



# Appraising the proposed BBC licence fee increase

A report by Indepen for ITV  
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## Executive Summary

### The BBC proposal

The BBC proposes that the level of the licence fee be increased from the current level of £131.50 by 2.3 per cent per annum above inflation over the next seven years, in other words an increase of 4.3 per cent per annum assuming inflation of 2 per cent.

The proposed licence fee increase not only exceeds anticipated inflation, but also exceeds the HM-Treasury forecast rate of growth in income per household, in other words affordability would decline over the settlement period. The impact of this would be most pronounced for those on low incomes.

In terms of revenue, household growth adds an additional 0.7 per cent per annum on top of the licence fee, based on household growth projections published by the Department for Communities and Local Government. This would contribute £640-790 million over the next seven years for a licence fee increase in the range 0-4.3 per cent per annum, sufficient to cover the £640 million - which PKF argue is overstated - for the BBC’s projected “non-discretionary” costs relating to digital switchover, building up the digital terrestrial network and extending national DAB radio coverage.

Assuming the licence fee increases inline with the BBC’s assumptions, our estimate of an additional £790 million due to household growth exceeds the BBC estimate of £700 million. Due to the lack of transparency in the BBC’s estimates we do not know how they calculated an estimate of £700 million for the contribution of household growth. However, the BBC do refer to an estimate of the number of households in 2002 in “Delivering Public Value - Supporting Information”. If a lower number of households were applied as a baseline in calculating the contribution of household growth this would yield a lower increment in revenues.

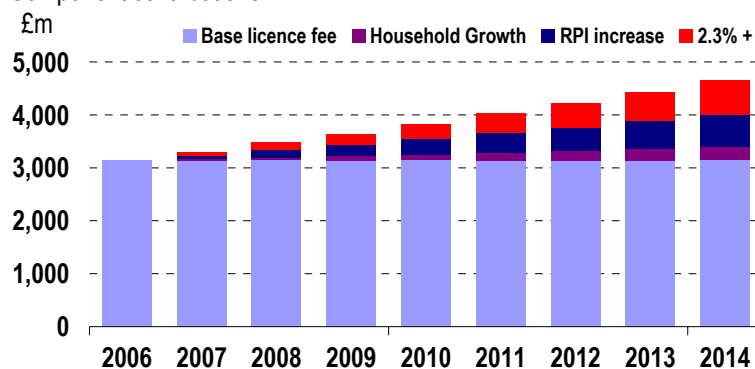
After allowing for the fact that household growth covers digital switchover costs without a need to raise the licence fee, the key policy question is what level of licence fee is required to enable the BBC to change its output mix and meet its objectives.

If the BBC only achieves the economy wide average rate of productivity growth of 2 per cent per annum, then an inflation indexed licence fee would be required i.e. RPI + 0. Should the BBC achieve higher productivity growth, more in line with ICT-intensive sectors of the economy, then the requirement falls to RPI-2 i.e. a fixed nominal licence fee of £131.50 would be adequate.

In contrast, the BBC is asking for an increase in the licence fee of RPI+2.3%, or 4.3 per cent per annum nominal in addition to the revenue contribution from household growth (see figure below).

### BBC Licence fee revenue projection

Component contributions



Source: BBC and Indepen calculations



Discussion about an appropriate level of funding to meet the needs of the BBC should be focused on a settlement in the range 0-2 per cent per annum nominal. In reaching a settlement, however, account should be taken of the potential impact on innovation and plurality in the commercial sector alongside consideration of what the BBC needs.

### **Potential adverse impact on innovation and plurality**

The proposed increase in funding and scope of the BBC's activities would impact on the commercial sector and on innovation, investment and plurality. Competition may also suffer if the BBC becomes too dominant. The BBC competes with the commercial sector in the following ways:

- the BBC competes for audience share which in turn determines the potential to raise advertising revenue by commercial broadcasters
- the BBC competes for scarce inputs such as talent and may act as a price leader
- the BBC introduces new services which are free to users and competes with private innovations supported by subscription or advertising models
- the television licence fee takes a slice of money out of households' budgets that might otherwise be spent on other communications and broadcasting services.

Potentially the largest impact of substantial increases in funding and a relatively unconstrained expansion in scope of the BBC's activities would be the crowding out of innovation and investment in new services by the commercial sector. Commercial investors will be wary of innovating and contributing to a creative future and "Digital Britain" if they risk competition from free services supported by the licence fee.

### **Evaluating the funding needs of the BBC**

Given the inherent problems in detailed "bottom-up" appraisal due to information asymmetries, the reasonableness of the BBC proposal can be evaluated using a "top-down" approach as follows:

- 1 Evaluate any change in the scope of the BBC's outputs which might justify additional funding.
- 2 Evaluate any sources of natural income growth.
- 3 Compare the proposed increase in the licence fee, after allowance for the above two items, with the rate of final consumer price increase in the economy generally.
- 4 Compare assumed input price growth and productivity growth with the economy as a whole. This step constitutes a more detailed examination of the one above.
- 5 Evaluate affordability relative to income growth and value for money relative to willingness to pay and public value.

The intended and unintended impacts of the proposal should also be evaluated.

The contribution of household growth on revenues is more than sufficient to cover the costs of "Digital Britain" in terms of digital switchover. This leaves the question of what level of licence fee is required to fund the BBC after allowance for digital switchover.

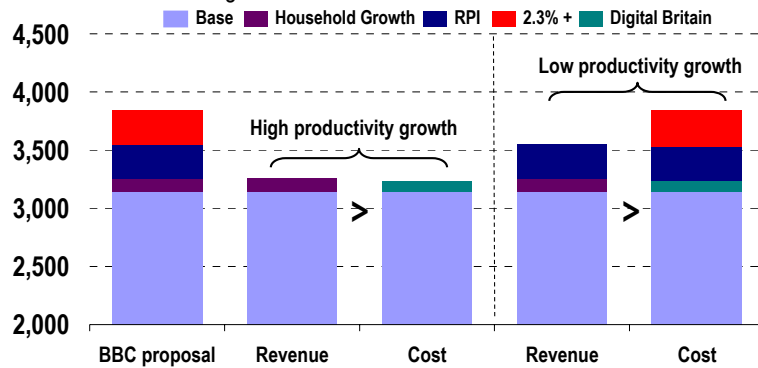
If the BBC only achieves the economy wide average rate of productivity growth of 2 per cent per annum, then an inflation indexed licence fee would be required i.e. RPI + 0. Should the BBC achieve higher productivity growth, more in line with ICT-intensive sectors of the economy, then the requirement falls to RPI-2 i.e. a fixed annum nominal licence fee would be sufficient.



The following figure illustrates our top down analysis of the BBC's needs after allowance for digital switchover and household growth under high and low productivity growth assumptions. Our assumption is that a settlement in this range would not be expected to generate the superinflation of input costs that a higher settlement might produce, and which the BBC argues is part of the reason it needs an above inflation settlement.

### Assessing the BBC's funding needs

£ million - annual average



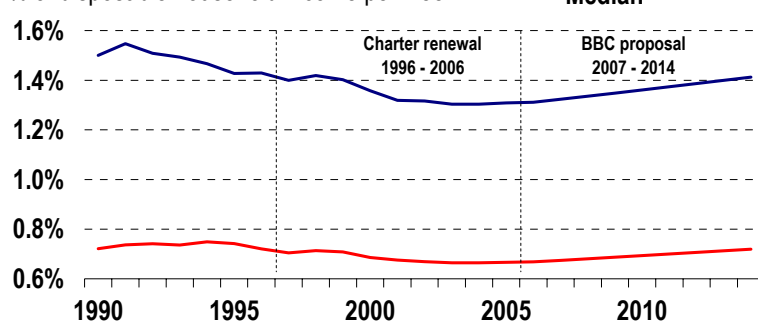
Source: BBC and Indepen calculations

In addition to looking at need, we have also examined the impact on affordability of the proposed increase of 4.3 per cent per annum in nominal terms. The proposed increase exceeds the HM-Treasury forecast rate of growth in income per household, in other words affordability would decline over the settlement period. This contrasts with the BBC claim that affordability would improve under their proposals using a simple projection of rates of household income growth based on unsustainable rates of increase over the past five years.

The effect this would be most pronounced for those on low incomes as the following figure, showing the impact for those on the lowest 10 per cent of income and those on median incomes, illustrates.

### BBC licence fee

% of disposable household income per week



Assumes £131.50 licence fee in 2006, RPI 2% per annum and RPI+2.3% adjustment, and real income growth 1.3% per annum

Source: BBC, DWP Households Below Average Income

Discussion about an appropriate level of funding to meet the needs of the BBC should therefore in our view focus on a settlement in the range RPI-2 to RPI+0, or 0 to 2 per cent per annum nominal versus the BBC proposal for a 4.3 per cent per annum nominal increase. In contrast to the BBC proposal which would see reduced affordability over time, a settlement in the range RPI-2 to RPI+0 would see improved affordability over time.

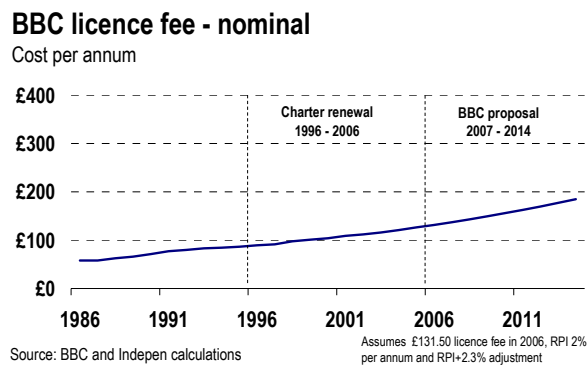


# 1 What is proposed by the BBC?

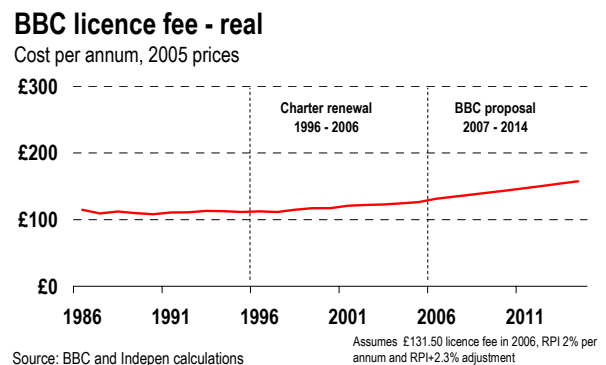
The BBC proposes that the level of the licence fee be increased from the current level of £131.50 by 2.3 per cent per annum above inflation over the next seven years, while the Government has confirmed licence fee funding for the next ten years. In nominal terms, the increase would be around 4.3 per cent per annum, assuming the Bank of England achieves its target rate of inflation of 2 per cent per annum.<sup>1</sup> The proposals therefore represent a substantial increase in the level of the licence fee.

Figure 1.1 shows the anticipated nominal increase extrapolated out to 2014 based on proposed growth of RPI+2.3 per cent and inflation of 2 per cent per annum. Figure 1.2 shows the anticipated increase in real terms, leaving aside the impact of inflation.

**Figure 1.1**



**Figure 1.2**



The BBC proposal is based on a required additional £6 billion of expenditure over the next seven years to cover a range of services. Of this £6 billion, the BBC proposes to 'self-fund' £3.9 billion through efficiency savings, enhanced collection, household growth and commercial dividends. The remaining £2.1 billion is to be met by the licence fee increase.

Figure 1.3 shows the anticipated increase in BBC licence fee revenue allowing for household growth, growth in retail prices (the RPI) and the proposed real increase of 2.3 per cent per annum.

<sup>1</sup> The BBC licence fee has been reclassified as a tax by the Office of National Statistics (ONS).

"All of the changes to the basket in 2006 affect both the CPI and RPI indices with the exception of the television licence fee. Following the recent reclassification of the television licence fee as a tax in the UK National Accounts, this item now falls outside the scope of the CPI and will no longer be included in its calculation from 2006 onwards. This reclassification does not have any implications for the RPI, which includes other taxes such as council tax and vehicle excise duty (VED)."

[http://www.statistics.gov.uk/downloads/theme\\_social/Social\\_Trends36/ST36\\_Ch05.pdf](http://www.statistics.gov.uk/downloads/theme_social/Social_Trends36/ST36_Ch05.pdf) Chapter 5, Page 68



Figure 1.3

**BBC Licence fee revenue projection**

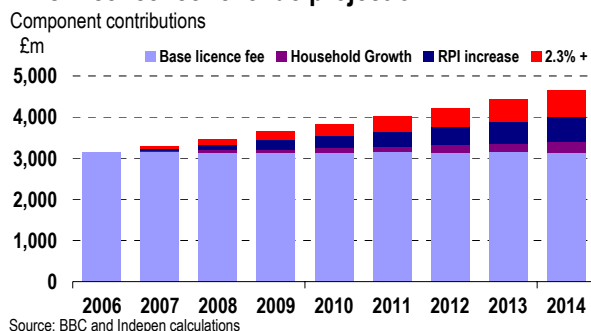


Table 1.1 sets out the elements of the proposed additional £6 billion of funding in nominal terms over 7 years, which will be facilitated by the RPI+2.3% increase in the licence fee.<sup>2</sup>

Table 1.1

Category	£ billion
<b>Content quality</b> , which involves improving broadcast output, for example cutting television repeats in favour of new programmes and placing more emphasis on educational output and global journalism.	1.6
<b>Digital services</b> , which includes making television shows available online and providing on-demand access to archived radio and television programmes.	1.2
<b>Local relevance</b> , which pertains to making the BBC more reflective of its UK audiences, by commissioning regional programmes and adding new local services, but also includes moving departments to a new broadcast centre in Manchester. In addition, the BBC proposes to create a new television region for central England.	0.6
<b>Digital infrastructure</b> . In accordance with the planned digital switchover by 2012, the BBC proposes to spend £700 million on encouraging the public to get to grips with digital technology. However, it is also keen to invest in high definition television, noting that “ <i>Sky is planning to launch its own HDTV service next year.</i> ” <sup>3</sup>	0.7
<b>Base costs</b> increase. Base costs include additional spending on sports rights and other broadcast rights, such as certain pieces of music. It also includes the price of paying on-air talent and increases in other staff salaries and pensions.	1.4
Additional <b>digital switchover costs</b> , which includes £200 million for Digital UK (Switchco) and £300 million for spectrum charges which may be imposed post-switchover.	0.5
<b>Total</b>	6.0

<sup>2</sup> BBC News. 11 October 2005. “What would a licence fee rise fund?” [http://news.bbc.co.uk/1/hi/entertainment/tv\\_and\\_radio/4330272.stm](http://news.bbc.co.uk/1/hi/entertainment/tv_and_radio/4330272.stm)

<sup>3</sup> BBC News. 11 October 2005. “What would a licence fee rise fund?” [http://news.bbc.co.uk/1/hi/entertainment/tv\\_and\\_radio/4330272.stm](http://news.bbc.co.uk/1/hi/entertainment/tv_and_radio/4330272.stm)



## 2 Competition, innovation and plurality

The proposal for additional funding should be considered in the context of its impact on the wider broadcast industry. The White Paper acknowledges this tension:<sup>4</sup>

*“...we also need to ensure that, in the interests of the public and the rest of the broadcasting world, commercial public service broadcasters such as ITV, Channel 4 and Five, commercial services like sky and commercial radio stations, and the wider industry all flourish too. The relationship between the BBC and those others has been the subject of intense debate for fifty years. And at the heart of that debate has been a conundrum – how can the BBC be a strong broadcaster with universal reach while not stifling innovation elsewhere or using its unique advantages unfairly to compete with others?”*

The BBC proposes both additional funding for traditional broadcasting (for example content quality) and for new forms of content and delivery channels in relation to podcasting and broadband (for example, the proposed BBCiPlayer which will allow people to view BBC programmes on demand for seven days after transmission).<sup>5</sup> A substantial part of this is additional to funding requested in relation to digital switchover.

Whilst the contribution of the BBC to quality programming and innovation can be a good thing, a substantial increase in funding and relatively unconstrained expansion into new forms of content and delivery platforms can be expected to crowd out commercial innovation and potentially act to undermine competition and plurality.

### 2.1 How BBC “competes” with commercial broadcasters

The BBC “competes” with commercial broadcasters and new media in four ways:

- the BBC competes for audience share which in turn determines the potential to raise advertising revenue by commercial broadcasters
- the BBC competes for scarce inputs such as talent and may act as a price leader
- the BBC introduces new services which are free to users and compete with private innovations supported by subscription or advertising models
- the television licence fee takes a slice of money out of households’ budgets that might otherwise be spent on other communications and broadcasting services.

#### 2.1.1 Competition for audience share and revenue

Figure 2.1 illustrates the significance of licence fee revenue relative to advertising revenue for other broadcasters. The proposed increase of RPI+2.3 per cent per annum would increase the disparity.

<sup>4</sup> DCMS. March 2006. “A public service for all: the BBC in the digital age.”

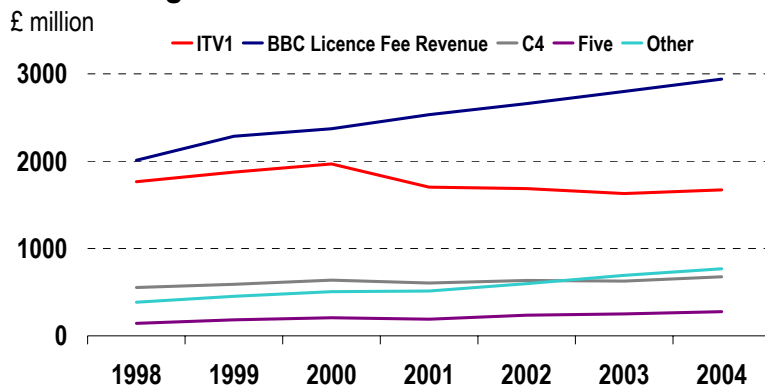
<sup>5</sup> Mark Thompson. 25 April 2006. Royal Television Society Fleming Memorial Lecture 2006: Creative Future – The BBC and content in an on-demand world. [http://www.bbc.co.uk/pressoffice/speeches/stories/thompson\\_fleming.shtml](http://www.bbc.co.uk/pressoffice/speeches/stories/thompson_fleming.shtml)

See also, commenting on the lecture: The Times. 26 April 2006. “How the BBC will remake itself to persuade the young to tune in.”



Figure 2.1

## Advertising and licence fee revenue



Source: BBC Annual Reports, Zenith Optimedia

The BBC is also able to offer services supported by the licence fee free of advertising and free of charge. This is attractive to consumers and also conditions them to expect the availability of content and new services free of charge. This environment increases the commercial risk for anyone attempting to launch an advertising or subscription based service.

### 2.1.2 Competition for scarce inputs

At the last settlement the BBC successfully sought increased funding to cover increases in the price of inputs. In part, this was justified against an assumed backdrop of growing commercial revenues and therefore pressure on prices of talent, premium content and outsourced production.

As Figure 2.2 shows much of the pressure in terms of overall revenue growth in the sector has come from the BBC itself rather than from the commercial sector. Increased funding appears in part to be fuelling the superinflation it is designed to offset. This issue has been highlighted by recent disclosures in relation to salaries paid by the BBC to star presenters.<sup>6</sup>

The potential problem has been recognised. The Secretary for Culture, Media and Sport noted before the House of Lords select committee on the BBC's charter review that:<sup>7</sup>

*"One of the questions I think we need to interrogate is the extent to which the cost of other broadcasters are led by the costs of the BBC."*

In economic terms this problem arises whenever the supply of an input is "inelastic" i.e. it is not that responsive to an increase in price in the short to medium term. Recent experience in the health sector has also highlighted this problem, with substantial real increases in funding fuelling increased input prices and costs, and therefore less additional output than might have been anticipated.

Figure 2.2 shows average staff costs for ITV and Sky versus the BBC. The steady increase in average staff costs for the BBC relative to the commercial sector will make it more difficult for the commercial sector to attract talented staff and/or raise their costs. The proposed increase in the licence fee would likely exacerbate this trend.

<sup>6</sup> The Guardian. 19 April 2006. "Fear, loathing and envy at the BBC as mole spills salary secrets of radio stars."

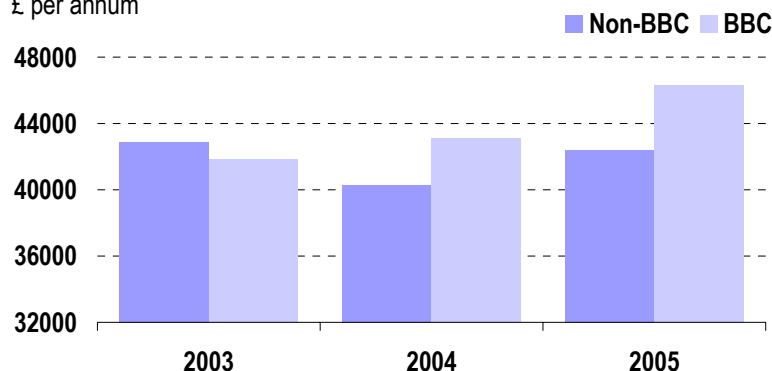
<sup>7</sup> The Times. 21 March 2006.



Figure 2.2

### Average staff costs

£ per annum



Source: BBC annual reports and industry estimate

### 2.1.3 Crowding out of innovation

Potentially the largest impact of substantial increases in funding and a relatively unconstrained expansion in scope of the BBC's activities would be the crowding out of innovation and investment in new services by the commercial sector. Commercial investors will be wary of innovating and contributing to a creative future and "Digital Britain" if they risk competition from free services supported by the licence fee.

In particular, the internet has greatly increased the scope for individuals and small groups of people to create "start-ups", experiment with new business models and, when successful, to grow the business very quickly. Google is a clear example. Even at the best of times, doing so is a risky enterprise. A rapidly growing BBC would increase such risks considerably.

The economic costs of foregone, or simply delayed innovation, can be very 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).<sup>8</sup> 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.<sup>9</sup>

Whilst the BBC has produced some very high quality content and services around the BBC website, the success of broadband and the internet are not dependent on this. The old chicken and egg argument that broadband content is required for broadband penetration no longer applies. The range of information and services available on the internet globally, including enhanced search, online shopping and services, and file sharing are driving the rapid take-up of broadband. Figure 2.3 shows the accelerating growth in broadband in the UK versus the OECD.<sup>10</sup>

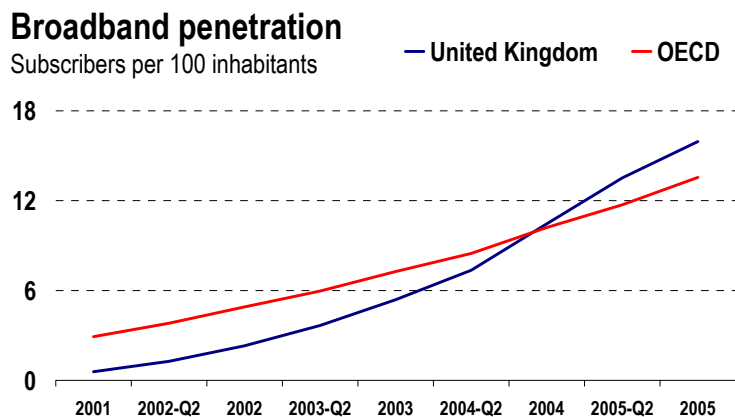
<sup>8</sup> Jerry Hausmann. 1997. "Valuing the effect of regulation on new services in telecommunications." Brookings Papers on Economic Activity. Microeconomics.

<sup>9</sup> Austan Goolsbee. January 2006. "The value of broadband and the deadweight loss of taxing new technology." National Bureau of Economic Research Working Paper 11994.

<sup>10</sup> OECD. April 2006. "OECD Broadband Statistics, December 2006."  
[http://www.oecd.org/document/39/0,2340,en\\_2649\\_201185\\_36459431\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/39/0,2340,en_2649_201185_36459431_1_1_1_1,00.html)



Figure 2.3



The growth in broadband should be viewed as a platform to promote innovation and creativity in the UK, rather than as something requiring a strengthened BBC.

The fact that dominance and the threat of entry into new markets can deter innovation is demonstrated by behaviour in the commercial sector where successful companies take care to promote an innovative environment by committing *not to enter* every new niche. This is illustrated by in the following box which summarises the findings of an academic study of Intel, a manufacturer of PC processors.<sup>11</sup>

#### How Intel promotes innovation by committing not to enter and dominate new markets

Intel's behaviour is strongly conditioned by the firm's belief that because it cannot match the variety of competencies of potential entrants, sustaining a credible commitment not to engage in an "ex-post squeeze" of entrants is critical to its success. Intel seeks to achieve such commitment in three ways.

First, it uses an internal organisation structure (separate divisions and profit and loss operations) and a widely publicised rhetorical device to distinguish between the task of expanding demand for microprocessors and growing profitable businesses in complementary markets respectively to signal that it expects both Intel and its competitors to make money in complementary markets.

Secondly, it subsidises entry for all potential entrants, predominantly via widespread dissemination of intellectual property. Thirdly, it attempts to commit to these subsidies through the creation of a separate organisational unit (The Intel Architecture Lab) which is structured as a cost centre and rewarded for its success in promoting the health of the ecosystem as a whole, or for stimulating the demand for microprocessors.

#### 2.1.4 Pressure on household budgets

The licence fee reduces household income available for other purposes. The licence fee is around 0.7 per cent of household disposable income for median income households and 1.4 per cent of household disposable for those households with the lowest 10 per cent of income.

As a proportion of disposable income after "non-discretionary" expenditure on housing, food, non-alcoholic beverages, clothing and footwear, transport, energy and education – the percentages are roughly 1 per cent for median income households and 3 per cent for households on the lowest 10 per

<sup>11</sup> Gawer and Henderson. December 2005. "Platform owner entry and innovation in complementary markets: evidence from Intel." National Bureau of Economic Research Working Paper 11852.



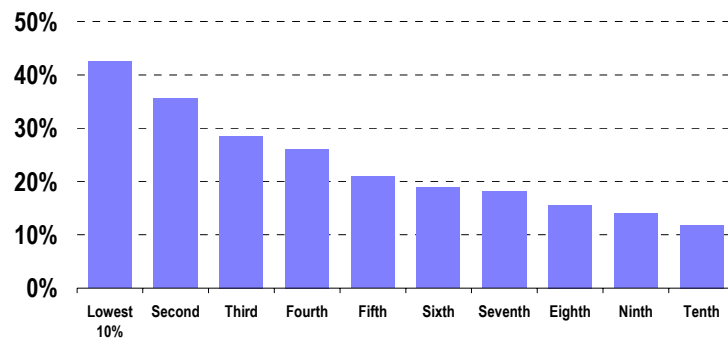
cent of income. Under the BBC’s proposals these shares would rise over the settlement period since forecast household income growth is expected to be lower than growth in the level of the licence fee.

Finally, we note that as a share of household budget expenditure on communications services, the licence fee is substantial and additional to other new categories of expenditure such as broadband subscriptions. Figure 2.4 shows the level of the current licence fee relative to current household expenditure on “communications” (adjusted to 2006 terms by inflating at 4 per cent per annum).

**Figure 2.4**

**BBC licence fee 2006**

% of communications expenditure



Source: ONS, Family spending 2004-2005

Figure 2.3 shows that the BBC licence fee represents an increasing level of household expenditure on communications for households in lower income categories. For households in the lowest 10 per cent of income category, the BBC licence fee accounts for over 40 per cent of expenditure on communications, compared to just over 10 per cent for households in the highest 10 per cent of income category.



### 3 How should the proposed licence fee increase be assessed?

Decision makers face a difficult task in appraising the reasonableness of the BBC proposals to increase the BBC licence fee. They can either analyse the detailed proposals, or use various benchmarks to assess their reasonableness.

DCMS commissioned an appraisal of the BBC proposals by PKF, which was published on 26 April 2006.<sup>12</sup> Whilst this provides a detailed assessment of the BBC proposals, the difficulties inherent in the “information asymmetry” between the BBC and those appraising its budget proposals (and between the BBC Board, senior management and managers) over funding needs nevertheless remain.

In this section we propose a number of “high-level” or “top-down” benchmarks to assist in assessing the BBC’s needs in terms of funding. In general these benchmarks focus on identifying reasonable bounds on future changes in the licence fee, taking the current level as given. The current base level is arguably generous already, given that unanticipated revenue growth occurred on top of a settlement that Chris Smith described in the House of Commons on 21 February 2000 as follows:

*“We believe that the licence fee settlement, together with self-help, should yield enough to ensure that the BBC enhances established services and develops a significant foothold in the digital world”.*

#### 3.1 Alternative “top down” approaches to appraisal

Given the inherent problems in a detailed “bottom up” appraisal due to information asymmetries, it is usual practice (for example by regulatory authorities in the UK) to look for simple benchmarks that can inform a judgement over the reasonableness of requests for funding increases.

The approach we propose is as follows:

- 1 Evaluate any change in the scope of the BBC’s outputs which might justify additional funding.
- 2 Evaluate any sources of natural income growth.
- 3 Compare the proposed increase in the licence fee, after allowance for the above two items, with the rate of final consumer price increase in the economy generally.
- 4 Compare assumed input price growth and productivity growth with the economy as a whole. This step constitutes a more detailed examination of the one above.
- 5 Evaluate affordability relative to income growth and value for money relative to willingness to pay and public value.

Finally, as discussed in the previous chapter, intended and unintended impacts of the proposed increase should be evaluated.

##### 3.1.1 Changes in scope – new versus additional outputs

The BBC has a significant degree of discretion to change its output mix, and in the first instance one would expect new outputs to be funded via savings in relation to existing outputs. Everything that is new should not automatically be assumed to be additional.

<sup>12</sup> PKF. April 2006. “Review of the BBC value for money and efficiency programmes.”  
[http://www.bbccharterreview.org.uk/publications/cr\\_pubs/pub\\_fundingbbc.html](http://www.bbccharterreview.org.uk/publications/cr_pubs/pub_fundingbbc.html)



The position we adopt is that the costs associated with digital switchover are the clearest candidate for additional funding. Switchover is a big part of building digital Britain, which is one of the public purposes of the BBC. The BBC should be funded to do so (we note however that commercial investment in switchover is not similarly funded).

Table 3.1 summarises the costs associated with switchover.<sup>13</sup>

**Table 3.1**

	£ million
Contribution to SwitchCo to meet its marketing costs in particular	200
Building up the digital terrestrial network (to support Freeview)	338
Extending national DAB coverage	102
Setting up a free digital satellite platform (FreeSat)	43
Developing high definition television	138
<b>Total</b>	<b>821</b>

Of the costs in Table 3.1, £640 million is for “non-discretionary” costs associated with switchover. We use this estimate in concluding that incremental revenues from household growth will more than cover the costs of switchover.

The BBC also identify costs associated with possible future radio spectrum charges for broadcast spectrum. However, the existence, timing and magnitude of such charges is yet to be determined. The most appropriate response in these circumstances is not to build in an expectation of the charge, but to allow for a television licence fee settlement that recognises spectrum charges as a contingent item. Finally, we note that there will be additional costs associated with targeted help with digital switchover which are not included in the BBC’s licence fee bid.

### 3.2 Income growth due to growth in the number of households

The BBC estimate that household growth will provide an additional £700 million over the settlement period, in addition to any increase in the level of the licence fee.

Using the Department for Communities and Local Government estimate for the number of households in 2005, and applying a household growth rate of 0.7 per cent per annum, we calculate that household growth would contribute approximately £790 million assuming the licence fee increased inline with the BBC’s proposals and £640 million with no increase in the licence fee.<sup>14</sup> Due to the lack of transparency in the BBC’s estimates we do not know how they calculated an estimate of £700 million for the contribution of household growth.

However, the BBC do refer to an estimate of the number of households in 2002 in “Delivering Public Value - Supporting Information”.<sup>15</sup> If a lower number of households were applied as a baseline in calculating the contribution of household growth this would yield a lower increment in revenues.

<sup>13</sup> BBC. Undated. “Charter Review Briefing – the future funding of the BBC.” Provided by the Charter Review Team to ITV.

<sup>14</sup> Department for Communities and Local Government. 2006. “Live tables on household and population estimates and projections.” <http://www.odpm.gov.uk/index.asp?id=1156099>

<sup>15</sup> BBC. October 2005. “Delivering Public Value - Supporting Information.” Page 5. [http://www.bbc.co.uk/thefuture/pdfs/bbc\\_licence\\_information.pdf](http://www.bbc.co.uk/thefuture/pdfs/bbc_licence_information.pdf)



Household growth will not similarly drive costs of broadcast and internet services (in this respect the services differ from, say electricity, where household growth raises costs and revenues). Household growth is therefore more than sufficient to cover costs associated with digital switchover.

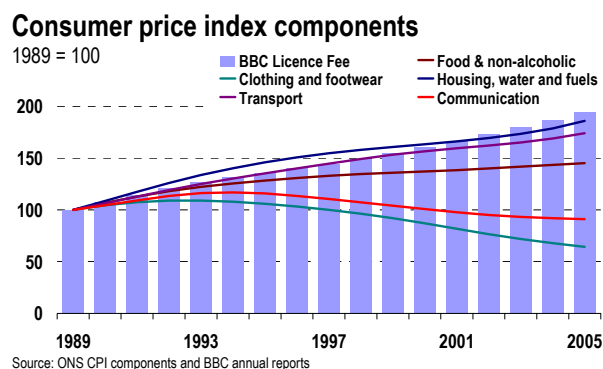
### 3.3 The proposed increase relative to inflation

Overall consumer price inflation represents the rate of change in the price of goods and services in the economy generally. If the price of a particular service is increasing faster than inflation then the price is increasing at a faster rate than average.

The 2000-2007 settlement included an increase in the licence fee of RPI+1.5 per cent, whilst the proposed increase is RPI+2.3 per cent per annum. Clearly these exceed the rate of increase in prices for goods and services across the economy as a whole.

In the recent past the BBC licence fee has increased relative to a range of other prices in the economy, and relative to inflation.

Figure 3.1



Output, or consumer, price growth would only be expected to exceed inflation if input price inflation were above average or productivity growth were below average compared to the economy as a whole since:<sup>16</sup>

$$\text{Consumer price inflation} = \text{input price inflation} \text{ minus } \text{productivity growth}$$

It is not on the face of it clear why the BBC should under-perform relative to the economy on either count. We now consider these two dimensions of inflation in somewhat greater detail.

#### 3.3.1 Input price inflation

The BBC identifies a need for an additional £1.4 billion in relation to base cost increases and refers to “*superinflation in broadcast costs to be funded by future BBC self-help.*” Some input prices, in particular wage costs, do increase faster than inflation. For example, if real wages growth averages 2 per cent per annum it will be offset by labour productivity growth of approximately 2 per cent per annum leaving an impact on output (consumer) prices identical to the inflation rate.

However, for the economy as a whole real wage growth is offset by productivity growth. Superinflation in the cost base should not be the result if the BBC achieves average levels of productivity growth.

<sup>16</sup> Bernstein and Sappington. 1999. “Setting the X Factor in Price-Cap Regulation Plans. *Journal of Regulatory Economics*. Volume 16(1).

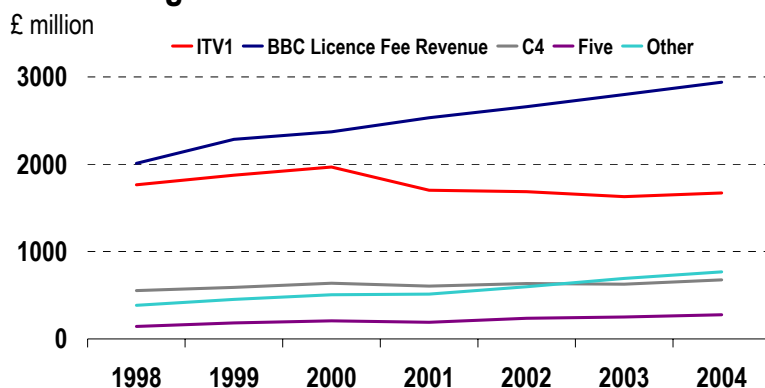


There is one further possible source of superinflation which is increased demand for specific inputs in the broadcasting sector itself where supply is inelastic i.e. it does not respond quickly or fully to an increase in demand. Likely examples include talent, premium content and elements of production.

At the last review it was thought that growth in commercial revenues would drive up input prices, however the licence fee itself was the primary source of real revenue growth in the market as illustrated in Figure 3.2.

Figure 3.2

### Advertising and licence fee revenue



Source: BBC Annual Reports, Zenith Optimedia

Concern has therefore grown that increased licence fee funding is itself a source of superinflation and therefore involves a self-fulfilling prophecy in terms of its impact on costs. This concern has been reinforced by recent revelations in relation to the price the BBC is willing to pay for talent (Section 2.1.2).

### 3.3.2 Productivity growth

Aside from the possibility that the increase in the licence fee itself is fuelling superinflation, the only alternative explanation (other than increased output) for above inflation increases in the licence fee is that the BBC expects to achieve lower productivity growth than the average for the economy as a whole.

Below average productivity growth would on the face of it be surprising given the scope for investment in information and communications technology (ICT) in the sector, and the high rates of productivity growth achieved in ICT intensive sectors of the economy.

Figure 3.3 shows trends in labour productivity per hour worked for the UK economy as whole and for the “communications” sector which includes broadcasting.<sup>17</sup>

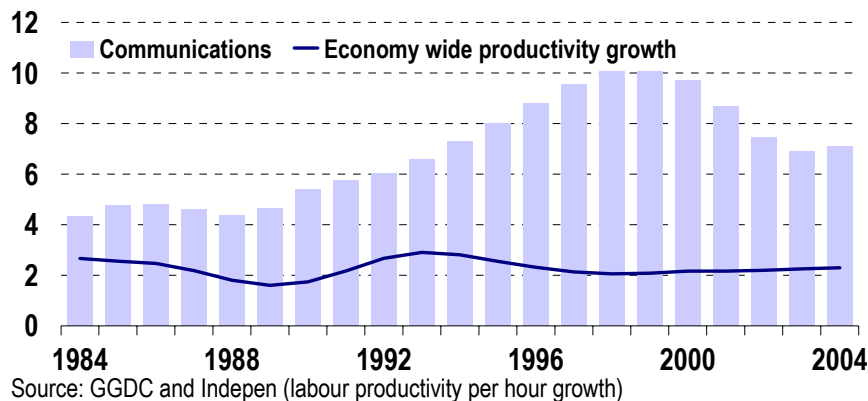
<sup>17</sup> Calculated using data from the Groningen Growth and Development Centre “60-Industry Database”. Smoothed trend calculated using Hodrick-Prescott filter.



Figure 3.3

## Communications productivity growth, UK

Compared to overall productivity growth, % per annum



The economy as a whole has achieved productivity growth of 2 per cent per annum, and is expected to continue to do so in the medium term (based on HM-Treasury Budget 2006 assumptions). However, the communications sector has achieved significantly higher rates of productivity growth rising from a low of just over 4 per cent per annum, reaching a peak of 10 per cent per annum and falling to over 6 per cent per annum.

In our view the most reasonable assumption in relation to the BBC is that it should be able to achieve productivity growth somewhere between that for the economy as a whole and the communications sector i.e. between 2 per cent per annum and around 6 per cent per annum. The mid point – productivity growth of around 4 per cent per annum – would appear to be in excess of the BBC's assumptions (though these are not entirely transparent).

If this rate of productivity growth were achieved then existing levels of overall output should be achievable in future with a constant nominal licence fee i.e. an RPI-RPI settlement would be sufficient.

At worst, if the BBC were only able to achieve productivity growth inline with the economy as a whole, real increases in the licence fee would not be required to enable the BBC to change its output mix in accordance with its objectives i.e. an RPI+0 settlement would be sufficient.

### 3.4 Willingness to pay, public value and affordability

Willingness to pay has been assessed in the past and, for a significant fraction of households, found to exceed the existing licence fee. Evidence of willingness to pay does not, however, inform a decision about what level of funding the BBC needs to deliver an appropriate level of services.

The reason for this is that in markets willingness to pay for services always exceeds cost, often by a very large margin (think of water or mobile communications services for example). If this were not the case those who purchase the services would not do so. Only the marginal consumer values a service at cost.

The same argument applies to public value. The fact that public value may be large is not a reason *per se* to increase funding (in fact the study by the BBC and Human Capital found a relatively modest margin for citizen over consumer valuations).<sup>18</sup>

<sup>18</sup> The BBC and Human Capital. October 2004. "Measuring the value of the BBC."



In considering public value in relation to the BBC it is also important to consider the extent to which the commercial sector delivers public value, and the possibility that an increase in funding for the BBC will crowd out such activity. An increase in public funding will not necessarily increase public value.

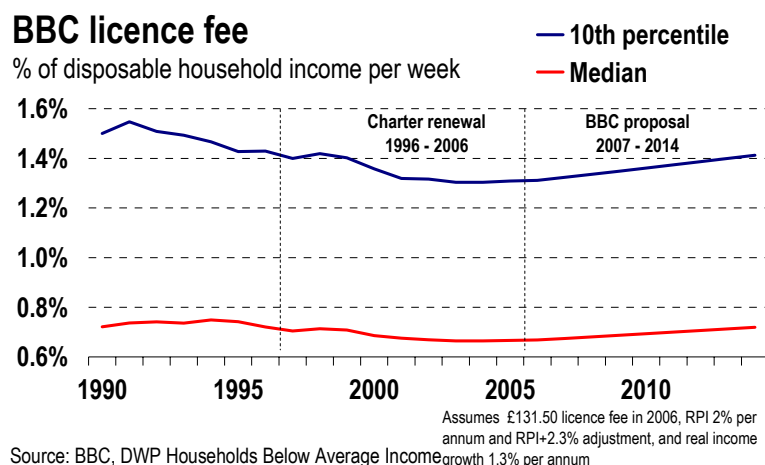
Whilst levels of expenditure relative to willingness to pay do not inform a decision as to what the BBC needs, trends in affordability do provide some information. In general real income in the economy grows because the value of services is growing faster than their price. Turning this relationship around, we can ask whether the licence fee is expected to grow more slowly or faster than household income growth, and therefore whether affordability is rising or falling.

Over the long term one might expect real income growth to broadly correspond to real GDP growth, though as the ONS note in “Social Trends” the two rates of growth can diverge due to shifts in income shares in the economy:<sup>19</sup>

*“Over the period as a whole since 1971, growth in household disposable income per head has been stronger than that in GDP per head, indicating that there has been a small shift between the shares of households and organisations in GDP in favour of households. However, between 2003 and 2004, real household disposable income per head grew by 2.1 per cent compared with growth in GDP per head of 3.1 per cent.”*

Basing forecast real household income growth on the HM-Treasury Budget 2006 in the short term, and on real GDP growth per capita in the medium term, Figure 3.4 shows the level of the licence fee on an RPI+2.3 per cent per annum relative to income for those on the lowest 10 per cent of incomes and those on median incomes.<sup>20</sup> This contrasts with a similar BBC analysis, which showed a falling share of disposable income based on a projection of income growth calculated using an average over the last five years.

Figure 3.4



It is apparent that the proposed licence fee would represent a rising proportion of household income. In the medium term the licence fee increase is expected to exceed household income growth by 1 per cent per annum (RPI+2.3% less real disposable income growth per household of 1.3 per cent per

<sup>19</sup> [http://www.statistics.gov.uk/downloads/theme\\_social/Social\\_Trends36/ST36\\_Ch05.pdf](http://www.statistics.gov.uk/downloads/theme_social/Social_Trends36/ST36_Ch05.pdf)

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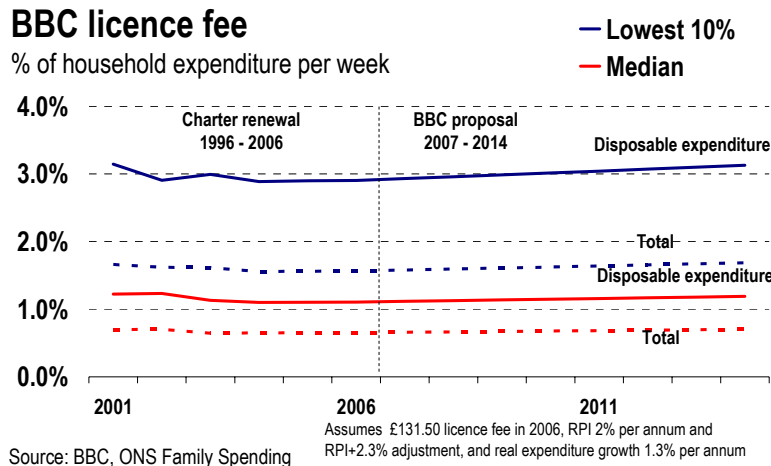
<sup>20</sup> HM-Treasury. Budget 2006. Tables A1, B3 and B5 of the Budget, and allowing for growth in the number of households of 0.7 per cent per annum.



annum based on real GDP growth of 2 per cent per annum less household growth of 0.7 per cent per annum).

We also consider household income less expenditure on “non-discretionary” items including housing, food and non-alcoholic beverages, clothing and footwear, transport, energy and education. Figure 3.5 shows that, on this basis, the licence fee represents a higher and rising share of discretionary income, particularly for low income households.

Figure 3.5



### 3.5 Legitimacy of the licence fee

The level of proposed licence fee increase represents a substantial increase in real terms and a declining level of affordability at a time when audiences are increasingly fragmented.

Figure 3.6 shows the growing fragmentation of the market, whilst Figure 3.7 shows the rise in licence fee revenue and declining audience share for BBC1 and BBC2.

Figure 3.6

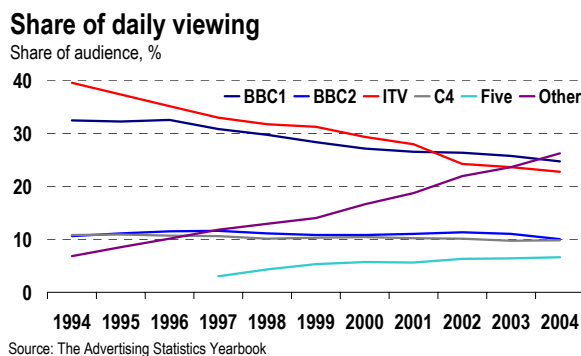
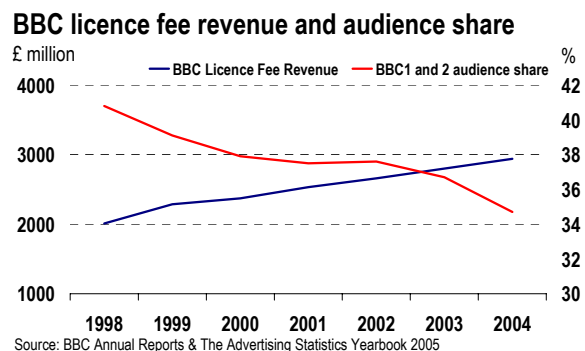


Figure 3.7



Households are also increasingly paying for services including satellite and cable TV, broadband and it is anticipated mobile TV in future. This combination risks undermining the legitimacy of the licence fee and therefore the contribution the BBC makes to plurality, competition and quality programming.

### 3.6 Conclusion

We find that household growth covers, on average over the period 2006-2014, the funding requirements for “Digital Britain” based on the costs of digital switchover. We then consider the extent



to which an increased licence fee is required to enable the BBC to meet its objectives. The answer depends on the extent to which the BBC can achieve efficiency gains.

If the BBC achieves productivity gains of around 4 per cent per annum – between the historical rate for the economy as a whole and for the communications sector – then increases in input costs would be offset by productivity growth and no increase in the nominal licence fee would be required to maintain a constant level of output (assuming constant licence fee funding prevents superinflation in relation to input costs).

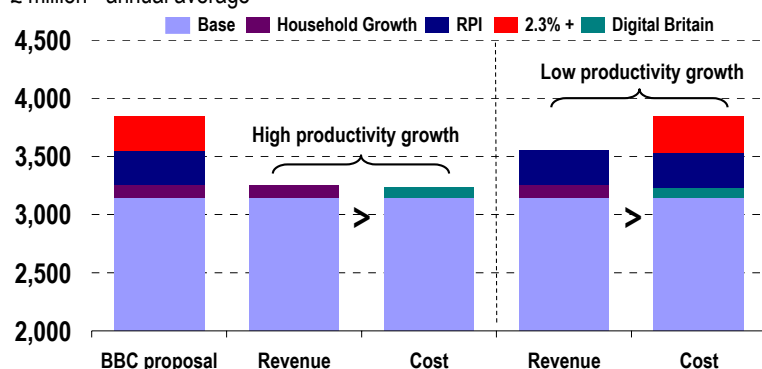
If the BBC only achieves the economy wide average rate of productivity growth of 2 per cent per annum, then input price growth will exceed productivity growth by the rate of inflation. An inflation indexed licence fee would be required to enable the BBC to change its output mix and meet its objectives i.e. RPI + 0.

Figure 3.8 shows the BBC proposal (RPI+2.3%) versus the alternative high and low productivity growth assumptions. With household growth funding the requirements for “Digital Britain” a settlement in the range RPI-RPI (or RPI-2) to RPI+0 would be appropriate based on our analysis.

Figure 3.8

### Assessing the BBC's funding needs

£ million - annual average



Source: BBC and Indepen calculations

Note:

(1) High productivity growth assumption – revenues, including those from household growth, exceed costs including those of “Digital Britain)

(2) Low productivity growth assumption – revenues, including those from household growth and RPI adjustment, exceed costs

In summary, household growth and an RPI adjustment (RPI+0 or 2 per cent per annum nominal) are more than sufficient to enable the BBC to meet its objectives (including those obligations associated with Digital Britain) even if the BBC can only achieve productivity growth in line with the economy as a whole. Should the BBC achieve higher productivity growth, more in line with ICT-intensive sectors of the economy, then the requirement falls to RPI-2 or 0 per cent per annum nominal. In contrast, the BBC is asking for an increase in the licence fee of RPI+2.3%, or 4.3 per cent per annum nominal. Discussion about an appropriate level of funding to meet the needs of the BBC should be focused on a settlement in the range 0-2 per cent per annum nominal.