



Review of the operation of the television production sector

A report for the Secretary of State for
Culture, Media & Sport

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About this document

In August 2015, the Secretary of State for Culture, Media and Sport asked Ofcom to carry out a review of the operation of the TV production sector. This document is our formal response to this request.

This review focused on four main areas of analysis:

- the changing market context;
- the effectiveness of the current regulations;
- the impact of production sector regulation on PSBs; and
- options for reform.

While carrying out this review, we have built on the evidence collected during our recent Public Service Broadcasting Review and consulted a variety of stakeholders on their views on the operation of the sector and its regulation. We also received a number of written submissions. These are listed in Annex 1.

Ofcom has also commissioned two reports from external consultants to provide an evidence base for this review. *Trends in TV production* by Oliver & Ohlbaum Associates, and *TV production sector evolution and impact on PSBs* by Mediatique are both published alongside this document and referenced throughout.

Contents

Section		Page
1	Executive Summary	1
2	The changing market context	7
3	The effectiveness of the current regulations	22
4	The impact of production sector regulation on PSBs	28
5	Options for reform of the regulations	33
Annex		Page
1	Stakeholder engagement	40

Section 1

Executive Summary

Introduction

- 1.1 In July 2015, we published our third review of Public Service Broadcasting¹. The review analysed changes in viewing habits resulting from the growth of the internet and on demand services in the UK. We recognised that live television remains very popular and viewing figures for live TV remain high. We also concluded that catch-up television watched over the internet, and programming and content premiered on the internet, are becoming increasingly important to audiences, especially younger audiences. The potential for significant change over the next decade could challenge current models of regulation for public service broadcasting.
- 1.2 The Review also analysed changes to the UK's production sector. We suggested that overall the production sector was in good health and was helping to support the overall purposes and objectives of public service broadcasting, namely the provision of TV programmes dealing with a wide range of subjects, of a high standard and catering for as many different audiences as possible.
- 1.3 However, we also noted the rapid pace of change in the sector in recent years, notably significant consolidation and the acquisition of some of the largest UK producers by global media corporations. Following the Review, the Secretary of State for Culture, Media and Sport asked Ofcom to undertake a more detailed review of the operation of the television production sector and to set out options for reform of its regulation².
- 1.4 In making his request, the Secretary of State reaffirmed his support for the objectives of the regulatory regime governing the production sector. These are to: *“promote cultural diversity and to open up the production system to new energies and voices; to stimulate the growth of small and medium sized enterprises (SMEs); promoting creativity and fostering new talent; and to tackle vertical integration within the UK programme supply market”*.
- 1.5 The Secretary of State also asked us to consider how the regulations might be adapted to promote content production, particularly in types of public service programming identified as being at risk in our third PSB Review, notably drama, arts and classical music, religion and ethics and children's programming
- 1.6 Parliament introduced two key regulations governing the production sector. Firstly, an independent production quota which ensures that at least 25% of programming is commissioned from independent producers. Secondly, Codes of Practice which the PSBs are required to publish setting out the principles they will apply when agreeing terms with independent producers.

¹ <http://stakeholders.ofcom.org.uk/consultations/psb-review-3/>

² <https://www.gov.uk/government/publications/response-to-ofcoms-third-public-service-broadcasting-review>

The UK production sector has changed significantly in the last twenty years and the last few years have seen that pace of change increase

- 1.7 The UK production market has changed from a cottage industry twenty years ago where producers operated on a work- for- hire basis, to a very successful sector that in 2014 generated £2.9bn in revenues and generated 30% of its revenues from overseas markets.
- 1.8 This success was facilitated by regulation introduced by Parliament in the Communications Act 2003 that enabled production companies to control and exploit the intellectual property from their programmes. This allowed fledgling companies to enter the market and build more sustainable businesses than previously, supplying programming in the UK and increasingly globally too. In 2001 only eleven of around 500 producers had revenues over £10m and only two had UK revenues over £50m. By the end of 2014 thirty three producers had revenues over £10m while eleven producers had UK revenues over £50m and five had UK revenues over £100m³.
- 1.9 The success of the sector has made independent producers attractive to a range of buyers, resulting in growing levels of consolidation. This consolidation has had three different effects:
 - 1.9.1 a smaller number of producers, operating in a more concentrated market. In terms of revenue, the top ten producers now account for an estimated 66% of all UK producer revenue, up from 45% in 2003⁴;
 - 1.9.2 an increase in the degree of vertical integration between broadcasters and producers. Six of the ten largest producers are now owned by broadcasters; and
 - 1.9.3 an increase in the level of foreign ownership. Since 2008, major US media groups such as NBC Universal and Warner Brothers have been acquiring a number of UK production companies. Today, seven of the ten largest UK producers are owned by large foreign media corporations.
- 1.10 Overall, consolidation has also led to a reduction in the number of UK television production companies: the number of UK television production companies has nearly halved from around 450 in 2006 to around 250 in 2014. However, levels of market entry remain high. In 2014, 84 producers were companies that were new to the market, with only 17 of those identifiable as being founded by established industry talent. Levels of market entry have also remained consistently high in recent years: an average of 31% all producers were new to the market in each year since 2009. This suggests that the conditions continue to exist for new and disruptive entrants to enter the market.
- 1.11 The production sector also remains geographically concentrated in London and the South East, where around two-thirds of all producers are based. The absolute number of producers active in some other regions is very low. Only one producer in each of Anglia, the Midlands and the West Country were identified as having a PSB network channel commission on air in 2014 while not a single North East producer

³ Oliver & Ohlbaum Associates report pp74-75

⁴ Mediatique report p13

was identified as having a programme on air in peak or daytime. A total of just 12 producers were active in Scotland, 10 in Wales and 5 in Northern Ireland in 2014.

- 1.12 Changes in the production sector also need to be understood in the wider context of two particular changing market dynamics:
 - 1.12.1 **Increasing global opportunities:** businesses in the UK's production sector are increasingly looking to exploit the revenue potential of international markets. Building scale in the UK production market has created businesses more capable of exploiting those opportunities.
 - 1.12.2 **Changing viewing habits:** the growth in on demand viewing and the greater use of the internet are changing how viewers watch TV. As we set out in our PSB review, these changes are raising questions about our model of public service broadcasting and how it will continue to support investment in UK content if we see a significant shift to on demand viewing, which could undermine the current models of funding.
- 1.13 Given the dynamic nature of this market, it is difficult to predict with any certainty how this market structure will evolve. It is possible that the market will consolidate further as global companies continue to acquire successful UK companies. However, we would note that further consolidation could be more challenging as the number of companies available to buy which would be attractive to foreign buyers is now much lower and market entry at the SME level remains high. Whilst it is possible that the market will change more radically over the next five years, it is equally possible that further changes will be more gradual.
- 1.14 We also note that decisions that the Government takes over the next 12 months could have a material impact on the UK's production sector. In particular:
 - 1.14.1 Decisions in relation to the size and scope of the BBC as part of the Charter Review process. For example, we note that the BBC Studios proposals could increase the market for independent producers by opening up more BBC commissions. We address the potential market impact of the Studios proposals in a separate document.
 - 1.14.2 The impact of any changes to Channel 4 Corporation. Changes to Channel 4 Corporation's publisher broadcaster status or a change in management approach as a result of privatisation could result in it reducing the currently high number of independent production companies it commissions from, which would limit the opportunities for a number of independent producers.

The PSB broadcasters remain the largest commissioners of content, but are facing challenges

- 1.15 Whilst the multi-channel sector and new entrants such as Amazon and Netflix are commissioning more, the PSBs continue to account for the vast majority of commissioning of new programmes. Excluding sport, the four PSBs BBC, ITV1, Channel 4 and Channel 5 accounted for 85% of all investment in new UK programmes in 2013. This is broadly unchanged from 2008 when the figure was 91%. Given this, the balance of negotiating power still lies with the PSBs: without regulation, the PSBs would have significant negotiating power over smaller producers.

- 1.16 The remit of the PSBs remain the most important factor in ensuring that programmes reflect the culture and communities of the UK and its nations and regions. It is the commissioning decisions of the PSBs that ensure that new programmes continue to reflect UK cultural identities.
- 1.17 There has been a decline in investment in UK programming by PSBs of £400m in real terms between 2008 and 2014. Although the PSBs have offset some of this because of changes in programming costs and changes in scheduling, this has led to a decline in commissioning of some at risk genres. During the course of this work, we have not found any evidence to suggest that this is because the production sector does not have the talent or the creativity to make these programmes. As we set out in our PSB Review, the concerns arise from the commissioning decisions of the PSBs, because at risk genres draw in lower audiences and lower advertising and are therefore commercially less attractive.
- 1.18 PSBs have also benefited from the acquisition of UK producers by large media companies. These new owners have enabled these companies to co-fund and cash-flow projects jointly with PSBs, helping to reduce proportion of the overall cost of production that the PSBs pay.

A number of features of the market continue to work well despite consolidation

- 1.19 In particular, the regime appears to be largely “self-correcting”. Most of the consolidation that has occurred has been due to independent producers being bought by companies that also control UK broadcasters. This is the case for 4 of the largest 7 producers acquired by foreign media companies. As a result, they no longer meet the definition of a qualifying independent producer. These companies fall outside regulation and they and the PSBs are free to negotiate terms on a fully commercial basis.
- 1.20 Importantly, because these companies do not qualify under the current regulation, they cannot be counted for the purposes of the independent production quota. There are only five of the ten largest producers which are independent and so qualify for the quota. Therefore, despite the level of consolidation in the sector, the quota has continued to provide effective protection for small producers.
- 1.21 Despite consolidation, the high number of SME producers still being commissioned means that there remains a strong and vibrant production sector which is economically successful and which is providing a good range and diversity of programming for UK viewers. In 2014, there were still 230 small producers (i.e. with revenues under £10m) with a programme broadcast on a PSB channel.
- 1.22 The regulatory framework continues to provide the opportunity for new entrants to enter the market and grow into medium and large indies, by owning and exploiting their intellectual property globally. This provides wider benefits to the UK economy. Overseas international revenues for all producers (excluding in-house) were £874m in 2014.

We have considered a number of options for reform that might be considered to address future concerns that could arise

- 1.23 Whilst a number of features of the market continue to work well, future concerns could arise as the market continues to change:

- 1.23.1 One potential concern is that future consolidation may not be linked to vertical integration, as it has been in the past. This would mean that larger companies would remain within the protection of the regulatory regime, potentially undermining one of its policy objectives.
- 1.23.2 A second potential concern is that producers and broadcasters are unable to reach commercial agreement on the exploitation of rights, and the associated revenues. Viewers increasingly expect broadcasters to make programmes available live, on demand, and supported by online content relating to the programme. Broadcasters will need to be able to access the rights that allow them to innovate on new digital platforms, whilst producers will want to retain the rights that they are best placed to exploit.
- 1.24 We have considered a number of options for reform. In doing so, our starting point has been to avoid further detailed and complicated regulation and to seek to promote industry negotiation, with regulatory action as a last resort. We have identified two options that might merit further consideration: tightening the definition of a qualifying independent producer and reform to the rights and revenue shares between PSBs and producers.
- 1.25 If we are concerned that larger producers are being inappropriately protected by the regulatory regime, then an appropriate response would be to tighten the definition of a qualifying independent producer. A size cap could be introduced to ensure that, in future, only SME producers qualify. This option would maximise the opportunity available to small producers to ensure new entrants continue to come into the market.
- 1.26 We note that a tightening of the definition would probably result in the loss of qualifying status for a very small number of larger remaining qualifying producers. We note that there appear to be five UK producers with UK revenues exceeding £50m who continue to qualify. In addition, consideration would need to be given to how to implement this in a way which ensured simplicity in its operation and prevented regulatory gaming.
- 1.27 The question of how rights and revenues are shared between PSBs and producers is particularly complex, and we have a strong preference for this being achieved through commercial negotiation. However, we remain open to evidence that particular aspects of the regulatory regime are either preventing commercial negotiations, or could be better designed so as to facilitate such negotiations.
- 1.28 We have also considered the potential for complete deregulation, but the outcome is, in our view, uncertain and risky. PSBs would, in all likelihood, continue to be able to choose from a range of suppliers over which they would be able to leverage their negotiating strength. Deregulation may also lead to fewer opportunities for small producers and would make the economics of running an SME in the production sector very challenging. As a result, there may be fewer opportunities for new creative talent to get programmes on air and grow new businesses, in particular by expanding overseas and exporting their programmes.
- 1.29 Finally, we would note that concerns the Secretary of State has raised about promoting content production in at risk genres may need to be addressed by considering broader concerns about the funding models and incentives of PSBs to commission the kinds of programming which are commercially less attractive. Our PSB Review set out our views on the areas that the Government might want to

consider further to maintain and strengthen the PSB system given the current challenges and future risks.

Conclusion

- 1.30 The production sector has undergone a number of significant changes. It has seen consolidation and many of the largest UK producers are now owned by large global media corporations. However, at this stage these changes do not appear to have had as great an impact on the delivery of the objectives of the regulatory regime as may at first be thought. There remains a diverse and vibrant SME production sector and the system continues to promote very high levels of market entry, thereby opening it up to new voices, encouraging creativity and innovation.
- 1.31 However, we have identified some areas of potential concern for the future. We have noted the potential for further consolidation in the market and we have highlighted the risk that broadcasters and producers might not be able to reach commercial agreement on how rights and revenues are shared in the face of broadcasters needing to adapt to changing viewing habits.
- 1.32 As a result, if the status quo is maintained, we continue to believe that it would be important to keep this sector under review.

Section 2

The changing market context

Introduction

- 2.1 In this section we set out our understanding of key market developments, including assessing how viewers' needs are changing rapidly, how this has affected broadcaster demand for new programmes and how the independent production sector has been transformed.
- 2.2 Our aim in setting out the main trends and features of the market is to provide a broad historical context and sound evidence base for this review. In doing so we aim to set out analysis that is central to assessing how well the regime is working, the need for regulation going forward and what the market impact of the options for reform set out in Section 5 might be.
- 2.3 We have also commissioned reports from two consultancies to provide a comprehensive view of the changing structure and dynamics of the market. These studies have been published alongside this report.⁵

Our third review of public service broadcasting noted how the broadcasting landscape has changed rapidly

- 2.4 As stated in our third PSB Review published in July 2015,⁶ the backdrop to any consideration of broadcasting markets is the growth of television viewing using the internet. While live television remains extremely important to viewers, catch-up TV watched over the internet, and programming and content premiered on the internet are becoming increasingly important to audiences, especially younger audiences. In 2014 10% of all adult⁷ audiovisual viewing was to on-demand programmes or online clips.
- 2.5 Our PSB Review set out how the trajectory and pace of future change is uncertain. We considered a base case of steady evolution towards online and non-linear viewing but we also noted the potential for more radical scenarios to emerge where on-demand viewing grows much quicker than expected. We suggested that there could be variants of these radical scenarios, some where the PSBs broadly maintain high levels of viewing and others where PSBs lose share of viewing to new entrants.
- 2.6 Today, only 50% of 16-24s' audio-visual consumption and 61% of 25-34s' is through live television⁸ (i.e. TV viewed at the time it is broadcast). Viewing of TV news by younger people aged 16-34 dropped by 29% between 2008 and 2014, to 39 minutes per person per week⁹. The emergence of new competitors such as Netflix and Amazon Prime, providing services directly over the internet, is giving consumers greater choice and making the landscape more competitive, including potentially in terms of demand for new programmes from producers.

⁵ *Trends in TV Production*, Oliver & Ohlbaum Associates, December 2015, and *TV production sector evolution and impact on PSBs*, Mediatique, December 2015

⁶ <http://stakeholders.ofcom.org.uk/binaries/consultations/psb-review-3/summary/PSBR-3.pdf>

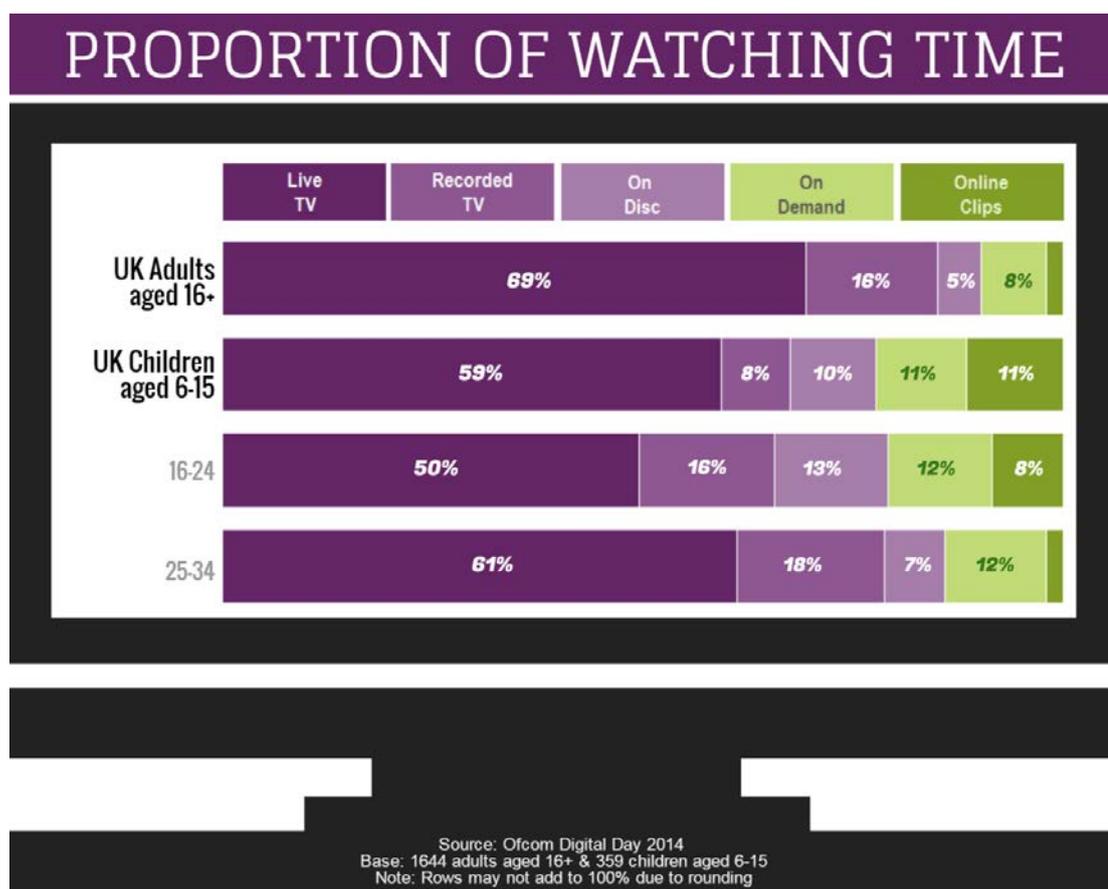
⁷ UK adults aged 16+

⁸ 2014 data, *Digital Day*

⁹ Source: BARB. Based on total viewing hours to the National/international news genre.

2.7 When we undertook our last review of the TV production sector in 2006¹⁰, the pattern of TV consumption was very different. Many people still relied on analogue television, the availability and take-up of the internet was lower, and internet connectivity was included in only a limited number of devices and services. In total, less than 2% of viewing was time-shifted¹¹ in 2006. As we set out in our PSB Review, the overall trends that have affected the TV sector in recent years include greater choice of channels for viewers, a decline in linear broadcast viewing, and a rapid growth in online content and consumption.

Figure 1: Proportion of watching activities, by age, 2014



2.8 It is in this context of rapidly changing audience needs, and rapidly changing industry trends in response, that we are undertaking this review. Some more specific viewing trends are particularly noteworthy in the context of this report, given the increasing importance of intellectual property (IP) rights that the PSBs must secure to meet the needs of viewers in a far greater, and ever more innovative, number of ways:

2.8.1 **Time-shifted channels are an important contributor to audience share.** The commercial PSBs all have time-shifted channels, including +1 (hour) channels and a +24 (hours) in the case of Channel 5. For some programmes, such as Gogglebox, more than 20% of total audience share can result from the +1 channel¹².

¹⁰ <http://stakeholders.ofcom.org.uk/consultations/tpsr/tpsr>

¹¹ http://www.barb.co.uk/trendspotting/analysis/catch-up-viewing?_s=4

¹² BARB

- 2.8.2 **PSB portfolio channels are extending the reach and impact of PSB content.** Time-shifted channels are only one component of PSB channel portfolios; others such as E4, ITV3 and 5USA are also important contributors to share and provide extra choice to viewers, as well as an opportunity in some cases to view content they may have missed on the main PSB channel, thereby extending the reach of PSB content further even though these channels are not formally PSB channels (except in the case of the BBC).
- 2.8.3 **Viewers are increasingly shifting to online catch-up viewing.** Online catch-up players now not only provide a way to watch programmes that were missed when broadcast, they can also provide online-only content or allow viewers to see an entire series at once ('box sets'). For some viewers, especially among younger audiences, the broadcasters' online players such as BBC iPlayer and All 4 are their default – perhaps even only – way of seeing the PSBs' content.
- 2.8.4 **Take-up of connected devices, 4G and superfast broadband.** Most consumers now have a connected mobile device such as a smartphone or tablet – sometimes multiple devices. The PSBs' online services have developed in tandem – all content providers now need to make their services available across an increasingly wide range of devices, and offer innovative services on them.
- 2.9 In response to changing viewer behaviour, the PSBs have over the years had to secure new rights from producers. These include rights for the use of programmes on portfolio channels, for non-linear access through online catch-up services, and rights that allow them to make content available across more devices or across other forms of new media such as social networks (e.g. Facebook and Twitter).
- 2.10 The PSBs are also having to respond to globalisation and the entry of new competitors enabled by the uptake of these new devices and online television services. As a result, the PSBs must increasingly ensure that the programmes they commission and broadcast meet the needs of viewers who have ever more choice from non-broadcasters and from overseas and pay-TV broadcasters. These trends are therefore having an impact on the characteristics of demand for, and also the supply of new programmes, by producers.

How the television production sector works in practice

- 2.11 Before setting out in detail the changes that have taken place in the market structure of the TV production sector, it is important to set out how the sector works, since some features have had a significant impact on how the sector has changed and also some help explain why in certain ways it has not changed. There are three main roles in TV content production value chain:
- 2.11.1 **Producers:** pitch, make, and sell programmes;
- 2.11.2 **Broadcasters:** buy and broadcast programmes; and
- 2.11.3 **Distributors:** enable the further exploitation of the programme.
- 2.12 The roles can be performed by separate companies or within vertically integrated companies. A single entity can perform all three roles: for example, the BBC and ITV operate in-house units for production, broadcast channels, and distribute

programmes and related rights. The production process itself can be divided into a number of distinct activities:

- 2.12.1 **Pitching:** Producers research and develop programme ideas, often for a particular schedule slot or type of programme that a broadcaster has invited ideas for. Producers then pitch their ideas to the broadcaster.
 - 2.12.2 **Commissioning:** In rare cases, a broadcaster may commission the programme straight away; in most cases, an interested broadcaster will propose amendments to the idea, sometimes provide development funding, and may also request a pilot episode.
 - 2.12.3 **Production:** When a broadcaster agrees to commission a programme, the producer organises the talent (writers, actors, director etc.) and films the programme.
 - 2.12.4 **Finished programme sales:** The producer sells the primary UK transmission rights to a UK broadcaster and/or the producer licenses a distributor to sell further rights to the work such as to international broadcasters.
- 2.13 This process is not automatically followed from beginning to end – very few programme ideas or pitches will lead to successful commissions. And of those, fewer still will be re-commissioned or be able to generate significant international rights or format sales. This means that there is a considerable amount of uncertainty and risk involved in TV production, as is the case in most creative industries.
- 2.14 The hit-driven, uncertain and risky nature of TV production has had a number of key implications for industry structure over recent years:
- 2.14.1 The ‘hit-driven’ nature of the industry has helped drive consolidation, as larger production companies can work on multiple productions at the same time, share risks more effectively across a number of programmes, and generate a pipeline of future programmes in order that they can replace ones that become tired and are not recommissioned.
 - 2.14.2 Foreign ownership of UK producers has also been encouraged by the high number of hits generated by UK producers and the success of British programmes around the world. In some cases, the same production company can make many different national versions of one programme.
 - 2.14.3 Given the uncertainties involved in TV production, broadcasters may prefer to deal with larger and/or well-known producers whom they trust to deliver a programme to the desired specification, budget and timing.
- 2.15 Throughout this review we distinguish between several different types of producer:
- 2.15.1 **In-house producers:** the production arms of UK PSB broadcasters (principally BBC Productions and ITV studios although Channel 5 now operates an in-house production division).
 - 2.15.2 **Non-qualifying producers:** previously independent production companies in which a group owning a UK broadcaster owns a shareholding greater than 25%.

- 2.15.3 **Qualifying independent producers:** independent production companies not tied to a UK broadcaster through significant common ownership¹³.
- 2.15.4 **Large producers:** often referred to in the industry as 'super-indies' (sometimes still qualifying, but mostly not). They are usually a conglomeration of different producers who specialise in a particular type of output and operate in a number of markets around the world and typically have UK revenues over £50m per year.
- 2.15.5 **Small producers:** there are a large number of small production companies. They typically generate revenues under £10m per year, with a significant proportion generating less than £1m per year in UK revenues.

The production sector has evolved through a number of stages over the last thirty years

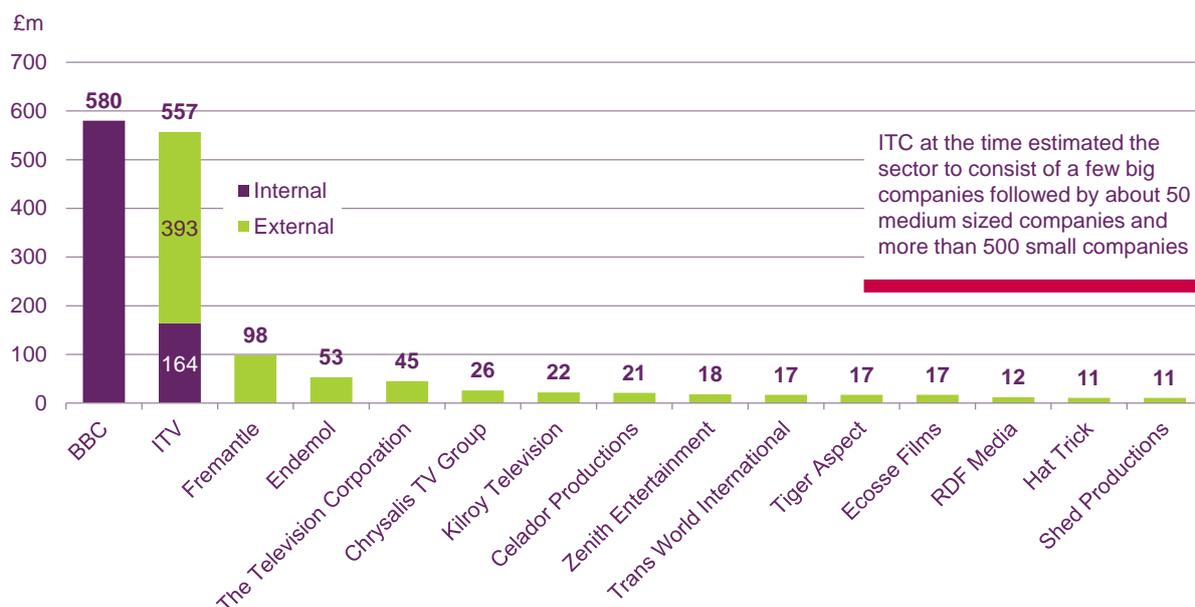
- 2.16 A combination of technological development, evolving viewer behaviour, and regulatory change has contributed to a fast pace of change in the TV content production sector. We have witnessed several stages of development from the 1980s to the present day.
- 2.17 **The birth of the UK independent production ('indie') sector.** Before the launch of Channel 4 in 1982, almost all TV programmes (i.e. on the BBC and ITV) were produced in-house. In the 1980s and 1990s, a 'cottage industry' of independent producers grew slowly. However, many producers effectively operated on a 'work-for-hire' basis with low, fixed margins¹⁴, given the high negotiating power of the three main commissioning broadcasters.
- 2.18 Fifteen years ago, the sector was still highly fragmented. Leading producers such as HatTrick, TwentyTwenty and Celador generally relied on one or two standout hits to grow but each never accounted for more than a few percentage points share of the total market. The ITC's 2002 programme supply review¹⁵ suggested that in 2001 there were also around 500 very small producers sharing 10% of the market.
- 2.19 **Early UK consolidation started 20 years ago.** Consolidation among UK companies started in the mid-1990s, driven by the growing market for externally produced programmes, the potential for economies of scale and scope, and the benefit of spreading risks across several programmes. The first big consolidator was Pearson TV who purchased Thames Television in 1994, All American Television in 1996 and Talkback in 2000, shortly after which the company was also sold to what became RTL in Germany who rebranded it as Fremantle. Fremantle was, in effect, the UK's first very large producer, as shown in Figure 2.

¹³ Per the Broadcasting (Independent Productions) Order 1991 (as amended), an independent producer is: (i) not employed by a broadcaster; (ii) does not have a shareholding greater than 25% in a UK broadcaster; or (iii) in which no single UK broadcaster has a shareholding greater than 25% or any two or more UK broadcasters have an aggregate shareholding greater than 50%.

¹⁴ A 'production fee' was typically negotiated as a percentage of the overall programme budget

¹⁵ *A Review of the UK Programme Supply Market*, the Independent Television Commission, 25 November 2002

Figure 2: Top UK production companies ranked by UK revenues, 2001



Note: UK revenue, but including overseas revenue from UK rights exploitation

Source: ITC, DGA, Oliver & Ohlbaum Associates analysis

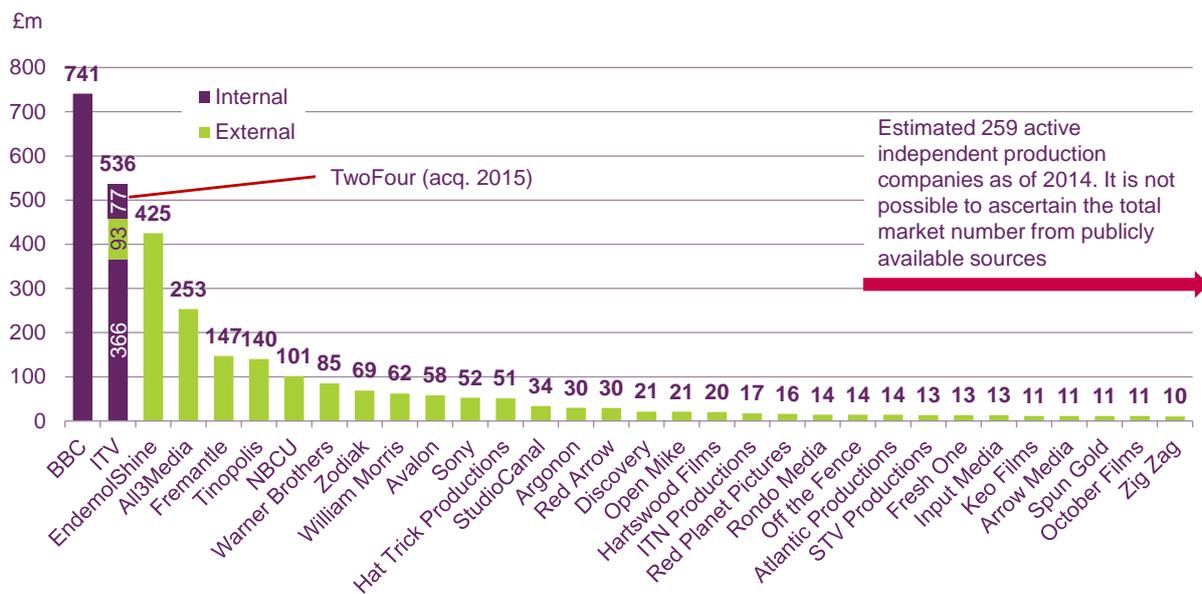
2.20 External capital, consolidation and the rise of the large producers.

Consolidators also saw the opportunity to build, and then ultimately sell, valuable companies of scale in a growing market, especially once interventions were put in place in 2003 that allowed production companies to control and exploit their own intellectual property (IP). In the five years from 2003 to 2008, consolidation occurred at pace, often funded by private equity. Many successful small producers were merged in quick succession under British-owned umbrella groups such as All3Media. However, Endemol and Fremantle also remained two of the biggest players in the market. Despite this, a long tail of small independent producers remained with nearly 400 companies having at least one programme on air on a PSB network channel in 2008¹⁶.

2.21 **IP development and exploitation.** Some production companies grew rapidly into very large producers thanks to fast growing secondary rights revenues, format exploitation and expansion overseas, especially into the US. A typical large producer may today have revenues in excess of £50m in the UK (see Figure 3), operate a diverse set of functionally separate production companies, operate in the US and other major TV markets, and own its own distribution arm to exploit its IP. By contrast, a typical qualifying indie is usually truly independent, relies on one or two commissions a year from PSBs and generates revenues under £10m per year.

¹⁶ Oliver & Ohlbaum Associates report p18

Figure 3: Top UK production companies ranked by UK revenues, 2014



Notes: UK revenue, but including overseas revenue from UK rights exploitation, some revenue numbers may include additional activities such as distribution and formats not strictly UK derived; ownership status correct to 2015; estimate for value of proposed externalisation of BBC Studios is c.£400m, currently included in in-house spend.

Source: Broadcast Now Survey 2015

2.22 **Globalisation.** The UK’s largest producers started to acquire overseas production companies, typically in the US, but also in Australia and in Europe. The strategy behind this expansion was to be able to generate a wide breadth of new ideas that could then be exploited by production arms they also owned around the world. Today, the global revenues of the likes of Fremantle and Endemol-Shine Group are in excess of £0.5bn 2014.

2.23 **Renewed vertical integration.** Major US media groups such as NBC Universal and Warner Brothers started to acquire UK production companies from 2008 onwards. TV production had been one of the fastest growing segments of the global media market, and hence was an attractive area for US broadcasters to expand into as they sought to diversify. UK producers proved particularly attractive due to the volume and quality of their programming ideas. In the UK, ITV has also recently started to increase the scale of its production division, purchasing both large and small producers in the US and UK.

Figure 4: Composition of the external production sector, 2001 and 2014

	2001	2014
Large UK-owned producers	0	3
Large foreign-owned producers	2	7
Total active producers in market	c.500	259

Notes: 'active' defined as having at least one commission on a PSB network in the relevant year; 'large' defined as top ten UK external producer; production companies consolidated within groups are only counted at group, not individual, level; excludes portfolio channels; 2001 figure of 500 producers as estimated by the ITC in 2002.

Source: Ofcom, ITC, Attentional, Oliver & Ohlbaum Associates analysis

PSB demand for new programmes remains the key driver of UK production sector revenues

2.24 Since the 1980s, the wider television sector has undergone a number of significant structural changes that have expanded the market opportunity for producers to make new TV programmes and exploit the associated IP:

2.24.1 **Non-PSB channels:** the rise of multichannel platforms and digital switchover (which made this wider range of channels available to all) has increased the number of available commissioners of new programmes. These non-PSB channels previously tended to rely on acquired programming and repeats, but are increasingly commissioning original content themselves. Of these, Sky has been the largest source and has won a number of programming awards.

2.24.2 **International demand:** foreign broadcasters have also emerged as customers of the UK production sector, buying rights to finished programmes and formats, and increasingly commissioning original series from UK production companies.

2.24.3 **New subscription video-on-demand (SVoD) services:** having established themselves in international markets, new online subscription services such as Amazon Prime and Netflix, have begun to commission more original programmes. While such services have, thus far, been heavily-focussed on US content they are now beginning to commission UK content too.

2.25 Despite these new sources of demand emerging, the four PSBs remain the main commissioners of new UK TV programmes and therefore the main source of business for production companies in the UK. In 2001 the BBC, ITV, Channel 4 and Channel 5 accounted for 90% of all programme commissions in the UK in terms of investment. In 2014, the PSBs remained the largest buyers of UK TV programmes,

still accounting for around 85% of all UK non-sport new TV programme investment, a figure that has remained broadly flat over the past five years¹⁷.

- 2.26 As we have set out in our PSB annual reports¹⁸, overall spending by the PSBs on first-run programming has been broadly flat over the past decade in nominal terms but fallen in real terms. In 1998, the PSB channels spent £2.5bn (in real terms) on network first-run UK-originations. This rose to reach a peak of £3.31bn in 2004 driven by the launch of the BBC portfolio channels and increased spend by the commercial PSB channels.
- 2.27 Spending has since fallen back in real terms and stood at £2.52bn in 2014. There has also been a shift in spending from in-house production to external producers, notably in genres such as entertainment, comedy and drama. But, given the stagnation in overall spending, PSBs' expenditure on external producers has also remained flat for the past decade in nominal terms.
- 2.28 While the overall characteristics of demand for new UK TV programmes have remained fairly constant in recent years, each PSB uses external suppliers to a different extent and their programme sourcing strategies have evolved in several different ways in recent years:
- 2.28.1 **BBC:** The BBC spends more with external producers than any other PSB. However, under the terms of its Charter and Agreement, it reserves 50% of its schedule for its in-house production division under the in-house guarantee. Beyond the 25% independent production quota, the remaining 25% of its schedule is open to competition between external producers and its in-house production division, the so-called window of creative competition (the WoCC). External producers have performed consistently well in the WoCC; in 2014/15, they won 77% of WoCC hours¹⁹.
- 2.28.2 **ITV:** ITV in recent years has focused on acquiring a number of external producers, mainly in the US, in order to diversify its business away from a reliance on broadcasting. As it has sought increasingly to focus on content production, it has directed a greater proportion of its overall programme budget to its in-house division ITV Studios. In June 2015, it made its first major UK independent producer acquisition, TwoFour Group, having previously acquired a number of very small UK producers. This acquisition has meant that ITV Studios has overtaken the BBC as the UK's largest supplier of new programmes in revenue terms (when sports and news are excluded).
- 2.28.3 **Channel 4:** Channel 4 commissions more new hours of programmes from external producers than any other PSB. Its investment with external producers is also almost as high as that of the BBC. This is largely as a result of it being a publisher-broadcaster without its own in-house production division.
- 2.28.4 **Channel 5:** Channel 5 is a much smaller buyer of new programmes than the other PSBs. It has also recently set up an in-house production division,

¹⁷ Oliver & Ohlbaum Associates report p12

¹⁸ <http://stakeholders.ofcom.org.uk/broadcasting/reviews-investigations/public-service-broadcasting/annrep/psb15>

¹⁹ <http://downloads.bbc.co.uk/annualreport/pdf/2014-15/bbc-papc-2015.pdf> (page 23)

and is starting to divert a proportion of its overall programme budget away from external producers.

- 2.29 We also note that in recent years Sky and other multichannel broadcasters have increased their investment in new original programmes. Including the commercial PSB's own portfolio channels, the multichannel sector spent around £350m on new UK programmes in 2013, as noted in our PSB Review Consultation document. The vast majority of this investment is with external production companies so any further growth in their investment is likely to benefit UK-based producers and increase overall demand.

Figure 5: PSB network channel programme sourcing trends, 2006 and 2014

Metric	BBC		ITV		Channel 4		Channel 5	
	2006	2014	2006	2014	2006	2014	2006	2014
Total programme spend	£1773m	£1360m	£1086m	£818m	£638m	£492m	£239m	£181m
New UK programme spend	£1549m	£1269m	£986m	£774m	£475m	£377m	£136m	£101m
External production spend	£404m	£409m	£344m	£227m	£475m	£377m	£134m	£97m
% of new UK spend with external producers	26%	32%	35%	29%	100%	100%	99%	96%

Notes: data in real terms at 2014 prices; ITV includes ITV Breakfast; includes news and sports rights.
Source: Ofcom, based on data provided by broadcasters

Overall, the UK external production sector has grown rapidly into a globally successful industry

- 2.30 **Overall UK external production sector revenues have grown strongly.** The UK external production sector (qualifying and non-qualifying producers) has experienced revenue growth at an average annual compound rate of 1.9% in real terms since 2008²⁰. In 2014, the sector overall generated £2.9bn in revenue, £2.7bn of which was generated from television²¹.
- 2.31 **International revenues have been the biggest source of growth in recent years.** Revenues from overseas markets have been an important driver of growth for the production sector in recent years, enabled by producers' ability to retain secondary rights both in the UK and internationally. International revenues from overseas sales of completed programmes, formats, and also brand new commissions from overseas broadcasters now account for 30% of all sector revenues, up from around 17% in 2006. This sector has been an overall success from a UK industrial policy point of view, expanding strongly overseas both in terms of exports of UK IP and through making brand new programmes in overseas markets.
- 2.32 **Producers increasingly contribute to the funding of PSB programmes.** One consequence of the growth in secondary rights revenues has been the growth of so-called 'deficit financing' and co-production deals. Under deficit financing, part of the funding of a programme comes from the producer rather than the broadcaster with

²⁰ 4.7% average annual growth in nominal terms at 2014 prices

²¹ Oliver & Ohlbaum Associates report p52

the hope that later sales of secondary rights (e.g. international sales of the programme) will allow recuperation of costs.

- 2.33 In some cases there could be formal co-production in which an overseas broadcaster, or another company, funds part of the production costs. Deficit financing acts as a form of risk-sharing between the broadcaster and the producer and can benefit both: the broadcaster pays less than it would otherwise have done, while the producer can gain the upside from selling secondary rights. While this is a positive contribution to programme funding, we note that third-party co-production and producer deficit financing have not offset reductions in real terms programme investment by the PSBs, as noted in our recent PSB Review.

There have been some significant changes to the structure of the production sector over the last decade

- 2.34 The success of the sector has made independent producers attractive to a range of buyers, resulting in growing levels of consolidation. This consolidation has had three different effects:
- 2.34.1 a smaller number of producers, operating in a more concentrated market. In terms of revenue, the top ten producers now account for an estimated 66% of all UK producer revenue, up from 45% in 2003²²;
 - 2.34.2 an increase in the degree of vertical integration between broadcasters and producers. Five of the ten largest producers are now controlled by UK broadcaster owning companies; and
 - 2.34.3 an increase in the level of foreign ownership. Since 2008, major US media groups such as NBC Universal and Warner Brothers have been acquiring a number of UK production companies. Today, seven of the ten largest UK producers are owned by large foreign media corporations.
- 2.35 Overall, consolidation has also led to a reduction in the number of UK television production companies: the number of UK television production companies has nearly halved from around 500 in 2001, to around 450 in 2006 and around 250 in 2014. However, analysis conducted for this report suggests that consolidation only accounted for only around 50 of the total reduction in producers used²³.
- 2.36 In 2001 almost all of the producers were small and only two had UK revenues over £50m²⁴. Of the producers used in 2014, 11 producers had UK revenues over £50m and five had UK revenues over £100m²⁵.

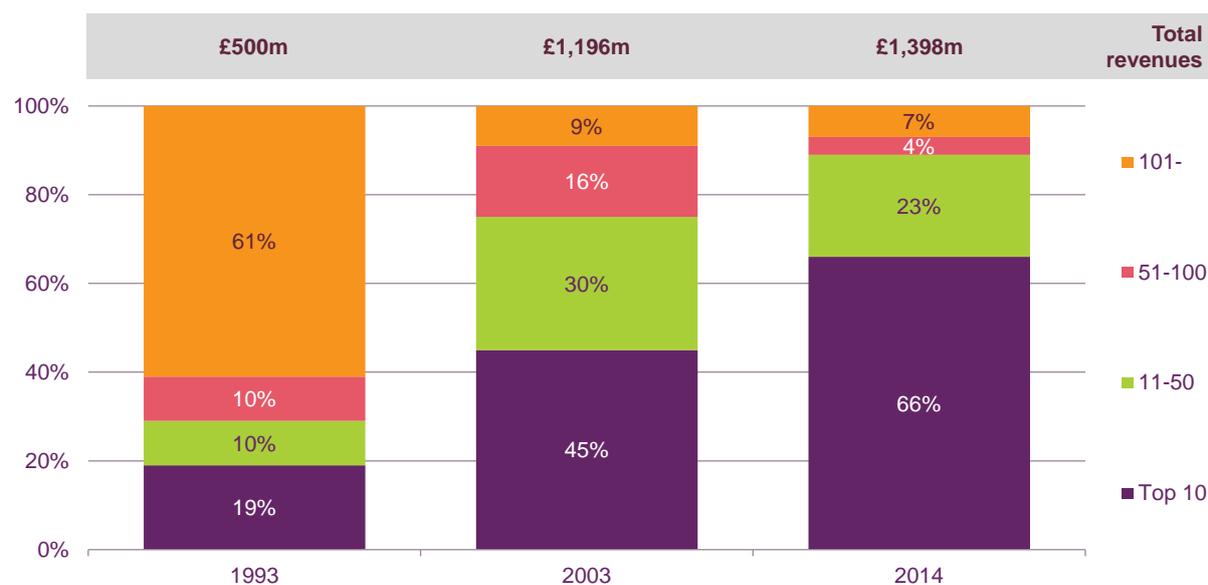
²² Mediatique report p13

²³ Oliver & Ohlbaum Associates report p19

²⁴ Oliver & Ohlbaum Associates report p75

²⁵ Oliver & Ohlbaum Associates report p74

Figure 6: Share of UK external production revenues, by rank of supplier, 2014



Source: Mediatique estimates, Broadcast, Televisual, Pact

Figure 7: Top 10 external producers, 2014

Producer	UK Revenue	Market share	Parent company	Independent qualification	Example programmes
Endemol Shine	£425m	20%	Apollo Global Management & 21st Century Fox	Non-qualifying	Big Brother, Deal or No Deal, Masterchef, Peaky Blinders, The Fall, Clash of the Choirs, Utopia
All3Media	£253m	12%	Discovery Communications & Liberty Global	Non-qualifying	Hollyoaks, Midsomer Murders, Embarrassing Bodies, Skins, Horrible Histories, Shameless
Fremantle Media	£147m	7%	RTL	Qualifying	The X Factor, Danger Mouse, Jamie Oliver, The IT Crowd, Great Railway Journeys, Suspects
Tinopolis	£140m	7%	Privately held	Qualifying	Question Time, BT Sport, Traffic Cops, Big Fat Gypsy Weddings, Hell's Kitchen
NBC Universal UK	£101m	5%	NBC Universal	Non-qualifying	Downton Abbey, Made in Chelsea, Birdsong, How To Cook Well with Raymond Blanc
Warner Brothers TV	£85m	4%	Time Warner	Non-qualifying	Waterloo Road, New Tricks, Supernanny, The Choir, Who Do You Think You Are?
TwoFour	£77m	4%	ITV	Non-qualifying	The Hotel Inspector, Educating Yorkshire, James Nesbitt's Ireland, Splash!, The Jump
Zodiak	£69m	3%	De Agostini	Qualifying	The Inbetweeners, Wife Swap, The Secret Millionaire, Fort Boyard
William Morris Endeavour	£62m	3%	William Morris Agency, Endeavour Talent Agency	Qualifying	World's Strongest Man, Barclays Premier League, Channel 4 Racing, Snooker, Wimbledon
Avalon Television	£58m	3%	Tiverton 2 (Jon Thoday, Avalon founder)	Qualifying	Russell Howard's Good News, Catastrophe, Not Going Out, Man Down, Workaholics

Source: Ofcom, Oliver & Ohlbaum Associates, Mediatique

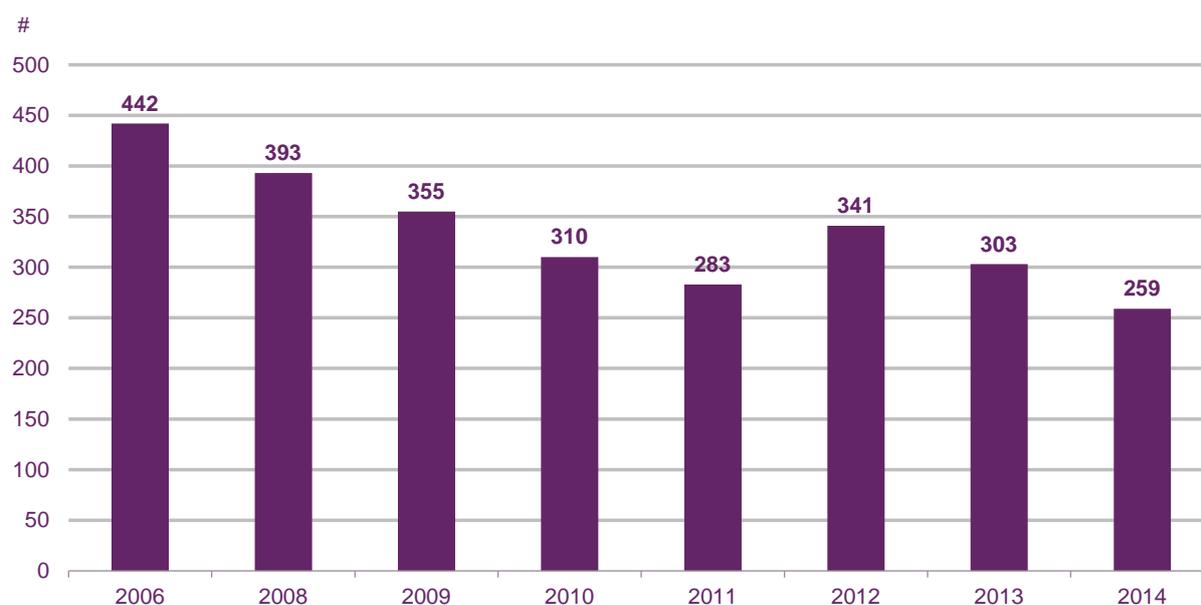
In several important ways the production sector has not changed significantly

- 2.37 **The PSBs continue to be the largest source of new business for UK producers.** As set out earlier, despite the growth of original commissioning from non-PSB channels and SVoD services, the PSBs, in total, continue to account for the vast majority of UK commissions. Producers looking to supply new programmes in the UK must still therefore effectively serve the four main PSBs. To date, Netflix and Amazon Prime have only commissioned a small handful of new original programmes from UK producers.
- 2.38 **The BBC and ITV also remain the largest producers in the UK market.** BBC Productions and ITV Studios both remain bigger than even the largest external producers in terms of UK production revenues. However, we note that the merged Endemol Shine Group may be bigger than BBC Productions when News and Sport investment is excluded.
- 2.39 **Qualifying producers remain a successful component of the market.** While the largest external producers tend now to be non-qualifying, qualifying producers continue to come up with successful programming ideas and broadcasters continue to rely on them. One indication of this is the success of qualifying independent producers within the BBC's WoCC²⁶: in 2014/15, 41% of hours in the WoCC were won by qualifying independent producers compared with 36% by non-qualifying producers and 24% by the BBC's in-house arm²⁷.
- 2.40 **There is still a strong, vibrant long tail of small, qualifying UK producers.** Despite the rapid pace of consolidation and the rise of large global producers, there remains large number of small qualifying producers. A total of 259 different producers had at least one programme broadcast on a PSB network channel in 2014, albeit down from nearly 450, as noted above.
- 2.41 Almost all of the small producers outside the top 50 in revenue terms are qualifying independent producers. It is also still the case that the hit-driven nature of the industry means even these small companies can grow quickly if they manage to find an appealing programming idea; a break-out hit such as The Great British Bake Off can transform the fortunes of a company. These small companies, even those with revenues under £1m per year, are profitable in aggregate.
- 2.42 **Levels of disruptive new market entry remain high.** The production sector remains characterised by high levels of new market entry. In 2014 a total of 84 producers (32%) were companies that were brand new to the market. Of these 84 companies, only 17 were identified as being owned by established industry talent. However, it should be noted that it was not possible to identify the backgrounds of the founders of all 84 companies. The level of new market entry has been consistent in recent years and has averaged around 30% since 2009.

²⁶ Under the terms of its Charter and Agreement, the BBC reserves 50% of its schedule for its in-house production division under the in-house guarantee. Beyond the 25% independent production quota, the remaining 25% of its schedule is open to competition between external producers and its in-house production division, the so-called window of creative competition (the WoCC).

²⁷ <http://downloads.bbc.co.uk/annualreport/pdf/2014-15/bbc-papc-2015.pdf> p23

Figure 8: Total producers active in the market on PSB network channels, 2006-2014



Note: producers counted as active if they have at least one programme on air on a PSB channel
Source: Attentional, Oliver & Ohlbaum Associates analysis

- 2.43 **The PSBs remain able to source programmes in all genres from a healthy range of suppliers, both large and small.** In most genres, there remains a healthy range of small independent producers supplying programmes. Larger producers also continue to make the programmes that PSB commissioners want in order to meet the needs of UK audiences and their remits.
- 2.44 Indeed these larger producers must meet the need of PSB commissioners if they wish to maintain a sizeable UK business, given that the PSBs account for around 85% of all UK demand for new television programmes. None of the PSBs have raised concerns with Ofcom, during the course of this review, about their ability to source programmes that reflect the culture and communities of the UK and its nations and regions from the largest global producers.

There are a number of scenarios for future market development and some potential risks to the system

- 2.45 **It is not clear whether production sector revenue growth will be sustained in the coming years.** Although the UK's external production sector has almost doubled in size in revenue terms over the last decade, much of this growth has come from producers making programmes overseas, especially in the US. Growth in the UK itself has actually been relatively slow, as set out earlier.
- 2.46 **Going forward there are some downside risks to UK demand.** Investment in new programmes may fall if the BBC reduces its overall budgets. Separately, ITV may continue to reduce spend with external producers and Channel 5 may also increasingly spend more in-house. In addition, any significant future change to the remit or ownership of Channel 4 could lead to it reducing its spend on new programmes and/or reducing the number of small suppliers it commissions.
- 2.47 **But there may be some new opportunities.** The UK market opportunity for producers may be increased if the BBC Studios plan is given the go-ahead. If it is, then external producers will be able to bid for the 50% of the BBC schedule that is

currently reserved for the BBC's in-house arm but they would also have to compete with BBC Studios for commissions from other broadcasters. It is not clear what the net effect would be on the external production sector.

- 2.48 **US demand for programmes from UK producers may also weaken.** The US cable network sector has been an important source of growing demand for UK producers. However, in the last year this sector has been somewhat challenged as the traditional US pay-TV market (cable, satellite and IPTV platforms) has started to contract slightly²⁸. As a result these cable network channels have seen the carriage fees paid by platforms fall while advertisers have also reduced spend with these channels. It is too early to tell whether these will be sustained downward trends.
- 2.49 **Consolidation is likely to continue, but the pace is likely to slow.** It is likely that larger producers will continue seeking to replace old formats with new ideas and talent from smaller producers. However, there are fewer independent producers of mid-tier scale left to buy in the market and so the large consolidators may instead increasingly refocus on funding key talent, both established and up and coming. As a result, the pace of consolidation is likely to be much slower in the next few years.
- 2.50 **Further vertical integration appears likely going forward.** It is possible that major US media corporations, and also ITV Studios, may continue to pursue further UK and global acquisitions in order to find new talent and ideas. If so, the degree of vertical integration would continue to increase going forward, given that the large US media corporations also tend to own UK broadcasters.

²⁸[TV flickers as viewers find new screens](#), *Financial Times*, Aug 14 2015

Section 3

The effectiveness of the current regulations

Introduction

3.1 In this section we set out the historical rationale for intervention in the programme supply market and the degree to which the objectives of the regime are being met today. We then consider the extent to which fulfilment of the objectives is due to regulation.

The Government has a number of objectives in regulating the production sector

3.2 In his request for this review, the Secretary of State reiterated that there were a number of public and industrial policy objectives for regulating the programme supply market:

3.2.1 **promoting cultural diversity and opening up the system to new energies and voices:** the best programme ideas originate from across the whole market and external producers often cater for a wider mix of genres;

3.2.2 **stimulating SME growth, promoting creativity and fostering new talent:** reducing barriers to entry enables independent producers to establish themselves as SMEs, promote British intellectual property, and attract overseas investment to a strong domestic sector.

3.2.3 **balancing vertical integration trends:** the vertical integration of broadcasters and producers in the supply market may lead to a lack of diversity of supply and therefore not deliver a broad range of genres or value for money.

3.3 In his letter requesting Ofcom conduct this review, the Secretary of State confirmed that these objectives still “hold good” but he also requested that Ofcom add two new priorities:

3.3.1 **promoting content production, especially in at-risk genres:** the PSB Review noted that there was minimal provision in some genres; targeted independent production incentives may be able to boost provision; and

3.3.2 **considering horizontal integration in the supply market:** merger and acquisition activity in the production sector may change the competitive balance of the sector and the effectiveness of the regulations.

3.4 Given that the Secretary of State has reiterated his support for the objectives of the regime, the aim of this review is to assess whether regulation is still required to deliver these objectives given past and likely future changes in the market. Our 2006 review of the production sector concluded that there is no one model that delivers creativity and innovation and that both broadcasters and producers have a role to play. It also stated that a mixed ecology of different types of producers and

broadcasters is important in delivering the objectives by encouraging a higher level of diversity than the market might be expected to deliver in the absence of regulation.

- 3.5 We concluded that diversity was best delivered not just in programming output but also as an input to the production of programmes. As an input, diversity in production takes many forms: social, cultural, geographic, corporate scale and structure, through a plurality of players in the market, diversity of TV channels and through diversity of commissioning within channels. In particular, diversity is likely to be best delivered by ensuring that there is a market opportunity to encourage disruptive new entrants which can grow to scale.
- 3.6 Our review in 2006 also highlighted that there were three key features of the overall market for television programme production which may lead to the crowding out of disruptive new entrants. These factors drove the need for intervention in order to ensure that diversity would be achieved through a thriving base of small independent producers:
- 3.6.1 **broadcaster negotiating strength:** the majority of originated programming was (and still is) commissioned by the four main terrestrial broadcasters, giving them negotiating strength and the ability to squeeze external producers commercially – possibly with the potential to reduce diversity and quality of TV content;
 - 3.6.2 **vertical integration:** this can produce incentives that result in a bias for in-house production, which may lead, at the margins, to inferior programmes being commissioned and diversity of the supply of content to viewers being damaged; and
 - 3.6.3 **geographic concentration:** TV production tends to concentrate in London which may damage the diversity of content available to viewers.

There are three main elements of current regulation aimed at delivering the objectives of the regime

- 3.7 The regulations affecting the commissioning of programmes from independent producers results from legislation that was last updated through the Act, comprising two main interventions applying to public service broadcasters:
- 3.7.1 **an independent production quota:** Ofcom must ensure that, in each year, not less than 25% of the total amount of time allocated to the broadcasting of qualifying programmes included in every licensed PSB channel is allocated to the broadcasting of a range and diversity of independent productions²⁹; and
 - 3.7.2 **codes of practice:** Ofcom must ensure that the provider of every licensed PSB channel draws up, and from time to time revises, a code of practice setting out the principles it will apply when agreeing terms for the commissioning of independent productions³⁰. Terms of Trade with

²⁹ Communications Act 2003, section 277

³⁰ Communications Act 2003, section 285

independent producers are typically then negotiated within the framework set out by these codes³¹.

- 3.8 These interventions apply only in relation to ‘independent’ producers³². In summary, the **definition of an independent producer** is one who is not an employee of a broadcaster; does not have a shareholding greater than 25% in a broadcaster; and is not a body corporate in which a broadcaster has a shareholding greater than 25% (or in which two or more broadcasters have aggregate shareholdings greater than 50%).
- 3.9 It is important to note that the independent production regulations are distinct from separate out-of-London and out-of-England quotas that are also in force, and which apply to all PSB investment in programmes including in-house production. They do not specifically apply to independent productions.

Outcomes appear to be broadly good, despite the considerable changes, but there are some areas of weakness

- 3.10 The evidence suggests that the objectives of the regime continue to be largely met, despite the considerable changes to the structure of the market that have occurred over the last decade, especially its consolidation and the acquisition of a number of major UK producers by large global media corporations.
- 3.11 **New producers are usually owned by brand new emerging talent.** Inevitably, many of the new small producers have some experience in the industry having worked for a broadcaster or another production company. But this is not surprising given that producers need TV experience in order to be successful, and indeed it is healthy: the flow of talent between broadcasters and producers (both inward and outward) leads to cross-fertilisation and new ideas. However, analysis conducted for this review found that only 17 of the 84 new entrant companies in 2014 were founded by senior established broadcasting executives.
- 3.12 **There remain many suppliers in most key genres, including some at-risk genres.** Small producers continue to supply programmes in most genres, including some at-risk PSB genres such as current affairs and children’s programmes. A total of 37 different companies were successful getting at least one drama commission on air in 2014, down only slightly from 46 in 2006. A total of 45 companies had a current affairs programme on air, a similar number to 2005, and 16 different companies even had a children’s programme on air, despite the BBC being the only commissioner.
- 3.13 **The external production sector remains concentrated in London and the South East.** Around 66% of all producers used by the PSBs are still based in London and the South East, precisely the same proportion as in 2008. The absolute number of producers active in some regions is low. Only one producer in each of Anglia, the Midlands and the West Country were identified as having a commission on air in 2014 while not a single North East producer was identified as having a peak time or daytime commission. A total of 12 producers were identified active in Scotland, 10 in Wales and 5 in Northern Ireland in 2014.
- 3.14 **Although the number has declined there is still a high number of small producers active in the market.** As set out earlier, 259 producers had at least one programme on air in 2014, although this is down from 442 in 2006. Of these, 88%

³¹ Communications Act 2003, section 285

³² as defined in the Broadcasting (Independent Productions) Order 1991 (as amended)

had an annual turnover of below £10m in 2014. We note that all PSBs have reduced the number of suppliers they work with but Channel 4 has reduced the number of producers it works the most, from around 200 in 2006 to around 100 in 2014.

- 3.15 **Small producers still win a significant share of PSB network channel programme commissions.** In 2014 producers with revenues under £10m accounted for 23% of all external PSB network channel first-run commissioned hours, excluding news and sports. While this is a fall from 38% in 2008, it seems that small producers are still able to win a healthy share of commissions from broadcasters. Qualifying independents are overwhelmingly small producers – a total of 75% of qualifying independent producers have a turnover below £1m, while only 4% have turnover above £25m.
- 3.16 **Larger consolidated producers continue to invest in new programme ideas and in new talent.** There is no clear evidence to suggest that large, vertically integrated, or foreign owned producers are damaging the quality or range of ideas available to PSBs. We have not seen any evidence to suggest that such producers are any less creative, or focus on particular genres to the exclusion of others. It is important to note that the output of the PSBs will be determined largely by what they believe viewers want to watch and what they are prepared to commission.
- 3.17 **It remains possible to grow very small independent producers into medium sized companies.** Despite rapid consolidation at the top end of the market, there is clear evidence that small start-up independent producers can continue to grow into medium sized companies. For example, Keo Films' revenue grew from £2.5m in 2008 to £11m in 2014. Similarly, Blast! Films' had revenue of £3.9m in 2008 and £9m in 2014.³³

Regulation has helped to ensure that the objectives of the regime have been met

- 3.18 Since the introduction of the quota in 1990 and also since the introduction of the codes of practice in 2003, each element of regulation has been important in delivering ensuring the objectives of the regime are met, but to varying degrees at different times. The three key elements of intervention work together towards delivering the overall objectives of the regime.
- 3.19 **The quota has become increasingly important backstop in delivering diversity in recent years.** After its introduction in 1990, the independent production quota obliged the BBC and ITV to commission more externally but gradually became more of a backstop measure as all PSBs exceeded it comfortably in subsequent years. However, the quota has gradually come under increased pressure in recent years as more and more large producers have become non-qualifying. The quota is therefore increasingly important in setting a floor on the proportion of PSB programmes that are produced by qualifying independent producers. Without it, it is possible that PSBs would increasingly rely on a small selection of larger producers whom they know and trust to deliver a programme to the agreed budget, timing and specification.
- 3.20 **The definition of a qualifying independent producer has balanced the effects of vertical integration.** The definition of a qualifying independent continues to balance the trend of vertical integration of producers with UK broadcasters since a producer acquired by a broadcaster will cease to qualify. Not only is there an element of 'self-

³³ Revenue data sourced from Broadcast Magazine Indie Survey (2009 & 2015)

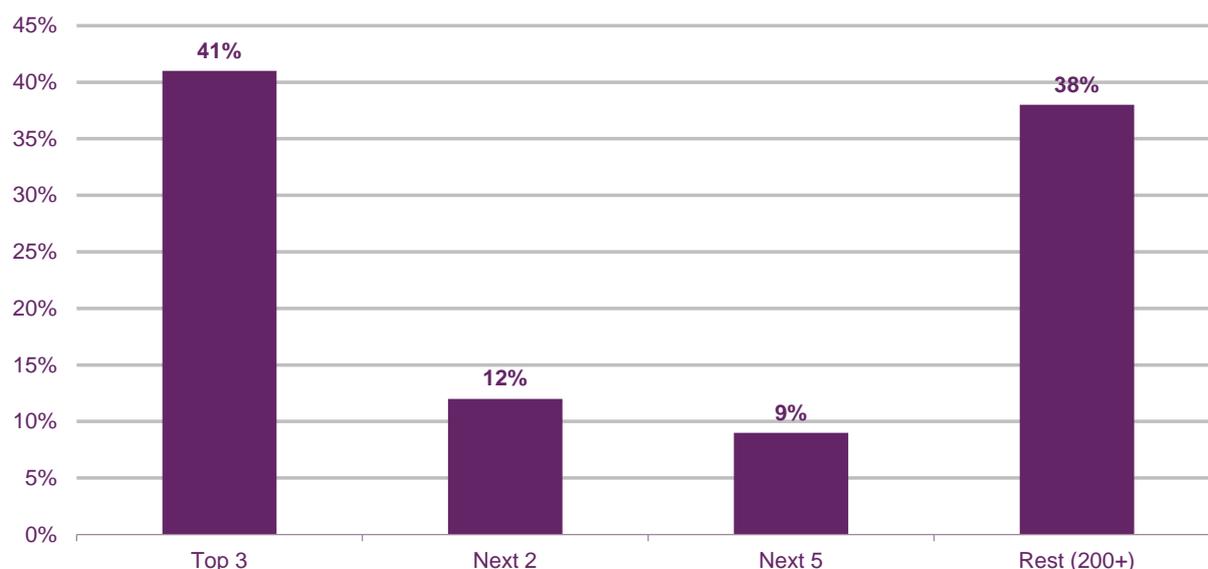
correction' (as vertical integration leads to non-qualification) but such non-qualification also provides opportunities for small producers since they can continue to provide output to meet PSBs' 25% quotas. The fact that well over 90% of qualifying independent producers are small producers indicates that the regime continues to be highly focused on benefitting SMEs.

- 3.21 **The definition has in the past resulted in high levels of diversity.** The definition is based on ownership criteria rather than an absolute numbers basis, and therefore has not in itself guaranteed that a high number of small producers are used. In the past this did not matter because of the fragmented structure of the market: in 2001 almost all external producers in the market were small producers so when using external suppliers, the PSBs would have to use a large number of small producers. However, today conditions are different, given the changes to the structure of the market. There are a number of large producers which still qualify under the current definition and therefore the PSBs could increasingly rely on a smaller pool of large producers to meet the quota, if they so desired or if they were incentivised to do so. As a result, today the definition does not absolutely guarantee the diversity and plurality that a fragmented base of small suppliers delivers, and this partly explains why the PSBs have been able to reduce the absolute number of suppliers they each use. However, as set out earlier in this section, outcomes remain good with 259 producers getting at least one commission on air on a PSB network channel in 2014.
- 3.22 **Regulation has encouraged small producers to enter the market.** The regulatory regime has proved critical in incentivising key talent to set up new production companies. Acting in combination, the interventions ensure that qualifying producers can win commissions from PSBs and retain IP rights which they can then use to grow into larger businesses. Small producers have indicated to us that they would not have been able to grow without retaining rights as a result of the Terms of Trade.

Nevertheless there may be some future challenges to the regime's effectiveness

- 3.23 While the regulatory regime continues to deliver its main objectives, a number of trends are beginning to emerge that are worth considering.
- 3.24 **The regime does not require the use of SME producers.** When the interventions were first put in place in 1990, almost all independent producers were small. But there are now a number of large producers who are qualifying independents and over time they have accounted for more of the output from the qualifying independent sector. The top 3 qualifying independent producers accounted for more of the total number of hours commissioned from all qualifying producers than over 200 small producers, as set out in the diagram below. While broadcasters are likely to continue having incentives to use small producers given the strength of their programming ideas, there is nothing in the current regulatory regime that requires them to do so.
- 3.25 **Neither the quota nor the definition guarantees that qualifying independent producers are used in a wide range of geographies.** Separately, out-of-London and out-of-England quotas, where they apply, relate to all PSB production investment including in-house, not just external suppliers. Therefore, there is no regulation that specifically ensures that independent producers are used across a range of geographies. Channel 4 effectively has to meet its out-of-London and out-of-England commitments using external suppliers given that it remains a publisher-broadcaster but it does not have to do so using qualifying independent producers.

Figure 9: Share of qualifying hours for the top qualifying producers (by revenue), 2014



Source: Attentional, Oliver & Ohlbaum Associates analysis

- 3.26 **An increasing number of commissions may be agreed outside the Terms of Trade.** The ability of producers and PSBs to negotiate terms outside of the overarching Terms of Trade is positive in that it helps the system remain flexible, but it also means that there are some risks. Under the current system, qualifying independent producers can still choose to agree terms which differ to the standard Terms of Trade, if both parties agree.
- 3.27 Given the high number of suppliers competing for each new commission, the PSBs could increasingly use their negotiating strength to force small producers to accept worse terms, simply to win the commission. If this became a more widespread practice, it is possible that small producers will in aggregate increasingly be unable to generate the profits or retain the rights required in aggregate to ensure a dynamic commercially sustainable and healthy SME production sector. Essentially, it is possible that custom and practice in the market could lessen the positive impact of the regulatory regime.
- 3.28 **The regime is unlikely to have any great effect on overall PSB content investment levels or investment in at risk genres.** As part of this review, the Secretary of State asked Ofcom to consider how the regulations can promote content production, particularly in the PSB genres that have been identified as 'at risk'. Our PSB Review concluded that investment in specific genres is driven principally by broadcaster demand, which is in turn driven by broadcaster funding and their incentives to invest in specific genres. As a result, intervening at the production sector level is unlikely to have any great effect on investment in these genres.

Conclusions

- 3.29 To date, the current regulatory regime has largely succeeded in meeting the objectives set for it. The market developments set out in the previous section have not fundamentally threatened achievement of the objectives, but they nevertheless pose challenges in some areas. Notably, there is nothing in the regime that guarantees that small producers will be used by broadcasters rather than large qualifying independents. Nor does it guarantee that qualifying independent producers based outside London and the south-east will be used.

Section 4

The impact of production sector regulation on PSBs

Introduction

- 4.1 In this section, we consider the impact of the current production sector regime on the public service broadcasters. In particular, we have focused on whether there is a significant negative impact of the regime on the PSBs and their investment in content, including at risk genres.

Regulation of the production sector affects PSBs in a number of ways

- 4.2 There are five broad ways in which PSBs can be affected by the production sector regulations:
- 4.2.1 **Accessing rights:** the current practice in the market is that PSBs negotiate for secondary rights (e.g. on-demand and other new media) separately from primary linear broadcasting rights. This could restrict the flexibility of PSBs to innovate in response to rapidly changing viewer behaviour.
 - 4.2.2 **Monitoring:** in order to meet the 25% independent production quota, the PSBs must monitor from whom they commission programmes and ensure that they commission sufficient programmes from independent producers rather than non-qualifying producers.
 - 4.2.3 **Programming choices:** it is possible that the PSBs, may have to commission and broadcast a programme from a qualifying independent producer, when they would, absent regulation, have made a different commissioning decision.
 - 4.2.4 **Growing in-house production:** strategically, PSBs may wish to expand their in-house production arms or to invest in independent production companies. The regulatory regime may deter them from doing this.
 - 4.2.5 **Financial impacts:** PSB would incur direct costs from the regime if they have to pay higher prices for rights than they would have done absent regulation. Indirect costs would occur if they had to forego rights to secondary and overseas rights or been obliged to commission programmes from independent producers that did not perform well.
- 4.3 The rest of this section sets out these concerns in more detail and considers that extent of each of them.

PSBs do incur some costs in monitoring compliance with the regime

- 4.4 Broadcasters told us that they do incur some significant transaction costs as a result of having to deal with a significant number of independent producers. For example:

- 4.4.1 the BBC indicated that it has significant compliance costs given the complicated range of quotas it must meet; and
 - 4.4.2 Channel 4 reported that it has high transaction costs owing to the number of production companies it deals with, and the level of reporting required for the various quotas it has to meet.
- 4.5 However, it is not clear what level of cost is created by the independent production sector regime alone. In their work for us (published alongside this review), consultants Mediatique report that “the scale of the resources required to manage the quota is not material”³⁴.

Some PSBs may have had to limit their investments in external producers

- 4.6 The regulatory regime limits the ability of broadcasters to commission more of their output from their in-house production arms where they operate one, given the 25% quota. The definition of qualifying independent producers may also disincentivise PSBs’ from investing in independent producers, given that the producer would lose qualifying status if the PSB acquired more than a 25% shareholding.
- 4.7 Despite this, the PSBs have invested in production companies, with ITV in particular making a number of outright purchases of UK production companies. However, the BBC (via BBC Worldwide) has limited its investments to a 25% shareholding in order that the companies in which they invest can retain their independent status.

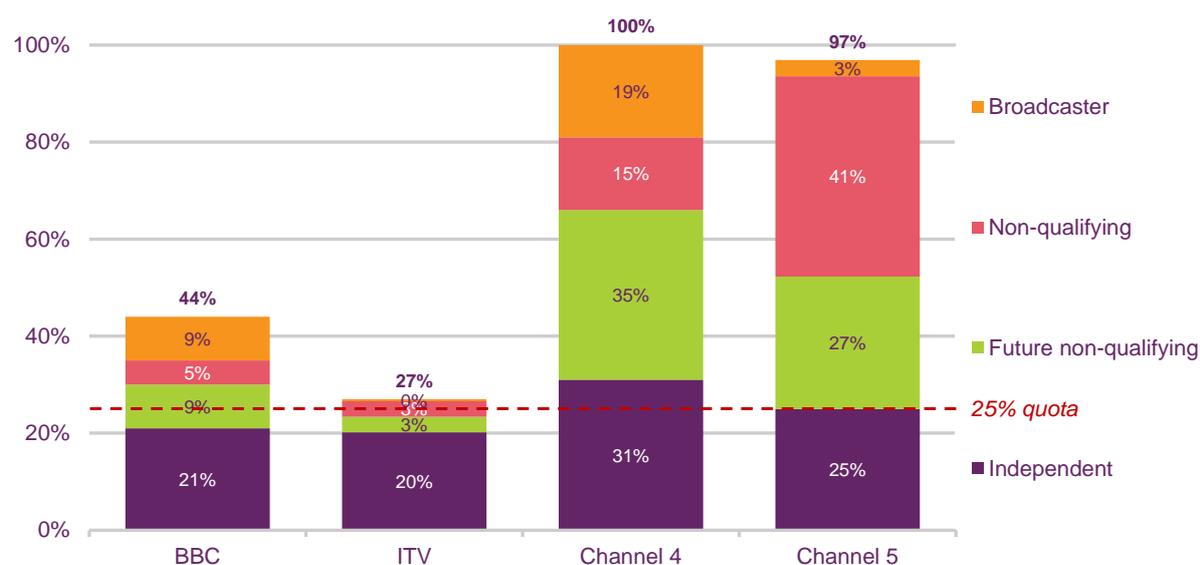
PSBs may find it more difficult to meet the 25% quota in the future

- 4.8 Today, all of the PSBs comfortably meet the quota for use of qualifying independent productions.³⁵ However, the consultancy reports we commissioned indicated that consolidation may mean that the quota becomes harder to meet in future.
- 4.9 At present, the BBC, ITV and Channel 5 are meeting the independent production quota using programmes sourced from production companies that (Endemol, All3 Media and TwoFour) will eventually cease to be qualifying independents as they have been acquired by UK broadcaster owning companies. This is illustrated in the chart below which shows the performance of the PSBs against the quota by type of producer used.

³⁴ Mediatique report p34

³⁵ http://stakeholders.ofcom.org.uk/binaries/broadcast/reviews-investigations/psb-review/psb2015/PSB_compliance_report_2015.pdf p6

Figure 10: External commissioning share of hours, by type of producer 2014



Notes: future non-qualifying producers include All3Media, Endemol-Shine and TwoFour; excludes portfolio channels and some overnight programming; excludes news and sports programmes.
Source: Attentional, Oliver & Ohlbaum Associates analysis

- 4.10 There is a therefore a risk that broadcasters will, in the next few years, have to make decisions more consciously on what programmes they commission and show on the basis of whether the producer is an independent production company or not. While this is the overt goal of the regime, the risk is that PSBs would have to commission and show a programme solely because it was made by an independent producer rather than because it was the best idea available.
- 4.11 In practice, this would be unlikely to be the case if equally attractive ideas are available from the independent producers or if broadcasters can adjust in time using the 75% of airtime not subject to the quota to commission the best ideas. Given sufficient forward planning, it should be possible for broadcasters to plan ahead and commission new programming ideas to ensure that the 25% quota is met with programmes that viewers find appealing and that meets their remit.

The PSBs may not be able to access the rights they require to meet changing audience needs

- 4.12 The PSBs increasingly require additional rights above and beyond those purchased as part of the primary licence for linear broadcast. For example the PSBs must currently negotiate to secure specific rights to show programmes via online catch-up services and on various different devices. Some PSBs have put forward the view that they are not able to secure the rights they require quickly or efficiently enough, or are required to pay prices that they regard as too high.
- 4.13 The regulatory regime encourages flexibility in how rights are negotiated and this flexibility has been used by broadcasters. When the PSBs launched their online catch-up players for instance, they were able to negotiate online rights for independent productions. Also, when the BBC extended the iPlayer catch-up window to 30 days and enabled downloads, they were able to negotiate the necessary extension of rights agreements.

- 4.14 During this review, we have heard suggestions from the PSBs that these negotiations to alter the Terms of Trade are now more difficult and take far too long at a time when PSBs need to move increasingly fast to innovate and meet rapidly changing audience expectations. For example, concerns were expressed about the time taken to agree new rights to enable downloads on to mobile devices at the time of transmission, or to allow viewers the ability to rewind an online programme to the beginning at the time of transmission.
- 4.15 Broadcasters argue that such rights should be included as standard in the primary rights package they initially acquire, rather than them having to be negotiated for separately as secondary rights. In response, producers and PACT argue that they are always prepared to negotiate if broadcasters feel they need more rights.
- 4.16 Given the inherent flexibility built into the current system, we believe that it should remain possible for broadcasters and producers to continue to conclude agreements that are in the interests of viewers. We also believe that negotiation between PSBs and producers remains the most desirable way for rights and revenue shares to be agreed and that it remains the best way to ensure flexibility in future. If evidence is presented in future that suggests that a negotiated approach cannot in practice deliver the rights that PSBs need, then we would consider what action Ofcom or Government might need to take. This could involve a change in the regulatory regime, as discussed in more detail in the next section.

The wider impact of regulation on the PSBs appears limited

- 4.17 The wider impact of the independent production sector regime on PSBs is somewhat unclear since the counter-factual is unknown. However, the current outcomes observed in the market suggest that there are some positive impacts on PSBs, as well as some negative impacts.
- 4.18 As discussed in section 2, one consequence of the regime has been a growth in deficit financing. This is where producers meet a proportion of the cost of making a programme in the expectation of being able to make a profit through the exploitation of the secondary rights that they retain under the negotiated Terms of Trade. The benefit for the PSBs is that they receive a programme without having to fully fund it.
- 4.19 However, some PSBs have suggested that the distribution of revenues between the broadcaster and the producer has become inequitable. To some extent this reflects a difference in perspective about where in the distribution chain the value of a production is created.
- 4.20 Broadcasters argue that the primary broadcast of a programme creates the secondary value for it and that they should hence secure a greater proportion of the secondary rights for a programme. But producers argue that they are best positioned to generate new value from secondary rights (e.g. by selling them overseas). Given these differing perspectives, it is difficult to reach a conclusive view on a 'fair' distribution of rights. Commercial negotiation on a case-by-case basis, with the backstop of regulatory intervention to prevent the exploitation of bargaining power by the PSBs (where it exists), is likely to prove sufficient.
- 4.21 However, we note that the average profit margins of small producers are low. Producers with annual revenues under £1m had average profit margins of 2.3% in

2014³⁶. As a result, any move to allow PSBs to retain a greater share of secondary rights revenues could lead to many small producers becoming unprofitable.

- 4.22 There is a question, however, about whether regulatory protection should be focused on just small producers or on all producers that are not owned by a broadcaster. Currently, some large producers benefit from regulatory protection even though they may be in a position to negotiate effectively with broadcasters. Some of the PSBs have argued that regulatory protection should be focused on small producers, not the larger producers. We consider this question in more detail in the next question.

The impact of the regime on PSB content investment, including at risk genres, appears limited

- 4.23 As set out in the previous section, the regime is unlikely to have any great direct effect on overall PSB content investment levels or investment in at risk genres, given that PSB content investment is largely driven by broadcaster demand.
- 4.24 However, it is possible that indirectly the regime could affect PSBs ability to invest in content and at risk genres as a result of any wider financial impacts of the regime which may lessen the funds available for investment in content.
- 4.25 However, given that the overall financial impact of the regime on PSBs appears limited, it is unlikely that there is much, if any, indirect impact on PSB content investment. In addition, we note that any reduction in the financial impact of the regime would not necessarily result in all PSBs increasing content investment, absent quotas or other regulations to guarantee this.

In summary, the regime has both positive and negative effects on PSBs but the negative effects appear limited

- 4.26 To date, the PSBs have benefitted from a vibrant, healthy and creative sector that brings fresh voices to TV production, and that has obliged in-house production arms (in the case of the BBC and ITV) to improve their output and cut their costs in order to compete. The high number of qualifying independent production companies means that meeting the 25% independent production quota does not appear to be overly onerous; and the financial impact appears relatively modest.
- 4.27 In conclusion, while it is a concern that the PSBs suggest that that they cannot access all of the rights they require to innovate quickly enough or cheaply enough, the arguments presented to us about the severity of this problem to date do not appear to justify significant change. Our preference remains to see commercial negotiations make the necessary changes to current arrangements wherever possible.

³⁶ Oliver & Ohlbaum Associates report p59

Section 5

Options for reform of the regulations

Introduction

- 5.1 In this final section, we consider how regulation might better deliver the objectives of the regime, lessen any negative impacts on the PSB system and improve the overall delivery of PSB goals for viewers in future.
- 5.2 In his original letter to Ofcom, the Secretary of State asked us to provide “the full range of options for reform of the main elements of regulation”. The options for change we discuss in this chapter have both potential positive and negative effects on the sector but ultimately it is a matter for Government to determine the trade-offs associated with any reform.

There are a number of potential options for reform

- 5.3 As set out in the preceding sections, we believe that some degree of regulation continues to be necessary and will still be needed in future so long as Parliament wishes to see the current public policy objectives of the regime maintained.
- 5.4 The interventions appear to have worked well and have broadly delivered the objectives for the regime. Notwithstanding the possibility of further radical structural changes to the wider broadcasting and also to the UK production sector, Ofcom believes that the legislation as it currently stands will continue to support diversity in the production sector in its many guises, at least for the foreseeable future.
- 5.5 As we explain below, we do not currently see a major case for change, particularly when considering the case for deregulation. However, if the Government sees fit based on the balance of associated risks, there are some ways in which the key elements regulation could be refined.

Deregulation would probably result in a significant reduction in the number of small producers

- 5.6 One possible option is to remove all elements of independent TV production legislation, namely the 25% quota, the ownership-based definition and the Codes of Practice that lead to the negotiation of Terms of Trade. This would leave PSBs free to commission as much or as little programming as they wished from every source, and all negotiations on rights retention and revenue splits would be on a purely commercially negotiated basis. However, they would still need to comply with the 10% European quota under the AVMS directive.
- 5.7 In practice, however, it is likely that deregulation would significantly harm the SME production sector and see the number of individual suppliers shrink significantly. There would be fewer opportunities for new creative talent to get programmes on air and therefore a loss of diversity and plurality in the supply of programmes to PSBs.
- 5.8 A removal of the Codes of Practice may also result in a return to the market model of the 1980s and 1990s when small producers operated on a work-for-hire fixed margin basis. As stakeholders have told us through the course of this review, this would remove much of the incentive for talented and entrepreneurial creative individuals to

set up their own new, small production houses, leading to further erosion of the SME base of suppliers.

- 5.9 It is also likely that the degree of vertical integration of broadcasters and producers would increase, given prevailing market trends for broadcaster owning groups to diversify into production in order to control rights and benefit from fast growing TV production market revenues.
- 5.10 It is also worth noting that no stakeholders have called for wholesale deregulation during the conversations we have had with them through the course of this review.
- 5.11 These risks may well outweigh any benefits this option would bring, including the easing of the regulatory burden on PSBs, the opportunity for them to realise cost savings associated with a consolidated supplier base, and the exploitation of new rights positions.
- 5.12 Ultimately, viewers may well be less well served if the level of diversity and creativity fell as a result of deregulation. While a smaller pool of suppliers would not necessarily lead to a shortage of quality programmes and new creative ideas, or limit innovation per se, we continue to believe that diversity is best delivered as an input to the production of programmes, as well as an output.
- 5.13 As set out earlier in this report, diversity in production takes many forms: social, cultural, geographic, corporate scale and structure, through a plurality of players in the market, diversity of TV channels and through diversity of commissioning within channels. Deregulation may negatively affect levels of diversity in terms of the number and types of producers and in doing so therefore reduce the potential of the system to maximise creativity and innovation.
- 5.14 We note that the current system has resulted in a UK production sector that is a global success commercially, supporting UK industrial policy while at the same time being creatively strong – UK TV programmes now regularly win the world’s biggest TV programme awards. Deregulation could put these outcomes at risk.
- 5.15 The precise outcomes that would be observed if the production sector regime were to be deregulated are far from certain but the downside risks appear considerable, especially to the number of SME suppliers active in the market and the diversity of producers.

Of the options for reform we have considered, two may have positive benefits

- 5.16 If Government is minded to change the regulations, there are several ways in which it could do so. Individually these are relatively modest changes but the size of the task would need to be weighed carefully against the scale of the benefits that such changes may deliver.

Codes of practice – reforming the approach to digital rights and revenue shares

- 5.17 An area of concern would be if producers and broadcasters were unable to reach commercial agreement on the exploitation of rights, and the associated revenues. Viewers increasingly expect broadcasters to make programmes available live, on demand, and supported by online content relating to the programme. Broadcasters will need to be able to access the rights that allow them to innovate on new digital

platforms, whilst producers will want to retain the rights that they are best placed to exploit.

- 5.18 As set out in section 2 of this report, viewers now expect PSB content to be available on the relevant PSB catch-up player for at least seven, and probably 30 days after initial linear broadcast, and to be able to access the same content across many devices, be that smart TV, mobile phone, or games console. PSBs also increasingly need argue they need to show programmes several times on their wider portfolio of channels to maximise their reach. Many new platforms and online services continue to emerge and these platforms require rapid innovation in order for them to be properly utilised by PSBs.
- 5.19 The PSBs have argued that they need more certainty of access to early window digital rights in the first month after a programme is first shown in order to innovate quickly to meet rapidly changing audience needs and to compete with new innovative platforms such as Netflix and Amazon Prime. Some PSBs have also suggested that they could generate more revenues if they had access to these rights than the producers currently do. The PSBs have therefore suggested that these rights should be packaged as standard within the primary licence for initial use of the programme, for no additional fee.
- 5.20 While we have sympathy with this position and agree that this is potentially a serious concern, given current trends in the market and the need for PSBs to be at the forefront of innovation, we have not received firm any evidence through the course of this review to suggest that the current system, based on negotiation, cannot deliver the rights the PSBs require in early windows or that the terms of accessing additional rights are disproportionate, especially in light of low producer margins.
- 5.21 We believe that it continues to be desirable that any necessary changes to current rights and revenue share terms should be delivered through commercial negotiation. A system based on open negotiation reduces the need for Government or the regulator to determine what the right split of rights and revenues is. A system based on negotiation is also likely to be much more flexible and able to adapt to the fast pace of change in the market and the rapidly changing needs of audiences. A system based on negotiation is also likely to better deliver different arrangements to suit the specific needs of each PSB to a greater degree than any standardised approach.
- 5.22 Any necessary changes to current rights and revenue share terms should therefore continue to be delivered through commercial negotiation. Government may however wish to consider whether some form of backstop is required to ensure that those negotiations are effective.

Definition of a 'qualifying' independent producer – introducing a size cap

- 5.23 One potential concern is that future consolidation may not be linked to vertical integration, as it has been in the past. This would mean that larger companies would remain within the protection of the regulatory regime, potentially undermining one of its policy objectives.
- 5.24 Currently, producers of any size no longer qualify if a UK broadcaster owning company acquires at least a 25% share in their business. However, some very large consolidated producers whose parent companies have no UK broadcaster ownership still qualify for the regime and receive protection under the Terms of Trade.

- 5.25 The PSBs contend that the scale of these consolidated companies mean that they no longer need protection in commercial negotiations at the point of commission. We have found that, in general, firm conclusions about negotiating power cannot be drawn because it will depend on the specific programme, producer and broadcaster in question. However, it seems likely that for most programmes broadcasters will retain the balance of bargaining power. As a result, there is no rationale to exclude large producers from the regime based on an assessment of relative bargaining power.
- 5.26 A size cap could ensure that the regime only protects small producers and in doing so therefore maximise the levels of diversity through plurality of suppliers. A size cap would also help ensure that high levels of disruptive new market entry are maintained - a further important factor in ensuring diversity and encouraging creativity.
- 5.27 How such a cap may be set, and the practicality of implementing and administering it, would have to be assessed further. Options include stipulating staff, headcount, turnover, or balance sheet metrics for producers or their parent companies. We note that SME-based interventions exist in other sectors.
- 5.28 However, any size cap would also need to be set extremely carefully in order to avoid weakening the incentives for new talent to either set up new small producers or to seek to grow to their companies to scale whilst also retaining their qualifying independent status. We note that some medium-sized UK independent producers like Hat Trick may not qualify if any standard definition of an SME was arbitrarily applied to the definition of a qualifying independent producer.
- 5.29 We also note the potentially greater costs of monitoring and, if necessary, enforcing such a quota, both for broadcasters and for Ofcom, given the likely need for detailed financial information to be provided by producers and the risk of companies gaming the system and changing company structures in order to try to continue to qualify.

We have also identified a range of other options for reform

Definition of a 'qualifying' independent producer – relaxing ownership rules

- 5.30 The independent production legislation has both balancing vertical integration trends and stimulating SME growth as primary objectives. Generally these are discrete objectives; however, horizontal integration trends have resulted in a situation where these two primary objectives may work against each other. As a result, it may be possible to relax the definition and allow vertical integration where the impact is of doing so is limited.
- 5.31 There is a range of outcomes that could be considered within balancing vertical integration trends. For example, the qualification definition is currently binary in its application – as soon as the 25% ownership threshold by a broadcast owning company is breached, the producer ceases to qualify.
- 5.32 In practice, not all broadcasters are comparable. There are, for example, some broadcasters that are large in international scale, but who, in terms of UK broadcasting presence, are actually relatively small. Some do not generally buy much new UK content, and many do not command high audience shares on the channels they do own.
- 5.33 It is not clear, therefore, that vertical integration with broadcasters of this kind affects diversity and plurality in any meaningful way. In fact, it may unfairly penalise the

acquired small producer who, to all intents and purposes, remains 'independent' of significant influence from a large broadcaster, PSB or otherwise.

- 5.34 Therefore, Government could consider to addressing this anomaly by reducing the extent of regulation by allowing producers with broadcaster-shareholders to qualify if the broadcaster has low audience share or is a small buyer of content.
- 5.35 However, any relaxation of the definition would likely allow PSBs to in part meet the quota using just a few very large qualifying suppliers. In general, large international broadcasters only choose to buy or build UK producers of scale. As a result, any relaxation of the definition could directly reduce the opportunity available for small producers and lead to a significant reduction in diversity and plurality. Equally, such a relaxation could also introduce a significant further distortion into the market, above and beyond the current intervention.

Reforming the independent production quota

- 5.36 In general, it appears that having a quota in itself is desirable, principally in terms of meeting the objective of stimulating an SME base of producers and in doing so delivering the wider benefits associated with diversity:
- 5.36.1 it ensures a guaranteed opportunity for independent small producers where PSB bargaining power and behaviours may result in such opportunities being much reduced absent regulation; and
 - 5.36.2 the quota is also therefore important in incentivising new creative talent to set up new small producers – it provides certainty of opportunity, and enough headroom to grow companies of scale with a chance of success if programme ideas are good enough.
- 5.37 **The quota could be raised.** Currently, the quota is set in legislation and therefore legislative reform would be needed to change it. The current level of 25% appears to have been successful in helping deliver and guarantee a large number of producers are active in the market. As set out earlier in this report, 259 producers were used in 2014 by PSBs, albeit down from around 442 in 2006. As a result, there seems little need to increase the quota unless Government wishes to see a higher opportunity for and possibly number of small producers used once again.
- 5.38 **The quota could be reduced.** However, given that the number of small producers is already falling, reducing the opportunity available for them under the quota would likely see the small producer base erode further and would also weaken the incentives for new talent to start up new producers and seek to grow their companies into successful medium sized enterprises, if they see a smaller opportunity and less chance of success in what is also a very difficult sector to succeed in.
- 5.39 In future, we expect that any continuing vertical integration of producers into broadcaster-owned groups is likely to mean that the PSBs will remain under pressure in meeting the quota. We have also noted the moderate cost factors that incentivise broadcasters to reduce the number of suppliers they work with.
- 5.40 Separately to considering reform of the overall level of the quota, Government could also consider three further options for reform of the conditions PSBs must meet in fulfilling the quota, depending on the importance it attaches to the various objectives of the regime, and the extent to which it wishes to further support these.

- 5.41 The existing legislation provides for a "range and diversity of independent productions" to be delivered under each PSB's commissioning activities as a whole. While the following objectives may be delivered by the existing legislation, the intention of the regime could possibly be made more explicit in a number of areas:
- 5.41.1 **addressing genre concerns:** levels of genre provision could be enforced in every relevant genre, to ensure a diverse base of small producers are used in each;
 - 5.41.2 **further bolstering SME policy:** the provision could explicitly reference size of producer as a relevant consideration when interpreting "range and diversity"; and
 - 5.41.3 **supporting production in the nations and regions:** the provision could explicitly reference geographical location (both national and regional) of producers as a relevant consideration when interpreting "range and diversity".

Production sector regulations can have little impact on promoting investment in at risk genres

- 5.42 As part of this review, the Secretary of State asked Ofcom to consider how to promote content production, particularly in at-risk genres where investment has declined. We noted in our PSB Review that there is currently little evidence to suggest that the larger consolidated production companies focus only on the most commercially attractive genres, leading to a lack of innovation in the less commercially attractive genres (e.g. current affairs). In addition, there is evidence that there remains a good range of suppliers in most genres. As a result, we conclude that the decline in investment in at risk genres noted in the PSB Review does not appear to be influenced by a lack of suppliers or changes in the structure of the production sector.
- 5.43 Investment in new programmes at a macro level, and also in specific at-risk genres singled out in our PSB Review, is instead predominantly driven by broadcaster demand. Investment in these genres can only really be promoted by ensuring that PSBs must or choose to invest in these genres.
- 5.44 Therefore, intervening at the independent production level is unlikely to have any great effect on investment in these genres and therefore the production sector regulations do not appear to be the right tools to achieve this policy aim. If Government wishes to promote greater content investment at a macro level or greater levels of investment in specific at risk genres then it will need to consider interventions which impact on broadcaster demand for these genres. Specifically, this would probably require tighter quotas in at-risk genres linked to mechanisms to fund the necessary additional investment.

Government could maintain the status quo, given that the system is likely to continue to support a large number of small producers

- 5.45 As we set out in our third Review of Public Service Broadcasting earlier in 2015, we believe that the regime as it currently stands will continue to deliver broadly good outcomes in terms of the stated objectives.

- 5.46 We also note other positive features of the market, separate from the stated objectives, that may be put at risk by legislative reform, including:
- 5.46.1 **British creative reputation:** the UK has long been seen as a world leader in quality TV production, whose programmes are sold and broadcast around the world, with many of these produced by small qualifying independent producers; and
 - 5.46.2 **the success of the UK production sector exporting overseas and attracting inward investment:** the sector continues to attract investment from global players and is one of the strongest areas of growth within the media sector and the economy as a whole.
- 5.47 These additional features of the market have been cited consistently by stakeholders we have consulted during the course of this review. The fact that the UK is believed to outperform in the global TV content market relative to its size is a point of pride for many of those in the industry. It also underpins a virtuous circle the industry enjoys; its high quality encourages fresh young talent to enter the market, and other sectors and foreign TV companies are eager to work in partnership with UK producers and broadcasters, both of which in turn drive higher standards across UK TV sector as a whole.
- 5.48 All players also benefit from a level of certainty delivered by the regime as a whole, in what is in general an uncertain market. Nearly every commission is a commercial risk, as it is generally difficult to predict whether a show will fail, succeed moderately or be an international hit. It may be for this reason that all stakeholders have for the most part said that they would be content with the broad status quo or, if they have proposed amendments, portrayed these as improvements rather than necessary repairs.

Conclusion

- 5.49 The production sector has undergone a number of significant changes. It has seen consolidation and many of the largest UK producers are now owned by large global media corporations. However, at this stage these changes do not appear to have had as great an impact on the delivery of the objectives of the regulatory regime as may at first be thought. There remains a diverse and vibrant SME production sector and the system continues to promote very high levels of market entry, thereby opening it up to new voices, encouraging creativity and innovation.
- 5.50 However, we have identified some areas of potential concern for the future. We have noted the potential for further consolidation in the market and we have highlighted the risk that broadcasters and producers might not be able to reach commercial agreement on how rights and revenues are shared in the face of broadcasters needing to adapt to changing viewing habits.
- 5.51 As a result, if the status quo is maintained, we continue to believe that it would be important to keep this sector under review.

Annex 1

Stakeholder engagement

Ofcom has consulted with a wide range of stakeholders

A1.1 We have met a wide range of stakeholders during this process, with the intention of being consultative and transparent in the absence of a formal consultation process. We have gathered a broad evidence base from both the interviews we have conducted and the written submissions we have received.

A1.2 We talked directly to the following industry stakeholders, either in person or via conference call:

All3Media	Argonon	Baby Grand Productions
BBC	Carnival Films	Channel 4
Channel 5	Creative Skillset	Double Band Films
Endemol Shine	Freemantle	Hartwood Films
Hat Trick Productions	ITN	ITV
Midnight Oil Productions	NBC Universal	Neal Street Productions
Nine Lives Media	Northern Ireland Screen	Pact
Pulse Films	Raise the Roof Productions	Sky
Sony	STV	Tern TV
TimeWarner	Zodiak Media	

A1.3 We have also received a large number of written submissions from the following stakeholders:

7 Wonder Productions	Abbott Vision	Air Television
All3Media	Bang Post Production	Boom Cymru
Boundless Productions	Brian Leith Productions	Brite Spark Films
British Film Institute	Carnival Films	Channel 4
Clan Productions	Clearview Productions	Compact Media Group
CPL Productions	Curve Media	Darrall Macqueen Ltd
Denham Productions	Department of Culture, Arts and Leisure (NI)	DLT Entertainment

Ecosse Films	Eleventh Hour	Flying Elephant
Free@Last TV	Fudge Park Productions	Hartwood Films
Hopscotch Films	Humble Bee Films	Illuminated Films
Jamie Oliver Media Group	JL Law Firm	Joseph Stacey
Juniper TV	Kindle Entertainment	Kudos
Lambent Productions	Lee and Thompson LLP	Magic Light Pictures
MediaLab UK	MG Alba	Midnight Oil Productions
Minnow Films	Novel Entertainment	October Films
Ofcom Advisory Committee for Scotland	Outdoor Productions	Outline Productions
Oxford Film and Television Company	Pact	Paul Sandler
Peacock Productions	Playground Television	Radio Independents Group
Raise the Roof Productions	Raw Cut	Raw Cut TV
Red Production Company	Reef Television	Rod Harrod
Sam Bullo	Skyworks	Smoking Dogs Films
Sorbier Productions	Spring Films	Stone City
Teledwyr Annibynnol Cymru	Telesgop	Tern TV
Testimony Films	The Garden Productions	Tinopolis
Urban Canyons	Virgin Media	Visible Ink
Voice of the Listener and Viewer	Waddell Media	Whizz Kid Entertainment
Wingspan Productions	Zodiak Kids	Zodiak Media Group