# A licence to kill?
# The impact of the BBC licence fee settlement on commercial radio

A report for the Commercial Radio Companies Association
by Indepen
February 2006

Indepen Consulting Ltd
Diespeker Wharf, 38 Graham Street, London N1 8JX
T +44 (0) 20 7324 1800 F +44 (0) 20 7253 4949 www.indepen.co.uk

Indepen is a management and economic consultancy. We understand and have experience of government, regulation and investors, as well as business and other forms of enterprise. We work to make business sense out of better regulation to produce better results for all stakeholders, and improved services for everybody. We use our knowledge to challenge constructively and our thinking is independent, distinctive and rigorous. We work in this way to promote both public and private value, with clients in the UK, EU and elsewhere in the world. Further information can be found at www.indepen.co.uk.

# Table of Contents

Executive Summary ........................................................ 1

1 Growth and innovation driven by commercial radio ........................................................ 6

2 Potential harm to innovation and plurality from an unconstrained and dominant BBC ................. 9

3 Conclusion: A prescription for the licence fee ........................................................ 14

# Executive Summary

## Commercial radio delivers significant social value

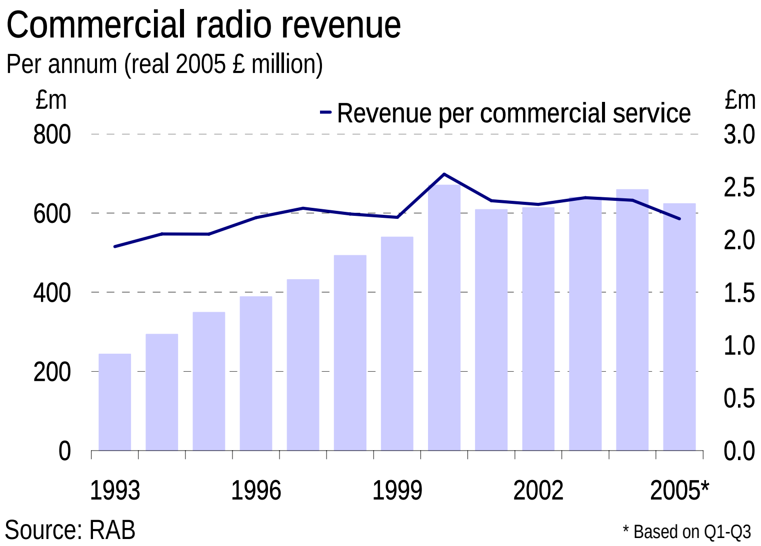
Commercial radio has played a key role in terms of the innovation and growth of radio services. It had revenues of £633 million in 2005, and employed 9,100 people. The total consumer benefits of all radio in 2000 were estimated by the Radiocommunications Agency at £1,400 million, of which some £800 million is from commercial radio, if benefits are attributed on a revenue/expenditure basis between commercial radio and the BBC. In addition, commercial radio is estimated by the Radiocommunications Agency to have generated £303 million of producer surplus, giving a total benefit of £1.1 billion each year.

Since the 1960s commercial and independent radio has been at the forefront of innovation. It initiated the mix of information and entertainment speech with popular music, which has now become the mainstay or staple of mainstream radio. It also pioneered current affairs, sport and personal advice phone-ins, as well as Asian and other ethnic-specific radio services serving communities across the UK. Commercial radio provides information, news and sports coverage, contributing to a sense of community and delivering both private and public value for society. Commercial radio also provides a cost effective form of advertising for local businesses, charities and not for profit organisations and for enterprise start-up and growth.

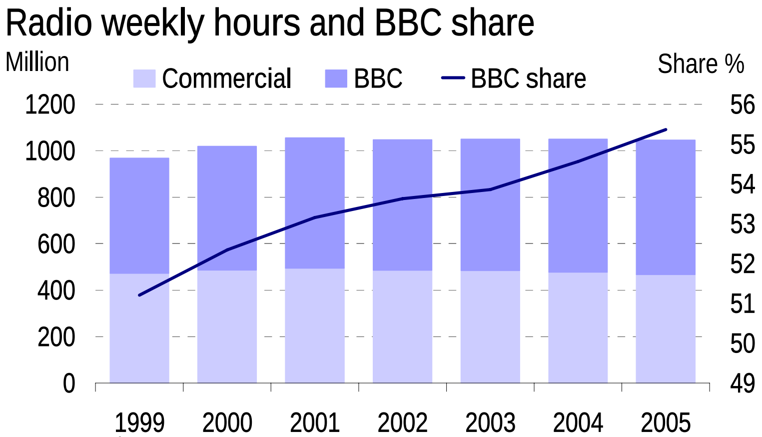
## BBC radio's growing market dominance threatens innovation and plurality

This outcome for commercial radio has been achieved despite the sector having to fight strongly to overcome the BBC's advantage of being financed by a hypothecated tax and not needing to carry advertisements. The BBC's proposed 2.3 per cent per annum real increase in the licence fee, growing dominance of the BBC in radio, imitation of new digital formats such as One Word by BBC 7, as well as the planned extension of BBC local radio services, call into question the prospects for innovation and growth of the commercial sector in the future.

Whilst some might argue that the BBC's radio services, including Radio 1 and Radio 2, do not compete with commercial radio because they do not compete for advertising, this market distinction is false. Both BBC radio and commercial radio, along with other media, compete for audience share and listening time which together determine the scope for commercial radio to attract advertising revenues. Total commercial radio revenue and revenue per service both peaked in 2000 in real terms as the following figure demonstrates.



This has occurred against a backdrop of static overall weekly listening hours with a rising BBC share, which reached 55.1 per cent in 2005, as shown in the following figure. Radio was allocated 17 per cent of the BBC budget in 2005, totalling £530 million, including a pro-rata allocation of overheads. It is unusual for a wholly publicly funded organisation to compete actively to such an extent with the commercial sector in today's economy.



Source: Rajar

If the BBC were a commercial entity, then its current market share, taking the radio market in isolation from other media, would be considered dominant and could raise competition concerns. However, we note that a significant proportion of advertisers regard radio and other media, particularly local press and the internet, as substitutes. The relevant market from a competition policy perspective is therefore arguably wider than the radio market.

## Raising input costs for commercial radio

The BBC has also acted in a manner that raises the price of inputs to commercial radio, both in respect of talent and content. The overwhelming flow of radio announcer and journalist talent is from commercial radio – which provides the initial training - to the BBC. In terms of presenters an illustrative example is Chris Moyles, whilst in terms of journalists an illustrative example is Peter Allen.

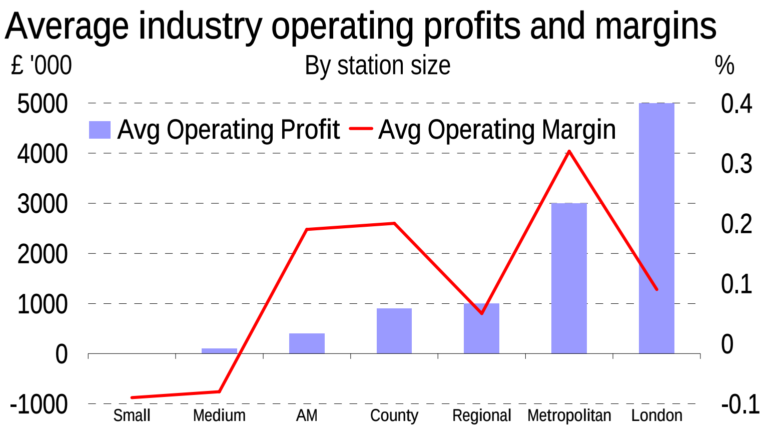
The BBC has negotiated terms for music rights that include substantial up-front payment for content rights and no risk sharing based on service demand. Such terms are commercially risky for commercial radio and will act to discourage commercial innovation, for example, in relation to on demand radio services, podcasting and web based interactivity.

## The BBC is putting innovation by commercial radio at risk

The BBC is putting such innovation by commercial radio at risk. The problem is compounded by the fact that some of the new areas where innovation is occurring relate to the complementarities with the internet (and interactive television), where the BBC has a very strong presence and is able to cross promote services. Aside from the dominance of the BBC and its effect on inputs, the key issue is the scope for the BBC to use licence revenue to enter new and complementary markets, thereby reducing incentives to innovate for commercial radio.

The dominance of the BBC and its guaranteed funding base extends beyond the dampening effect on innovation by commercial radio – competition and plurality at the local level may also ultimately be undermined. If radio is considered to be a separate market from other media, then local commercial radio mergers may be precluded, and the alternative of local commercial radio exiting altogether becomes a possibility, leaving only the BBC. In this regard, it should be noted that the BBC is developing plans for five more BBC local radio stations.

The weak historical profitability in some segments of the sector, as shown in the following figure, implies this risk is real given the increasing dominance of the BBC. Stations at greatest risk are those in the small and medium categories.



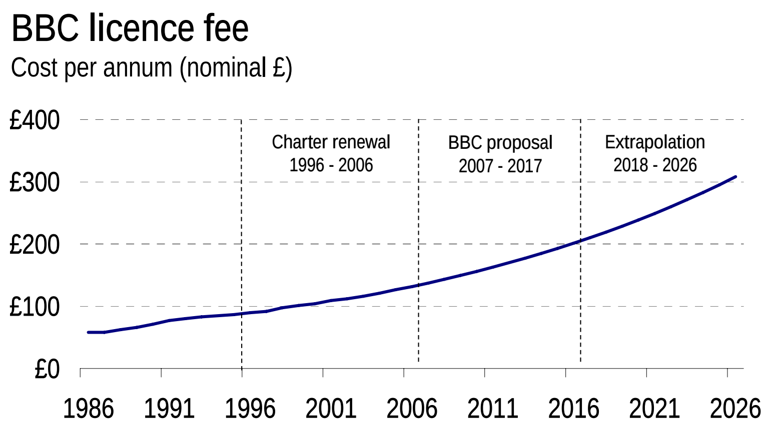

Source: Ofcom

The plurality of the market is only protected from private sector dominance, not BBC dominance. While a minimum of two private players (or none) are allowed in each market there is no constraint on the BBC dominating the market.

## Substantial growth in the BBC licence fee is proposed

Looking ahead, the BBC's proposals for its future funding provide for substantial (2.3 per cent per annum) real increases in the licence fee and so the BBC's overall funding. Whilst the public rationale for this has been the need to fund digital switchover of terrestrial television, only part of the funding is required for this purpose. The overall resources available to the BBC will therefore steadily increase out to 2013/14. This is very different from the historical picture where the licence fee has been more or less constant in real terms.

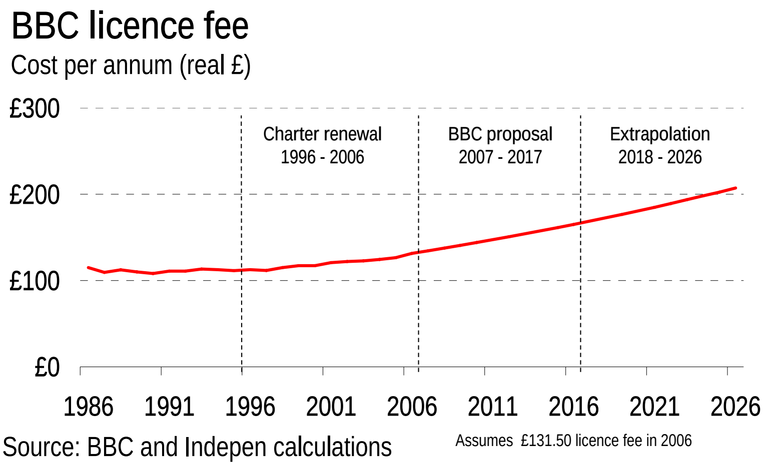
The following figures show the historical level of the BBC licence fee, and the licence fee if the proposal by the BBC for growth of 2.3 per cent above inflation is accepted during the period of the new Charter (assuming inflation of 2 per cent per year). The chart also shows the level of licence fee by 2026 assuming continued growth of 2.3 per cent per year above inflation.




Source: BBC and Indepen calculations

Assumes £131.50 licence fee in 2006, RPI 2% per annum and RPI+2.3% adjustment

Growth of 2.3 per cent per annum also exceeds the HM-Treasury assumption for the medium term real growth rate – in other words the licence fee would be expected to grow as a share of income in the medium term. On current trends the licence fee will exceed £200 per annum in nominal terms by 2016 and £300 in nominal terms by 2026. The following figure shows the level of the licence fee in real terms.

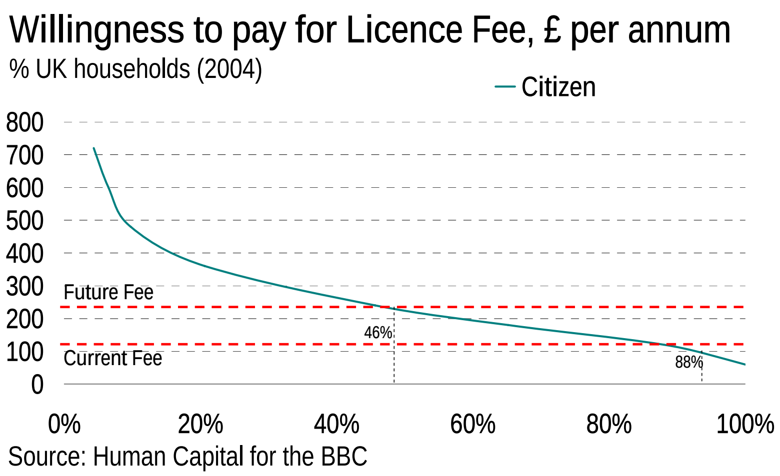



Real growth of 2.3 per cent per annum in the licence fee also implies that the licence fee represents a growing proportion of household income in the medium term, based on the long term real GDP growth assumption used by HM-Treasury of 2 per cent per annum.

### The legitimacy of the licence fee may decline in future

The increasing level of the BBC licence fee may ultimately undermine the legitimacy of the licence. Increased diversity and choice, and the development of pay-to-view and listen models, including internet, mobile TV and radio services, are both increasing competition for the household "communications budget" and providing new ways for consumers to pay for the content they want. These developments may offset the impact of income growth in terms of acceptance of the licence fee.

Assuming willingness to pay remains constant over time, a declining proportion of the population will value the consumer and citizen benefits from the licence fee at more than the level of the licence fee in future. Whilst 88 per cent of consumers are willing to pay the current licence fee allowing for citizen benefits, only 46 per cent would be willing to pay a licence fee of twice the current level allowing for citizen benefits, the position reached by 2026. These percentages amount to approximately 20 million out of 22.5 million households today, and 12 million out of 26 million households in 2026.



## Broadcasting policy should provide predictability for commercial radio

A lack of assurance of the limits to funding of BBC radio during the duration of the new charter substantially increases commercial risk for commercial radio, particularly those companies contemplating investment in new and innovative services. The most effective means of managing this risk from a public policy perspective would be to ring fence funding available to new and existing BBC radio to limit unnecessary harm in the commercial radio market.

Whilst independence for the BBC is seen as desirable, this goal does not preclude ring fencing of the licence fee when the Charter is reviewed, particularly in relation to services that are close substitutes for those provided by the private sector.

To ensure that this policy is effective, we propose that the BBC adopt a consistent approach to accounting for the costs of individual services including overheads over time, and that the Comptroller and Auditor General be authorised to scrutinise how the BBC spends public money (as proposed by the House of Commons Committee of Public Accounts in January 2005). Given changes in the basis for, and level of radio funding in the BBC accounts, an agreed approach and independent audit would be required to ensure that ring fencing was transparent and credible.

We note that the original rationale for the entry of BBC into formats such as Radio 1 in 1967 was to counter the loss of listening to the pirate stations, which were taking many listeners away from the BBC. The original rationale for the BBC presence in such market segments no longer applies following the introduction of licensed commercial radio services in 1973.

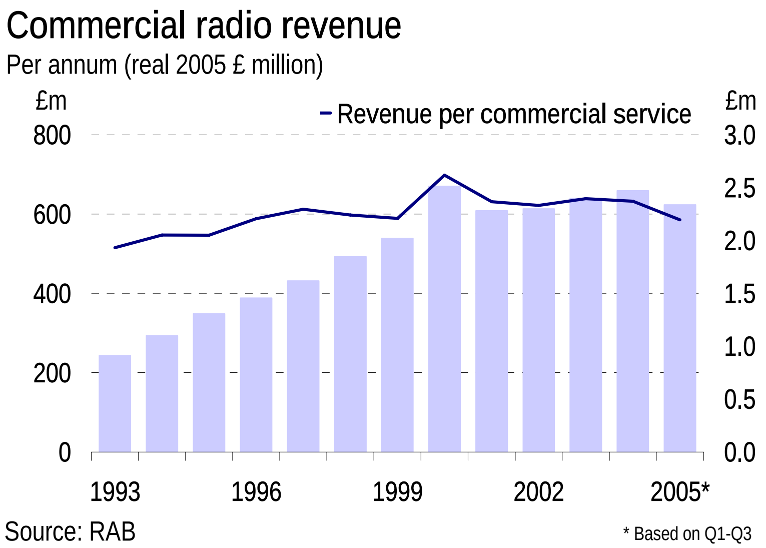
While we do not propose a specific level for the amount of public money that should be spent on radio services, this could be determined via an assessment of new and existing BBC radio services using the public value tests applied by the BBC. In carrying out an assessment, the contribution of commercial radio to public value should be assessed alongside BBC radio services. Following such a review spending on radio should be capped in real terms.

# 1 Growth and innovation driven by commercial radio

## 1.1 Benefits of commercial radio

Commercial radio plays a key role in terms of the innovation and growth of radio services. It had revenues of £633 million in 2005, and employed 9,100 people.[1] Commercial radio revenue grew rapidly during the period 1993-2000, when it peaked in real terms. Figure 1.1 shows this growth and revenue per commercial service, which also peaked in 2000.

**Figure 1.1**




It is apparent that the growth in revenues was predominantly driven by growth in the number of commercial services, since growth in revenue per commercial service is less dramatic than overall revenue.

The total consumer benefits of radio in 2000 – the "consumer surplus" was estimated by the Radiocommunications Agency at £1,400 million,[2] of which some £800 million is from commercial radio, if benefits are attributed on a revenue/expenditure basis between commercial radio and the BBC. In addition, producer benefits of £303 million were estimated for commercial radio.[3] Taking the estimated consumer surplus and producer surplus gives a total social surplus of £1,100 million per annum for commercial radio. (An earlier study, on which the consumer surplus estimates of the Radiocommunications Agency were based, included two estimates of consumer surplus.)[4]

---

[1] Radio Advertising Bureau (RAB) and personnel communication from CRCA based on the Skillset 2003 Census of Audio visual industries. http://www.skillset.org/

[2] The Radiocommunications Agency. February 2001. "The economic impact of radio." http://www.ofcom.org.uk/static/archive/ra/topics/economic/eis-report.pdf

The Radiocommunications Agency noted that it is possible that the benefits from radio are underestimated due to the methodology used.

[3] Based on an estimate for 1988 which the Radiocommunications Agency scaled up to reflect inflation and expected growth of about 3.5 per cent per annum.

[4] MVA in association with Aegis Systems Ltd. October 2000. "Survey to determine the consumers' surplus accruing to TV viewers and radio listeners." http://www.ofcom.org.uk/static/archive/ra/topics/economic/surveys/tvradio.pdf
For radio, including the value of improved digital services, the estimate of consumer surplus was £6.20 per month per person. For existing radio services without any value attributed to improved digital services the estimate of consumer surplus was £2.30 per month – the estimate used by the subsequent Radiocommunications Agency to derive the £800 million consumer surplus estimate. A split was provided in the MVA (2000) study which showed the BBC accounting for a larger share of overall surplus than commercial radio in relation to the estimate of £6.20. However, this difference may be accounted for by the fact that both advertisers and radio listeners will have levels of willingness to pay for commercial radio, whereas the survey only captures the

The outcome in terms of social benefits for commercial radio has been achieved despite commercial radio having to fight strongly to overcome the BBC's advantage of being financed by a hypothecated tax and not needing to carry advertisements.

## 1.2 Innovation driven by commercial radio

Since the 1960s independent commercial radio has been at the forefront of innovation. It initiated the mix of information and entertainment speech with popular music, which has now become the mainstay of mainstream radio. It also pioneered current affairs, sport and personal advice phone-ins, as well as specialist and niche interest stations such as Asian and other ethnic-specific services. Commercial radio provides information, news and sports coverage, contributing to a sense of community and delivering both private and public value for society.

Commercial radio also provides a cost effective form of advertising for local businesses, charities and not for profit organisations and for enterprise start-up and growth. An example of business start-up and growth using commercial radio advertising is The Carphone Warehouse which built a hugely successful brand across the 1990s using radio as their principal advertising medium.[5]

In the 1970s LBC in London successfully developed its format based on sports coverage, speech and phone-ins, a format replicated nationally on BBC Radio 5 and latterly, Radio 5 Live. In the case of the Asian networks, the first commercial station started in 1989 in London and was followed by new Asian services in Bradford, Birmingham, Leicester and Manchester. In the mid-1990s the BBC started its own Asian services.

Similar developments are occurring now in digital radio: following the introduction by commercial operators of Sunrise, the BBC launched BBC Asian Network; similarly, it was commercial radio that pioneered black and urban music through Kiss and Choice, subsequently mimicked by BBC 1Xtra, while speech-based Oneword was soon replicated by BBC Radio 7.

The BBC has also announced plans to extend its local services, historically a mainstay of commercial radio. The BBC plans five more local radio stations based in Somerset, Dorset, Cheshire, Bradford and the Black Country.[6] While only a provisional trail, this increases the level of risk for commercial radio and may set a precedent for future unnecessary intervention in core areas for commercial radio by the BBC.

## 1.3 Current and future development of the radio market

Current and future developments include simulcast radio services, on-demand radio services, programme enhancement and interactivity, personalised music services and digital music sales.

A large number of commercial radio stations and all BBC radio stations currently simulcast their services on the internet. An increasing proportion of radio listeners are accessing these services. 19.7 per cent of people had listened to the radio on the internet in September 2005, 22 per cent growth compared to the same period in 2004.[7] The internet radio market is likely to continue to increase due to increasing broadband penetration and consumer adoption of non-PC internet radio devices. Whilst the internet and other digital radio services offer the opportunity for commercial radio operators to

listener component. In addition, no split was provided between the BBC and commercial radio for the estimate of consumer surplus of £2.30. For these reasons we apportioned the more conservative estimate of £2.30 per person per month according to revenue/cost shares in the market.

[5] Radio Advertising Bureau – Case Study Database. http://www.rab.co.uk/rab2004/showContent.aspx?id=641

[6] BBC. March 2005. BBC Statement of Programme Policy 2005/06. "Nations and regions." http://www.bbc.co.uk/info/statements2005/pdfs/nations_regions.pdf

[7] RAJAR. Q3 2005.

generate subscription revenues, the fact that the BBC is advertising free and free to air is likely to limit the scope for subscription services in the UK.[8]

Through its Radio Player service on bbc.co.uk, the BBC offers a large portion of its programming on-demand during a 7-day window after broadcast. In November 2005, the BBC recorded 6.3 million on-demand listening hours, equivalent to about 3.3 per cent of total BBC listening hours in an average month (percentage calculated using figure of 2.3 billion annual listening hours in 2004). There is also some commercial radio activity in this area, for example Jazz FM (GMG) offers on-demand access to a library of around 200 archive programmes. In the commercial sector, Virgin Radio podcasts an edited version of its breakfast show, including advertising, and Xfm podcasts some of its sessions. In future, the use of downloaded audio content (including podcasts) is likely to increase significantly.

Stations' websites are becoming increasingly important to commercial radio operators' businesses. The majority of commercial radio stations and all BBC radio stations have websites. In addition, the BBC provides an extensive range of content on bbc.co.uk. Though this content is not specific to radio, it includes a prominent link to the BBC radio websites.

Experience also demonstrates the BBC's desire and ability to be available on every platform which is a complement (or potential substitute) for broadcast radio. Whilst commercial radio is exploiting these opportunities, they illustrate the growing dominance of the BBC and its ability to leverage and "cross sell" services including television, the internet and radio. Commercial media are constrained from matching this capability due to restrictions on cross-media ownership.

Online services are becoming increasing integral to radio services in order to grow beyond advertising promotions, yet the unconstrained presence of the BBC online and continued growth into the radio market constrain the ability of commercial radio to invest and innovate in developing new services.

[8] In the US, AOL offers a 200-channel advertising-free package, delivered by XM Satellite Radio, at a price of $5 per month (to non-subscribers) while live365.com charges $3.95 per month for an advertising-free version of its service (live365.com, pricing information as of 31 January 2006 based on a 12-month subscription).

# 2 Potential harm to innovation and plurality from an unconstrained and dominant BBC

## 2.1 Historical development of BBC and commercial radio

BBC Radio started as local radio, partly for technical reasons, as it was not at first possible to retransmit the same programme to different areas. The local programmes were appreciated but, by the early 1930s, as the airwaves became more crowded and interference increased, the BBC abandoned local radio and the first national and regional services were born. Ofcom summarised subsequent developments as follows:[9]

> *"This situation continued until 1967, when the three BBC networks – Home (with regional programmes), Light and Third – were renamed Radio 4, Radio 2 and Radio 3 respectively and were joined by the new national Radio 1, designed to counter the loss of listening to the pirate stations, which were taking many listeners away from the BBC. At the same time, the BBC re-started local radio, beginning with BBC Radio Leicester. A further 19 stations followed over the next six years." Page 24*

The subsequent development of licensed commercial radio services in 1973, some 18 years after the BBC faced its first commercial competition in television, has not seen a reversal of the BBC's entry into formats originally designed to counter the loss of listening to the pirate stations.

Licensed commercial stations were local, generally covering cities or counties. There was only one station per area, except in London, where there were two with different remits: Capital, broadcasting entertainment, and LBC, broadcasting news and information. The rest of the commercial local stations around the country offered a broad range of programming and were all locally owned and run. Localness has, therefore, been an important feature of commercial radio since its inception.

## 2.2 Continued growth and dominance of BBC radio

Only strong private companies are well placed to innovate in the marketplace, since innovations are costly both in terms of immediate finance, employee time commitment and also risking market share. Since, all else being equal, audiences prefer to listen to stations with fewer advertisements, commercial stations must offer better and, wherever possible, more innovative services than the BBC.

Frequently, innovative services can be copied easily by the BBC, which is able to bring the successful innovations to its stations and platforms, thereby competing for audience share and listening time and reducing incentives for commercial radio to innovate.

Whilst some might argue that the BBC's radio services, including Radio 1 and Radio 2, do not compete with commercial radio because they do not compete for advertising, this market distinction is false. Both BBC radio and commercial radio, along with other media, compete for audience share and listening time which together determine the scope for commercial radio to attract advertising revenues. As Ofcom noted in "Radio – Preparing for the future":[10]

> *"…the major role played by the BBC in radio, accounting for over half of total radio listening and almost half of total radio funding, means that any review which considered only commercial radio*

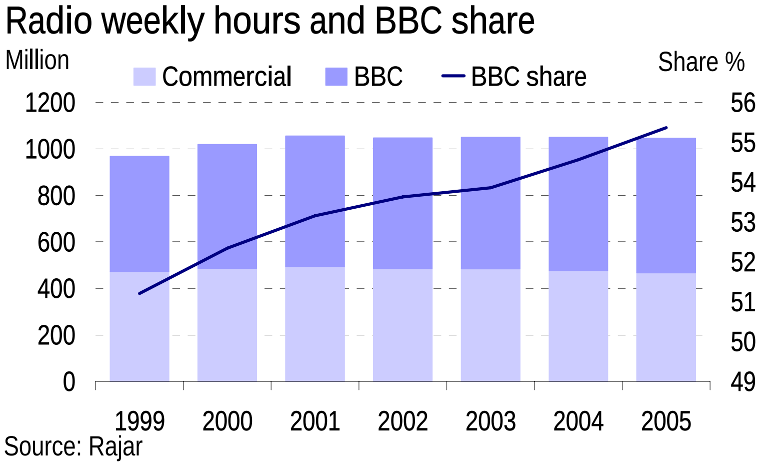
[9] Ofcom. December 2004. "Radio – Preparing for the future Phase 1 developing a new framework." http://www.ofcom.org.uk/consult/condocs/radio_review/radio_review2/radio_review.pdf

[10] Ofcom. December 2004. "Radio – Preparing for the future Phase 1 developing a new framework." http://www.ofcom.org.uk/consult/condocs/radio_review/radio_review2/radio_review.pdf

*would be deficient in its understanding of the factors which influence industry and audience behaviour." Page 34.*

The growing prominence of the BBC relative to commercial radio, measured by both market reach and weekly hours, is illustrated in Figure 2.1.

**Figure 2.1**




If the BBC were a commercial entity, then its current market share, taking the radio market in isolation from other media would be considered dominant and could raise competition concerns. However, we note that a significant proportion of advertisers regard radio and other media, particularly local press and the internet, as substitutes.[11] The relevant market from a competition policy perspective is therefore arguably wider than the radio market.

## 2.3 BBC dominance re-enforced by public funding

The BBC is not only dominant in the market place, but has at its disposal guaranteed licence fee funding. This source of revenue provides the BBC with the scope, with no commercial risk, to imitate others innovations and to develop and enter adjacent markets which are complementary to broadcast radio.

Radio was allocated 17 per cent of the BBC budget in 2005, totalling £530 million including a pro-rata allocation of overheads.[12] This amounts to £11.8 million per radio station for the BBC compared to commercial radio revenue of £2.2 million per station in 2005, although the format differs in terms of national versus local coverage. Even a modest reallocation of current funding within the BBC could see substantial increases for radio and related services, for example, a reallocation of one per cent of the total BBC budget for 2005 would be equivalent to a 5.8 per cent increase in expenditure on BBC radio.

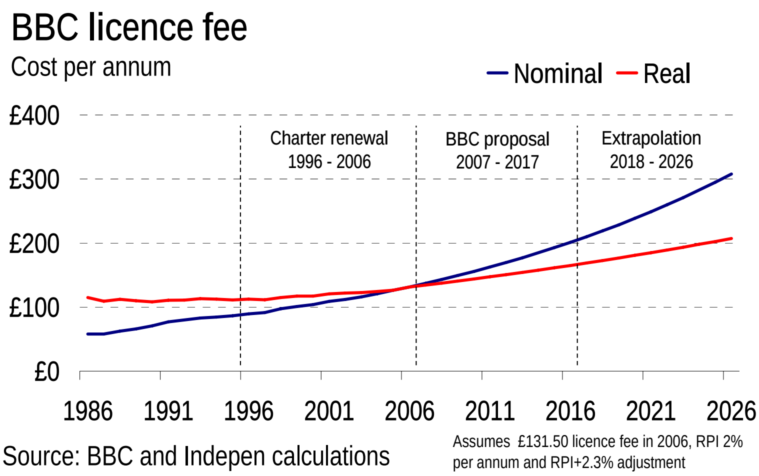
Looking ahead, the BBC's proposals for its future funding provide for substantial (2.3 per cent per annum) real increases in the licence fee and so the BBC's overall funding. Figure 2.2 shows the

[11] Phillipa Marks and Paul Grout. February 2004. "Radio Mergers Are Not Substantial: The impact of the Communications Act and the Enterprise Act on radio mergers." Report for the Commercial Radio Companies Association. http://www.indepen.co.uk/panda/docs/RadioMergers-Final.pdf

[12] BBC. June 2005. Annual report and accounts 2004/2005. http://www.bbcgovernors.co.uk/annreport/report05/BBC_2004_05.pdf

historical licence fee, the increase proposed by the BBC during the current Charter and a projection based on the proposed rate of real increase.[13]

**Figure 2.2**




Whilst the public rationale for this has been the need to fund digital switchover of terrestrial television only part of the funding is required for this purpose. The overall resources available to the BBC will therefore steadily increase out to 2013/14. This is very different to the historical picture where the licence fee has been more or less constant in real terms with periodic increases offset by inflation on average. Real growth of 2.3 per cent per annum in the licence fee also implies that the licence fee represents a growing proportion of household income in the medium term, based on the long term real growth assumption used by HM-Treasury of 2 per cent per annum.[14]

## 2.4 BBC radio competes unfairly for scarce inputs

Not only does the BBC compete for audience share, it also competes for scarce inputs with commercial radio, bidding up their cost. Examples of this are provided by experience in the market for radio announcers and journalists, and the market for content.

In the market for talent the overwhelming flow is from commercial radio to the BBC. In other words, commercial radio is the industry training ground, but the BBC is able to outbid commercial radio for talent once commercial radio has invested in creating it. In terms of presenters who started out in commercial radio before moving to the BBC an illustrative example is Chris Moyles, whilst in terms of journalists and an illustrative example is Peter Allen.

Radio sports coverage rights are almost always purchased by the BBC at prices that commercial radio is unable to match based on commercial advertising revenues. This means that the payment for radio sports rights is inflated by publicly subsidy in excess of the rights' underlying commercial value.

## 2.5 Forgone innovation involves large social losses

The growth and dominance of BBC radio, its secure and growing funding base and the impact of the BBC's conduct on the cost of scarce inputs harm the prospects for growth, innovation and investment by commercial radio.

---

[13] The base year for the real estimates is 2005 and the inflation assumption of 2 per cent per annum is based on the mid-point of the Bank of England's inflation target range of 1-3 per cent per annum.

[14] HM-Treasury. December 2005. "Long-term public finance report: an analysis of fiscal sustainability." http://www.hm-treasury.gov.uk/media/F59/32/pbr05_longterm_513.pdf

Innovation, in terms of the introduction of new services, can involve substantial increases in consumer welfare since their willingness to pay for such services may greatly exceed their cost. Where innovation is foregone or delayed, the cost to society can therefore be large.

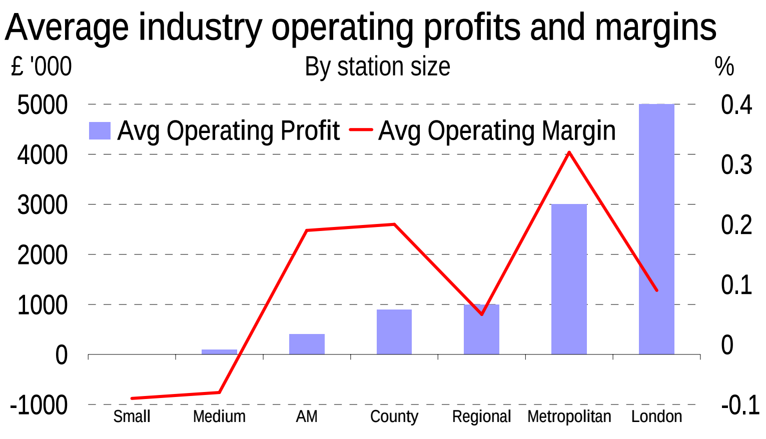
For example, Hausmann (1997) considered the impact of regulatory delay on the net present value of new services and found that the welfare costs of delay can be very large (Hausmann provides an estimate of $33.5 billion for delays to mobile telephony in the US due to regulation).[15] Another study by Goolsbee (2006) also concluded that the costs of delay can be high relative to conventional estimates of economic costs due to market distortions.[16]

The scope for future innovation by commercial radio, and the extent to which such innovation may be foregone if BBC radio is not constrained in some way, are necessarily uncertain. The key point is that commercial radio, and new and existing business that have prospered with the support of radio advertising, will be harmed if the BBC is not constrained with potentially large losses to social welfare.

## 2.6 Segments of the commercial radio market are threatened by the growth of the BBC

Figure 2.3 shows the profitability of commercial radio in terms of average operating profit (the bars) and average operating margin (the line) for different scales and locations from small station size to London stations.[17]

**Figure 2.3**




Source: Ofcom

In Figure 2.3 the radio industry is segmented by size of station on the following basis:

- small: local licences typically serving less than 150,000 adults (aged 15+);
- medium: local licences typically serving between 150,000 and 350,000 adults;
- AM: local stations broadcasting on medium wave (MW);
- county: covering either large towns or county wide locations, with greater than 350,000 adults;

[15] Jerry Hausmann. 1997. "Valuing the effect of regulation on new services in telecommunications." Brookings Papers on Economic Activity. Microeconomics.

[16] Austan Goolsbee. January 2006. "The value of broadband and the deadweight loss of taxing new technology." National Bureau of Economic Research Working Paper 11994.

[17] Ofcom. 2004. "Radio – preparing for the future." Phase 1 – developing a new framework. http://www.ofcom.org.uk/consult/condocs/radio_review/radio_review2/radio_review.pdf

- metropolitan: licences covering a metropolitan urban location (excluding London);
- regional: licences covering a region of the UK; and
- London: licences covering the whole of the London area.

While operating profits are highest in London, which has the highest population coverage and so greatest revenue potential, the level of competition there keeps average margins lower than in metropolitan areas outside London, where competition is not so great. Small stations are the least profitable, with a negative average operating margin of around -9 per cent of revenue.

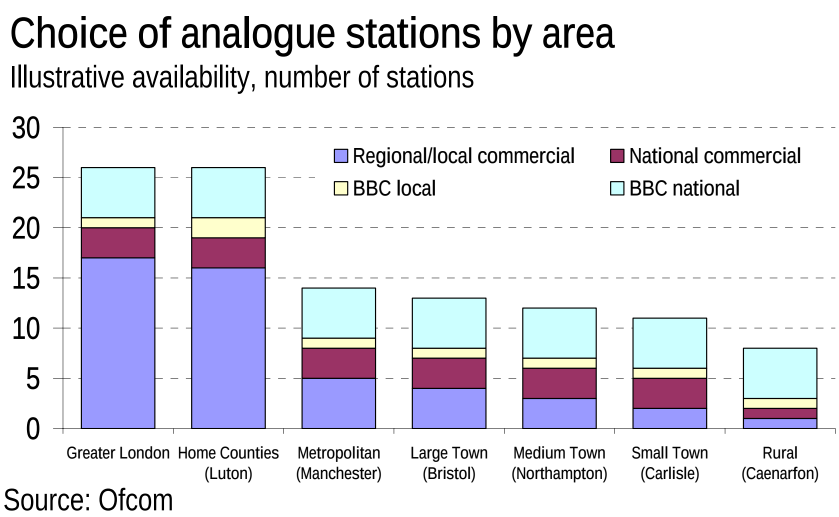
There is considerable variation in the profitability of smaller stations, with around 50 per cent of them making an operating profit and 50 per cent a loss at the time of the Ofcom review in 2004. Even if stations that have been on air less than three years are excluded (to take account of potential start-up losses), the proportion of small stations making a loss is still around 50 per cent. The same is true of the medium-sized stations.

Digital radio currently has very few listeners despite considerable investment in services, and so is loss making. This is expected to continue to be the case for some time. The ability of companies to fund this investment in digital radio depends on their analogue services being profitable.

## 2.7 Plurality could suffer

Figure 2.4 shows that the number of commercial radio stations is particularly small relative to the number provided by the BBC in small towns and rural locations.

**Figure 2.4**




It is at the local level that the BBC is investing in further radio stations and where the profitability of commercial radio is weakest. Competition for audience share could therefore undermine the viability of commercial radio in rural areas and smaller towns, leading to a loss of plurality. This outcome is more likely given guidance which constrains mergers of commercial radio stations and treats the relevant market as the narrow radio market (rather than considering competition from other media and the internet).[18]

[18] Phillipa Marks and Paul Grout. February 2004. "Radio Mergers Are Not Substantial: The impact of the Communications Act and the Enterprise Act on radio mergers." Report for the Commercial Radio Companies Association. http://www.indepen.co.uk/panda/docs/RadioMergers-Final.pdf

# 3 Conclusion: A prescription for the licence fee

## 3.1 Accountability of the BBC

The BBC is a publicly funded body, paid for directly with each household television licence. It is constitutionally established by a Royal Charter, with an accompanying agreement that recognises its editorial independence and sets out its public obligations in detail. Responsibility for ensuring that the BBC meets these obligations and delivers 'public value' effectively under the existing charter period (1996-2006) lies with the Board of Governors, whose main role is to ensure that the BBC remains independent of political and commercial interference and is run solely in the interests of viewers and listeners. The BBC also publishes an annual report detailing financial expenditure and various outcomes.

However, in contrast to other publicly funded bodies the BBC is not consistently monitored by the National Audit Office (NAO), which typically audits the accounts of central government departments and agencies, as well as a wide range of other public bodies, and reports to Parliament on the economy, efficiency and effectiveness with which they have used public money.

Under an agreement, the BBC Governors' Audit Committee can invite the NAO to carry out value for money reviews on a non-statutory basis. However, the NAO cannot operate independently in choosing topics to examine and the limited rights of access to obtain information restricts the level of the value for money assessment that can be made. The House of Commons Committee of Public Accounts notes that:[19]

> *"a number of organisations operating at arms length from Government, such as Ofcom, are held accountable to Parliament without any suggestion that this undermines their independence from Government. Independent scrutiny of the BBC…on behalf of Parliament would support rather than threaten the BBC's independence from Government."*

The lack of public accountability is also reflected in the difficulty faced in interpreting the accounts over published by the BBC over time. Differences in methodology and reporting mean that a consistent time series of expenditure is not easily obtained. This has been acknowledged by Ofcom who noted that:[20]

> *"...until 5 years ago the BBC spent more money on radio than was received by all of the commercial stations combined. BBC spending appeared to decline in 2003, although this is partly due to a change in the way the figures are presented in the BBC's accounts."*

## 3.2 Declining legitimacy of an increasing licence fee

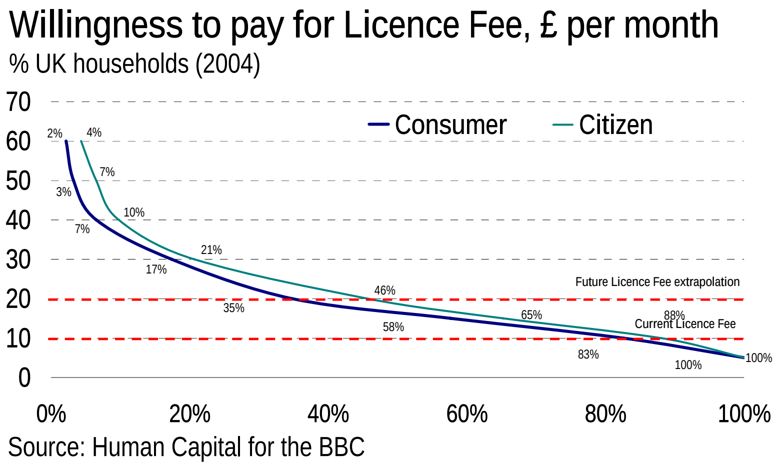
The threat to the vibrancy, potential for innovation and plurality of commercial radio stems from both the BBC's dominance in the market and the risk this implies for commercial radio. The level of the overall licence fee settlement as part of the current Charter review can be only part of the answer, though the BBC's proposals may push the limits of the legitimacy of the licence fee if an ever declining proportion of the population consider the fee value for money in future (as illustrated by Figure 3.1).[21]

[19] House of Commons Committee of Public Accounts. January 2005. "The BBC's investment in Freeview: Third report of session 2004-05." Report, together with formal minutes, oral and written evidence.

[20] Ofcom. December 2004. "Radio – Preparing for the future Phase 1 developing a new framework." http://www.ofcom.org.uk/consult/condocs/radio_review/radio_review2/radio_review.pdf

[21] The BBC and Human Capital. October 2004. "Measuring the Value of the BBC." http://www.bbc.co.uk/thefuture/pdfs/value_bbc.pdf

**Figure 3.1**




Assuming willingness to pay remains constant over time, a declining proportion of the population will value the consumer and citizen benefits from the licence fee at more than the level of the licence fee in future. Whilst 88 per cent of consumers are willing to pay the current licence fee allowing for citizen benefits, only 46 per cent would be willing to pay a licence fee of twice the current level allowing for citizen benefits, the position reached by 2026 (the proportions are smaller when private benefits alone are considered). The forgoing percentages amount to approximately 20 million out of 22.5 million households today, and 12 million out of 26 million households in 2026.

## 3.3 Reducing the scope of BBC radio

One option for scaling back the impact of the BBC on commercial radio would be to sell the BBC's own "commercial" services, namely Radio 1 and 2. To the extent that these services deliver public value they could continue to do so as part of the commercial sector, which has introduced many of the innovations at the community level that meet the criteria identified in relation to public value.

As noted in Section 2, the original rationale for the entry of BBC into formats such as Radio 1 in 1967 was to counter the loss of listening caused by North Sea pirate stations, a rationale that no longer applies following the introduction of licensed commercial radio services in 1973. Further, as Ofcom note:[22]

> *"As digital take-up progresses and a larger number of services becomes available to all listeners, there may be reduced grounds for intervention. But even then, we believe that the market alone would not deliver all that citizens and consumers expect of radio." Page 126.*

## 3.4 Managing the risk to innovation and plurality via ring fencing

Another approach to managing the risk that a generously funded BBC presents to commercial radio, and to innovation and plurality, would be to provide some confidence over the future extent of activity in the radio market by the BBC. This would require the following related changes flowing from the Charter review:

i. Ring fencing of the allocation of funds for BBC radio as a part of the overall settlement

ii. A cap on spending in real terms

[22] Ofcom. 2004. "Radio – preparing for the future." Phase 1 – developing a new framework. http://www.ofcom.org.uk/consult/condocs/radio_review/radio_review2/radio_review.pdf

To ensure that this policy is effective, we propose that the BBC adopt a consistent approach to accounting for the costs of individual services including overheads over time, and that the Comptroller and Auditor General of the NAO be authorised to scrutinise how the BBC spends public money (as proposed by the House of Commons Committee of Public Accounts in January 2005). Given changes in the basis for, and level of radio funding in the BBC accounts, an agreed approach and independent audit would be required to ensure that ring fencing was transparent and credible.

While we do not propose a specific level for the amount of public money that should be spent on radio services, this could be determined via an assessment of new and existing BBC radio services using the public value tests applied by the BBC. In carrying out an assessment, the contribution of commercial radio to public value should be assessed alongside BBC radio services.

The outcome of such a reappraisal should not preclude the possibility of transferring services that essentially mimic the format of commercial services to the commercial sector, in order to reduce the dominance of the BBC, reinvigorate the sector and promote innovation.