the contributions made by the NCLs. The cap would therefore prevent modifications to the NWA to bring the contributions of all the Channel 3 licensees in line with their respective QR.⁶¹ Specifically, at the current level of the NPB, the cap already limits the contributions of both UTV and Channel below their respective QR shares, but does not affect the contribution made by STV North or STV Central. However, it is the case that, because it is a large licensee, if STV Central's contribution were based on QR, it would be less than its current contribution under the C1/C2 mechanism. [X].
- 7.21 It is our preliminary view that option 2, when considered against the statutory framework for the NWA:
 - 7.21.1 would be unlikely to affect the ability of the licensees to offer a competitive network service as, theoretically, increasing the contributions made by the smaller licensees would have no overall effect on the NPB;
 - 7.21.2 would be unlikely to enable the licensees to meet their regional programming obligations; and
 - 7.21.3 does not have any adverse impact on competition between the Channel 3 service and other competing national services, given that we do not consider that potential changes to the cost sharing arrangements within the NWA should affect the provision of a competitive nationwide service. On the other hand, modifying the arrangements so that the commercial viability of the NCLs could be threatened clearly has the potential to restrict competition between the licensees.
- 7.22 Consequently we do not consider that option 2 is consistent with the statutory objectives of the NWA. Further, given the cap on NCL contributions set by the merger undertakings, we do not consider this option would be practically possible to implement.

⁶¹ The effect of the merger undertakings is discussed above at paragraph 4.75 ff.

Option 3: Seek to determine a more efficient set of cost sharing arrangements

- 7.23 Our third option offers an alternative method of cost sharing that seeks to identify a middle way between the existing model (option 1) and one based on QR share (option 2) by concentrating on the affordability of licensee contributions to the network. This alternative approach is based on licence size, and so the discussion below considers the position of licensees of different sizes, irrespective of their ultimate ownership.
- 7.24 In a network composed of differently sized licences, economies (and diseconomies) of scale mean that each small licensee's capacity to contribute to network costs will be impacted by both its size and particular regional obligations. However, the maximum amount that the smaller licensees could contribute to the NWA while maintaining both the viability of their broadcast licences and meeting their regional obligations is currently unclear. Because of this, although the existing payment structure seems to be affordable for all licensees, both
- 7.24.1 whether the smaller licensees could afford to pay more; and
- 7.24.2 the exact extent to which the smaller licensees are dependent on higher payments by larger licensees
- are also unknown.
- 7.25 Conceptually, we consider that the 'efficient' contribution level for the smaller licensees can be represented by the maximum amount a new entrant would be prepared to contribute while still being able to earn a reasonable return on its investment in the licence, taking into account the existing level of regional programming obligations. If the smaller licensees currently pay less than that efficient contribution level, then a gap, which we describe as the *efficiency deficit* in Figure 4 below, may exist.
- 7.26 Equally, it may be the case that, even if the smaller licensees were contributing to the full extent they could, the larger licensees would still need to contribute more than their QR share in order to meet the full costs of the Channel 3 network. In those circumstances, what could be described as a *structural deficit* would exist between the efficient contribution level for smaller licensees and a purely QR based contribution from larger licensees.
- 7.27 By aggregating the maximum amount which an efficient operator of the small licences would be prepared to contribute to the network, it is possible to determine the minimum amount that the larger licensees would have to contribute to current network costs over and above their QR-level. This is shown in the schematic diagram which follows below:

Figure 4: Schematic diagram of small licensee contributions to network costs

- 7.28 Cost sharing arrangements which calculated contributions on the basis described above would enable an efficient small licensee to meet its regional obligations while remaining as close as possible to the QR benchmark identified in section 5. This option also minimises any 'subsidy' inherent within a federal Channel 3 structure with licensees of unequal sizes, and should in theory take account of our responsibilities under Schedule 11 of the Act. The resultant positions of ITV plc and the NCLs can be arrived at by aggregating the contributions required from the licences that each owns.
- 7.29 However, whilst we consider it could be appropriate to make amendments to the NWA that require the smaller licensees to increase their contributions, such an approach is likely to be both highly contentious and difficult to calculate. In addition to requiring an assessment of the efficient maximum contribution for each of the smaller licence areas (including those owned by ITV plc), it is also unclear whether, and to what extent, any revised cost sharing mechanism should take account of the benefits that both STV and ITV plc derive from common ownership of licences. Because, as noted at paragraph 7.8 above, any reduction in the contribution for one licensee effectively requires another to pay more, we anticipate that it may be difficult for the licensees to agree a method for calculation. It is worth noting that, given the current level of the NPB, Channel and UTV already contribute at the level of the merger undertakings cap.
- 7.30 Unless the smaller licensees controlled by the NCLs already operate at the maximum efficient level, changes to payments which minimise any structural deficit in the NWA are either unlikely to be achievable or may potentially have the effect of leaving the smaller licensees unable to meet their current regional obligations. It is perfectly possible therefore that a change to licensee contributions on the basis of efficiency would require a reassessment of the regional obligations set last year as a result of the Second PSB review.
- 7.31 Finally, as with option 2, although we are able to modify the NWA so that the smaller licences controlled by the NCLs pay a greater amount towards the NPB, the practical impact of those modifications is likely to be limited by the merger undertakings cap.
- 7.32 It is our preliminary view that option 3, when considered against the statutory framework for the NWA:

- 7.32.1 would enable the licensees to offer a competitive network service. As with option 2, in theory, an increase to the contributions made by the smaller licensees would have no overall effect on the NPB;
- 7.32.2 might enable the licensees to meet their public service remits, regional programming obligations and out of London quotas. The effects of this option are unclear and will depend on the difference between the existing and "efficient" arrangements. We are mindful, however, that the viability of some of the smaller licences could be adversely affected if the contributions to the Network Programme Budget required from those licence holders were to increase; and
- 7.32.3 does not have any adverse impact on competition between the Channel 3 service and other competing national services, given that we do not consider that potential changes to the cost sharing arrangements within the NWA should affect the provision of a competitive nationwide service. On the other hand, should any modification of the arrangements threaten the commercial viability of the NCLs, that would clearly have the potential to restrict competition between the licensees.
- 7.33 Consequently it is uncertain whether option 3 is consistent with the statutory objectives of the NWA. As discussed above, given the cap on NCL contributions set by the merger undertakings, it is unlikely that it would be practically possible for us to implement this option. However, we do invite the views of respondents as to whether this is an approach worth exploring in more detail and, if so, how we might go about determining what an efficient level of contribution for the smaller licensees might be.

Concluding comments

- 7.34 As noted above, in this review we have been concerned with the identification and quantification – to the extent possible – of the impact of the cost sharing arrangements relevant to the operation of the NWA. Our analysis has identified the C1/C2 cost sharing arrangements in relation to ITV1's NPB as being the most significant in terms of how costs are shared between the regional Channel 3 licensees. As indicated above, our analysis suggests that in 2009 ITV plc would have paid around £[<] more than would be the case if costs were simply shared on a pure QR basis. Given the overall size of the NPB in 2009, £[<] would in fact represent about [<] of the total NPB. Although £[<] is clearly not a trivial amount in absolute terms, given the overall size of the NPB, we do not think that the allocation of that £[<] per se is likely to fundamentally affect the ability of the licensees collectively to provide a competitive Channel 3 network service.
- 7.35 We are mindful, however, that while the statutory objective for the Channel 3 network service is unaffected by the options described, we are also under a duty to take account of the effect of the NWA on the ability of the licensees to meet specific regional obligations. We are concerned that the imposition of further costs on the NCLs could adversely affect their ability to fund regional programming. Consequently, of the three options discussed above, at this stage we consider that option 1 is the option which is most likely to be compliant with the current legislative framework for NWA.
- 7.36 We would, however, welcome the views of interested parties on all of the options for allocating network costs between the licensees. We are also seeking further information on the impact of each of the options on the business models of the

regional licensees to determine the extent to which further changes might be possible.

- 7.37 Finally, we are aware that, although we do not believe that the current cost sharing arrangements in the NWA adversely affect the continued provision of a nationwide, competitive Channel 3 service, it may be the case that if ITV plc perceives that the current cost sharing arrangements under the NWA are unfair then that may ultimately make it unwilling to continue to participate as a Channel 3 licensee. As we noted in the Second PSB Review,

“...with the continuing decline in the value of all of the Channel 3 regional licences, unless all the members of the network are willing participants in, the networking arrangements cannot be sustained.”

- 7.38 We are conscious that, although both the broadcasting environment and the ownership structure of the regional licences has changed significantly since the NWA were first developed, the framework within which we are required to assess the operation of those arrangements (and indeed their substantive structure) has not. There are considerable tensions in this system. The arrangements cover the single largest element in the licensees' cost base and, because any modification within the cost sharing arrangements that benefits one licence holder must negatively impact on another, it is difficult for the licensees to reach a consensus on change. Equally, while Ofcom has a statutory obligation to assess the continuing suitability of the NWA, we may only introduce amendments within the scope of a regulatory framework that was designed for an analogue world. Although we will retain our duties for as long as arrangements between the regional licensees are governed by statute, we consider that it would now be appropriate to remove the regulatory burden which formal annual reviews place on Ofcom and on the licensees.

Q6: Are there any alternative approaches to those identified above which you consider would provide a fairer distribution of costs? In your response, please explain how this alternative approach is compatible with our duties under Schedule 11 of the Act.

*Q7: Which of the three options for allocating costs under the NWA described in section 7 do you prefer and why? In your response, please explain whether and how your preferred option or options are compatible with our duties under Schedule 11 of the Act. Licensees should also set out the impact which they believe **each of the options** would have on their business.*

Q8: Taking account of the conceptual framework in option 3 above, how can we determine the maximum contribution to the NWA that an efficient firm or new entrant would be prepared to make for the smaller licences? In your response, please explain how this would affect the existing allocation of costs between the regional licensees.

Annex 1

Responding to this consultation

How to respond

- A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 5 October 2010**.
- A1.2 Ofcom strongly prefers to receive responses electronically. We would also be grateful if you could assist us by completing a response coversheet (see Annex 3), to indicate whether or not there are confidentiality issues. Please email anthony.szynkaruk@ofcom.org.uk attaching your response in Microsoft Word format, together with a response coversheet.
- A1.3 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation:

Anthony Szynkaruk
5th Floor
Content & Standards
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 7981 3806

- A1.4 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.
- A1.5 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views.

Further information

- A1.6 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Anthony Szynkaruk on 020 7783 4341.

Confidentiality

- A1.7 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.
- A1.8 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish

all responses, including those that are marked as confidential, in order to meet legal obligations.

- A1.9 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at
<http://www.ofcom.org.uk/about/account/disclaimer/>

Next steps

- A1.10 Following the end of the consultation period, Ofcom intends to publish a statement as soon as practicable.
- A1.11 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see:
http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom's consultation processes

- A1.12 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.
- A1.13 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at
consult@ofcom.org.uk. We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.
- A1.14 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is Ofcom's consultation champion:

Vicki Nash
 Ofcom
 Sutherland House
 149 St. Vincent Street
 Glasgow G2 5NW

Tel: 0141 229 7401
 Fax: 0141 229 7433

Email vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

- A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

- A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

- A2.3 We will be clear about who we are consulting, why, on what questions and for how long.
- A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.
- A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.
- A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.
- A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

- A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

- A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.
- A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response. This will speed up our processing of responses, and help to maintain confidentiality where appropriate.
- A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.
- A3.4 If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.
- A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title: ITV Networking Arrangements Review

To (Ofcom contact): Anthony Szynkaruk

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing

Name/contact details/job title

Whole response

Organisation

Part of the response

If there is no separate annex, which parts?

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

Name

Signed (if hard copy)

Annex 4

Consultation questions

Q1: Do you agree with the basis on which we have determined which costs are relevant to an assessment of costs shared between the licensees under the NWA?

Q2: Do you agree with the assessments of relevance which we have made in relation to individual agreements? If not, please provide reasons to support your views?

Q3: Do you have any further information relating to the section on Additional Arrangements from paragraph 4.80 onwards which you consider to be relevant to our assessment of cost sharing under the NWA? In particular, we invite the Channel 3 licensees and ITV Network to submit further information on these issues.

Q4: Do you agree with the alternative cost allocation methodologies and our evaluation of their suitability as benchmarks? Should we consider different benchmarks for different categories of costs?

Q5: Are there any other potential allocation methodologies that should be considered? If so, please set out your proposed cost allocation methodology and also how it fits with the economic principles set out above.

Q6: Are there any alternative approaches to those identified above which you consider would provide a fairer distribution of costs? In your response, please explain how this alternative approach is compatible with our duties under Schedule 11 of the Act.

*Q7: Which of the three options for allocating costs under the NWA described in section 7 do you prefer and why? In your response, please explain whether and how your preferred option or options are compatible with our duties under Schedule 11 of the Act. Licensees should also set out the impact which they believe **each of the options** would have on their business.*

Q8: Taking account of the conceptual framework in option 3 above, how can we determine the maximum contribution to the NWA that an efficient firm or new entrant would be prepared to make for the smaller licences? In your response, please explain how this would affect the existing allocation of costs between the regional licensees.

Annex 5

The statutory framework for reviewing the NWA

Introduction

- A5.1 The framework for this review is set out in Schedule 11 of the Act. Ofcom must not approve revised ITV Networking Arrangements (or propose modifications to the existing arrangements), unless it is satisfied that the revised arrangements (or proposed modifications) satisfy the competition test set out in paragraphs 6(3) and 6(4) respectively of Schedule 11 of the Act.
- A5.2 The Act sets out the three statutory tests - described below - that Ofcom must take into account, alongside its wider statutory duties, when carrying out this review. Ofcom reviews the ITV Networking Arrangements in this document from the Ingenious of these statutory tests and duties. In addition Ofcom must also be mindful of its wider statutory duties and public policy objectives. As a general rule, Ofcom must not propose, impose or approve arrangements or modifications to the arrangements unless it considers that such arrangements or modifications are satisfactory.
- A5.3 The statutory competition test is focused on restrictions of competition arising from the arrangements themselves, as opposed to restrictions of competition arising from the unilateral behaviour of one of the parties to the arrangements. When this test was conceived, the Channel 3 licensees were not so unevenly matched. ITV plc now owns 11 of the 15 licences, affording it a position of strength within the ITV network that creates different competition issues, which we believe are not covered by the statutory competition test, but which are nevertheless relevant to the arrangements between ITV licensees.

The “Competition Test”

- A5.4 The statutory Competition Test set out in paragraph 6 of Schedule 11 of the Act is in two parts:
 - 5.4.1 Arrangements satisfy the first Competition Test if they do not have as their object or effect the prevention, restriction or distortion of competition within the United Kingdom. If the arrangements satisfy this test, there is no need to consider the second test; and
 - 5.4.2 Arrangements satisfy the second Competition Test if (a) they do have such an object or effect; but (b) they would satisfy the criteria set out in section 9 of the Competition Act 1998.
- A5.5 Before making a decision about whether a competition test is satisfied or not, Ofcom must consult the Office of Fair Trading. In determining whether arrangements or modified arrangements would satisfy either of the tests, Ofcom must ensure the principles it applies and the decisions it reaches are consistent with the EC Treaty and any relevant decisions of the European Court. In addition, it must have regard to any relevant decisions or statements of the European Commission.

- A5.6 The NWA are excluded from the application of the Chapter I Prohibition under Schedule 2 to the Competition Act 1998 to the extent that they fulfil the relevant competition tests set out in Schedule 11 of the Act. However, the licensees are still prevented from engaging in any practice which is prejudicial to fair and effective competition (towards external parties and to each other) by conditions in their licences. The licensees also remain subject to the Chapter II prohibition in the Competition Act 1998.

The “Effectiveness Test”

- A5.7 Ofcom must not approve, impose or propose arrangements and/or modifications unless Ofcom considers those arrangements / modifications to be satisfactory for the purpose of enabling regional Channel 3 services (taken as a whole) to be a nationwide system of services which is able to compete effectively with other television programme services provided in the United Kingdom.

The “Regional Programming Test”

- A5.8 Ofcom must not approve, impose or propose arrangements and/or modifications unless Ofcom considers those arrangements/ modifications to be satisfactory, including the likely effect of the arrangements/ modifications on the ability of Channel 3 licensees to maintain the quality and range of regional programmes and other programmes which contribute to the regional character of the services.
- A5.9 It should be noted that the second and third statutory tests relate to public policy rather than specifically to competition law.
- A5.10 In addition to the above statutory tests, paragraph 8 of Schedule 11 of the Act states that Ofcom must not approve, impose or propose arrangements and/or modifications if such arrangements/modifications would be likely to be prejudicial to the ability of the Channel 3 licensees, or any of them, to comply with:
- 5.10.1 their public service remits;
 - 5.10.2 their regional production obligations⁶²;
 - 5.10.3 their regional programming obligations; or
 - 5.10.4 conditions imposed on them following a change of control.

Ofcom’s other duties and objectives

- A5.11 Section 3 of the Act sets out Ofcom’s general duties and the matters that Ofcom must take into account in performing its duties. These matters include:
- 5.11.1 our principal duty to further the interests of citizens in relation to communications matters and consumers in relevant markets, where appropriate by promoting competition;
 - 5.11.2 our obligation to secure the application, in the case of all television and radio services, of standards that provide adequate protection to members of

⁶² In addition to the above statutory tests, paragraph 8 of Schedule 11 of the Act requires Ofcom to take into account the impact of the arrangements or modifications to the arrangements on the ability of the Channel 3 licensees to comply with certain of their licence obligations.

- the public from the inclusion of offensive and harmful material in such services;
 - 5.11.3 the desirability of promoting the fulfilment of the purposes of public service television broadcasting in the United Kingdom;
 - 5.11.4 the desirability of promoting competition in relevant markets;
 - 5.11.5 the desirability of promoting and facilitating the development and use of effective forms of self-regulation; and
 - 5.11.6 the desirability of encouraging investment and innovation in relevant markets.
- A5.12 Ofcom also has a general regulatory principle that it will always seek the least intrusive regulatory mechanisms to achieve its policy objectives.
- A5.13 Ofcom also believes that the following public policy objectives (as articulated in the 2005 Review) are appropriate guiding principles to follow when reviewing the NWA:
- 5.13.1 the documents that together comprise the NWA should continue to reflect accurately the actual operational arrangements;
 - 5.13.2 organisational arrangements should be robust to changes in corporate ownership;
 - 5.13.3 the non-consolidated licensees should be able to continue to meet their specific licence obligations efficiently and effectively;
 - 5.13.4 the principles which underlie the relevant cost sharing arrangements should be transparent and clearly understood by all parties to the NWA; and
 - 5.13.5 there should be an appropriate degree of non-discrimination between parties to the NWA and (where appropriate) any relevant third parties.