Carriage of TV Channels in the UK: policy options and implications

Report for the Department for Culture, Media and Sport

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Mediatique

Contents

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Abstract

In this report for the Department for Culture, Media and Sport, Mediatique reviews the regulatory and commercial context governing the carriage of public service broadcasting (PSB) channels on pay TV platforms. The central objective is to consider whether a deregulatory regime – allowing PSB channels and platforms to negotiate the terms of carriage – would lead to a more equitable flow of payments between the parties, and whether this in turn would lead to an increase in expenditure on UK original content.

In order to address these issues, we review the current legislation and guidelines affecting PSB channel carriage and the dynamics around payment flows and content outcomes. We thereafter table options that might be considered by Government and stakeholders as a means of meeting the dual objectives of deregulation and positive original content outcomes.

In the course of the analysis, we have used historical data, (limited) international evidence and a simple numerical model to determine possible outcomes that could arise in the event that PSBs and platform operators freely negotiated the terms of carriage of core PSB channels. This simulation of a 'carriage consent' regime is provided as a means of informing the debate about payment flows, and is subject to a range of constraints in terms of any policy execution – for example, around current domestic and European legislation and implementation risks affecting consumers and viewers.

We also point out a number of further complications – including whether a deregulatory approach would necessarily and reliably lead to increased investment in UK content, a key Government policy goal.

We conclude that an outcome whereby payments flow from TV platform operators to PSBs is plausible and that this could lead to an increase in expenditure on original UK content industry wide. However, we stress that our analysis and modelling permit other conclusions to be drawn. Further, the implementation challenges are considerable.

As a result, this paper should be viewed as a contribution to the current debate on platform fees and original content expenditure, and is aimed at providing a detailed framework for further discussion rather than a firm set of conclusions and policy recommendations.

Executive summary

Overview

- DCMS, as part of its preparations for a Communications Bill, has identified the payments between public-service broadcasters (PSBs) and pay-TV platforms as an area of potential reform and commissioned Mediatique to produce a report investigating the key issues
- Currently PSB channels are carried on cable systems at no cost to either platform operator or broadcaster (under an exemption granted to cable operators under the Copyright Act) and on Freeview as part of PSBs' gifted capacity on digital terrestrial television (DTT)
- On satellite, PSB channels pay Electronic Programme Guide (EPG) listing fees on Freesat and a number of additional charges to BSkyB for carriage on the Sky Digital platform, where the charges are set by Sky under the Technical Platform Services or TPS regime, which permits the recovery of certain costs incurred by Sky in developing and maintaining its TV platform
- The availability of PSB channels on these TV platforms reflects a range of rules at both European and domestic level regarding requirements to 'offer' and to 'carry' PSB services; these vary depending on the platform and the governing legislation in respect to Copyright and Communications acts and relevant European law around access to satellite platforms not covered by other legislation

Objectives and scope

- DCMS has asked Mediatique to answer two inter-related questions: would a change in the balance of payments between PSBs and TV platforms lead to an increase in expenditure on UK original content and could a policy effecting such a change be essentially deregulatory?
- What impact might any proposed policies have on the consumer and what implementation issues and sources of mitigation might be identified?
- After having determined the potential effect of changes to the regulation of carriage, we were asked to review a number of specific policy options and rate these as to their effectiveness in addressing the dual objectives of deregulation and positive UK content outcomes
- In this report, we review both historical and international data on carriage of free-to-air channels via TV platforms, and have spoken with a range of stakeholders to canvas market perspectives

Approach

- Taking a cue from the US market, where cable and satellite operators negotiate commercial terms with free-to-air (FTA) broadcasters for consent to 're-transmit' free channels, and where withholding/denial of carriage are exercisable powers, we have considered a hypothetical 'carriage consent' regime for the UK – deregulatory in nature – under which both channels and platforms would have to right either to deny or to withhold carriage, entering into commercial negotiations over the terms of any carriage arrangement; we have constructed a simple illustrative model to track potential outcomes
- We observe that both pay-TV platforms and PSB channels benefit from the carriage of these services: pay platforms are able to offer popular network programming to customers without their having to switch to alternative platforms while PSB broadcasters are able to reach pay-TV households thereby increasing reach and viewing

- The value of these benefits is reflected in the 'income at risk' for each side were the channels not carried – for platform operators, the lost subscription income from customers who 'churn' off the platform in favour of other platforms where the channels are available; for broadcasters, the reduced viewing (and therefore advertising revenues in the case of ad-funded channels) in those pay-TV homes that do not churn, either because the channels are no longer available or where subscribers must inconveniently 'toggle' to another platform within the home – e.g., Freeview – to access them
- Mediatique has asked whether deregulation of the UK market allowing commercial negotiation would change the quantum and flow of payments, and whether such a change would result in more investment in original content than in the *status quo;* the answer to these questions in turn informs our preliminary conclusions

Provisional conclusions

- We have concluded that the benefits arising from both sides of the carriage equation are not necessarily equitably split between the parties under current arrangements, and that platform operators arguably benefit more than PSBs. If our analysis is correct, this suggests that commercial negotiations conducted under a carriage consent regime might result in a flow of payments from platform operators to PSBs for the right to carry the PSB channels
- Given the essentially unpredictable character of commercial negotiations, there is no guarantee that arrangements favouring the PSBs would actually be the outcome following market-based negotiations, even if our estimations of benefits are accurate
- As our model is informed by limited and sometimes inconclusive domestic and international evidence on consumer behaviour in relation to churn and viewing, we have generated broad ranges rather than precise numbers; while we believe our analysis to be plausible directionally and quantitatively, different assumptions on consumer behaviour would generate different outcomes, including scenarios where the payments would flow even more significantly in the opposite direction (i.e., *from* channels *to* platforms)
- We also conclude that payments to PSBs would lead to incremental expenditure on original content, assuming current investment profiles of pay-TV channels and network channels remain in place and as long as certain additional safeguards are available; again, alternative scenarios are possible (although, in our view, less plausible)
- Limited consumer disbenefit resulting from a flow of payments from platforms to PSBs would largely affect pay-TV subscribers, who would see subscription prices increase if pay-TV platforms passed on to retail customers any carriage consent payments owed to PSBs; other parties affected might include pay-TV channel operators and Sky's own channels, in the event that pay-TV platform operators seek to offset the incremental costs of carriage consent fees by reducing affiliate and own-content expenditure
- Owing in part to concerns that licence fee payers who are also pay-TV subscribers might end up paying more for BBC channels, we have **excluded the BBC from our calculations under a carriage consent regime** but have assumed it would be protected by any safeguards such as a zero cost 'must carry' obligation
- While determining the value of the benefits is complicated and controversial, we estimate that the size of the potential incremental flow to commercial PSBs and the likelihood that this would lead to an increase in investment in original UK content, taken together, justify a review of the current regime governing carriage
- Indeed, simply from the point of view of promoting equity between the parties (and notwithstanding content outcomes), we conclude that the current system may not adequately capture the level of mutual benefit arising from the carriage of PSB channels, suggesting changes might be warranted

- We grant, however, that the desirability of reform on the grounds of inequity alone (i.e., separate from objectives around content investment) is a matter for policy makers

Indicated policy options

- The key option under consideration (a carriage consent regime) would see all PSBs except the BBC able to withhold their channels from pay-TV platforms and the platforms in turn able to deny carriage to these PSBs; this would involve the removal of existing 'must offer' obligations, a reform of the regime under which Sky charges for access and an end to the exemption for cable operators from the Copyright Act, which underpins the current practice of no payments in either direction
- As such, this option brings with it considerable execution issues, as detailed in the main report; there is no guarantee that such issues can be resolved within the context of current regulatory constraints, both at domestic and European level
- We further consider a carriage consent option under which all commercial PSB broadcasters could negotiate agreements collectively, to ensure that TV platforms with market power are not able to differentially treat PSBs
- This collective option creates additional regulatory risk, given the restraints likely to apply to any framework permitting commercial PSBs to negotiate together; we table it as a way of further validating assumptions around carriage consent and to support our range of potential (if hypothetical) outcomes
- The carriage consent options (separately and collectively negotiated) are modelled with and without a back-stop of 'must carry' at zero cost, exercisable by each PSB on a regular basis (e.g., every three years) – as in the US system; in other words, PSBs would elect *either* to enter into negotiations, running the risk of failing to agree terms, *or* to exercise their right of 'must carry' at no cost
- In options involving a carriage consent regime based on market negotiation (with a back-stop of 'must carry'), the BBC would effectively default to a 'must carry' right at zero cost
- We have also considered two further options: mandating zero rate TPS for all PSBs including the BBC (for that element of Sky's charges related to the recovery of common costs); and retention of the status quo
- In the option where carriage consent is negotiated separately by all commercial PSBs (with no back-stop of 'must carry'), the outcomes range from a payment flow to platform operators of £110m per year to a flow in favour of the PSBs of £190m per year. If a back-stop of 'must carry' is available, the flows would logically be expected to be in favour of the PSBs, ranging from c£10m to £190m a year. Collective negotiations would generate outcomes that are even more positive for the PSBs
- The potential increase in UK content expenditure by commercial PSBs depends crucially on whether the two privately owned PSBs (ITV, Channel 5) spend 'consent' payments on content rather than on other investments or on dividends to shareholders; this may in turn depend on whether spending commitments can be subject to undertakings around their PSB licences or other scrutiny (e.g., by Ofcom)

Key caveats

- In general, our modelling of carriage consent outcomes suggests very wide ranges and is meant to inform the debate rather than to specify precise results

- The carriage consent regime outlined in this report provides a deregulatory benchmark against which a number of policy options can be considered; its key advantage lies in permitting an estimate of the equitable payment flows that would or should arise in a market negotiation
- We stress that our assumptions in this report are based on current platform penetration, content expenditure profiles, airtime prices, etc. – all of which are subject to change; likewise, the valuation of benefit and payment flows is directional and indicative rather than precise and validated, and dependent on a series of assumptions about consumer behaviour for which there is no detailed evidence
- In particular, while we have reviewed both international and UK historical experience, these are of limited applicability to the current situation, for a range of reasons, for example:
  - US 're-transmission' payments reflect the limited penetration of over-the-air television after decades of reliance in that market on cable TV; in the UK, Freeview/Freesat provide an obvious alternative to pay TV platforms, available at no incremental cost to the many homes already equipped with aerials and/or satellite dishes suitable for reception of FTA signals
  - The only relevant UK benchmark dates from a carriage dispute between Sky and ITV in the late 1990s, when the Sky Digital platform was in its infancy, analogue terrestrial TV still dominant and a host of other complicating factors (including ITV's attempts to promote take-up of its own pay-TV platform, ONdigital/ITV Digital) obscure the underlying dynamics
- Our estimates are therefore expressed as plausible ranges; depending on assumptions made about consumer behaviour in response to a cessation of carriage, a case can be made for payments to flow *from* channels *to* platforms (although we rate these outcomes as being far less likely)
- We also draw attention to our comments on future evolution of TV platforms and the prospect of new entry into TV via, for example, IP delivery; any rules around carriage consent, back-stop 'must carry' and appropriate prominence should be applied to any platform seeking to transmit PSB channels (provided they are of sufficient size to warrant inclusion in the regulatory framework); consideration of more fundamental shifts – for example a growth in non-linear consumption at the expense of linear TV – are outside our scope

1. Introduction

In preparation for a forthcoming Communications Bill, the Department for Culture, Media and Sport (DCMS), following early consultation with stakeholders, has identified the system of payments between public-service broadcasters (PSBs) and TV platforms as a potential area for regulatory reform. It has commissioned Mediatique to analyse the current arrangements and the potential to increase investment in UK-originated TV content through policy changes in this area.[1]

In its brief to Mediatique for this report, DCMS stated:

> *In formulating its broadcasting policy the Government aims to de-regulate where possible and to increase investment in UK content. Hence, it will not increase the amount or complexity of regulation if the only result is to shift resources from one part of the value chain to another. In order to consider making changes to the regulatory and legal framework governing re-transmission charges in the next Communications Bill, the Government would have to be satisfied that doing so would result in a net increase in investment in UK content.*

The present paper is aimed at contributing to an informed debate about the dynamics of payments between PSBs and pay-TV platform operators. Our starting point is to interrogate whether a new, market-based regime under which both sides to a carriage arrangement would be free to deny or withhold carriage would permit the benefits of carrying a channel to be fully captured, and whether it would lead to payments different from those currently in place. We use this as a deregulatory benchmark to assess potential changes to the current regime and to establish some broad principles around carriage and its value. In particular, we consider the effects that such a hypothetical deregulatory model would likely have on original content investment in the UK.

If we find that a market-based regime would both lead to incremental investment in UK content *and* rectify a market distortion, the case for adopting such a regime would be doubly made.

Establishing whether such an outcome is realistic requires resolution of analytical, quantitative matters that – given its scope – this report only explores at an indicative, directional level. Because definitive answers are unlikely to emerge from this analysis we are therefore not recommending specific proposals. However, we do provide broad and plausible ranges for the value of PSB carriage on TV platforms and the implications for content investment and believe these warrant further study by all stakeholders, including Government.

Background

Policy context

TV platforms play a key role as access gatekeepers to TV services for their subscribers: in the UK, just over half of all households rely on either BSkyB (satellite) or Virgin Media (cable) for their main-set TV service, while nearly all remaining homes use Freeview or Freesat for their primary set.[2] In light of the policy objective of ensuring universal availability of public-service broadcasting, current European and UK legislation effectively mandates that all core PSB channels (the BBC's channels, ITV1, Channel 4/S4C and Channel 5) are carried by all pay-TV operators and featured prominently within their electronic programme guides (EPGs). Today, these channels account for c50% of TV viewing in pay-TV households and pay platforms are an important contributor to PSB channels' reach.

[1] Mediatique Limited is a strategic advisory boutique based in London specialising in the media and communications industries. It may act (or have acted) for companies mentioned in this report. Its responsibilities in the current analysis are to DCMS and no other entity.
[2] BT Vision, a pay-TV platform, provides PSB channels via Freeview, and therefore does not 'carry' these services.

Although the relevant legislation does not specifically prescribe the commercial terms that should operate between PSBs and platform operators, there is broad consensus across the industry that the current regulatory regime leaves little or no leeway for any party to credibly threaten to deny or withhold carriage – that is, for a platform to 'drop' a PSB's core channel, or for a PSB to withdraw its channel from a platform. The relevant regulations vary by reception mode, as summarised in the table below.

Figure 1: Key regulations covering carriage of PSB channels, 2012

Platform	Must PSBs offer?	Must platform carry?	Subject to copyright?	Additional regulatory terms
Cable	Yes	N/A	No	Defined as 'electronic communications network' Cable 'must carry' is a back-stop provision only and has never been invoked; exemption from Copyright Act for cable systems provides right to cable operator to re-transmit free-to-air signals available in the clear
Satellite	Yes	No	Yes	Technical platform services regime for Sky. Satellite platforms are not required to carry PSBs but European Directive (and Comms Act) stipulates FRND carriage 'subject to terms'.
DTT	Yes	Yes	Yes	Spectrum gifted to PSBs

As a result, cable platforms (i.e., Virgin Media) carry PSBs with no fees paid in either direction; Freesat charges to list channels on its EPG; and Sky collects a fee under the Technical Platform Services regime (TPS) linked to recovery of key platform development and maintenance costs. Sky's relevant common cost contribution charges for core PSB channels totalled c£14m in 2011.[3]

The parties' effective inability to deny carriage means that they cannot credibly negotiate terms. As a result, current commercial arrangements (i.e., no payments in the case of cable and TPS-regulated payments in the case of pay satellite) do not necessarily reflect the real market value to either side of the carriage of PSB channels. Were such negotiations to be possible, with neither side holding regulatory advantage, alternative compensation arrangements for the carriage of the core free-to-air (FTA) PSB channels on pay-TV platforms might be achievable.

The current debate

In response to the current situation, some broadcasters (including the BBC and ITV) have argued that the regime is unfair and potentially damaging to the funding of original UK content (of which the PSBs are the key suppliers). They argue that there is a case for TV platforms to pay for PSB channels to reflect the commercial benefits that arise, and point to relevant benchmarks in other markets. Indeed, the current debate around carriage of FTA channels was spurred partly by developments in the US, where in recent years FTA broadcasters have succeeded in extracting substantial cash payments from cable and satellite operators for the right to carry their channels, despite the free availability of these services over the air. Crucially, unlike their UK counterparts, US broadcasters can legally prevent platform operators from carrying their signals without their 're-transmission consent'. This has led some UK PSBs to suggest that if similar rules were introduced in the UK, similar payments would follow.[4] It is further claimed that any such payments would fund increases to original UK content budgets.

[3] We describe the TPS regime in detail on in Box 1-B, page 16, which includes a review of recent unilateral reductions announced by Sky.
[4] An overview of the US regime is provided in Appendix B.

A simple read-across from the US, while useful in informing our analysis, is not strictly applicable, owing to the differences between the two markets. The long history of cable provision of network TV has left a significant number of US homes with no workable, immediate and cost-free alternative to their cable subscription as a way of receiving free-to-air channels (for example, in those homes where there is no longer a working aerial or aerial plug). In the UK, most Sky customers would have the means to access PSB channels even if these were not available via the Sky EPG, suggesting that customers could 'toggle' between, for example, their Sky set-top box and digital terrestrial TV available through the DTT tuner in their TV sets.

All the same, it seems plausible that payments could fairly flow in favour of PSBs in the event that commercial negotiations were permitted. A pay-TV platform operator is able to gain and retain paying subscribers partly because it can make available both pay and free channels on an integrated basis, allowing subscribers to watch all channels without having to change their mode of reception and to plan their viewing using an integrated EPG. Were FTA channels to be withdrawn from a platform, at least some subscribers (notably those not subscribing to key premium content such as movies and sport) can be expected to migrate to competing providers where these FTA channels are available[5]; this increased 'churn' would translate into significant reductions in income for the spurned platform. (For their part, PSBs would be expected to retain their viewing share in churning households, given that the decision to churn was related to the value churning subscribers attach to the affected channel).[6] With all the downside apparently affecting the platform operators rather than the channel, one might expect that any payment arising in a commercial negotiation would flow to the channels from the operator and not the other way around.

However, benefits from carriage do not arise on one side of the bargain only. If a channel were to be dropped by a platform, its reach and viewing can be expected to suffer to at least some degree in those households (potentially a large majority) that do not churn even in the absence of the dropped channel. Some non-churning homes may not have access to alternative means of receiving the dropped channel (for example, they may not have a working terrestrial aerial or aerial plug and do not choose to remedy this). Even for those homes that do have alternative means of reception (on a second set equipped with Freeview, for example, or via the DTT tuner on the main set), the inconvenience of having to 'toggle' between TV platforms may well reduce overall viewing of the dropped channel. This effect may be most marked for that proportion of viewing that is through serendipity (e.g., channel surfing) or via channel selection from the EPG, where the dropped channel may no longer be listed. For commercial PSBs, any overall reduction in viewing would result in lower advertising revenues.

Thus both PSBs and pay-TV platform operators would stand to lose from an abandonment of carriage, and it is not clear *a priori* whose at-risk income is greater.

Commercial context

Despite the rules currently in place governing access and carriage, negotiations between PSBs and pay-TV platform operators relating to various carriage terms have in fact taken place on numerous occasions in the past. As Box 1-A shows, parties have traded carriage rights even for core PSB channels (at least until the 2003 Communications Act came into force). In the current market, operators and channel groups continue to negotiate terms for portfolio channels (for example HD variants) and video-on-demand rights. These negotiations have

[5] Indeed, the increased availability of sport and movie channels on other platforms, such as BT Vision, may mean that options for households churning to retain their convenient access to PSB services may be much wider in future.

[6] This migration might in fact benefit PSB channels, as they have higher shares on the 'free' TV platforms (e.g., Freeview and Freesat) than they have on platforms where they compete with pay-TV content. A more nuanced version of this argument is presented in Appendix A.

involved payments in cash[7] and in kind and have operated in both directions. Notably, in a recent development Sky has explicitly offered a discount on the fees it sets under the TPS regime to account for the supply of VOD services from broadcasters.

Under current rules, however, such negotiations are very unlikely to be possible for the core (licensed) PSB services, which are subject to the array of 'must offer/must provide' provisions listed above, and which may represent significant benefit to a platform operator judged by viewing share achieved by PSB channels on pay-TV platforms. Thus, it is unlikely that the commercial value of such carriage is being captured. The fact that carriage of non-core services can be commercially negotiated (e.g., the commercial PSBs are free to withhold their HD variants from Sky and Virgin), and that payments may be made for these non-core services that offset TPS payments for core channel carriage, does not explicitly address the underlying benefit of the carriage of the core PSB channels themselves.

Sky's TPS charges are set without explicit reference to any platform benefit arising from carriage (see Box 1-B, page 16). As a consequence, there are at least two methods of ensuring that the benefits of carriage are captured and payment flows established to reflect the benefits: either to amend TPS to require a calculation of platform benefit (and to consider ways in which this would apply to cable and other platforms as well) or to reform the rules around PSB carriage to permit withholding or denial of carriage, enabling a 'market' outcome through commercial negotiation. Establishing the outcome of a deregulatory regime is therefore the first objective we have set ourselves in this report.

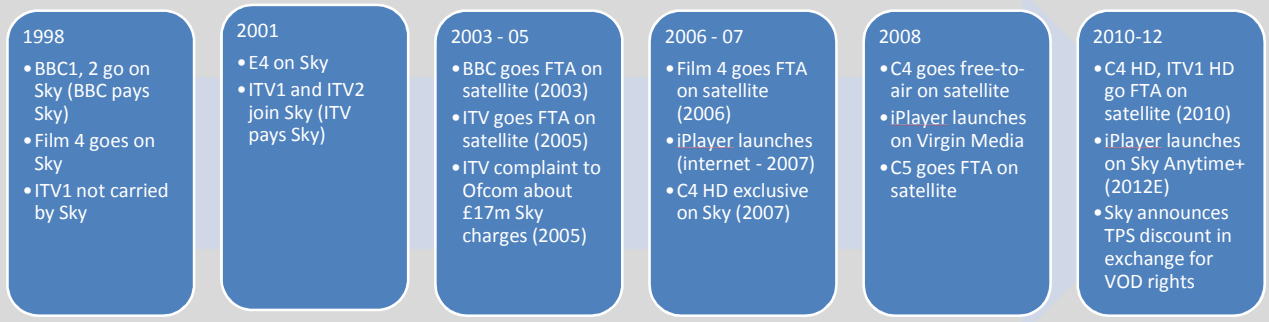
Box 1-A: A brief history of platform/PSB negotiations

Prior to the introduction of the current regime (certainly prior to the 2003 Communications Act), the inclusion of PSB channels in commercial platforms was not a foregone conclusion and was indeed the subject of well-publicised negotiations between the BBC and Sky (1998 and 2003) and ITV and Sky (1998-2001).

In the latter case, a failure to reach agreement meant that ITV1 was kept off the Sky Digital platform throughout the period 1998-2001. An agreement was only reached following the failure of ITV Digital (the favouring of which was at the root of ITV's decision to withhold its core service from Sky) and ITV's perception that it needed to secure carriage for ITV2 to remain competitive. In both cases, broadcasters ended up paying Sky a negotiated yearly fee (in the region of £10m-£20m each) for carrying their channels. The BBC thereafter elected to put its services 'in the clear' on satellite, and extracted new terms from Sky to reflect a reduced level of services (rather than paying for encryption/decryption, the BBC needed regionalisation services only, to ensure the 'right' BBC service was delivered on relevant set-top boxes).

The current TPS regime, formalised with guidelines published by Ofcom in 2006, is partly the outcome of a regulatory review following complaints by broadcasters that these payments were not fair. Under TPS, Sky must charge fees that are Fair, Reasonable and Non Discriminatory (FRND) and is permitted to cover relevant costs; but the idea of payments reflecting mutual benefits is not part of the framework.[8]

[7] At least in some cases Sky has been known to pay in cash for some portfolio channels not available 'in the clear' – for example, the HD variants of ITV2, ITV3 and ITV4 that now reside behind a pay wall on Sky.
[8] TPS is discussed in Box 1-B, page 16.



Although the current regime has provided greater clarity, the key subject of payments is only partially settled, with the relevant provisions in the 2003 Act stating that PSBs must only do their best to secure carriage 'subject to the need to agree terms'.

Interestingly, we have found different readings across the industry as to the degree of freedom that this gives each party to deny carriage and hence to negotiate effectively – for example, on some readings ITV could have its signal removed from Sky if it so wished; however, as the ITV1 signal is 'in the clear' via satellite, Sky subscribers could manually tune their set-top boxes to continue to receive at least one regional ITV1 service. Consequently, it is unclear whether or to what extent the current payments (or their lack) are the result of commercial realities or policy intervention.

Since the introduction of the 2003 Act, the market has changed in a number of important ways. First, Sky is now in c9.6m UK homes and thereby forms an even more important part of PSBs' mass-market delivery of their channels, which may make Sky's negotiating position stronger. Second, following the BBC's lead, PSBs have all started transmitting their signals 'in the clear' via satellite, thus potentially further weakening their bargaining position since, arguably, Sky no longer 'carries' their signal and only provides its consumers with suitable reception equipment.

Throughout this period, PSBs and platform operators have conducted commercial negotiations over a number of assets not covered by 'must-carry/must-provide' regulations, including 'portfolio' channels (ITV2, More4, etc.), HD variants and interactive services. At least in some cases, this has involved platforms paying PSBs in cash for carriage rights.

In recent years, the syndication of programmes for VOD catch-up has been a key tradable asset. In its recent unilateral reduction in TPS charges applying to PSBs, Sky has explicitly provided a 30% discount for those PSBs providing a VOD service (for example, ITV Player or the BBC iPlayer) on the Sky Digital platform.

Overview of this report

As requested by DCMS, we consider the question of potential changes to the regulatory regime covering the carriage of PSB channels on pay platforms through two key prisms: would any change be deregulatory; and would the effect be to lead to an increase in expenditure on original UK content?

In **section 2**, we consider whether the removal of obstacles to commercial negotiations between channels and platform operators would allow carriage benefits to be valued and payment flows to occur that reflect these benefits. In doing this, we consider a hypothetical **carriage consent**[9] regime: namely, one in which either party (a PSB or a platform operator) can withhold carriage at will if mutually satisfactory terms cannot be agreed between

[9] Note that in our references to these payments between PSBs and pay-TV platforms we have elected to use the term 'carriage consent' rather than 're-transmission consent', given that re-transmission is not applicable to the case of satellite carriage in the UK, as all PSB signals are 'in the clear' and do not need to be 're-transmitted' to be received by a satellite dish.

the parties.[10] Based on limited (and often disputed) evidence, we consider the financial losses that both PSBs and platform operators would have at stake in such negotiations. Based on this, we then address the difficult question as to which direction such payments are likely to flow – i.e., in favour of channels or platform operators.

This analysis is based on the hypothetical condition that fully unimpeded commercial negotiations are possible – which may not be realistic. However, this exercise permits the calculation of plausible outcomes in relation to the capturing of benefit for both parties to a carriage arrangement, and serves as a deregulatory benchmark against which to judge what may be more feasible changes to regulation (a review of which can be found in the final section of this report). Reliably predicting the outcome of negotiations is an impossible task. Nonetheless, we draw on available evidence and our own modelling to produce plausible ranges for outcomes that would result from commercial carriage negotiations. We find that, on balance, such negotiations are likelier to make PSBs better off and platforms worse off; however, other outcomes cannot be ruled out.

In **section 3**, we address the issue of content outcomes, asking whether platform operators or PSB channels are more likely to spend any incremental income arising from carriage consent agreements on original content. At first sight, it appears reasonable to expect that a regime in which the balance of payments favoured PSBs would lead to increased investment in UK-originated content, given that PSBs currently account for c90% of all such investment (on Ofcom's definition). However, this is no more than a hypothesis: for example, privately owned PSBs (ITV, Channel 5) could simply pass on any extra revenues they get from platforms on to their shareholders in the form of dividends; moreover, assuming that PSBs will always contribute the vast majority of original content commitment is to unfairly discount plans by Sky and other pay-TV channel operators to invest more in original content in the future.[11]

Indeed, it is not inconceivable (although counter-intuitive in the light of historical trends) that investment in original content could increase if payments were to flow in the opposite direction (that is, from PSBs to pay-TV platforms).

Finally, platform operators could pass on any increased costs of meeting their channel payment obligations to their subscribers, cut their own original content spending (e.g., in the case of Sky, which plans currently to increase such spending) and/or reduce their payments to pay-TV channel affiliates (with a further effect on the latter's original content funding plans). By extension, if payments actually flow *to* platforms *from* PSBs, platform operators could 'share' the payments with subscribers via lower subscription fees, increase payments to affiliates, increase their own spending on content or elect to distribute the gains via dividends to shareholders.

In short, even in a scenario where payments flow to PSBs and their investment in content increases, there may be offsetting reductions in overall commitment to original content expenditure owing to the responses of pay-TV platforms and pay channels.

In **section 4**, we review the practical implications of any carriage consent regime. Clearly, allowing full negotiations to take place is fraught with significant problems, including:

[10] Note that although this describes the US regime to some extent, it would be a mistake to assume that simply because US broadcasters have succeeded in securing payments from platform operators the same would happen in the UK. The two markets differ in a number of important aspects, not least widely different business models and levels of pay-TV penetration and the lack of a terrestrial alternative in many homes (see Appendix B for details of the US case).

[11] We note that with the sale of its stake in pay-TV channel portfolio UKTV in 2011, Virgin Media no longer operates linear pay-TV channels, and its content investment is now solely via affiliate fees to third parties. Sky, however, has set public targets for increasing its UK content expenditure.

- There is no certainty that free commercial negotiations would lead to a flow of payments which results in an increase in original content investment. Although the current US regime was widely expected to lead to cash payments in favour of FTA channels, it took some twelve years before these materialised.[12] Short of explicitly mandating specific payments through regulation, outcomes cannot be guaranteed. A 'market simulation' approach – whereby a regulator could mandate payments similar to those that would be obtained under negotiations, thus dispensing with the risks associated with a real-world negotiation such as service black-outs – is similarly fraught, and runs against the challenge set by DCMS of reducing rather than increasing regulation.
- Allowing the parties to negotiate credibly would mean accepting the possibility that PSB channels might not be carried by a large operator (if negotiations were to break down), thus compromising the universal availability that is at the core of the PSB compact, the BBC's Charter Agreement and the logic of a universally payable licence fee.
- Even if these problems can be addressed, there are also fundamental issues around legacy regulations, EU law, copyright and challenges arising from evolving technology that may stand in the way of effective negotiations. Key among these is the fact that PSB broadcasters transmit their signals for free and unencrypted – via satellite and terrestrial spectrum – which raises doubts about whether PSBs can legally prevent satellite operators from carrying their signals, since 'carriage' here does not involve 're-transmission'.

Also in section 4, we consider longer-term developments that may have an impact on carriage consent regulations. In future, there may be a number of platforms offering both linear and non-linear TV services, for instance via the internet (an example might be Apple or Google TV). Without any changes to the current rules, would these platforms also charge PSBs for platform access services? Would this lead to ever higher charges being paid by the BBC and the commercial PSBs, thereby compromising their ability to fund original content? Or would, instead, protections under 'net neutrality' ensure that PSB services would be delivered without charge via the internet? These questions call for a discussion of the scope of any relevant legislation in terms of the effects on both content expenditure and platform penetration outcomes. In turn, the latter calls for an examination of the relevant types of platform in terms of technology and business model. Detailed consideration of these issues is beyond our scope.

Finally, in **section 5** we draw on the analysis in the preceding sections to identify several policy options aimed at securing an outcome consistent with the dual objectives of deregulation and an increase in UK original content expenditure. Although all options involve compromises, we believe that a nuanced approach enabling limited commercial negotiations to occur is likely to lead to increased investment; however, other options may also be viable to varying degrees.

Sources and acknowledgements

In the course of the work leading to this report, we have reviewed the regulatory framework as it exists today, considered certain pertinent international benchmarks, and undertaken our own analysis. We have spoken confidentially with a range of stakeholders, including all the PSBs and main platform operators. For the avoidance of doubt, Mediatique is solely responsible for the views expressed in this report, which should not be construed to represent the views of the DCMS or any other party.

[12] See Appendix B for a discussion of the US experience.

Box 1-B: Current platform payments, including Technical Platform Services (TPS) – an overview

Under the current system, the PSBs collectively pay c£14m in annual Platform Contribution Charges (PCC) to Sky under the TPS regime and further fees for EPG listings and regionalisation (ensuring that the right regional service of a PSB channel is received on set-top boxes across the country). Note that this figure does not cover commercial PSB extension channels such as ITV2, More4, 5US, etc. Other payments between PSBs and platform operators include the following:

- Freesat charges EPG listing fees only and, currently, no payments are made in either direction on the cable platform (for linear PSB channels).
- The new IP-DTT hybrid platform YouView will also be seeking to recover some of its platform development costs, although it is unclear how much, if anything, PSBs will be obliged to pay.
- In addition to these flows, Sky and Virgin pay (or have paid) fees to the PSBs for other channel services – for example, Sky currently pays an undisclosed amount to ITV for exclusive access to HD variants of ITV2, ITV3 and ITV4. It is worth noting that the commercial PSBs are likely to calculate their distribution 'bill' with a given platform on the basis of the net amounts that they pay and/or receive.
- Neither Freesat nor YouView is a regulated provider of TPS, although both have adopted key principles from the regime in their charging and actual/proposed cost recovery mechanisms.

Focus on TPS

Owing to the market power of the Sky satellite platform in the UK, the terms of the carriage of free-to-air channels on Sky are subject to TPS, under which Sky is permitted to recover specific costs related to the building and maintenance of its satellite delivery platform. Sky also charges for specific services (e.g., EPG listings, regionalisation, conditional access). The Platform Contribution Charges apply to all channels, including Sky's own. The system is reviewable by Ofcom in the event of any complaint but TPS charges are set by Sky and not by Ofcom.

According to Ofcom's TPS Guidelines[13], 'the costs that Sky should be entitled to recover from TPS customers should be restricted to costs which it reasonably, necessarily and efficiently incurs in the provision of TPS to those customers or in order to develop and operate the DSat platform.'

Under TPS, it is accepted that PSB channels benefit from their availability on the Sky platform (and from the investment BSkyB has made to develop its satellite platform) and charges are expected to be proportional to each channel's benefits (which Ofcom allows to be calculated through publicly available viewership figures – so that, e.g., the BBC's fees are far higher than Channel 5's). However, Sky is explicitly not required to 'net off' these benefits against any benefit that the platform derives from its ability to incorporate PSB channels into its service.

In its guidelines, Ofcom writes:

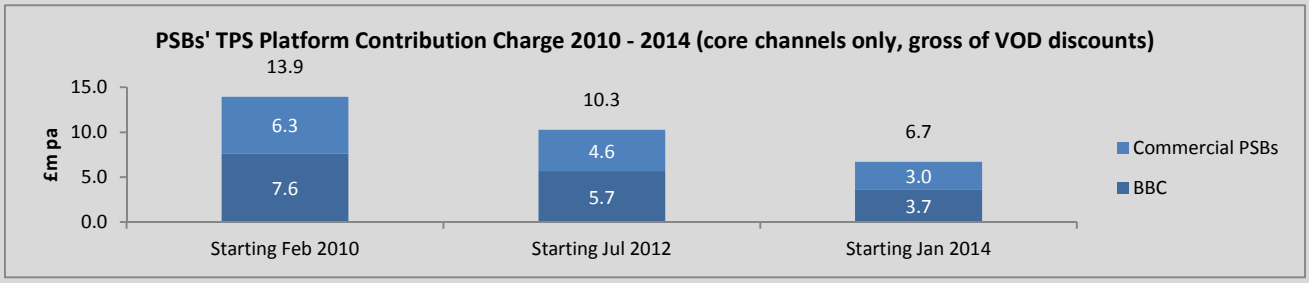
> *'Where the Sky DSat platform derives a benefit from providing TPS to a particular TPS customer, e.g., making a particularly attractive service available on its platform which encourages the take up of the platform, Ofcom might expect that this benefit be 'netted off' against the benefit that this TPS customer derives from using TPS. However, Ofcom may also consider it FRND for Sky to exclude these effects when establishing its charging methodology due to the complexity involved in assessing the magnitude of the*

[13] Available at http://stakeholders.ofcom.org.uk/consultations/tpsguidelines/statement/

impact of individual TPS customer's services on, for example, the take up of the platform or churn from the platform.'[14]

The common costs that are recoverable from PSBs relate mainly to two broad categories of expenditure by Sky – the cost of set-top boxes (which Sky provides free to subscribers) and a proportion of marketing expenditure including spend on customer retention. For the former, Sky has recognised that higher-functionality STBs – for example, which provide IP connectivity and PVR memory – are not required in order to ensure that channels are distributed to subscribing homes, and therefore Sky only apportions the cost of an entry-level STB (c£40) to the cost recovery 'pot' applicable to PSBs, and does so only for new subscribers, not those getting a second or replacement STB. For marketing, Sky makes a judgement as to whether a particular campaign is dedicated to promoting the platform overall (where costs are recoverable) or to promoting specific pay services (such as premium movie and sport content). It is worth noting that these judgements are Sky's alone, and although they are reviewable by Ofcom, this is only contemplated in cases where disputes arise. Over time, Sky has recovered costs on a 'lagging' basis, with the early heavy investments in platform creation and maintenance amortised over the subsequent periods.

Under the TPS regime, in return for carrying their core linear channels on its platform, all PSBs pay Sky (i) a channel-specific PCC based on a rate-card and (ii) smaller, fixed charges for certain services such as EPG listings and regionalisation. In March 2012, BSkyB announced an across-the-board reduction of PCC fees, lowering the PSB's payments for core channels from £13.9m to £10.3m per year effective July 2012. Sky also provided guidance for a further likely reduction in 2014 leading to a PSB PCC bill (for core channels only), of c£6.7m per year.



From July 2012, PSBs will also be able to benefit from a 30% discount to their PCCs provided they offer a VOD service (catch-up) to Sky; if all PSBs do so, the collective charge under the recoverable portion of TPS would amount to c£7.2m per year from July 2012 and an indicative £4.7m from 2014.[15]

It is instructive that of the common costs recovered by Sky, the core PSB contribution accounts for 25%; removing all the PSB payments from the total (including those accounted for by PSB extension channels), Sky's own channels and its retail partner channels represent nearly all the residual fees recovered.

[14] Ofcom: *Provision of Technical Platform Services: Guidelines and Explanatory Statement.* 21 September 2006.
[15] http://corporate.sky.com/documents/pdf/20c24d2e1c62406594e1a79de5f917db/bskyb_and_sssl_published_price_list_effective_1_july_2012.pdf

2. Estimating benefits and payment flows arising from carriage

In this section we consider the payments that would likely flow between PSBs and platform operators under a hypothetical regime in which either party would be free to withhold or deny carriage of a core PSB signal, at will, if satisfactory terms (including, possibly, payments) cannot be agreed between the parties. Note that such a regime – which we call '**carriage consent**' – is essentially deregulatory in that it means the removal of PSB-specific 'must-offer/must-carry' provisions, the removal of TPS pricing and the enablement of market-based mechanisms of price discovery.[16]

We are aware that implementing such a regime in practice would involve a number of important challenges, not least in relation to copyright legislation, European rules on FRND access and expectations of universal access to PSBs (arguably of particular importance in the case of the licence fee-funded BBC). We discuss these issues at length in section 4, where we also explore ways in which they might be addressed (with the effect that the deregulatory thrust may be somewhat weakened).

For now, our aim is simply to explore what outcomes such a regime might plausibly yield in terms of payment quanta and direction *if it could be implemented*. We therefore ignore these practical concerns, with one key exception: for reasons that we discuss in section 3, we assume that **carriage consent rules would not apply to the BBC** (which would neither benefit from nor incur the costs of any payment flows discussed in this report). Including the BBC in a carriage consent regime would raise fundamental questions about the licence fee and the BBC's Charter that fall outside the scope of this report.[17]

In this section we consider first the 'benefits' that commercial PSBs (via the core channels ITV1, Channel 4/S4C and Channel 5) and platform operators derive as a result of the carriage of core PSB channels. We then move on the question of payment flows: if one party is shown to benefit more than the other, it is reasonable to expect that a commercial negotiation (in which suppliers could withhold or platforms could deny carriage) would lead to compensating payments to address the imbalance. For the sake of simplicity, we assume that the difference between the platform and PSB 'benefit' is split 50/50, so that the party with the bigger benefit pays half of this to the other party.

Of course real-life negotiations do not follow models, however sophisticated. Factors such as negotiating skill, market power and differing perceptions of value all make commercial agreements inherently unpredictable. Given the scarcity of relevant data and evidence from real-life negotiations, estimates such as ours can be no more than indicative and directional. Consequently, in our numerical modelling we have opted for a radically simplified approach that avoids several complex issues as specified below. Attempting to account for these factors would unduly complicate the analysis and provide potentially spurious results.

The discussion in this section aims to be as intuitive and non-technical as possible. Readers seeking further details are referred to Appendix A which provides a more analytical account of our approach.

[16] Through the introduction of blocking mechanisms such as copyright protection and/or conditional access. Note, however, that it is not clear this can be achieved through copyright alone – we return to this point in section 4.

[17] When we come to discuss content and consumer outcomes, it will become clear that there is a danger that pay-TV subscribers would effectively pay twice for BBC channels – once through the licence fee and again in the event that TV platforms were to pass any carriage consent fees owed to PSBs onto subscribers. In addition, commercial negotiations might lead to service black-outs, which the BBC would find difficult to reconcile with its obligations to be universally available.

Benefits at stake

Intuitive approach

Intuitively, we can posit that both broadcasters and platform operators benefit from the carriage of channels:

- Broadcasters benefit because all of a platform's subscribers (including those without access to alternative means of reception, such as Freeview) can easily tune into their channels as part of normal viewing. This contributes to reach, viewing share and advertising revenues.
- Similarly, by including PSBs' channels in their EPGs, pay-TV operators offer their subscribers a convenient single point of access (and, for subscribers without alternative means of reception, their only way of accessing PSBs). This increases the value of the platform service for consumers and can translate, for example, into a higher number of subscribers, lower churn and greater willingness to pay on the part of subscribers than might otherwise be the case.

Each party therefore profits from carriage. However, this intuitive sense of benefit can easily be attacked from both sides of the bargain. For example, broadcasters might argue that:

- If pay platform operators did not exist, UK households would instead rely on Freeview or Freesat to receive their PSB services; PSBs' reach would be just as high as today, and their share of viewing (and advertising revenues) would in fact be higher, given that PSBs generate better viewing shares on lower-capacity platforms such as Freeview.
- Successful pay platforms were only able to achieve their current large-scale penetration as a result of PSBs' presence on their platforms, so that platform operators therefore owe a 'historic debt' to PSBs.
- Given today's high penetration of DTT-capable TV sets in pay-TV households,[18] PSBs' reach (although not viewing) is largely independent of whether or not they are carried by platform operators.

For their part, pay-TV platform operators might argue that having PSBs on their platforms does not in fact bring them incremental benefit, as most of their subscribers are able to receive PSB services via alternative means, and that the true value that pay platforms offer their subscribers (for which they actually pay) lies in the premium content and functionality that the platforms provide.

In order to discuss these issues objectively, a more careful definition of the concept of 'benefit' is needed.

Benefits at stake, incremental churn and viewing impairment

In a scenario in which either party could credibly threaten the other with a cessation of carriage if negotiations fail, the commercial value at stake would be the income that each party would stand to lose if a platform were to stop carrying a channel. We call these potential losses the **benefits at stake** associated with carriage.

As part of this project we have constructed a simple numerical model[19] to estimate these amounts. In this model, benefits depend mainly on two types of behaviour that a platform's subscribers may exhibit in response to a channel no longer being carried:

[18] Some pay TV homes still use analogue TVs in conjunction with digital set-top boxes provided by TV platform operators; increasingly, however, receiving equipment in UK homes will be DTT enabled even if the sets are connected to, for example, Sky or Virgin STBs.
[19] Full details are provided in Appendix A.

- A platform's benefits at stake are driven by the **incremental 'churn' –** that is, the percentage of the platform's customers who would drop their subscription as a result of the channel's absence and switch to a rival pay-TV operator or a free platform such as Freeview, where they can continue viewing the channel. This incremental churn is then translated into lost subscription income. Although we expect incremental churn to be relatively small, even small values can result in significant losses for platform operators.
- A channel's benefits at stake are driven by the **viewing impairment** that would result**:** that is, the percentage by which viewing of the channel would decrease among subscribers who *stay* with the platform after it has stopped carrying the channel. By definition, viewing impairment in non-churning households would be offset by any viewing generated via an alternative, available means of accessing the dropped channel (e.g., Freeview on a second set or via the DTT tuner on the main set).[20] The net viewing impairment is then translated into lost advertising revenue.

Simulation ranges

There is only very limited publicly available evidence that might inform the churn and viewing impairment likely to result from a given channel being dropped from a given platform. Faced with this difficulty, we have opted for the following approach:

- We consider *broad plausible ranges* of incremental churn and viewing impairment, and report our estimates of benefit corresponding to various plausible values of each of these parameters.
- For a given combination of PSB channel and platform operator, and a given a combination of plausible values for churn and viewing impairment, we estimate the losses expected to be experienced by each side.[21] This allows readers of this report to consider benefits at stake as a function of whatever levels of incremental churn and viewing impairment they believe are realistic.

Further review of the limited international evidence of comparable cases as well as a detailed summary of our own modelling is available in Appendix A).[22]

We conduct two variants of this exercise:

- **Separate negotiations:** We estimate the losses that parties would incur if a single PSB's core channel were to stop being carried by a single platform. We repeat this for all possible combinations of commercial PSBs (C4/S4C, Channel 5 and ITV/STV) and main platform operators (Virgin Media and Sky), adding the potential losses on each side to produce industry-wide benefits at stake for commercial PSBs and platform operators.[23]

[20] Note that, for households that do not churn, viewing drops not only among those without alternative means of reception such as Freeview (whose viewing would drop to zero), but also (albeit to a smaller extent) among those that do have an alternative, since the PSB's channel would not be conveniently accessible to viewers using the pay-TV platform's EPG and/or on their main TV set.

[21] Specifically, given expected incremental churn and viewer impairment, we estimate the platform's and channel's benefits at stake by multiplying these two values by the amount that each party makes from each subscribing household (through advertising in the case of channels and subscriptions in the case of platforms), and then by the operator's number of subscribers. Full details are provided in Appendix A.

[22] We note that, although better estimates for the relevant parameters may be obtainable through primary research (e.g., attitudinal consumer surveys), this is beyond the scope of this report.

[23] Dropping different channels would inflict different levels of churn on a platform operator, with the departure of popular channels resulting in bigger losses. This means that the plausible ranges for incremental churn vary from channel to channel (and are generally smaller than for the case when all PSBs are able to negotiate together). Given the directional/intuitive nature of the modelling, we believe it would be spurious to report the range of benefits corresponding to each platform and PSB negotiating individually. Nonetheless, the industry-wide estimates presented in section 5 are based on the bottom-up approach outlined here.

- **Collective negotiations:** We estimate the losses that parties would incur if *all* commercial PSBs were to stop being carried by a given platform. We conduct this exercise twice, once for each of the two main platform operators, again adding the potential losses on each side to produce industry-wide benefits at stake for commercial PSBs and platform operators.[24]

For the sake of simplicity, in the remainder of this section we only discuss the case of collective negotiations. However, in our options analysis in section 5 we consider both types of negotiations (separate and collective) explicitly. It is worth noting that results in both cases do not differ markedly – unsurprisingly, given that ITV accounts for the bulk of commercial PSBs' viewing and benefits. **The implication of this is that the estimates provided in our tables broadly reflect benefits at stake under carriage consent negotiations, whether under separate or collective negotiations.**

In the case of platform operators' losses, these are a function of incremental churn. Our estimates of this relationship are given in Figure 2 below, which shows the combined yearly losses[25] that the UK's two main pay-TV operators (Sky and Virgin Media), would incur should their subscriber base fall by percentages ranging from 0% to 20%:

Figure 2: Plausible benefits at stake for operators (£m per year to nearest £10m)

Incremental churn	0%	2%	4%	6%	8%	10%	12%	14%	16%	18%	20%
Operator benefit at stake (£m per year)	0	80	160	240	320	400	480	560	640	720	800

As to the losses that broadcasters would incur, in our model these depend on both viewing impairment in non-churning homes and (albeit to a lesser degree), viewing in homes that churn to alternative platforms (free or pay) or abandon TV altogether. Thus in Figure 3 below we have estimated commercial PSBs' potential losses for multiple combinations of these two variables:

Figure 3: Plausible benefits at stake for commercial PSBs when they negotiate collectively[26] (£m per year to nearest £10m)

Incremental churn ↓	Viewing impairment in non-churning homes →										
	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
0%	0	90	170	260	350	430	520	610	690	780	870
2%	0	80	170	250	340	420	510	590	680	760	850
4%	0	80	170	250	330	420	500	580	660	750	830
6%	0	80	160	240	330	410	490	570	650	730	810
8%	0	80	160	240	320	400	480	560	640	720	800
10%	0	80	160	230	310	390	470	550	620	700	780
12%	0	80	150	230	300	380	460	530	610	690	760
14%	0	70	150	220	300	370	450	520	600	670	740
16%	0	70	150	220	290	360	440	510	580	650	730
18%	0	70	140	210	280	350	430	500	570	640	710
20%	0	70	140	210	280	350	420	480	550	620	690

The following important considerations should be noted:

[24] In the case of collective negotiations, we expect more households to churn than if any single channel were dropped in isolation, and we also expect non-churning households to go to greater lengths to secure reception of channels dropped by their platform (e.g., by investing in aerials so as to receive Freeview), thereby mitigating viewing impairment.
[25] That is, the amount by which their income would decrease.
[26] Figures represent the sum of commercial PSBs' potential losses if they were all simultaneously dropped by Sky, plus their losses if they were all simultaneously dropped by Virgin Media – but not if they were dropped by both platforms simultaneously.

- We have ignored several important aspects that would need to be considered in a more quantitative study. These include the steps that a platform operator may take to reduce churn after losing a PSB (e.g., introducing price reductions or securing additional exclusive content or even acquiring a competing PSB) and various iterations of competitor response (e.g., how rival operators might treat a particular PSB on other fronts in future).[27]
- We warn against taking the upper level of the likely range of benefits in the tables above as truly indicative, since in such extreme scenarios PSBs and platform operators would likely take steps to ensure that losses are mitigated. For example, platform operators could provide the means of receiving PSB channels for all subscribers, for example via a DTT 'dongle' at no cost (as Sky Italia did in a carriage dispute in Italy) and PSBs could seek to mitigate their drop in viewing by publicly campaigning for consumers to switch pay-TV platforms (as has happened in US disputes).[28]

From benefits to 'fair share' payments

Conceptual aspects

Implicit in our discussion so far has been the assumption that benefits at stake do not include any payments that one party might make to the other in exchange for carriage; rather, benefits are defined by reference to the advertising or subscription income at risk.

Under a market-driven, carriage consent regime in which either party can threaten to withhold carriage, both parties would be worse off if negotiations were to fail – i.e., this would be a 'lose-lose' situation – and in principle either party would be prepared to make a payment to the other rather than lose carriage. Such payments are particularly plausible if one party (say, a PSB) has far lower benefits at stake than another (say, a platform operator); in this case, the party with relatively little to lose can threaten to withhold carriage unless the one with more to lose gives way.

A simple example may be instructive. Suppose that Channel B is available on Platform A, and that its presence is worth £5m to the platform in annual benefits independently of any payments between the parties (e.g., through locking in or winning subscribers, or encouraging them not to churn). For its part, Channel B gains a direct benefit of £1m per year (e.g., through advertising revenues arising as a result of viewing outcomes in homes served by Platform A). In this example, the platform's benefit is greater than the channel's. Rather than risk losing Channel B, Platform A agrees to make a payment leading to an equalisation of the benefits between the two, or £2m – 50% of the difference between platform and channel benefits.

In real-life negotiations parties would rarely have such clarity about the benefits at stake, and even if they did they would be under no obligation to reach such an equitable outcome. Factors such as unequal negotiating skill or financial resilience may be decisive in tilting the balance in either direction in a negotiation. Also, importantly,

[27] In particular, if under a deregulatory regime platform operators might be allowed not only to 'drop' a PSB channel but also to re-use the vacated EPG slot to promote other channels, including their own, it might then be possible (but by no means certain) that the platform would in fact be better off without the PSB channel, so that the net benefits of carrying the channel are negative. We ignore this possibility. We also ignore the effects of the length of the black-out (assumed to be permanent), benefits of regionalisation and benefits of access to platform-delivered VOD services and EPG prominence. Our model also involves many other more technical simplifications – see 'What this model omits', in Appendix A for a fuller discussion.

[28] For the Italian case see 'Sky Italia rubbishes Mediaset's dongle complaint' *Digital TV Europe* Nov 20, 2009. For the US case see Appendix B.

if historical precedent has established a 'default' position (such as, for example, that neither party should pay the other, as is currently the case with cable and the PSBs), this can have an influence on the course of negotiations.

Nonetheless, a 'split the difference' arrangement as in the example above is worth considering as economic theory suggests that such payments are a plausible (but by no means guaranteed) outcome of commercial negotiations under a carriage consent regime based on reasonable assumptions.[29] This arrangement allows us to provide a quantitatively meaningful sense of what an 'equitable' or 'fair' payment would be.

Estimates

Our estimates for 'fair payments' are generated directly from the benefits at stake estimated above, from which we simply 'split the difference' between commercial PSBs' and platform operators' benefits for each plausible combination of incremental churn and viewing impairment. The result of the calculations is shown in Figure 4 below, in which positive numbers denote payments by platform operators to PSBs and negative numbers the converse.

Figure 4: 'Fair share' payments – estimates (£m per year rounded to nearest £5m)

Incremental churn ↓	Viewing impairment in non-churning homes →										
	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
0%	0	-45	-85	-130	-175	-215	-260	-305	-345	-390	-435
2%	40	0	-45	-85	-130	-170	-215	-255	-300	-340	-385
4%	80	40	-5	-45	-85	-130	-170	-210	-250	-295	-335
6%	120	80	40	0	-45	-85	-125	-165	-205	-245	-285
8%	160	120	80	40	0	-40	-80	-120	-160	-200	-240
10%	200	160	120	85	45	5	-35	-75	-110	-150	-190
12%	240	200	165	125	90	50	10	-25	-65	-105	-140
14%	280	245	205	170	130	95	55	20	-20	-55	-90
16%	320	285	245	210	175	140	100	65	30	-5	-45
18%	360	325	290	255	220	185	145	110	75	40	5
20%	400	365	330	295	260	225	190	160	125	90	55

The following observations should be noted:

- As in the case of benefits, the estimates above reflect the range in the case of collective negotiations by PSBs. We have also considered in our model the scenario of separate negotiations – and again the resulting payments, on average, are broadly similar to those obtained under collective negotiations. However, while the range of likely payments is favourable to PSBs in all likely cases where collective negotiations are permitted, this is not necessarily true when negotiations take place separately. Even here, however, expected payments would be in favour of PSBs, on average, and of a magnitude similar to that corresponding to collective negotiations.[30]
- Again we emphasise the directional and indicative nature of our estimates, which are based on a range of observable factors obtaining today and may change in the future (e.g., when conditions at the time of licence renewal are taken into account). Also, the broad ranges generated in our benefits estimates mean that the corresponding flow-of-payments estimates are similarly broad.

[29] See Appendix A.
[30] This reflects the fact that, under separate negotiations, smaller channels are more likely to fail to extract payments from platform operators.

Preliminary implications

Our analysis suggests that there are significant benefits at stake in the carriage of PSBs' channels by pay-TV operators. Within this broad range, a case can be made in favour of determining a narrower range, consistent with the (admittedly inconclusive) evidence from other jurisdictions (as detailed in Appendix A).

In our view, a plausible range of 'fair payments' is of the order of £20m to £220m per year in favour of PSBs under collective negotiations. Under separate negotiations our estimates produce ranges that are lower, and include outcomes that favour platforms over PSBs (ranging from payments to platforms of £110m through to payments to broadcasters of £190m). In general, while payments in favour of PSBs are in our view more likely, payments flow in the opposite direction cannot be ruled out.

We stress that the outcome of carriage consent negotiations is impossible to predict, and readers are invited to consider the range of payments generated in Figure 4 to form their own conclusions. We also refer to the options outlined in Section 5.

3. Impact on content and consumers of a change to carriage regulation

Summary and overview

In this section we explore the likely impact of a policy-induced change in the balance of payments between PSBs and platform operators in terms of two main outcomes:

- A higher or lower amount invested industry-wide in original content, compared to current trends; and
- Higher or lower prices charged to pay-TV subscribers compared to the *status quo.*

Assessing these outcomes involves considering the likely, inter-dependent reactions of industry participants across the value chain – PSBs, platforms and pay channels – to a relatively small change in PSBs' and platform operators' revenues or costs.

Such an analysis is unavoidably inexact. Although we do propose some tentative ranges for content investment outcomes below (which in turn inform our more detailed impact analysis in section 5), our chief aim in this section is to establish a qualitative understanding of the dynamics in order to inform stakeholder and Government views.

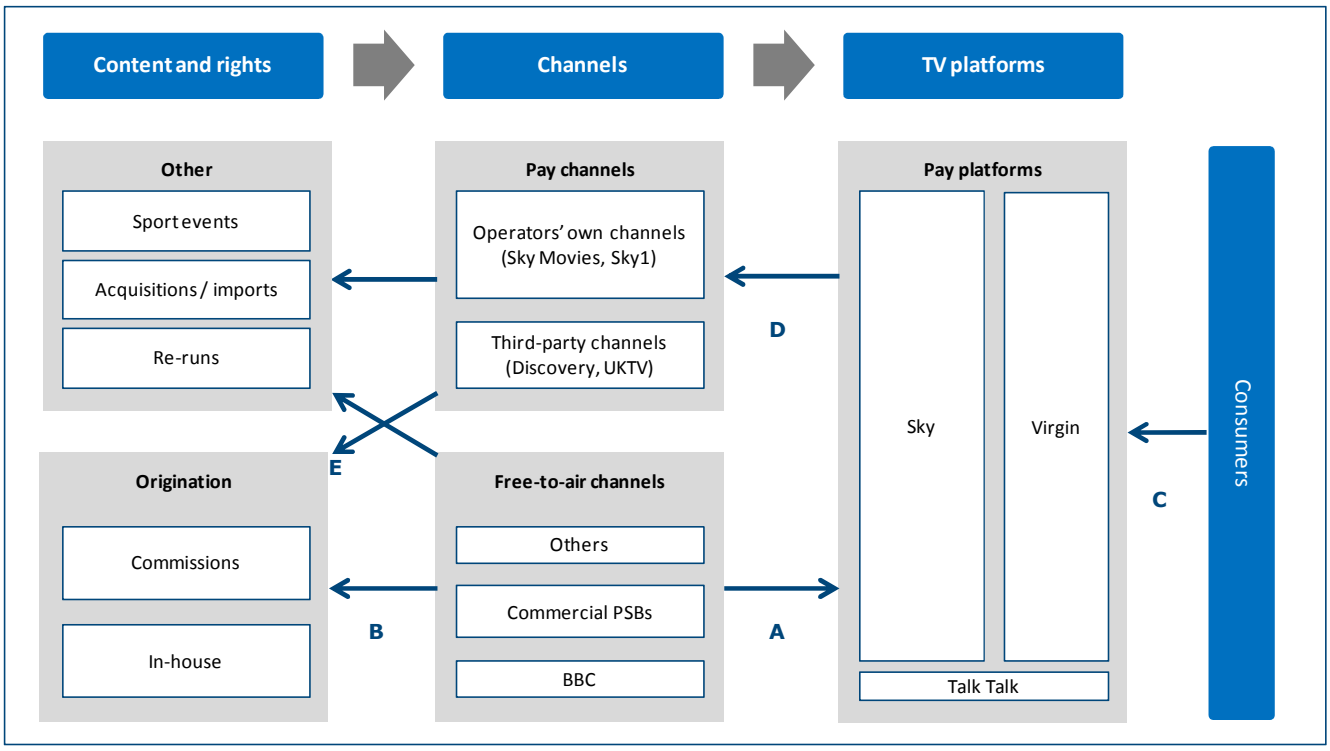
In determining the implications of changing payments flows on investment in original content, we have defined outcomes very broadly. For example, we do not attempt to draw conclusions in relation to particular genres that might be favoured or disfavoured depending on the flow of payments, nor have we sought to ascribe greater importance to investment by existing PSBs compared to other providers (or indeed individual PSBs versus others).

We begin with an overview of the value chain and the way in which payments flow across it today, before providing a framework for considering impacts on these flows of any changes to carriage arrangements. We then provide an overview by category of market participant - PSBs and platform operators – separately. We conclude with a summary, incorporating high-level quantitative estimates of content outcomes that will be used in our policy options analysis in section 5.

Value chain

There is a range of payment flows among consumers, platforms, channels, content producers and rights owners in the UK. The situation today is illustrated in Figure 5 below, which shows the main relevant players and payments between them:

Figure 5: Simplified value chain. Arrows denote payment flows today[31]



The main flows are as follows:

- **Consumers** pay monthly subscription fees **to pay-TV platforms**, in return for which they receive a range of TV channels and services (arrow **C** above). In 2010 this amounted to c£8.2bn.[32]
- **Pay-TV platforms pay carriage** fees to a number of **pay channel** owners in return for a commitment to carriage behind a pay wall (**D**), with fees typically paid on a per-subscriber basis. Sky owns a number of pay channels itself, including entertainment, sport and movies services.[33] We estimate that pay-TV operators spent c£3bn on content in 2010, equivalent to 40% of their relevant retail revenues.[34]
- **Pay channels** (both third-party and those owned by platform operators) spend money on content and earn revenues from both pay-TV platforms and from advertisers. Based on Ofcom and Mediatique estimates, in 2010 pay-TV channels spent:

[31] This diagram omits all free or 'open' platforms such as Freeview, Freesat – and even Sky, in one of its guises (i.e., as a regulated 'open access' platform) – and thus only includes 'pay' platforms. We also omit consumers' payment of the licence fee and advertisers' spend on both free-to-air and pay channels on the grounds that these are unlikely to be affected by a change in the balance of payments between PSBs and TV platforms. We explore pay versus FTA platforms in greater depth in section 4, where we look at more practical issues around carriage consent.

[32] Mediatique estimate. Includes consumer spend in double and triple-play packages combining TV, telephony and broadband.

[33] In addition to the carriage fees paid to channels (many of which it owns, so that payments are intra-company), Sky's pay-TV business is also charged a per-channel fee by its platform business (another intra-company payment) for EPG listings, conditional access, platform contribution fees, etc. This is relevant to our later discussion because, under TPS regulations, the platform charges that Sky levies on PSBs for carriage must reflect the platform's running costs divided fairly across all the channels that it carries, including Sky's own, with each channel's weight linked to its benefits from carriage.

[34] Includes spend on operators' own channels (e.g., Sky1, Sky Living) as well as fees paid to third-party pay channels (e.g., MTV, Discovery).

- Around £215m on non-sport originations (**E**) – including £140m by Sky's channels and £75m by others (including Discovery, UKTV and NBC).[35] It should be noted, however, that Sky has made a public commitment to increase its original content expenditure over the next three years
- Significant amounts on domestic sports rights in the UK, with total multichannel sports rights expenditure reaching c £1.3bn (mainly accounted for by Sky)[36]
- Around £0.8bn on acquisitions (mainly imported movies) and repeats.[37]

▪ **Free-to-air channels spend** significant amounts on UK-originated content (**B**), the vast majority of which is accounted for by the PSB channels. Programming budgets at these channels also include payments to secure sports rights, movie rights and acquired content.

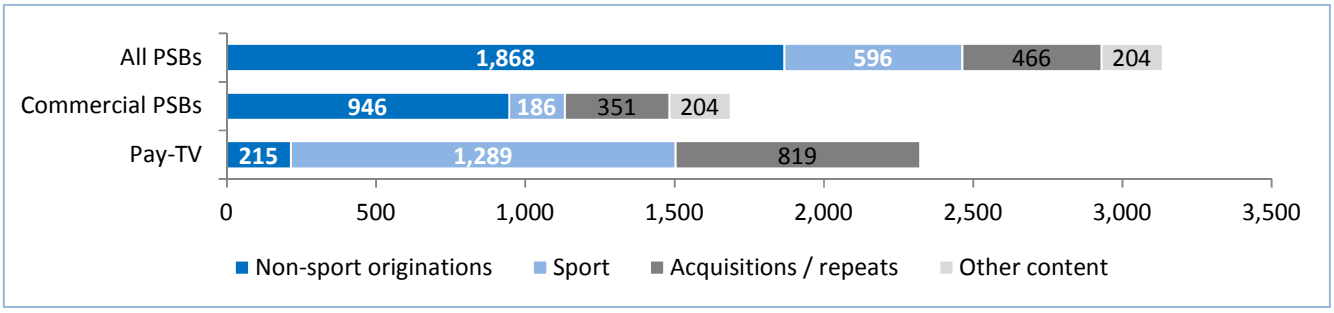
In 2010 PSBs spent c£2.46bn on content origination – £1.33bn by the BBC and £1.13 by the commercial PSBs[38], representing 60% and 56% of their total revenues respectively. This includes spend on sports rights and production of £596m. PSBs also spent £0.47bn on acquisitions and repeats.

▪ **Free-to-air channels currently pay distribution** and platform contribution charges to secure carriage on certain pay-TV platforms (**A**).

In particular, PSBs pay around £14m per year to Sky as their contribution to common cost recovery, in addition to payments for regionalisation and EPG listings; the BBC also pays for 'red button' delivery. Carriage of core PSB core channels on Virgin Media is free.

A clear conclusion is that investment in original UK content is mainly delivered by the PSB channels, reflecting the primacy of such content in driving audience share for FTA channels as well as PSBs' regulatory and statutory obligations. For their part, pay-TV providers are largely dependent on sports and acquisitions (mainly of US product) to populate their schedules. Sports programming and rights aside, PSBs spend more in absolute terms on originations than other channel operators, and also more as a proportion of their total content budgets, as illustrated in Figure 6.

Figure 6: Content investment by PSBs and pay-TV channels, £m, 2010 – indicative estimates[39]



[35] Mediatique estimates: The difference between Ofcom's £2.3bn of content expenditure by multi-channels and the £3bn paid by pay platforms for content is accounted for by the non-content costs and profit margins of third-party channels included in pay-TV packages.
[36] Origination spend by multi-channels on sport content for 2010 was £1.28bn. Source: Ofcom Communications Market Report 2011, Fig 2.38.
[37] Based on subtracting the above from total multichannel content spend of £2.32bn. Source: Ofcom, *ibid.*
[38] Ofcom, *ibid.*
[39] Based on Ofcom's 2011 *PSB Report*, Ofcom's 2011 *Communications Market Review* and Mediatique estimates based on industry discussions. 'Other content' denotes content spend by commercial PSBs' portfolio channels, which in turn is a combination of originations and acquisitions.

We expect the PSBs' share of market-wide origination spend to decline over time as pay-TV channels increase their expenditure on original content and assuming PSB expenditure continues its steady decline of recent years. This reflects Sky's stated content strategy in particular, as its original content budget is set to increase to supply its wholly owned channels (e.g., Sky Arts, Sky1, Sky Living, Sky Atlantic); in addition, other multi-channel owners are likely to increase their relevant investment to drive audience share and to protect/improve carriage fees in future negotiations with platform operators.

Further investment might come from new entrants (such as Netflix or Google), which may seek to bolster their content propositions with original content.

Synopsis of our analysis

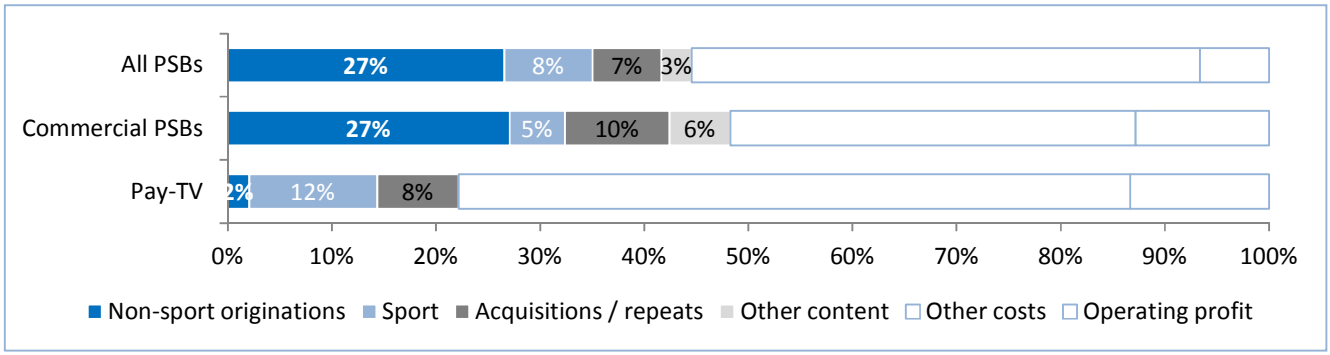
In terms of the flows denoted by the arrows in Figure 5 above, our principal task in this section is to assess how a change in flow A (payments between platform operators and PSBs) would be reflected in changes in flows C (payments by consumers), B (origination spend by PSBs), D (carriage fees to third-party channels) and E (origination spend by pay channels). Specifically, given the preliminary conclusions in Section 2 that carriage payments could well flow in favour of PSBs, we ask:

- How much of any extra revenue would PSBs re-invest in UK-originated content?
- How much of any corresponding extra costs would platform operators pass through to consumers (in the form of higher subscription prices) and to their content suppliers (in the form of lower fees paid to third party pay channels and cuts to their own programme budgets, where relevant)? In this latter case, to what degree would cuts in content expenditure by pay-TV operators affect the level of their UK non-sport origination spend?

In general we assume that – short of regulatory intervention – private firms will act to maximise profits and will increase or decrease their investment in UK-originated content only when, and to the extent that, doing so makes sense in terms of long-term shareholder return. Therefore, answering the questions above requires consideration of what a profit-seeking firm would do given its options.

There is a clear pattern in the proportion of total revenues that different players spend on UK content. Leaving sport aside, the difference is striking, with PSBs spending 27% of their revenues on UK-originated content compared to only 2% for pay-TV operators. Even including sport the difference is significant, at 35% versus 14%:

Figure 7: Content investment by PSBs and pay-TV channels as a percentage of revenues, 2010 – indicative estimates[40]



How much PSBs and pay-TV operators spend today may not be reliably indicative of future spending. Our task is to consider, rather, the impact on content investment of a small *change* in revenue or costs, not how revenues are allocated today (i.e., we are concerned about the effects of marginal, not average, changes to revenues or costs). To do this, we first need to further differentiate the key players, as not all PSBs have the same incentives or constraints.

The public service broadcasters

The PSBs account for the vast majority of UK origination spend, investing £1.9bn in 2011 alone (excluding sport and movies). By comparison, we estimate that only £239m was spent on original content by other broadcasters, including pay-TV and free-to-air channels.[41]

Any change to the payment flows between PSBs and platform operators would by definition directly affect the size of the available revenues that could be spent on content; this is not the same as saying, however, that any change would necessarily lead to an increase or decrease in such spending. We review here the likelihood that PSBs would in fact channel any payments they receive from platform operators into a higher commitment to original content spend (and by implication whether the same dynamic would obtain in the opposite direction – i.e., whether PSBs would spend less on original content were their payments to platforms to increase).

While it is impossible to predict with certainty, we expect that not-for-profit PSBs are very likely to dedicate the bulk of any incremental income received from platforms to programming budgets, and to continue to favour original content over acquired. The fully commercial PSBs will have different incentives (and are more likely to acquiesce to the preferences of private shareholders). In our base case, we have assumed that c40-60% of any incremental income received by PSBs from platform operators would be spent on original content, in line with historic patterns of investment. We underline, however, that this assumption is critical to our general conclusions about the value of promoting payment flows in favour of commercial PSBs as the basis for increasing UK content

[40] Sources for revenues and profits are company annual reports from BBC, ITV, Northern & Shell, Channel 4, Sky and Virgin Media. 'Other content' denotes content spend by commercial PSBs' portfolio channels, which in turn is a combination of originations and acquisitions. Percentages are versus overall company revenues including non-broadcasting (e.g., newspapers in the case of N&S) and non-consumer (e.g., business broadband in the case of Sky) activities. For the BBC, revenues denote income for UK PSB Group and operating profits denotes operating surplus for the same segment of £19m. For the case of pay-TV we compare multichannel content spend as reported by Ofcom to reported revenues for Sky and Virgin Media (and omit smaller platforms), thereby treating platform operators and pay channels as a single, vertically integrated entity.

[41] Figures for 2011 are based on Mediatique's own estimates, informed by an informal audit of stakeholders and its own analysis. As this report was being finalised for publication, Ofcom published its 2012 report, confirming expenditure in line with these estimates. Where necessary – e.g., to account for different data sources for 2010 and 2011 – we have made relevant adjustments.

creation (even if the value in terms of generating equitable flows reflecting benefit remains valid in any event). *Guaranteeing* that ITV and Channel 5 invest carriage consent income in original content would only be possible if the commercial PSBs were subject to some form of regulation – licence terms upon renewal for example. We explore this point further below, and in later sections of this report.

We also assume the opposite is true: that any increased payment made to platforms by the PSBs would reduce the amount the funds available to these channels to be spent on original content. To an extent this might be mitigated at the BBC and Channel 4 by efforts to make savings elsewhere before allowing the increased burden to have an impact on origination – their key focus. However, the privately owned commercial PSBs operate according to different incentives (not least the need to generate profits for shareholders).

Not-for-profit public-sector broadcasters – BBC, Channel 4 and S4C

The not-for-profit public-sector broadcasters (BBC, Channel 4 and S4C) therefore might be expected to devote a significant proportion of any cost savings or incremental income from a changed balance of payments to content, after allowing for some overhead costs.

The content investment profiles of these PSBs are biased heavily towards originated content, with the BBC spending 92% of its total network content spend and Channel 4 spending 68% on original commissions in 2010. Any increase in the total content budgets of these players resulting from payments from platforms (or savings on the current payments made for carriage) would therefore be likely to be spent on original content, consistent with current expenditure trends.

Moreover, both publicly owned broadcasters could be directed to use any payments in this way, given their ownership. The BBC already has in place commitments to particular genres and categories of content – the recent *Delivering Quality First* undertakings, for example, placed limits on the proportion of BBC resources that can be allocated to securing sports rights (capped at 9 pence in every pound of licence fee income). It is possible therefore to envisage putting arrangements in place (at least in the case of the BBC) to ensure that any incremental revenues arising from platform payments or savings from carriage fees are targeted toward originations. In the case of Channel 4, its mandate is to fund original UK content, and the targeted acquisitions of US programming of recent years have reduced markedly in any event, owing to the aggressive competition for such programming from Sky.

Privately-owned broadcasters – ITV and Channel 5[42]

The content investment profiles of the private-sector PSBs (ITV and Channel 5) are different to their not-for-profit PSB counterparts, as they both have to account for commercial pressures (including the cyclical and structural challenges to the advertising market, which remains their core funding source) and to respond to the objectives of private shareholders (particularly in the case of ITV, a listed company with institutional shareholders seeking optimal returns).

As commercial organisations, ITV and Channel 5 cannot be expected necessarily to invest incremental revenues or cost savings in any asset (programming or other) for which they do not expect an adequate return that is justifiable to shareholders. Management at these PSBs will face a range of strategic questions when determining their content investment strategy: should they return incremental income to shareholders in the form of

[42] All the PSB wide estimates (Ofcom and Mediatique) include STV and UTV within the ITV numbers, where relevant.

dividends, or can they justifiably invest additional income in content as a means of maximising audiences and potential generating incremental returns over the longer term?

Strategic choices around the use of available income will also be informed by competitive considerations: if the BBC and Channel 4 were both to increase their spending on original content as a result of gaining fees from platform operators (or seeing their carriage costs decline), ITV and Channel 5 may elect to increase their own spending in response in order to remain competitive in terms of viewing share. There is clearly a link between what BBC1 spends on content, for example, and what ITV1 determines it must spend in order to compete. ITV1 spends the vast bulk of its total network spend on originated content, a far higher figure than Channel 4, owing to having to compete with BBC1 for similarly broad mass market general audiences which clearly exhibit preferences for home-grown programmes. This 'quality benchmark' discipline has been a common characteristic of the TV landscape for decades.

Nevertheless, it remains the case that an increase in the pool of funds available to ITV and Channel 5 might not result in an increase in content investment on par with that delivered by the BBC and Channel 4 and that – left to commercial forces alone – the outcome is highly uncertain. Given this (and given a plausible base case would see carriage fees flow *only* to commercial PSBs and not to the BBC), it may be important to consider how the desired outcomes can be ensured via regulation, whereby a substantial part of any incremental payments (or savings) would be dedicated to original content (as a condition, for example, of renewing PSB licences). Although this might be said to be inconsistent with a broadly deregulatory agenda, we believe that such an objection is fundamentally weakened by the fact that these conditions would apply only to what are already highly regulated entities (i.e., PSB channels).

Platform operators

Like private-sector PSBs, platform operators responding to changes in the flow of payments (in either direction) would face a range of options for absorbing/deploying the extra costs or revenues. As listed companies (which both pay-TV platform operators are currently) they can be expected to act in a way that optimises shareholder return (or minimises a negative impact).

For example, if platform operators were to receive payments from PSBs, would they simply pass these on to their shareholders in the form of dividends? Or would they find it more profitable to pass these on to their subscribers in the form of lower pay-TV subscription prices, thereby attracting more subscribers? Or would they elect instead to invest in their platform proposition – for example, in the form of new technology, or additional content (their own, or from third parties)?

The range of potential responses is equally wide in the event that platform operators are faced with paying PSB channels for carriage – the likely outcome of carriage consent negotiations in a plausible base case. Would such payments be passed through to consumers, in the form of higher subscription fees? Might operators seek instead to offset the increased burden by reducing payments to their other content suppliers to (whose own original content expenditure might thereby be threatened) or – in the event they are themselves investors in original content – elect to cut their own programme investment? Finally, might they simply 'swallow the cost', to the detriment of their shareholders?

Determining likely responses is difficult, not least as the dynamics of the platform universe in which pay-TV operates shift continuously, and investment strategies may at times favour platform competitiveness over short-term shareholder returns and at other times the opposite. However, it is important to note that, for pay-TV platforms, the link between any incremental revenue or cost (due to consent fees) and increased or decreased

investment in UK-originated (by pay channels) is more indirect and conditional than it is for commercial PSBs. Thus, for example:

- Platform operators have a broader range of potential uses for any funds beyond investing in content, from network enhancements to set-top box subsidies to mobile telephony. There is no reason why revenues gained (or costs incurred) in the TV business should be absorbed in TV-related activities.
- PSBs are more constrained about passing on any costs to their customers (i.e., advertisers), partly because of competition from non-PSB channels and other media, and partly because of regulatory controls applying to ITV that constrain its pricing power.
- In any event, of the (unpredictable) percentage of their changed costs/revenues that operators decide to reflect in reduced/increased content spend, only a percentage would go to UK-originated content.
- For content spend incurred by pay channels not owned by platform operators (e.g., Discovery), decisions taken by pay-TV operators could have a compounding effect, in that a reduction in affiliate fees paid to third-party channels may prompt those channels in turn to alter their own content investment strategies.

Although these effects are largely unpredictable, it is reasonable to expect that their net effect is a compound weakening of the impact that a change in operators' revenues or costs would have on expenditure in UK-originated content. For example, consider the impact of an extra £100 paid by operators to PSBs. Let us assume that operators pass 50% of any the increased burden through to subscribers. Of the residual amount, a proportion (say 10%) might be absorbed by reductions in affiliate fees paid to third party channels. Of the rest (90%), only a fraction (perhaps 30%) might have an impact on non-sport origination (by contrast, today only c10% of pay channels' content budgets goes to non-sport originations). The net effect in this example is that only £14 of the £100 in carriage fees to PSBs would end up in the form of a reduction in UK origination expenditure by the pay operator.

These considerations, as well as the relatively small portion of pay-TV revenues that is currently spent on UK originations suggest – but do not prove – that any incremental costs or revenues imposed on/secured by pay-TV operators as a result of carriage consent negotiations are unlikely to have a significant impact on pay channels' investment in UK-originated content.

Impact on subscriber prices

We expect platform operators to pass on a substantial part of any charges payable to PSB to their subscribers.[43] To the extent that such costs are proportional to a platform's number of subscribers (and traditionally carriage fees have been negotiated on this basis, both for pay channels in the UK and for FTA channels in the US), carriage consent fees are a variable cost affecting all operators. Economic theory suggests that a significant part of the costs could be passed on to consumers. Evidence from the US shows that operators have passed on c50% of re-transmission costs, and there are grounds to expect that rates could be higher in the UK.[44] We therefore suggest there is a significant risk that pay-TV subscribers would bear the brunt of any lost revenues suffered by pay-TV operators.[45]

[43] It is worth noting that even regulated platforms such as Sky are relatively unconstrained, (except through market forces) in setting consumer prices and conducting their relationships with suppliers.
[44] See our discussion of 'platform operators and consumer pass-through' in Appendix A.
[45] Such an outcome would be potentially problematic if carriage payments were received by the BBC. Indeed, platform subscribers could end up in effect paying twice for the BBC: once through the licence fee and once through increased subscription fees. This merits the

Also uncertain is how pay-TV operators would respond in the (in our view unlikely) event that they received incremental payments from PSBs. In the context of the UK's mature and highly competitive platform market, however, one might expect a proportion of any PSB payments to platforms to be reflected either in reduced subscriber fees (or at least a freezing of prices for a period of time) or an enriched consumer proposition (e.g., additional services added to bundles with no price increase).

Any obligations that platform operators are not able to pass onto subscribers are likely to be borne either by platform itself or its other suppliers. Operators might:

- absorb costs without any change to existing operations and thereby reduce dividends;
- reduce payments to third-party channel suppliers, seeking offsetting savings;[46]
- reduce investment in their own content. Given the relatively small commitment by multi-channel owners to original content, any effect here is likely to be modest[47]; and/or
- reduce non-content costs such as network upgrades, customer service, marketing, etc.

In the case of a flow from channel to platform operator, the operator may elect to maintain current levels of investment (in the platform and in content) and simply pass the benefit through to shareholders directly in the form of increased dividends. In determining its policy in this regard, the operator will look to balance competitive pressures and investment requirements. The example of Sky is instructive in this regard: it has invested heavily in the roll-out of PVR technology and broadband, HD and VOD rights for key content, and sports and movie rights, seeking to build long-term value rather than distributing income.

Any decision to invest in the platform (including content) rather than increase dividends will necessarily involve a consideration of competitive pressures, particularly in light of new market entry (e.g., most recently, Netflix). These considerations arguably trump the effects of a change in the flow of funds between PSBs and platform operators.

Conclusions

The effect of any change in payment flows between platform operators and PSB channels is difficult to determine. A payment to PSBs is likely to result in higher expenditure by these channels on original content (certainly in the case of the BBC and Channel 4 but less reliably so in the case of ITV and Channel 5). However, there is no sure way of predicting how platform operators would respond. For example, the carriage fees flowing to PSBs might simply be passed on to pay-TV subscribers, or lead to a reduction in original content expenditure by pay-TV channels (either third parties or channels owned by the operator). Equally, a flow in the opposite direction, from PSBs to the platform operators, may lead to lower consumer prices, higher dividends or increased investment in the

exclusion of the BBC, explicitly through legislation, from any platform payments, cost savings or role in negotiations, as we have argued, granting the BBC access only to any zero-rate 'must-carry' right that emerges from a change in regulation.

[46] Note that this could have a perverse effect on the BBC. Alone among PSBs, the BBC has a stake in traditional pay-TV channels, through BBC Worldwide's shareholding in UKTV. Income generated by the joint venture supplements the licence fee. There is therefore a possibility that the BBC's commercial income could be reduced as a by-product of the introduction of payment flows from platforms to PSBs (a risk not run by commercial PSBs, which currently have no traditional pay channels in their portfolios). For its part, ITV derives some income from Sky in return for making the HD versions of ITV2, ITV3 and ITV4 exclusive to the Sky platform. It has no SD pay channels, however, and the sums associated with HD carriage are believed to be relatively small.

[47] However, as noted earlier, Sky has made a public commitment to increase its original content expenditure over the next three years; these plans might conceivably be scaled back in the event that it is obliged to pay PSBs a carriage fee.

platform. As a result, net effects on content expenditure (and consumer prices) are far harder to determine than gross outcomes.

However, the current trends in relation to original content (where PSBs outspend multi-channels by a wide margin, both in absolute terms and relative to revenues) suggest that flows to the PSBs will result in higher expenditure than flows to operators. While this may not always be true in the future, it is worth re-stating that FTA broadcasters have relatively straightforward business models, with content expenditure the most likely category for incremental spend. Platform operators, for their part, have a number claims on investment, including technology, platform enhancement and network improvements.

Even if operators passed on up to 100% of the increased burden to their subscribers (the top end of the range that we consider in our model), this would only affect half of UK homes (i.e., those subscribing to pay TV), while all homes would benefit from the increased commitment to original content stemming from a flow of payments to PSBs from platform operators.

Despite all the complexities identified here, we have summarised the likely dynamics of payments from a PSB to a platform operator, and vice-versa, in the following table, where we provide an informed estimate of the potential scale of impact on original spend and subscriber prices. These remain subject to a significant margin for error in the context of shifting competitive pressures, market entry and viewing outcomes.

Figure 8: evaluation of the impact on payments (from/to PSBs to/from TV platforms)

Impact of/on…	Origination spend by PSBs	Origination spend by pay channels/ operators	Subscriber prices
Payments from PSBs to TV platforms	Substantial proportion of any increased costs likely to translate into lower content expenditure Between 40-60% of increased costs passed onto reduced content spend	Potential for platform operators to spend payments on original content, particularly in the current competitive context ...however, current patterns of expenditure and operators' broad cost base suggests that the impact on UK originations may not be significant	Potential for platform operators to pass on a proportion of payments to reduce subscriber fees (or alternative methods of increasing subscriber utility) ...between 50-100% of payments in line with US experience
Payments from TV platforms to PSBs	Significant increase in content spend for BBC, C4 and S4C – 40% - 60% of payments translated into higher original content expenditure Competing objectives at ITV and C5 may reduce proportion of payments that is spent on content, although actions of BBC and C4 will create pressures to match spend	Platform operators might be forced to reduce their own origination spend – although likely to be mitigated by competitive pressures (leading to marginal reduction in budgets) There is an additional risk that payments from platforms to PSBs are partly passed on to third-party pay channels (e.g., Discovery, UKTV) ...however, current patterns of expenditure and operators' broad cost base suggests that the impact on UK originations may not be significant	Platform operators likely to reflect payments in higher subscriber fees ...in the absence of direct competitive pressure, passing on between 50-100% of costs

In broad terms, we can state the implications of this analysis as follows:

- Payments by platform operators to PSBs are likely to lead to a net increase in content spend.

- Payments in the opposite direction (from PSBs to platform operators) are likely to lead to a net decrease in origination spend. This decrease might be smaller in scale than the increase in the opposite case, as TV platforms themselves might invest incrementally in content.

4. Practical considerations arising from a carriage consent regime

In this section we address several important practical issues that, for the sake of simplicity, have been deliberately avoided thus far. These fall into four broad groups:

- Commercial uncertainty: there is no guarantee that the outcome of commercial negotiations would lead to a net increase in expenditure in UK-originated content – even if such an outcome is likely;
- Potential tensions with broader PSB policy – e.g., the need to ensure universal access to PSBs;
- A number of complex, interlinked issues concerning 'open' platforms, the TPS regime and free-to-air satellite signals; and
- Long-term considerations around new entry and platform evolution.

Below we address each of these issues in turn, and then evaluate the key implications.

Uncertainty about the outcome of commercial negotiations and content impacts

Our analysis so far has established that:

- A deregulatory carriage consent regime in which both platform operators and PSBs can choose to withhold carriage if no satisfactory compensation arrangements can be agreed could plausibly lead to payments by platform operators to PSBs.
- Payments from platform operators to PSBs are likely to lead to an increase in content origination spend (provided that adequate regulatory safeguards are in place).

Our analysis thus suggests that Government's twin aims of promoting deregulation and increasing UK content spend may dovetail in the adoption of a policy permitting commercial negotiation between platforms and commercial PSB channels to take place. However, other outcomes are indeed possible, if in our view less likely.

Given our preliminary conclusions in Section 3 suggesting that a flow in favour of the PSBs is likelier to generate positive content outcomes than one in the opposite direction, we consider a number of ways in which this can be promoted, even at the risk of reducing the purity of a deregulatory framework.

Even if payments can reliably flow in favour of PSBs, there remain difficulties in relation to ensuring that these flows do indeed translate into UK origination expenditure, particularly in the case of the privately owned PSBs, whose incentives and responsibilities to shareholders differ from those of not-for-profit PSBs.

One straightforward way of guaranteeing a positive outcome would be to define the rights granted to a commercial PSB under a carriage consent regime (including any safeguards put in place) as a regulatory asset offered as part of its licence terms. This would join access to free spectrum and appropriate prominence as rights accruing to licensed broadcasters, against which a range of obligations could be extracted, including incremental UK origination spend in line with the payment flows arising from carriage consent. While not strictly deregulatory, such an approach is consistent with the licensing regime that currently operates for commercial PSBs.[48]

[48] Ofcom recently reported to DCMS on the subject of the renewal of Channel 3 and Channel 5 licences (http://stakeholders.ofcom.org.uk/binaries/broadcast/tv-ops/c3_c5_licensing.pdf). It specifically raises the issue of 're-transmission fees' as potential elements of any renewal. Of the options outlined by Ofcom, extending current licences in the short term subject to re-licensing at a later date would allow primary legislation to be considered in which a carriage consent regime could be instituted either for renewing licensees or for an auction under which new entrants would value the licences, including carriage consent, and bid accordingly.

Preventing adverse outcomes

The estimations of likely payments between TV operators and PSBs can only be indicative, as they rely on input assumptions about consumer behaviour that are fundamentally speculative in the absence of more robust empirical data. Because of this, we provide only plausible ranges in our outcome estimates, mirroring corresponding ranges in plausible evidence in populating our model inputs.

Even if these issues could be overcome and the output ranges could be narrowed down considerably, we would still face the fundamental problem that commercial negotiations are inherently unpredictable. They are conducted by individuals and firms that differ not only in terms of market power (which, conceivably, a model could aim to reflect), but who also have incomplete information, different levels of patience, financial resilience and negotiating skills.[49]

In particular, the possibility that negotiations might allow pay-TV operators to extract significant payments from PSBs – thereby potentially leading to a net decrease in spend on content origination – cannot be altogether ruled out. We have considered three ways in which policy makers can mitigate this risk:

- **Collective negotiations:** as discussed in section 2, collective negotiations in which commercial PSBs act as a group are likelier to lead to settlements in their favour. This is particularly the case for smaller PSBs, whose leverage when negotiating with a large platform operator may be minimal.[50] However, the risk of 'black-outs' if negotiations break down (see below) cannot be avoided even under collective negotiations. Further, allowing collective negotiations may require an explicit exemption from competition law, which may or may not be feasible.
- **US-style mix of carriage consent and 'must-carry':** consistent with US practice (see Box 4-A below), new regulations could allow PSBs to decide, periodically and for each platform, whether to operate under a carriage consent regime or under 'must-carry' (whereby platforms are required to carry channels at no cost). The likely effect of this would be that payments *by* PSBs would be all but ruled out, even though the likelihood of payments *to* them would not be increased.
- **'Market simulation':** regulators could impose payments designed to simulate what equitable market negotiations should lead to, using a more sophisticated version of the model that we presented in section 2. We believe that such an interventionist approach based on any theoretical model is likely to be highly controversial, especially given the paucity of relevant data. Therefore, we believe this approach should be avoided if alternatives are available.

Of the three sources of mitigation, only the second – US-style re-transmission consent and 'must carry' back-stop – is likely to provide a future-proof way of ensuring that payments flow to the party most likely to increase original content expenditure (i.e., the PSBs). While the present logic for favouring PSBs (namely, incentivising investment in UK content) may or may not be applicable in future, arguably there is merit in such a feature on general policy grounds. By adopting a policy that is deliberately partial to PSBs, policy makers thereby increase the value of the regulatory assets bestowed on commercial PSB licensees in return for whatever obligations future policy makers sees fit to require. This would allow carriage fees flowing to PSBs to be added to appropriate

[49] For a case study of the negotiation between MTV and Sky, see *Sky High: the Inside Story of BSkyB*, Mathew Horsman (Orion Books, London, 1998), pp. 106-117.

[50] If collective negotiations are not allowed, policy makers should be mindful of the possibility that platform operators would seek to 'divide and rule' by offering better terms to one or two broadcasters and deny the remaining PSBs a market-rate platform fee.

prominence and access to DTT spectrum as key regulatory levers to extract obligations from PSBs including content obligations.

Box 4-A: The US regime – key aspects

Every three years the US regime requires broadcasters to make a binding decision as to whether to enter into 're-transmission consent' negotiations with pay-TV operators (whereby the parties can withhold or deny carriage if negotiations fail) or invoke must-carry privileges (whereby operators are required to carry a channel with no money changing hands). In effect, this ensures that negotiations rarely go against broadcasters' interests, except when they over-estimate their negotiating strength before choosing a regime or market conditions change during a three-year period. This represents a deliberate policy decision to strengthen broadcasters' negotiating positions and is justified partly on the grounds that doing so encourages investment in content and partly as a counterweight to platform operators' perceived market power (which, opponents of the regulations argue, has greatly diminished in recent years thanks to competition from new platforms).

Although initially this regime did not lead to cash payments (even if platforms and broadcasters did trade benefits in other ways), since the mid 2000s payments have become increasingly important – expected to reach c US$ 1bn in 2012 and US$3-5bn by 2015.

The regime has been controversial since its introduction in 1992. In recent years, impasses in negotiations have led to well-publicised 'blackouts' of broadcasters' channels on pay-TV platforms and to politicians' demands for intervention by the Federal Communications Commission (FCC). However, in the FCC's interpretation the law only allows for limited intervention, mainly centred on ensuring that parties negotiate in 'good faith' – the exact meaning of which is the subject of a current consultation.

The US regime is discussed in more detail in Appendix B.

Potential tensions with other aspects of PSB policy

Subscribers paying twice for the BBC

A scenario in which pay-TV platform operators pay PSBs for the right to carry their signals could mean pay-TV subscribers paying twice for accessing BBC content: once directly via the licence fee and once indirectly via a small percentage of their pay-TV subscription fees. This concern is particularly acute if operators are able to pass on a significant part of any platform fees to their subscribers.

At first glance this may seem acceptable on the grounds that any increase in subscriber fees could be said to reflect the convenience of having PSBs on the same EPG as pay-TV channels and not to be seen as a payment to access PSBs *per se* (since nearly all pay-TV subscribers can access PSBs through alternative means at little or no extra cost – for example, by using a DTT-equipped TV set). However, it would remain the case that the BBC would receive more revenues from pay-TV subscribers, directly and indirectly, than from other viewers.

Perhaps more importantly, there is a long tradition of audiences expecting the licence fee to secure access to the BBC's services on all platforms at no additional cost. If platform operators explain to audiences that their basic-tier fees contain a component associated with providing the BBC channels, the legitimacy of a universal licence fee could be further questioned, especially by audiences who have limited interest in the BBC's services.

This problem might be partly avoided if operators were allowed to make PSB reception optional for their subscribers; arguably, this would be a strongly deregulatory approach. But this would also be inconsistent with a universal BBC licence fee. Given these various issues, we see no realistic alternative but to exclude the BBC from

receiving platform fees altogether. Clearly, doing so significantly reduces the amount by which investment in UK content can be boosted through platform payments, but this is likely to be unavoidable.[51]

Risk of non-universality of PSB provision ('black-outs')

In order for true negotiations to take place parties must be able to withhold carriage if no agreement is reached. This raises the possibility of 'PSB black-outs' – that is, of periods during which a PSB would be unavailable on a given platform, as is commonly the case with FTA networks in the US. We have considered three mitigation strategies:

- Accept the risk for commercial PSBs and exclude the BBC: The risk of back-outs could be accepted as the unavoidable cost of allowing negotiations. However, while this may be an option in the case of commercial PSBs, in the case of the BBC we believe it would be untenable, for the same reasons given above in connection to subscription fees – i.e., it would have the effect of denying licence-fee payers access to BBC content on the platform of their choice.
- Adopt a mandatory arbitration procedure: This is likely to be a lengthy, controversial process. In any event, more research is needed to establish its suitability.
- Force mandated payments based on 'market simulation': we believe, however, that this would lack credibility – at least until there is relevant and credible data available.

Open platforms, free-to-air signals and the TPS regime

A number of complex, interconnected issues related to 'open' platforms, the availability of free-to-air signals and the TPS regime mean that creating the regulatory environment for commercial negotiations between PSBs and platforms such as Sky involves several challenges. Before we discuss these challenges, we provide an overview of the commercial, technical and regulatory landscape in the box below.

Box 4-A: TV platform business models and TPS regulations: how they interact

Historically, TV platforms in the UK have operated under one of two business models:

- **Pay-TV** platforms charge consumers a monthly fee and (PSBs aside) are free to decide which channels to carry and to negotiate terms as they see fit. The clearest example of a UK pay-TV platform is Virgin Media (Sky is a more confusing case for reasons that we explore below).
- **FTA platforms** are fundamentally business-to-business concerns whose customers are broadcasters (to which platforms provide 'access) and have no commercial relationship to consumers. They are generally 'wholesale' as opposed to retailer platforms, and generally operate as marketing companies (Freeview and Freesat are the key examples). They are generally 'open' to any qualified broadcaster (subject to capacity) from which they extract fees (spectrum, listings fees, etc).

[51] We note that the Director General of the BBC Mark Thompson, in his MacTaggart Lecture in 2010, argued in favour of re-transmission fees, but not for the BBC. '...let's leave the BBC out of it. It's funded by the licence fee and should always strive to be universally available — in my view, the BBC's services should be freely available on all platforms ideally with no charges or transfers of money on either side. So I'm not suggesting that re-trans should apply to the BBC.'

As a result of TPS regulations Sky is both a 'retail' and a 'wholesale' provider of services – both a retail pay-TV and wholesale 'open access' platform. Indeed, TPS is an answer to concerns around Sky's ability to deny broadcasters access to its platform and mandates that Sky provide access (outside its own pay packages) on Fair, Reasonable Non Discriminatory (FRND). We discuss this in more detail below.

Other key characteristics of both types of platform are outlined below:

	A. Pay-TV or 'retail' platforms	B. FTA or 'wholesale' platforms
Revenue sources	Three revenue sources: **Consumers'** subscriptions (main source) **Advertisers** (for ads on platform-owned channels) **Broadcasters** who offer to pay or share revenues for right to be in platform	Single revenue source: platform service/listing fees from participating broadcasters As a business, strictly a B2B model: however, they can also be consumer brands – e.g., "Freeview", "Freesat"
Transmission	Signal must be encrypted, and accessible to paying subscribers only Proprietary, closed networks (cable) Encrypted signals on radio spectrum (conditional access)	Channels often transmitted 'in the clear' via radio waves since most platform customers (i.e., channels) do not seek subscription fees Transmission often arranged by broadcasters themselves; in these cases, platform does not 're-transmit' but mainly provides channel discoverability (e.g., EPG)
Main examples	Virgin Top-Up TV Sky (pay-TV business only – see below)	Freeview Freesat Sky (platform business only – see below)
Typical ownership	Stock market-listed, profit-making firms	Broadcaster JVs Platform profits not primary purpose
Regulation (access)	Relationship to channels relatively **unregulated**	Relationship to channels in case of Sky is **regulated by TPS regime**

The TPS regime

The regime covers the B2B relationships between Sky and its (channel) customers. TPS-style principles have been informally adopted by Freesat, although it is not a regulated TPS provider; YouView, the IP-DTT hybrid platform planned for launch later in 2012 is also adopting some of the principles of TPS.

Sky remains the only operator in the UK whose platform is formally regulated as to access under TPS. Under this regime, Sky must, subject to capacity, offer carriage to all interested channels for a fee designed to cover the costs of launching, running and marketing the platform, plus a reasonable risk-adjusted return. Sky charges for services (e.g., EPG listing, regionalisation, conditional access) and levies fees as part of a "platform contribution." Ofcom's guidelines[52] state that the amounts charged should be determined on a basis that seeks to distribute the platform's costs among customers in line with the benefits they derive from being on the platform, so that channels that benefit more from the platform pay more.

Sky effectively operates two separate businesses:

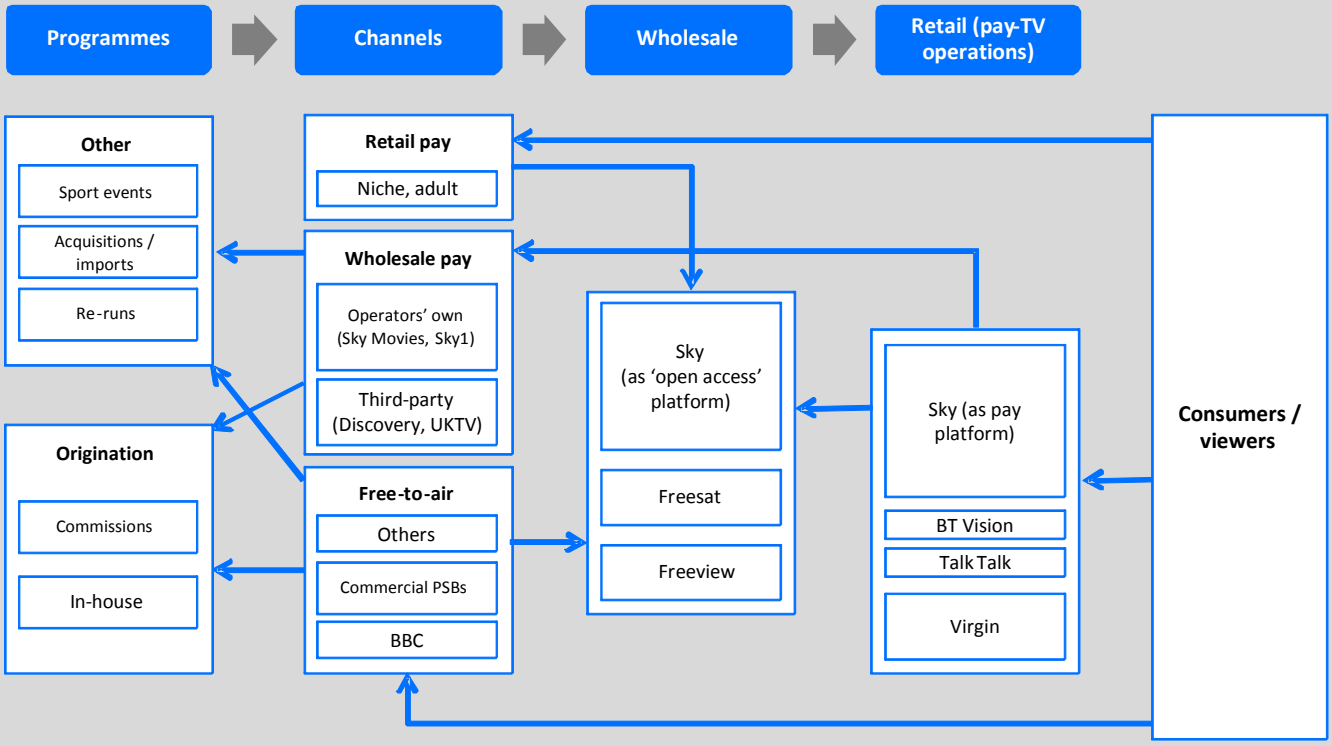
[52] Ofcom: *Provision of Technical Platform Services: Guidelines and Explanatory Statement*. 21 September 2006.

- A traditional retail platform (of type A above) selling various packages of channels at different prices direct to consumers
- A TPS-regulated, open (or 'wholesale') platform (of type B above) which carries (i) free-to-air broadcasters, including all the PSBs, which arrange their own transmission but must pay (FRND-based) fees in order to be featured on the platform; (ii) pay-TV broadcasters retailed by Sky (whose notional payments under TPS are offset via affiliate fees paid by Sky); (iii) a la carte services (or, for example, adult, home shopping, interactive or 'red button' propositions, or even a competing tier of pay channels, of which there are none currently); and iv) Sky's own channels

Consumers who use Sky set-top-boxes fall into two types:

- Paying, active subscribers to the pay-TV platform (currently c 9.6m in the UK); and
- Non-subscribers who have opted to receive Sky's free service (c400,000); mainly lapsed former subscribers to the pay-TV platform who have paid a one-off £25 fee to receive the free service).

A version of the graphic we provided in our section on content (section 3) is provided here to summarise this analysis:



The range of complications around TPS, and open versus closed platforms, gives rise to a number of considerations for policy makers, as we set out below.

PSBs' unencrypted satellite signals make commercial negotiations difficult

Over the past decade, all the PSBs have begun transmitting their main channels unencrypted ('in the clear') via satellite. This poses a fundamental challenge to the notion of commercial negotiations between PSBs and the

operators of satellite-based platforms. As we have argued, for true commercial negotiations to happen, both PSBs and platform operators would need to be able to 'withhold carriage' if negotiations break down – that is:

- PSBs would need to be able to prevent platform operators from using their signal; and
- Platform operators would need to be allowed not to include PSBs in their platform.

The first condition is problematic: satellite-based platforms such as Sky simply receive signals from satellite transponders that have been leased by the PSBs themselves. Further, these signals are broadcast unencrypted and are legally receivable for free by any number of reception devices such as satellite-enabled TV sets. Thus it can be argued that all that firms such as Sky do is offer their customers appropriate reception equipment of a type that all manufacturers of Freesat-compliant consumer-electronic devices are able to sell. Because no 're-transmission' or decryption is involved, it is unclear whether broadcasters can invoke copyright law to prevent a satellite platform from receiving their signals. This fundamentally undermines the notion that PSBs can negotiate payments for their signals.[53]

We note, for example, that Sky may be able to instruct subscribers to manually tune to a relevant regional ITV or BBC service – all of which are available 'in the clear'. Whether this channel could then be assigned by the consumer (or by the platform operator) to the EPG without permission may be more problematic.

Assuming that this is correct (and a finer legal analysis is beyond the scope of this report), we have considered two alternatives:

- **Introduce ad-hoc legislation** allowing PSBs to stop satellite operators from using their signals. However, it is unclear whether this is achievable in the context of broader UK and EU law. In any event, opponents could reasonable claim that such a policy would be a market distortion, as it would in effect create a property right in a context in which rights holders (PSBs) have, by going 'in the clear', effectively extinguished these rights.
- **Require broadcasters wishing to negotiate for carriage fees to encrypt their signals**. However, unless PSBs can ensure that all satellite audiences (and not just those who subscribe to the operator with which they are negotiating) are able to decrypt their signals, then broadc asters risk losing significant audiences. In any event, further work is required to establish the feasibility of this.

The TPS regime precludes meaningful negotiations

Because Sky pay-TV subscribers receive a given PSB channel as a result of the payment by the PSB of a TPS fee, for as long as TPS is the regulator-sanctioned way of answering the question of payments between channels (including PSBs) and Sky, true negotiations cannot take place.

For negotiations to be meaningful, the 'benefits' at stake for Sky should be those accruing to the combined business (that is, the open platform plus the pay-TV business) and not only by the platform business, since most of the benefits that Sky captures from PSBs are reflected in subscriber revenues which do not materially affect the open platform business' income.[54]

[53] Such issues have been raised in the US recently, with the launch of Aereo, a service that uses 'personal' aerials to take the terrestrial signal of free-to-air networks and distribute it to US homes. The company argues that there is no need for 're-transmission' fees as the signals are freely available over the air.

[54] We note that the TPS regime does not allow for these to be reflected in a meaningful way. Under the guidelines, an increase in subscription revenues does not increase the open platform business' income (or benefit) but only results in a marginal reapportionment of the platform's costs among its customers (with Sky's pay-TV business paying more and PSBs paying slightly less).

Enabling commercial negotiations between PSBs and operators thus presupposes changing or replacing the TPS regime so that PSBs can negotiate directly with Sky as a corporate entity. Although a detailed assessment of how this could be done is beyond the scope of this report, we have considered the following options:

- **Exclude PSBs from TPS but leave other channels' regime unchanged**. This is not without consequences, however: under the current TPS guidelines the costs of running the platform are spread across all channels, and if PSBs stop their contribution other channels might see increased fees. On the current TPS rate card, the PSBs account for a relatively small proportion of TPS fees (c25% of Platform Contribution charges), with Sky's pay-TV channels and its retail partners accounting for nearly all of the rest. As a consequence, TPS fees for non-PSB FTA broadcasters (e.g., Discovery Quest) should only increase by a small percentage; in any event, these other channels are free to negotiate with Sky to extract payments if they believe the value they contribute to the platform is greater than the benefit they themselves derive after paying access charges. Channels in this category also include Dave and Yesterday (part of the UKTV family of which other variants are behind a pay wall) and the extension channels of the commercial PSBs (e.g., ITV3, More4, Channel 5*). We note that PSBs would be able to 'bundle' their channels in negotiations with Sky around carriage of core PSB services.[55]
- **Revise or replace TPS altogether**: although a general critique of TPS is beyond the scope of this report, we have identified other issues with TPS that may give policy makers reason to consider this broader question.

Sky's hybrid nature as an open and pay-TV platform inflates its negotiating power

Finally, we note that TPS regulations governing access make no distinction between Sky subscribers and consumers who use Sky's platform without subscribing to Sky[56] and that any broadcaster that pays TPS automatically makes its signal available to both groups. As a result, any broadcaster that withholds its signal from the Sky pay-TV business would also withhold it from the households that are not Sky subscribers but use Freesat from Sky to receive PSBs. While for PSBs other than the BBC this may *in extremis* be acceptable, even then it means that commercial PSBs have more to lose financially (through lost advertising and reach) if they withhold carriage from Sky than if they only lost access to Sky's paying subscribers.

To mitigate this, policy makers could consider two approaches:

- **Changing the TPS regime so that both consumer groups are treated separately**, effectively creating two platforms for regulatory purposes: a pay-TV platform for subscribers and an open platform for others, so that carriage on one does not imply carriage on the other. This does not necessarily represent an increase in regulation, since TPS and the 'open platform' model that it creates is already a regulatory construct.
- **Accept the asymmetry.** The distortion that it introduces is relatively minor (around 400,000 households for the free platform compared to 9.6m households for the pay-TV platform).

Long-term considerations

Given the current deregulatory thrust of policy making, any policy options should be considered in light of their potential robustness as tools to secure content outcomes over the long term. Any dove-tailing of the

[55] We explore this in greater detail in section 5.

[56] Former Sky subscribers can continue to receive FTA channels with their Sky equipment after paying Sky a small (c£25) fee. This is also available as a product (branded 'Freesat by Sky', although there is no relationship to BBC/ITV Freesat) to any home for a one-off fee of £175 – see http://www.sky.com/shop/freesat/home/

Government's timing in its policy agenda with the BBC's Charter and the commercial PSBs' licence renewals will take us through to 2025 at least.

This poses a number of challenges for policy makers, as there are significant drivers of change in the next 10-15 years which may transform the dynamics and players within the media sector.

- Increasing penetration of household and mobile internet connections is creating new routes to market for content owners seeking to reach viewers. Many platforms have already incorporated IP connectivity into their suite of distribution options, and IP-based platforms may emerge as a primary means of content delivery over time, ushering in new forms of navigation, search and discoverability. This would have significant implications for existing distribution platforms, such as satellite and terrestrial, which may become marginalised.
- Such a trend could be characterised by significant new entry, including by existing players from adjacent markets such as Google or Apple. Any such services launched by these players are likely to rely on third-party content (including from the PSBs), but may not necessarily be captured by legislation that is designed for traditional broadcast platforms.
- Consumer take-up of new platforms will be accelerated by changes in the underlying behaviour and preferences of viewers. At present, nearly 90% of all viewing hours of long-form TV content are generated via linear, scheduled channels; however, any significant shift towards the consumption of content on a non-linear basis may diminish the role of broadcast channels and indeed the value of traditional EPGs and the notion of 'appropriate prominence'. However, channel brands such as BBC and ITV are likely to remain crucial – certainly in the short to medium term – as key sources of viewing traffic, even if not delivered over existing means of distribution.
- Wholesale new entry and behaviours may introduce new business models to the TV sector, potentially replacing traditional pay-TV subscription models and linear advertising models with new approaches based around behavioural/contextual advertising or micro payments.

These potential developments pose a number of issues for policy makers seeking to ensure that regulations remain relevant over time. Indeed, any policy options arising from this analysis will need to be flexible in order to adjust to changes in the nature of relationships between potentially different sets of players over time. Three issues are paramount:

- It will remain difficult to impose strict conditions on emerging or nascent players, whose business models may not have gained sufficient market traction to justify taking on significant obligations (particularly if these are financial). There is a case to be made that policy around carriage of PSBs should only be applied to 'platforms' once they have become a principal means of reception for a meaningful number of households This is the approach already used in defining a satellite service for the purposes of applying must-offer provisions for PSBs in relation to the Sky platform.[57]
- The benefits that platforms might derive from carriage of PSB channels may not be so easy to define if and when linear channels are replaced by non-linear equivalents. By way of example, the carriage of iPlayer may

[57] For example, Section 272 of the Communications Act (2003) defines a satellite service as one that 'a) consists in or involves the broadcasting of television programme services from a satellite; and (b) is used by a significant number of the persons by whom the broadcasts are received in an intelligible form as their principal means of receiving television programmes.'

replace the carriage of BBC1 as the major driver of benefit that Virgin Media derives from its relationship with the BBC. A broader approach to defining content distribution by player (as opposed to channel brand) may be required.

- Inevitably, there may be some conflation of policy considerations around the treatment of 'platforms' and the rules governing internet delivery (i.e., the 'net neutrality' debate). In a context where a significant number of homes receive a linear TV service over IP, many of the issues addressed in this report around platform access, carriage consent and payment flows are potentially transformed, and new rules may have to be created (up to and including a fundamental re-consideration of the definition of platforms and networks).

From the perspective of PSBs, it will be seen as crucial that new platforms are not able to adopt access policies that require broadcast channels (aiming for universal reach) to pay for distribution on myriad new platforms.

A number of discrete refinements can be applied to broad policy options that might ensure that the policy agenda is flexible enough to cope with market developments, although fundamental re-appraisals may be required depending on the speed with which IP networks substitute for broadcast in the future. A consideration of the regulatory task in this regard is outside the scope of this report.

Summary

Our analysis in this section is summarised in the table below:

Issue	Potential mitigation strategies
There is no guarantee that commercial negotiations would go in PSBs' favour as expected	Introduce US-style must-carry back-stop Allow collective negotiation by PSBs Bar negotiations and force mandated payments based on 'market simulation' – but this is likely to be highly controversial
Payments from platforms to PSBs may mean subscribers paying twice for the BBC	Exclude BBC from negotiations
PSBs may be dropped if PSB-platform negotiations break down, affecting viewers and reducing public value of PSB through lost universality	Exclude BBC from negotiations and accept the risk for commercial PSBs Adopt mandatory arbitration procedure Force mandated payments based on 'market simulation' (but this is itself problematic)
PSBs' unencrypted satellite signals make commercial negotiations difficult	Introduce ad-hoc legislation Require broadcasters wishing to negotiate for carriage fees to encrypt their signal
The TPS regime precludes meaningful negotiations	Exclude PSBs from TPS but leave other channels' regime unchanged Replace TPS altogether
Sky's hybrid nature as an open and pay-TV platform inflates its negotiating power	Change the TPS regime so that pay and FTA 'customers' are treated separately Accept the asymmetry
Other legal issues[58]	E.g., remove the exemption under the Copyright Act currently applied to cable

[58] We have been advised that DCMS is considering separately the cable exemption under the Copyright Act and therefore we have not included an analysis of this within our more detailed work. We assume for the purposes of our report that the exemption under Section 73 of that Act can be removed. We are also mindful that the TPS regime is subject to EU regulations, and any changes here would have to consistent with European legislation. Detailed consideration of the implications is beyond the scope of this report.

5. Policy options

The analysis in this report has thus far generated a number of provisional findings relevant for policy. To summarise:

- With adequate regulatory oversight, payments from platform operators to commercial PSBs have the potential to result in an increase in investment in UK-originated content.
- A carriage consent regime in which PSBs and pay platform operators can negotiate a fee for carriage would represent a significant deregulatory step and is likely (but not certain) to lead to payments in favour of PSBs.
- There are two main safeguards that policy makers might employ to increase the likelihood that negotiations result in payments to PSBs (and thus increases in content investment): (a) introducing a US-style re-transmission-consent back-stop and (b) allowing PSBs to negotiate collectively vis-à-vis platform operators.
- A 'market simulation' approach (whereby Ofcom would mandate payments based on a theoretical view of what fair market negotiations should yield) is not a viable option and should be ruled out, since any such adjudication would be likely to be excessively controversial and highly interventionist.

For the reasons we have explored, the BBC should not be included in carriage consent negotiations over carriage consent. That leaves the simpler question of whether negotiations should be allowed for commercial PSBs. Depending on the answer, further questions arise:

- If a carriage consent regime is introduced, should this incorporate either (or both) of our two safeguards (US-style back-stop or collective negotiations), so as to promote an outcome where payments flow in commercial PSBs' direction and the desired investment increases are obtained?
- Short of a carriage consent regime, what changes, if any, should be introduced to the current system of payments – for example around TPS?

The answer to each of these questions leads to different policy options. In general, each safeguard against adverse investment outcomes carries with it the price of weakening the deregulatory and market-led thrust of a pure carriage consent policy. If these compromises are not acceptable to policy makers, options not involving carriage consent can be explored.

In this section we consider the following six options:

Options involving carriage consent:

A. Carriage consent for commercial PSBs, without safeguards against adverse outcomes from negotiations

B. Carriage consent for commercial PSBs, with collective negotiation

C. Carriage consent for commercial PSBs, with US-style must-carry back-stop

D. Carriage consent for commercial PSBs, with both collective negotiation and back-stop

Options not involving carriage consent:

E. The removal of TPS Platform Contribution Charges for PSBs and the explicit imposition of a zero-payment regime for PSBs on all platforms

F. The status quo

Options involving carriage consent (options A-D)

In general, carriage consent involves three main risks:

- **Commercial PSBs may fail to secure payments** under commercial negotiations, and therefore will not be able to increase their investment in UK-originated content. In particular, the possibility that *platform operators* secure payments from PSBs, potentially leading to a *decrease* in content investment, cannot be ruled out.
- **Commercial PSBs may fail to increase their content investment** in line with the payments they secure through carriage consent negotiations.
- **Possibility of consumer and citizen harm from black-outs:** carriage consent presupposes that PSBs and platform operators can withhold carriage if negotiations break down. However, were this to happen, consumers would be negatively affected inasmuch as the lack of carriage prevents them from conveniently accessing the blocked PSB channel (and associated access to relevant channel content via planners/personal video recorders); for some, it would mean not being able to watch a PSB channel at all. Other harms include the cost of any remedial actions that consumers may take to regain access to the channel – for example, investing in a new aerial to receive Freeview signals. Finally, there is also citizen harm associated with the loss of universality of a PSB signal.

In what follows we explore different strategies for addressing the risks identified.

Safeguards against adverse content outcomes

In section 4 we considered two safeguards for preventing the possibility of negotiations going against commercial PSBs: (i) an allowance for collective negotiation by PSBs and (ii) a US-style 'must-carry' back-stop. Each has different merits and drawbacks in terms of likely impact on content expenditure, the degree to which it allows for market-led outcomes and the degree to which it is 'interventionist' in the sense of being biased in favour of PSBs. The following observations apply:

- By increasing PSBs' bargaining strength, allowing collective negotiations generally increases the likelihood that payments would flow in their favour – as well as increasing their corresponding quanta, thereby leading to the highest expected impact on content spend. However, the possibility of adverse flows cannot be ruled out.
- By contrast, by allowing PSBs to choose whether to invoke must-carry rules, a US-style back-stop effectively precludes payments by PSBs.[59] Expected payments to PSBs and impact on content are somewhat lower than under collective negotiations, but still likely to be considerable.
- While both safeguards are interventions designed to 'help' PSBs, the extent to which this is a market distortion depends, partly, on the degree to which platforms can be deemed to have undue market power vis-à-vis PSBs, and the degree to which these safeguards are deemed to be adequate remedies. We leave these questions to policy makers and do not attempt to answer them here. Of course, ultimately these potential downsides are to be weighed against the benefits of expected impact on content investment – again, is a question for policy makers.

[59] Note however that there is an exception to this: a case where a 'weak' PSB could over-estimate its bargaining strength, choose negotiations rather than 'must-carry', and be unable to change options for a long period of time. We assume this to be unlikely.

- Arguably, collective negotiations are a more market-led option than a US-style back-stop in that (independently of the merits or otherwise of intervening to increase PSBs' bargaining power) the negotiations themselves would have the structure of 'normal' carriage negotiations in the relatively unregulated market of pay-TV, in which either party can withhold carriage and fees are a matter of consent.

These options are summarised in Figure 9 below, in which 'dual safeguards' refers to the possibility of introducing both safeguards simultaneously, as we consider under our option D.

Figure 9: Safeguards' strengths and weaknesses[60]

	No safeguard	US-style back-stop	Collective negotiation	Dual safeguards
Investment impact	◕	◑	●	●
Pro-PSB bias	○	◑	◕	●
Market-led	●	◑	◕	◔
Risk of adverse impact	◕	○	◕	○

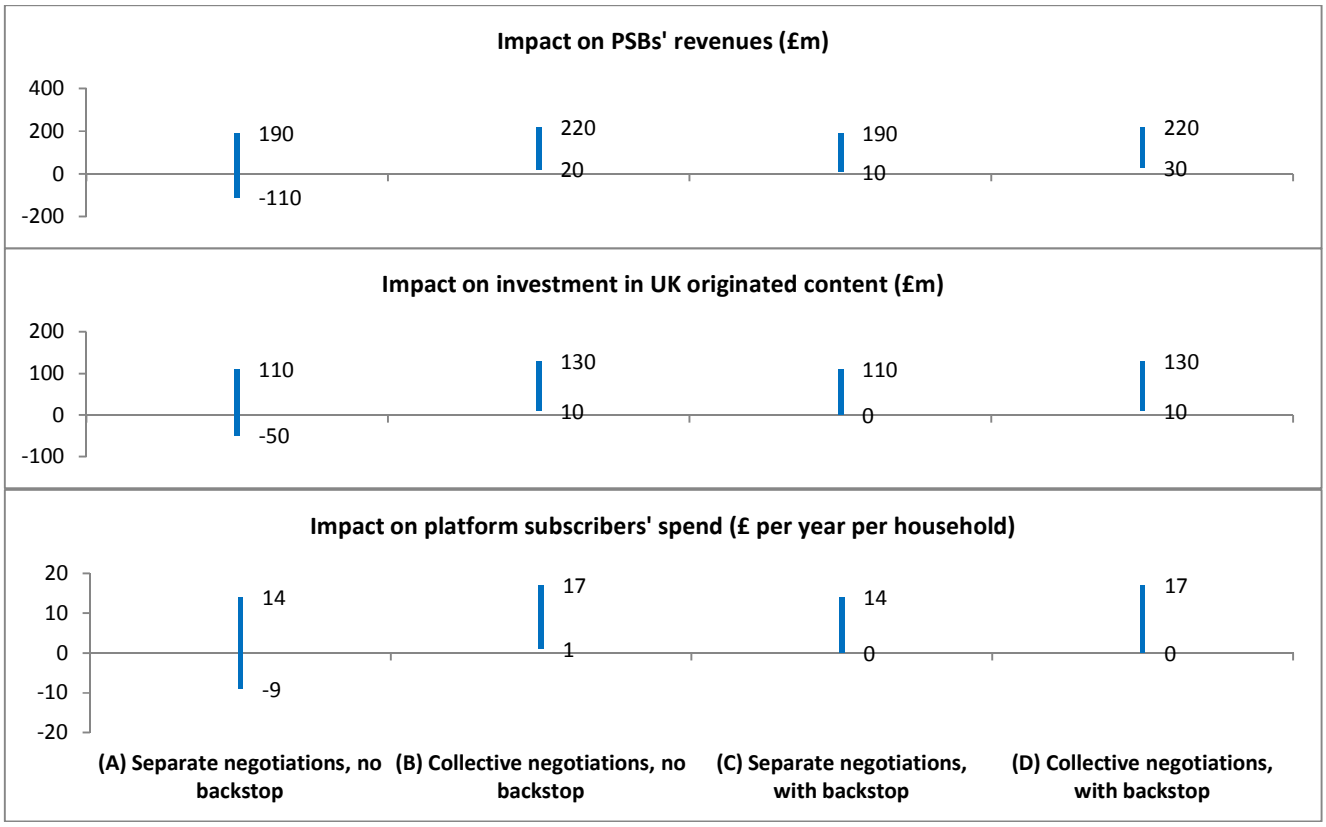
Quantitative estimates

In Figure 10 overleaf we set out our quantitative estimates for the impacts of each policy option on investment in UK original content spend and consumer costs. We highlight a number of caveats in relation to these outcomes:[61]

- All estimates are based on the same simplified model we used in section 2 and are subject to the same limitations.
- For all policy options, it is assumed that Platform Contribution Charges under TPS would stop for all PSBs[62]; the effects of this are included in our estimates for PSB revenues, content origination expenditure and consumer spend. Note however that this only makes a marginal difference (currently, relevant TPS fees are c£14m per year for all core PSB channels combined but are set to decrease in any event).
- We have not attempted to determine what impact these scenarios would have on expenditure by platform operators themselves and the potential implications on carriage payments to pay-TV channels. There are plausible arguments to suggest that platform operators may reduce their commitment to original content were they forced to make payments to PSBs, although this will be subject to internal strategic decisions which might actually result in maintained (or indeed increased) investment in original content as a means of competitive mitigation.

[60] In the figures in this section, the Harvey Balls are denoted as follows: a filled-in circle = *Definitely*, three-quarters = *Largely*, half = *Moderately*, one-quarter = *Somewhat*, empty = *Insignificantly, if at all*.
[61] In all options we also assume that appropriate prominence protections remain in place. All of the outcomes are crucially linked to the ability of PSB channels to continue to reside on the front page of EPGs. Further details are provided in Appendix A.
[62] Specifically, the model assumes that Platform Contribution Charges (currently the bulk of TPS charges) stop but other charges do not.

Figure 10: Estimated impacts [63]



The following observations are relevant:

- In all options involving carriage consent negotiations with at least one of the two safeguards, PSBs are net beneficiaries - receive amounts of between £20m and £220m per year. However, if no safeguards are introduced, option (A) shows that negotiations may lead to significant payments in the opposite direction. The risk is strongly mitigated if collective negotiations are allowed (B) or a US-style back-stop is introduced (C-D).
- Pay-TV subscribers may be expected to shoulder most of the costs of any increase in payments to PSBs by pay-TV operators. The ranges above suggest that (under carriage consent options) they might be required to pay up to £17 per year.
- Carriage consent options with at least one of the two safeguards generate a range of content investment increases of between £10m and £130m a year. However, the full range of outcomes in the model (including the option where there are no safeguards) extends from a payment in favour of platform operators at one extreme of £110m and a payment in favour of PSBs of £220m, suggesting the impact on content expenditure ranges from a decline of £50m to an increase of £130m per year.

[63] Estimates refer to range between maximum and minimum, and should be taken as indicative and directional only. Impact on PSB revenues includes the abolition of relevant TPS charges for all PSBs, including the BBC, but does not assume any other payments to the BBC. Where broad ranges are shown, less attention should be paid to maximum values – which are relatively unlikely to be materialise.

Options not involving carriage consent (options E-F)

Figure 11: Summary of options E-F

	(E) Removal of all payments for PSBs	(F) Status quo
Main advantages	PSBs no longer subsidise platforms; marginal increase in content investment	Minimal risk of unintended consequences; the system broadly works
Main disadvantages	A potentially complex intervention for relatively little gain	Missed potential opportunity to increase investment in UK-originated content

TPS and the case for a zero-payment regime for all PSBs (option E)

Should Government decide against introducing a carriage consent regime, we believe there is a case for explicitly mandating a zero-payment 'must-carry'/'must-offer' regime applying to all core PSB channels, similar to what is used in several European countries. Although the amounts in question under the *status quo* are small, the current fees are not even notionally linked to a market settlement (inasmuch as they do not aim to capture the platform's benefits) but rather simply comply with the FRND requirements of the regime. The result is that PSBs effectively subsidise a platform (Sky) that likely derives more benefit than it confers.

Having said this, we recognize that the amounts in question are small (currently c£14m per year for all PSBs combined[64]) and decreasing to c£5m by 2014 (assuming all PSBs make their VOD services available to Sky). The removal of TPS may entail more design and implementation costs than the benefits it may yield. **We also concede that the difficulties of ensuring that any reform of TPS is consistent with European legislation are a serious potential constraint.**

A further question concerns whether a zero-rate TPS regime for core PSB channels should concern the totality of the fees or only the Platform Contribution Charge (which is the bulk of the fees). The remainder of the charges correspond to fixed fees for specific services such as regionalisation and EPG listings, and is significantly less controversial among stakeholders. While there are arguments for and against including these, we believe this is a matter of detailed implementation beyond the scope of this report.

The status quo and the need for clarity (option F)

Leaving the current legal and regulatory regime unaltered does not necessarily mean that the current balance of payments would stay in place indefinitely. For example:

- Sky has already reduced the level of payments for PSBs under TPS, and may well do so again in the future. One might envisage an outcome where these charges trend toward zero in any event. However, there is no certainty they will do so.
- More significant changes to the current balance of payments, even without regulatory reform, are possible. In our primary research for this report we found a surprising degree of confusion across the industry as to what the current rules do and do not allow. It is not inconceivable that in future, without any new policy or regulatory intervention, a PSB or platform operator could seek to extract different payment arrangements. The result may not only be adverse to public policy objectives (i.e., increasing investment in content) but may

[64] Platform Contribution Charge only, including all BBC channels plus commercial PSBs. Based on rate card effective July 2012, these charges will reduce in the aggregate to c£10m.

also signify a further departure from a 'normal' market outcome in which each party would have similar negotiation levers (e.g., being able to withhold/deny carriage).

For the specific case of the BBC, this uncertainty is particularly problematic. To the extent that the regime allows operators to demand additional payments, the BBC's Charter and the universal, mandatory nature of the licence fee mean that the BBC's potential 'losses' from a drop in carriage, although not financial, are significant. Consequently, its 'willingness to pay' to maintain carriage is likely to be disproportionately large (i.e., larger than that of a commercial PSB of similar size) and this is a vulnerability that policy should address.

Therefore, we believe that Government should at a minimum ensure that in future all ambiguity is removed from policies and regulations concerning fees for carriage of PSBs – even if this means perpetuating today's balance of payments.

Other considerations

TPS and non-PSB free-to-air broadcasters

Were TPS fees to be abolished for core PSB channels (either under a carriage consent regime or through our option E), this gives rise to two further issues. First, assuming that Sky continues to charge all other channels a share of recoverable subsidy, there is as risk that the burden on these channels may increase. For the extension channels operated by the commercial PSBs (such as ITV2, E4 and 5*), this risks undermining the intent of the reform, and for non-PSB FTA channels (e.g., Dave, Yesterday, Quest) it could mean adverse impacts on firms that are largely unrelated to the issues discussed in this paper.[65] However, in our analysis we have confirmed that the bulk of the recoverable charges under TPS are in fact borne by Sky itself and by channels retailed by Sky (which typically receive far more in affiliate fees than they pay in platform contributions) – and these channels would bear the brunt of any increase in TPS fees. As a result, the financial burden on FTA channels as a result of a zero rate for core PSB channels would be relatively small (and in any event is likely to reduce further as Sky makes further unilateral reductions in TPS).

Moreover, FTA channels are already able to withhold their service from Sky, even if Sky must permit access under the 'open access rules'. Thus channels can make a determination as to whether they hold enough bargaining power to secure alternative compensation from Sky or whether they accept their TPS charges as a reflection of the benefits they receive from distribution in Sky homes. (We grant that Sky's market position with regard to gate-keeping access makes it a more difficult negotiating partner for smaller non-PSB channels.)

It is also worth recalling that the PSB extension channels are already able to be withheld from pay platforms. Were there to be a zero rate for core PSBs, commercial PSBs could seek to secure alternative terms with Sky for their extension channels (and indeed may elect to 'bundle' their channels in any carriage consent negotiations, similarly to how US networks with pay channels have linked carriage of pay channels to FTA propositions).

Given Sky's market position and its substantial subscriber base, it appears sensible to suggest that TPS remain in place as a back-stop to protect access to Sky homes for all FTA propositions. This would not preclude exempting core PSB channels from having to pay.

[65] Note however that these firms' (limited) investment in content could be negatively affected by the (limited) effect of a TPS fee increase.

Questions requiring further investigation

Throughout this report we have highlighted certain key questions for which answers are ambiguous, and these may significantly affect the feasibility or advisability of different policy options. For example:

Questions bearing on the feasibility of carriage consent:

- **Enforceability of commercial PSBs' content commitments:** As have noted earlier in this section (and in our analysis in section 3), commercial PSBs such as ITV may not invest the bulk of the proceeds from any carriage consent payment in content; ensuring they do so might only be possible via further intervention (the desirability and structure of which require additional study). For example, the right to negotiate payments from platform operators might be seen as a regulatory asset that can be bestowed on PSB licensees alongside spectrum and EPG prominence. How such an asset should be priced – and, in particular, whether its pricing can be left to market mechanisms such as competitive bidding for licences – is a difficult question that should be studied carefully by Ofcom in the event that Government wishes to proceed with further consideration of carriage consent regulations.[66]
- **'The satellite FTA question':** As noted in section 4, a key presupposition of carriage consent is PSBs' ability to prevent platform operators from carrying their signals – which currently all PSBs transmit unencrypted via satellite. It is unclear whether copyright law would restrain operators from making the signal available to their subscribers, given that the signal is available free to air. A review of technical and legal issues is required.

Other issues

- **Competition law:** Allowing collective negotiations by PSBs may require an explicit provision under competition law. Determining whether this is the case, and the nature of such a provision, is beyond the scope of this report.
- **Broader aspects of a review of TPS:** As noted above, a general critique of TPS is beyond the scope of this report. However, we have noted several issues with the regime – many of which have also been pointed out to us by industry stakeholders. Policy makers may wish to consider a broader review of TPS looking at its scope (e.g., which platforms, which broadcasters?) and principles (e.g., cost recovery or benefit sharing?). Such a s review would require extensive consideration of the constraints imposed by European legislation.
- **The feasibility of a mandatory arbitration recourse:** Finally, we have noted that under carriage consent the possibility of 'black outs' cannot be ruled out. Nonetheless, it may be possible to impose mandatory arbitration in certain cases and/or specific provisions governing negotiations designed to prevent impasses (such as the 'good faith' guidelines currently being reviewed in the US – see Appendix B). Whether this can be done, and how, are questions that policy makers should explore further.

Summary

Our analysis in this section is summarised overleaf.

[66] We note however that prospective licensees could be offered the choice of bidding for a licence with or without carriage consent rights. Equally, under our 'back-stop' options licensees who prefer not to have the obligations associated with these rights could simply opt for must-carry.

Figure 12: Summary of options analysis[67]

	(A) Separate negotiations, no backstop	(B) Collective negotiations, no backstop	(C) Separate negotiations, with backstop	(D) Collective negotiations, with backstop	(E) Removal of all payments for PSBs	(F) Status quo
Top-level pros/cons						
Main advantages	Market-driven intervention with significant upside for content investment	Maximum possible outcome on content investment	Possibility of significant content impact; adverse outcomes highly unlikely	Maximum possible outcome on content investment; adverse investment outcomes highly unlikely	PSBs no longer subsidise platforms; marginal increase in content investment	Minimal risk of unintended consequences; the system broadly works
Main disadvantages	Adverse investment outcome cannot be ruled out	Interventionist and pro-PSB; adverse investment outcome cannot be ruled out; raises competition law questions	Interventionist and pro-PSB	Most interventionist and pro-PSB; raises competition law issues	A potentially complex intervention for relatively little gain	Miss potential opportunity to increase investment in UK original content
Deregulatory agenda						
Market led?	◕	◑	◔	◕	○	n/a
Pro-PSB bias?	○	◔	◔	●	○	n/a
Investment in content						
Incremental investment	*Low*	*High*	*Moderate*	*High*	*Very low*	n/a
Risk of adverse impact	*Moderate*	*Very low*	*Low*	*Very low*	*Very low*	n/a
Consumer impacts						
Risk of black-outs	◕	◑	◔	◕	○	○
Retail spend increase (£ per year per sub)	2	9	7	9	negligible	n/a
Outstanding issues						
Enforceability of content commitments	X	X	X	X		
Satellite FTA question	X	X	X	X		
Competition law		X		X		
Broader aspects of TPS review	X	X	X	X	X	
Mandatory arbitration recourse	X	X	X	X		

[67] All figures are strictly indicative. Retail spend increase is at mid-way point of ranges. For the Harvey Balls, a filled-in circle = *Definitely*, three-quarters = *Largely*, half = *Moderately*, one-quarter = *Somewhat* and empty = *Insignificantly, if at all*.

Appendix A: Quantitative model

In this Appendix we discuss the quantitative model behind the simulations provided in this report. It is organised in two parts: first, we set out the rationale and calculations involved; we then discuss our approach to sourcing and estimating values for the main parameters upon which our simulations rely.

Analytical framework

Definitions and overview

By the **commercial value** (or **benefits at stake**) created by carriage we mean the *incremental income* (profit, not revenue) that a commercial, free-to-air broadcaster and a pay-TV platform operator would derive from carriage of a linear signal, *not counting any compensatory payments between the two parties*, as compared to a hypothetical situation in which the operator did not carry the broadcaster's signal.[68]

By a **carriage consent regime** we mean hypothetical legal, regulatory and technical arrangements whereby a PSB channel can only be carried by a platform if both its owner and the platform operator agree; that is, either party can **withhold** carriage at will if it feels that arrangements with the other are unsatisfactory.

By **'fair payments'** we mean an arrangement whereby the parties agree to 'split the difference' between their benefits – that is, the party with higher benefits at stake makes a payment to the party with lower benefits at stake equal to 50% of the difference between benefits so that, at the end, each party profits equally from carriage.

At a high level, our model is structured as follows:

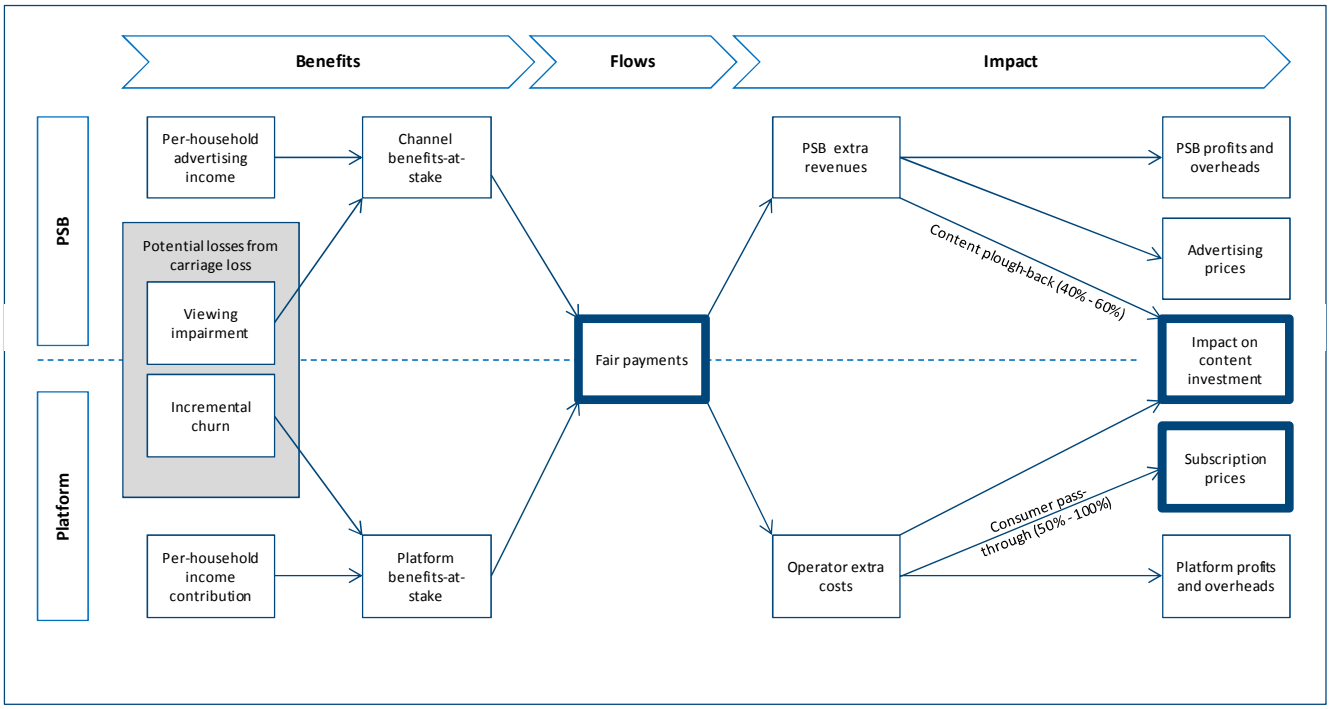
- We begin with the benefits at stake in a negotiation between a given PSB and platform operator. For the operator, these are driven mainly by the number of subscribers that it could lose if the PSB's channel were to be withheld from the platform. For the broadcaster, benefits are driven mainly by the percentage by which viewing of the channel would drop among subscribers of the platform in question. (Both of these drivers are parameters that we estimate separately from the rest of our model. See the subsection titled 'Estimation of key parameters' below).
- We then compare each side's benefits and consider the corresponding 'fair payments' as defined above. We find that, in general, payments arising from carriage consent negotiations are likely to flow from pay-TV operators to PSBs and not in the opposite direction.
- We then consider commercial PSBs' likely response to receiving additional revenues from platform operators. We find that the net effect is akin to a reduction in fixed costs and as such likely to be converted in large part into profits. However, as we argue in section 4, not-for-profit commercial PSBs can be expected to use carriage consent income to increase origination spend, while privately owned commercial PSBs may or may not do so (depending on shareholder preferences) and can only be obliged to do so via some additional regulation (e.g., as part of revised licence terms). Our base case is that 40% - 60% of the extra revenue is invested in UK-originated content – which is one of our two key outcomes.

[68] We take benefits to be strictly incremental – that is, net of the benefits that parties could enjoy if they resort to their next-best alternative if negotiations between them fail. However, in the case of platform operators, we assume that their alternatives do not include the possibility of re-using a PSB's EPG slot to promote an alternative channel from whose viewing they can profit.

- Finally, we consider platform operators' likely response to an increase in their costs arising from carriage consent. Based on published reports and economic theory we expect some 50% - 100% of carriage consent costs to be passed on to platform subscribers – our second key output. Of the remainder, we expect only a small proportion to be reflected in a marginal decrease in content investment by platform operators.

The overall model is illustrated in Figure 13 below. Note that we show the dynamics here on the basis that payments flow in favour of PSBs. The same modelling structure applies in cases where the flow is in favour of platform operators, with the effects on consumer pass-through and content investment operating in the reverse direction.

Figure 13: Summary of our model



We have used this model in two ways:

- By applying it separately to each possible combination of commercial PSB (C4/S4C, ITV1 and Channel 5) and main pay-TV platforms (Sky and Virgin Media), in each case we have using appropriate churn and viewing impairment parameters as estimated later in this Appendix. We then add all the benefits on each side as well as the corresponding payment flows and the impacts on content investment and subscription prices to obtain industry-wide estimates of each output.
- As above, but considering all commercial broadcasters as a single negotiating entity (collective negotiations).

Finally, as we discuss below, in preparing this report we have had to confront the lack of publicly available data that can be used reliably to predict values for our two driving parameters (viewing impairment and incremental churn) for UK channels. Our approach has been to use broad plausible *ranges* for each parameter, with lower and upper bounds determined on the basis of international evidence and our own modelling, as we set out below under 'Estimation of key parameters'. For each PSB/platform combination we have then subdivided the plausible ranges of the two parameters into several sub-intervals and thus constructed a grid of input parameters; the model was then run for each point in the grid.

Benefits, viewing impairment and incremental churn

Intuitively, the benefits at stake associated with a channel that is already being carried are equivalent to the income that the PSB and the platform operator would stand to *lose* if carriage were to cease.[69] In turn, the potential losses for both parties are driven by two questions of consumer behaviour: how many subscribers would churn if the channel were to stop being carried and by how much would viewing of the PSB increase or decrease as a result of a drop of carriage?

Broadcasters' potential losses from a lack of carriage stem from decreased ad revenues due to declines in viewing. In turn this **viewing impairment** is due to (among other things):

- Decreased viewing by those subscribers who stay with the platform after the channel is dropped (typically a large majority). While some subscribers have alternative reception equipment (e.g., DTT) others do not; in addition, some live in areas or accommodation where alternative reception is costly or unavailable. Even among those who do have alternative means in place, we expect a drop in 'non-appointment' viewing.
- Increased, decreased or unchanged viewing by a small minority (typically under 10%) of subscribers who leave the platform (or '**churn'**) in response to the cessation of carriage and go to other platforms or stop viewing TV altogether. Those who go to free platforms might be expected to increase their viewing of the PSB channel in line with PSBs' higher share of viewing in non-pay-TV platforms; those who go to rival pay-TV platforms may be expected to keep their viewing unchanged; and those who drop out of TV altogether (presumed to be a very small number) stop viewing the PSB. For simplicity, in our model we ignore these effects and assume that all churning customers continue to view the PSB as they did before they churned.[70]

For platform operators, losses stem from decreased subscription revenues, which in turn are due mainly to:

- Some consumers defecting ('churning' from) the platform in response to the absence of a PSB's channel; and
- The operator optionally and slightly lowering its subscription fees (or delaying a planned hike) to entice potentially disaffected subscribers to stay.[71]

In principle the widespread penetration and availability of free platforms such as Freeview and Freesat 'lowers the stake' on both sides: the easier it is for consumers to view a PSB regardless of whether it is carried by their platform operator, the less likely they are either to churn or to decrease their viewing. Nonetheless, it may be argued that even with 100% penetration and availability of such alternative platforms the potential losses on either side would still exist, since some viewers would simply not bother 'channel surfing' outside their platform's EPG (thus affecting their viewing), and at least some users might resent a PSB's absence from an EPG, even if it is readily available through their TV set tuner (for example, as it would make planning, recording, etc., harder for programmes from the PSB).

Our calculation then proceeds as follows: for each PSB/platform combination we start with a range of plausible values of incremental churn and viewing impairment (themselves estimated as per our discussion under

[69] For modelling purposes, we assume that any losses associated with cessation of carriage are incurred immediately and stop being incurred if/when carriage resumes.

[70] Since we expect this group of churners to account for only c 10% of subscribers or even less, any complicated set of assumptions as to viewing habits post-churn are likely to lead to extremely small changes compared to a simple assumption of perpetuation of viewing behaviour following departure from the platform.

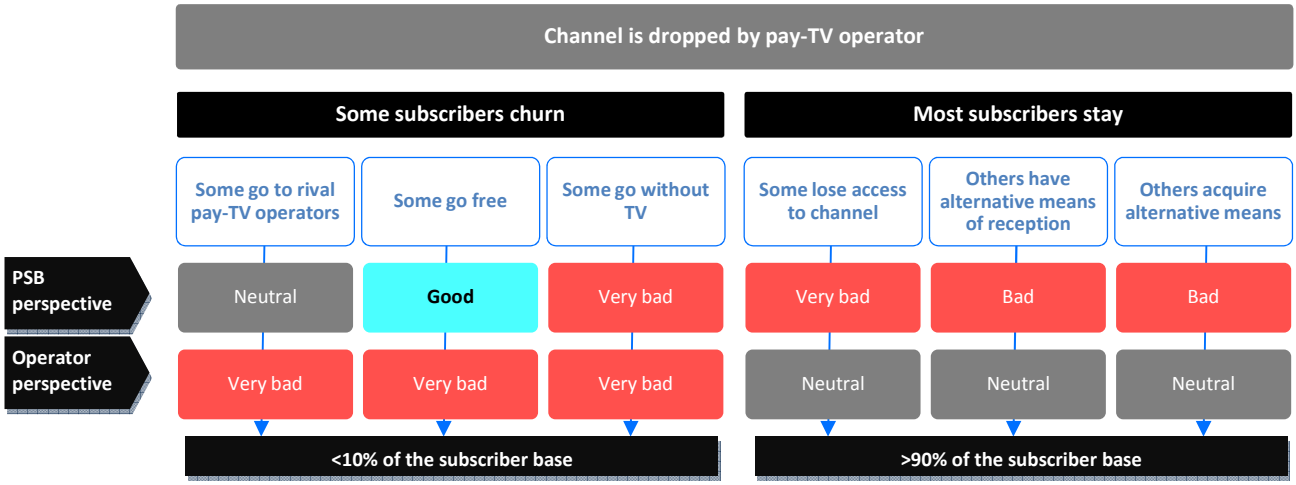
[71] In theory, the operator would adjust its price optimally so as to maximise its total profit or minimise its losses; in general, this could involve a combination of lost subscribers and lowered prices. We note Sky Italia once issued free DTT adapters to its subscribers after it lost carriage of Mediaset's signals – thus proving the value it attributed to preventing churn.

'Estimation of key parameters' below). Given a combination of these two parameters wethen calculate the parties' benefits as follows:

- **PSBs' benefits:** we estimate a PSB's benefits by multiplying the channel's total advertising revenues attributable to viewing through the platform (which in turn are a function of the number of households that use the platform, the channel's viewing share among subscriber households and the channel's viewing share across all households) by the expected viewing impairment (for each plausible combination of viewing impairment and churn). We assume that broadcasters incur no marginal per-subscriber or per-platform costs for linear carriage, so that the revenue at stake is also the marginal impact on profit – i.e., the PSB's benefit.[72]
- **Platform operators' benefits:** we first multiply the expected churn value by the operator's number of households to obtain the number of households that would churn for a given churn percentage. We then multiply this by what we estimate to be operators' marginal contribution per household.[73] The result is the marginal impact on operators' profits from a cessation of carriage – or, equivalently, the operator's benefits from carriage.

The situation is summarised in the diagram below:

Figure 14: Drivers and dampeners of PSB and platform operators' losses following the loss of carriage



[72] Channel 4 does not have shareholders requiring dividends. By treating Channel 4 as if it were a private, profit-making firm we are simply assuming that its board, in its concern for generating marginal revenue (for public service purposes) can be expected to behave similarly to a private-sector firm.

[73] For Sky, we use retail revenues minus content costs minus direct network costs – all as reported in its 2011 annual report. For Virgin Media (which does not report its cost break-down), we assume the same contribution margin as for Sky, as a percentage of cable ARPU.

Fair payments

The benefits that parties enjoy from carriage (e.g., additional advertising or subscription revenues) are independent of any payments between them. Rather, the benefits are those *in exchange for which* any payments would be made.

In a commercial carriage negotiation payments are expected to be smaller than the financial benefits gained by either party, since otherwise the paying party would see no point in the carriage. Rather, they are a way of *redistributing part* of the gains from carriage in a way that both parties can agree on.

Of course, in a free commercial negotiation there are no rules about how the benefits should be split. Each party may have its own perception of value, negotiation skill and information. However, a conceptually standard settlement is to 'split the difference' – that is, to agree the total value accruing from carriage for both parties and then to effect a payment from the player with most benefits (or, equivalently, most to lose from a cessation of carriage) to the other; economic theory then suggests that the outcome is stable under certain conditions.[74] Note that this sort of settlement is intuitively 'fair' in that the 'pie' has been cut in half. Also, if the 'pie' is defined adequately (namely, so that each party's benefit is defined as net of what its counterparts' competitors can offer), a 'fair' division is not incompatible with some types of market power.[75]

What this model omits

It is worth stressing that our model is deliberately simplified and fails to consider several important factors. Given the degree of uncertainty concerning the driving behavioural variables, we believe that more modelling sophistication would be misplaced. However, interested readers should note that, in particular, we omit considerations of:

- How a platform operator might adjust its pricing to limit customer defection following the loss of a free-to-air channel (i.e., an economically rational/optimal response based on demand elasticity)
- The impact on platforms of subscribers defecting from a platform not in response to a channel being dropped but to operators passing on part of their carriage consent fees to their subscribers when a channel is *not* dropped; and the related consumer harm
- How, upon losing a carriage deal, a PSB's revenues might fall by a percentage larger than its drop in viewing as a result of the loss of an advertising cost-per-thousand (CPT) premium associated with universal/high reach
- Other possible responses by the channel operator or the PSB, including:
  - A case where the affected PSB partners with rival platforms (a common US tactic) to air advertisements encouraging subscribers of the platform in dispute to churn, thereby putting pressure on the initial operator to settle as well as recovering some lost viewers

[74] In economics this is a particular case of the Nash bargaining solution, and under certain conditions is 'natural' in that it is stable – see e.g., Ken Binmore, Ariel Rubinstein and Asher Wolinsky (1986) 'The Nash Bargaining Solution in Economic Modelling' *RAND Journal of Economics* Vol 17 No 2, Summer 1986.

[75] Specifically, if party A is easily 'replaceable' by party B (e.g., if a broadcaster is undifferentiated and has no loyal audience, so that platform subscribers would not notice its absence), then party A's benefits at stake are small and under our 'fair deal' would likely pay the other. Market power of this kind is not incompatible with 'splitting the pie in half', since, given our definition of benefits, the pie under dispute only includes what each party brings over and above what its counterpart can achieve under the best alternative (see footnote 68). However, if one party has its very existence at stake (e.g., a small channel that may go bankrupt without carriage) while the other only has a financial stake of relatively low importance to it, then the latter can afford to delay agreement until the former accepts a small 'slice' of the pie. This second kind of market power may indeed prevent 'fair payments' in our sense.

  - A case where the affected platform operator populates the vacated EPG slot with one of its own channels or one with which it has a commercial relationship[76]

- Responses by competitor platforms or broadcasters, including the possibility of coordinated withholding
- The length of time during which carriage may be withheld, and the long-term effects that even a short-duration block can have on an operator's subscriber base
- The fact that any decision to allow or deny carriage is likely to be revisited multiple times – and the effect that the consideration of this has on negotiators' decisions
- The 'choreography' of the negotiation – e.g., whether it starts from a position of carriage or no-carriage, which party speaks first, how 'patient' each is to a standoff, etc.

Estimation of key parameters

Benefits

As mentioned above, there is a general scarcity of available empirical data concerning the two key behavioural drivers for benefits: the impact on (a) churn and (b) viewing that follows after a channel stops being carried by a platform. Given this (and given that conducting primary research is outside our scope), we draw on the limited international data available to produce broad plausible ranges of each of the two parameters for each combination of core PSB channel. (Thus, for example, in the absence of Channel 4 we assume that 1% - 3% of a platform's subscribers would churn and that viewing in non-churning households would drop by between 40% and 60%).

Plausible ranges for incremental churn

We start by considering four known international cases of withheld free-to-air signals to inform our churn assumptions:

- A cross sectional study carried out by the General Accounting Office in 2002 found that, on average, American satellite platforms signed up **24%** more customers in areas where they were allowed to carry (terrestrial) broadcasters' channels.[77]
- In a 2001 publication, the US Federal Communications Commission (FCC) quoted an unpublished report by operator DirecTV stating that being able to carry broadcasters' signals increased subscriptions by **17%**.[78]
- In a 2010 sponsored report[79] by US academics Salop, Chipty, et. al, the authors cite anecdotal and journalistic evidence related to two US cases of broadcaster/operator negotiating impasses and blackouts. In one (TWC vs

[76] We assume that appropriate prominence rules would remain in place, so that the slot of the withheld channel remains vacant during any black-out period.

[77] The study controlled for variables such as urban versus rural households, which means that the difference in take-up not explained simply by rural households' using satellite TV as their only way of accessing the nearest city's TV stations. See US General Accounting Office (2002): *Issues in providing cable and satellite television services*. Report to the Subcommittee on Antitrust, Competition, and Business and Consumer Rights, Committee on the Judiciary, U.S. Senate. Available at http://www.gao.gov/assets/240/236118.pdf. See also discussion in W Rogerson (2010): *Economic analysis of the competitive harms of the proposed Comcast – NBCU transaction*, p 31 (a sponsored study).

[78] See , FCC (2001), *Eighth annual report,* FCC 01-389, p 30, par 59.

[79] See Salop, Chipty, DeStefano, Moresy and Woodbury (2010): 'Economic Analysis of Broadcasters' Brinkmanship and Bargaining Advantages in Re-transmission Consent Negotiations'. Note that this paper was sponsored by Time Warner Cable.

Fox / KAYU, 2008), the drop in subscribers was estimated at **16% - 28%**; in another (Sinclair/Mediacom, 2007) the corresponding figure was estimated at **4% - 5%**.

- As part of a recent investigation concerning re-transmission rights, Chile's Free Competition Tribunal published[80] a submission by an affected party with detailed data from a mass attitudinal survey exploring respondents' willingness to pay and to churn following the hypothetical cessation of carriage of a major broadcaster whose share in pay-TV households is c 25% (i.e., more than ITV1's corresponding share). Among households with adequate reception of terrestrial TV and reached by an alternative pay-TV provider, the *claimed* willingness to churn (whether to switch providers or to drop pay-TV) was **29%**; among households not covered by competitors (but with good terrestrial reception) the figure was **22%**.

It must be pointed out that these data sets have only limited read-across applicability to the UK market, for a host of reasons. For example, the availability of alternative free-to-air networks in UK homes is greater than in comparable markets internationally. However, while these figures hardly represent a scientific sample, together with a general awareness of television viewing they do allow for some high-level observations:

- First, in general the reported drops in share of viewing are of the same order of magnitude as the viewing share of the channels – or groups of channels – in question. The ratio between the two quantities is around 1 for the Chilean case and slightly less for the 2007 and 2008 US cases (assuming a network share of 10% - 20% in cable homes, per channel). The earlier US cases suggest a smaller ratio of around 0.5.
- Intuitively, we expect that the absence of popular channels from a platform should have a proportionately larger impact on churn. However this is likely to depend not only on a channel's viewing share but also on the loyalty of its viewers.
- Finally, on the basis of academic insights about TV viewing,[81] for small channels we would expect that the churn generated, if any, would be far smaller even than the channel's share of audience

On the basis of these considerations, we have produced ranges for the impacts that dropping a channel would have on a platform's churn, expressed as percentages of each channel's share. We stress that other analysts could use different inputs and thereby generate different (and equally valid) outcomes. Additionally, we have also produced ranges for the hypothetical case in which (i) all commercial PSBs leave a platform simultaneously (e.g., if a collective negotiation were to fail) and (ii) all PSBs including the BBC leave simultaneously.

Our ranges are shown in the table below, where they are also translated into absolute churn figures on the rightmost two columns:

Figure 16: Assumptions for incremental churn

Broadcaster		Impact on platform churn as a percentage of PSB channel's viewing share in platform		Incremental churn in absolute terms	
PSB name	Share[82]	Min	Max	Min	Max
BBC1+2	23%	30%	80%	7%	19%
ITV1	15%	30%	80%	5%	12%
Channel 4 / S4C	4%	30%	70%	1%	3%

[80] The case's documentation can be found at http://www.tdlc.cl/Portal.Base/Web/VerContenido.aspx?ID=1412.
[81] Specifically, the 'double jeopardy' effect – see Barwise and Ehrenberg (1998): *Television and its audience:* London: Sage, p 44.
[82] Average of channel share across digital satellite and digital cable platforms. Source: Ofcom: *Communications Market Report 2011* p 141.

Broadcaster		Impact on platform churn as a percentage of PSB channel's viewing share in platform		Incremental churn in absolute terms	
Channel 5	3%	30%	60%	1%	2%
Commercial PSBs	23%	40%	80%	9%	16%
Main 5 PSBs	46%	50%	80%	23%	37%

Plausible ranges for viewing impairment

Estimating the drop in viewing share by non-churning households is more difficult because in this case we found no usable data and had to result to estimates from first principles. To do this:

- We relied on existing data from Ofcom on the number of Sky and Virgin Media subscribers who also have access to Freeview. We assumed that among those households which do not have access to Freeview, viewing of the blocked PSB would drop to zero, except for a small number of homes that would buy DTT equipment as a result of the drop in PSB carriage (specifically, we link this number to the pay-TV platform's number of subscribers and the channel's viewing share).[83]
- Among those households that had or acquired Freeview equipment, we assumed that viewing of the PSB channel would not be as high as before. Specifically, we assumed that:
  - 30% of the channel's viewing in subscriber homes already took place on Freeview-only sets before carriage stopped; this level of viewing remains unaltered in all Freeview-enabled homes;
  - 40% of viewing of the PSB channel is appointment viewing, and all of this survives (this is a simply a common-sense assumption to reflect the value in average viewing profiles of such destination programmes as long-running soaps).
- This means that 70% of channel viewing would survive in households with Freeview – or, alternatively, there would be a 30% drop. We then compute a weighted average between this 30% (corresponding to households with Freeview) and 0% (corresponding to households who don't have or acquire Freeview, which we assumed depends on channel popularity).
- Finally we add and subtract 25% of the resulting value so as to reflect the highly approximate nature of this exercise, and obtain a range. After rounding the upper and lower ends to the nearest 10% we obtain our expected viewing drops for each channel. These are listed in the table below:

Figure 17: Assumptions for viewing impairment

Broadcaster		Drop in viewing in non-churning homes	
PSB name	Share[84]	Min	Max
BBC1+2	23%	30%	50%
ITV1	15%	30%	60%
Channel 4 / S4C	4%	40%	60%
Channel 5	3%	40%	60%
Commercial PSBs	23%	30%	50%
Main 5 PSBs	46%	20%	40%

[83] We assume that non-churning Sky homes would not have (or seek) access to BBC/ITV Freesat, since this would require multiple dishes (and/or STBs/sets/viewing cards).
[84] Average of channel share across digital satellite and digital cable platforms. Source: Ofcom: *Communications Market Report 2011* p 141.

PSB uses of extra revenues and content investment

As discussed in section 3, in general there can be no guarantees that private-sector commercial PSBs would by their own choice invest any revenues gained from carriage negotiations into content – let alone UK originations. Although for Channel 4 and S4C the situation is different (since as not-for-profit institutions they can be said to invest all their revenues, and their ownership means they are more susceptible to obligation) even in their case there is no guarantee that the content in question would be UK origination.

As we argued in section 3, we believe that this can only be solved through effective regulation, specifically through additional content obligations included in commercial PSB's licences reflecting expected gains from carriage consent. For the purposes of our modelling exercise, we have assumed that **between 40% and 60%** of additional revenues accruing to PSBs in our scenarios would be re-invested into UK-originated content.

Platform operators and consumer pass-through

Finally we turn to the impact of carriage consent fees on platform operators. Although this subject has been discussed at length by various US academics as well as the US regulator, the FCC, there is limited solid data available. The main econometric study available,[85] conducted in 1997, found a pass-through rate of around 50%; however this was in a context in which US cable operators faced little competition (as satellite and IPTV were then in their infancy). Subsequent commentators[86] have argued that with increased competition pass-through should approach 100%. We note that, to the extent that this observation is valid for the US, it should also be applicable to the UK given the relatively competitive British market (as compared to the US circa 1997). Nonetheless, this – like much of the relevant commentary – is largely speculative, and a look at the relevant economic literature suggests that while pass-through rates can even exceed 100%, in general they are highly unpredictable.[87]

In view of this situation, we have chosen to use a broad pass-through range of **50% - 100%**.

[85] G.S. Ford and J.D. Jackson (1997), 'Horizontal concentration and vertical integration in the cable television industry,' *Review of industrial organization,* 12(4):501-518 pp 513-14, quoted in M Katz, J Orszag and T Sullivan (2009), 'An economic analysis of consumer harm from the current re-transmission consent regime' (a sponsored report submitted to the FCC).

[86] E.g., Ford et al, *ibid.*

[87] As noted in the economics literature, on purely theoretical grounds there is no simple answer to the question of pass-through. For example, a perfectly competitive industry can be expected to pass on 100% of any increase in variable costs to its customers if the increase applies to all competitors, 0% if it only affects a small competitor, and anything in between if it affects competitors unevenly. In the monopolistic case, a monopolist would likely pass on less than 100% of the variable-cost increase (but could pass on more, depending on the elasticity of demand). Oligopolistic cases, as well as increments in fixed costs (or partially fixed costs) are significantly more complex. See, e.g., Amir et al, 'On taxation pass-through for a monopoly firm' *Annales d'Économie et de Statistique* No. 75/76 (Jul. - Dec., 2004), pp. 155-172.

Appendix B: The US regime

Legal and regulatory regime

The current US regime dates back to the 1992 Cable Television Consumer Protection Act and its subsequent extension to satellite platforms in the 1999 Satellite Home Viewer Improvement Act (SHVIA). Under this legislation, every three years FTA broadcasters have the right to choose between two sets of rules in their dealings with platform operators: (a) must-carry,[88] whereby the operator is forced to carry the broadcaster's signal with no money changing hands; and (b) re-transmission consent, whereby the operator can carry the broadcaster's signal only by mutual agreement (which often involves some form of negotiated compensation). Once a broadcaster has chosen one set of rules it cannot switch to the other until the end of the three-year period. This regime applies to commercial FTA broadcasters only (non-commercial broadcasters such as local community TV stations can demand carriage but not compensation).

The US regime does not stipulate that payments (whether in kind or in cash) should take place, or that they should be in broadcasters' favour; option (b) only creates a setting for effective commercial negotiations by allowing either party to withhold carriage. However, because it is broadcasters and not platform operators which decide between the two regimes, the regime's net effect is to favour broadcasters, since they can be expected to choose (b) only when they would prevail in commercial negotiations.

This bias in favour of broadcasters is deliberate and is justified mainly on two grounds. First, the regime aims to favour localism: many US broadcasters are independently owned (despite their affiliation to national networks such as ABC, CBS, NBC, etc.) and are required to produce local programming (particularly news) as part of their licence obligations. This is akin to the UK's PSBs and their content obligations. Second, at the time that the relevant laws were passed there was a (disputed) perception that increased consolidation gave platform operators excessive bargaining strength.

This regime was controversial when it was approved (it was the only occasion in which Congress overrule a veto by President George Bush Sr, who had opposed the legislation) and remains so today. However, a current attempt at repealing must-carry (thereby ensuring that carriage can only happen by mutual consent – the Next Generation TV Marketplace Act) – appears unlikely to progress through Congress.

Negotiations in practice

For more than a decade after the introduction of the regime (and contrary to some broadcasters' expectations) there were no known cases of platform operators paying broadcasters for re-transmission rights. However, this is not to say that no value was exchanged. For example, local stations would often delegate re-transmission negotiations to the national networks to which they were affiliated (e.g., ABC, NBC – see below), which in turn would negotiate with cable companies at a national level. In those negotiations, payment was often in the form of a cable company carrying a cable-only channel owned by the network (e.g., hypothetically, MSNBC) whose initial lack of consumer awareness would have made it otherwise unattractive to operators. Another common approach was for cable operators to commit to buying advertising time in lieu of payments – partly so as not to set a precedent for cash payments.

Cash payments began in the mid- 2000s. Their relatively sudden appearance has been explained variously as a result of increased competition among platform operators (e.g., the growth of satellite operators DISH and

[88] By 2009, only 37% of broadcasters were relying on 'must-carry' (FCC *ibid*).

DirecTV, as well as IPTV platforms owned by phone companies); a decrease in the value that national networks place on being able to negotiate re-transmission fees on their affiliates' behalf; and the negotiating style of some key players, notably Rupert Murdoch (for the Fox network).

Black outs and 'good faith' rules

Carriage negotiations tend to become public when existing contracts are about to expire. In some high-profile cases negotiators have withheld carriage just before major media events such as the Super Bowl, thus inflicting major damage on whichever party can be blamed for the impasse. This has led to angry customers and politicians pressuring the Federal Communications Commission to help prevent black-outs; however, current laws only require that parties negotiate in 'good faith' and, the FCC argues, does not allow for regulators to demand that an agreement be reached, e.g., through compulsory arbitration. The FCC is currently conducting a consultation on whether 'good faith' guidelines should be strengthened so as to make impasses less likely. The FCC is understood to be opposed to the notion of its having to arbitrate on matters of benefits and fair payments between broadcasters and operators.[89]

Amounts

Payments are becoming increasingly common, and they are also growing in size. They are typically negotiated on a per-household basis, with fees for the main broadcasters understood to be in the region of $0.50 per household per month, or $6 per household per year. For 2012 payments are expected to generate between $0.8bn and $1.8bn, and by 2016 are expected to reach between $2.6bn and $5.3bn, eventually accounting for some 13% - 20% of TV stations' income.[90] Importantly, not all of this money stays with local broadcasters, as national networks often demand that a portion be payable to them ('reverse re-trans') and in any event national networks own some local stations directly.

Key differences versus the UK

The US and UK markets differ in so many important respects that any direct read-across would be unjustified. Key differences include:

- **Local franchising and affiliates:** Traditionally, US broadcast licences have been awarded at a local level to local businesses that are often separate from, but often *affiliated* to, national networks such as ABC, CBS and NBC (where this is not the case, local stations are *owned and operated* by the networks). As businesses, affiliates are often small and local and are arguably in a weak position versus pay-TV operators, although some are owned by larger groups (and indeed some cable companies are also small and local). US re-transmission consent and must-carry regulations have been largely about managing the evolving power relationships between these two industries as they go through successive waves of consolidation.
- **Absence of UK-style satellite free-to-air channels:** In the UK (see section 4), broadcasters make their own arrangements to uplink and broadcast their satellite signals unencrypted across the UK so that they can be received by any compatible equipment – from Freesat-compliant TV sets to Sky boxes. By contrast, US satellite operators are responsible for up-link and re-transmission using their satellite capacity and to their

[89] See 'Can the FCC end the Retrans Wars?' *Multichannel News* 10 Oct 2011.
[90] Forecasts by Nomura, SNL Kagan and Morgan Stanley. By comparison, our estimates of 'fair payment' payments to PSBs under US-like rules (section 5) suggest payments worth around 8% PSB's commercial revenues at the mid-way point of our range.

own customers only – i.e., essentially as part of a closed platform. While (as noted in a recent UK report[91]) this means that US broadcasters do not incur the relevant technical distribution expenses (satellite capacity, etc.), it also means that, unlike their UK counterparts, US satellite operators actually *re-transmit* broadcasters' signals, thus ensuring that – barring explicit legal provisions – carriage requires broadcasters' consent.

- **Higher pay-TV penetration**: the US's higher penetration of pay-TV (currently estimated at c80% of households[92]) means that pay-TV operators have significantly more power than their UK counterparts as a gateway to broadcasting. This was even more the case when the current US regime was introduced in 1994, when cable operators were often the only pay-TV operators in a given area (i.e., before significant competition from satellite operators and, later, IPTV from telcos). Households' reliance on cable or satellite to receive even free TV signals is strengthened by poor local terrestrial networks and the long-entrenched position of cable (as a result of which many US homes are no longer equipped to receive terrestrial signals).

Further reading

Further introductory briefings on the US case can be found at:

- Federal Communications Commission: *Notice of proposed rulemaking: amendment to the commission's rules related to re-transmission consent*. FCC 11-31 (2011)
- Terrance O'Reilly (ed): *Programmer-Distributor Negotiations: Retransmission Consent and Other Federal Rules*. Nova (2008)

[91] See Oliver and Ohlbaum (2011): PSB network re-transmission and access charges in the UK: the case for change. Report prepared for the BBC, available at http://downloads.bbc.co.uk/aboutthebbc/reports/pdf/Re-transmissionandAccessChargesReview.pdf.
[92] Source: Ofcom

Appendix C: Glossary of terms

Black-outs – *Period during which a channel is not available on a TV platform owing to a carriage dispute*

Churn – *rate at which subscribers cancel their subscriptions to a pay-TV platform (as a percentage of the base)*

Commercial PSB – *Entity licensed as a public service broadcaster but which rely on commercial revenues rather than grants or access to the licence fee (i.e., ITV1, Channel 4/S4C, Channel 5)*

Copyright Act – *The current UK copyright law. It gives the creators of literary, dramatic, musical and artistic works the right to control the ways in which their material may be used. Section 73 of the Act exempts cable operators in the context of FTA broadcasts in the UK.*

CPT (Cost per thousand*)* – *The benchmark 'price' used by advertisers and media owners to reflect the cost of an advert being viewed 1,000 times.*

DCMS – Department for Culture, Media & Sport

DTT – Digital terrestrial television (Freeview, BT Vision)

DSAT – Digital satellite television (Sky and Freesat)

DCAB (or Cable) – Digital cable television (Virgin Media)

ECN (Electronic Communications Network) - *Fixed line telephony or cable transmission network (such as telephone or cable TV, as defined in European and UK law)*

EPG (Electronic programme guide) – *Continuously updated menus displaying broadcast and scheduling information for current and upcoming programming (and backward scrolling for TVs with Video-on-Demand capability)*

FRND – Fair, reasonable and non-discriminatory

Freesat – *brand name for marketing company promoting free to view satellite television*

Freeview – *brand name for marketing company overseeing development of the DTT consumer platform*

FTA (Free-to-air) – *Unscrambled digital channels*

HD – High definition

In-the-clear – *Unscrambled digital programming received by any digital service*

IPTV (Internet Protocol TV) – *The delivery of linear broadcast TV over the internet rather than via broadcast platforms (TalkTalk TV is currently the only 'true' example in the UK, as BT Vision is a hybrid IP-DTT platform)*

Linear (and non-linear) programming: *TV content that is viewed as a scheduled broadcast, as opposed to content that is recorded (e.g., via a PVR) or delivered 'on demand' (e.g., over the internet or via IPTV) for viewing at a time of the viewer's choosing*

Must carry – *Government regulation stating that a service must be available on all platforms*

Must offer – *A broadcaster is required to provide wholesale access to content/channels on regulated terms*

Ofcom (Office of Communications) – *regulatory body with responsibility for communications and media*

Origination, originated – *Content that is commissioned or produced in the UK*

PCC *(*Platform contribution charge) – That element of TPS that relates to common costs recoverable by the regulated TPS provider

PSB – Public service broadcasting

Re-transmission consent, or re-trans – *The option open to US FTA broadcasters to choose to negotiate terms under which their signals will be carried by TV platforms*

STB – Set-top box

SD – Standard definition

TPS (Technical platform services) – *Services relating to encryption, EPGs and use of Sky's interactive technology and systems, allowing broadcasters and operators of interactive TV services to make their content available on Sky's digital set top boxes*

VOD (Video-on-demand) – *Interactive TV technology that allows subscribers to view programming in real time or download programs and view them later (examples include the BBC iPlayer, ITV Player, Sky Anytime+, etc.)*

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