

PO-CH/NL/0213
Part A

Part A

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Begins: 23/11/87

Ends: 15/2/88


 PO -CH /NL/0213

 PART A

Chancellor's (Lawson) Papers:

THE INDEPENDENT
TELEVISION SYSTEM AND
CHANNEL FOUR

and Channel Four

Disposal Directions: 25 Year

[Signature]

12/9/95

PO -CH /NL/0213

PO -CH

PART A



PMP

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

Colin Miller Esq
PS/Home Secretary
Home Office
Queen Anne's Gate
LONDON SW1

23 November 1987

Dear Colin,

The Home Secretary met the Chancellor, Lord Young, the Financial Secretary and Mr Renton at 10.30 am in No.11 Downing Street on Wednesday, 18 November. Also present were Professor Griffiths (No.10 Policy Unit) Mr Gilmore (Treasury), Mr Hyde (Home Office), and Mr Evans (DTI).

The Home Secretary said that he was glad of the opportunity to discuss trilaterally the issues set out in Mr Mawer's note of 6 November.

The meeting began by considering ITV contracts. The Chancellor said he thought the proposed limits on companies having or investing in more than one contract might be too restrictive. Lord Young said that he saw no particular reason to prevent one company holding, for example, two regional contracts. The Chancellor said that he would be interested to see proposals worked up on the basis that no company could own or have a substantial investment in more than two contracts, except in London, where there should be a ceiling of one contract. The Home Secretary agreed that it would be sensible for the IBA to aim to have different contractors for each region, but they should not be precluded from allowing one company to have an interest in two contracts if that would give the best broadcasting service. It was also noted that the procedure for terminating contracts might lack credibility if existing contractors were not able to take over another region in mid-franchise. In any case, these restrictions should be imposed by secondary legislation, so that the Government could respond flexibly to changes in this field.

Turning to the question of quality and performance reviews, the Chancellor said that he was content with the four proposed tests, but would like to add to them an explicit preference for applicants whose programmes would come substantially from independent producers, with the proportion rising over time. It was agreed

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that a positive preference for independent production was desirable, but would be difficult to quantify at the tendering stage: the best solution might be to include under "programme plans" the need for applicants to show how they intended to increase the proportion of independent programmes.

On quality reviews, it was agreed that it would be desirable to avoid an obligatory annual system. It was also agreed that 8 years was the right length of contract; on that basis, the Government would need to be able to institute a formal review at any time, but fixed reviews after 2 and 5 years would seem reasonable. The Home Secretary said that there could be no guarantees that the imposition of yellow and red cards would be immune from judicial review, but he agreed with the Chancellor's view that the Government should not volunteer an appeal process. Mr Renton said that he had been impressed by the Canadian idea of performance bonds, where contractors had to offer a bank guarantee (but did not need to have the money up front) that they would fulfil the terms of their franchise. Professor Griffiths pointed out that a financial penalty was already built into the proposed scheme, as a yellow card would undoubtedly affect the contractor's share price. Lord Young said that the best solution would be for the licence to be made conditional on fulfilling the terms of the tender: it would be useful to have legal advice on this.

The Chancellor said that the proposals on financial terms seemed rather complicated. He agreed that the levy must be progressive, but he was not clear why it could not be calculated directly on advertising revenue. Mr Gilmore was asked to provide illustrations of the difference between a progressive levy on revenue and the same levy on revenue per household. It was agreed that it would be desirable to have some flexibility to alter the rate of the levy - if this could be done in future Finance Bills, then there would be regular opportunities for review. It was noted that both the contract-price and the revenue levy would be deducted before profit was calculated for corporation tax.

There was a brief discussion of the proposal that contractors should be required to participate in networking arrangements. Officials were looking at this area, and they should consider how proposals could be framed so that programmes had to be available to contractors, but did not necessarily have to be bought by any individual company.

It was agreed that there were strong reasons for the retention of ITN. However, it would be consistent with the Government's policies of improving efficiency through competition if contractors were allowed to opt out of it if they wish. Officials should work up a package allowing both minority shareholdings and opting out from 1993, which could be put to the Prime Minister for her views.

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There might be advantages in the minority shareholdings being confined to a separate company to exploit non-core business on a fully commercial basis.

Lord Young said that he felt the pressures on Channel 4 to move down market might be eased if it proved possible to have a fifth channel, to help meet the demand for advertising time. The Chancellor said that in his view holding Channel 4 to its remit was no more difficult than enforcing all the other ITV contracts: he wondered if here, too, the remit could not be written into the licence. Lord Young thought this might help, and it was agreed that officials would produce a draft licence for Channel 4, which might be backed up by annual reviews and a yellow/red card system, for Ministers to consider further the possibility of treating Channel 4 as a normal franchise though with its present distinctive remit.

I am copying this letter to Paul Steeples (DTI), Professor Griffiths (No.10 Policy Unit), Mr Gilmore (Treasury) Mr Hyde (Home Office) and Mr Evans (DTI).

Yours sincerely,

Maira Wallace

MOIRA WALLACE
Assistant Private Secretary

H/EXCHEQUER

C. 14 DEC 1987 ✓ 14/11

ON MR GILMORE

ES CST FET PM & EST
SIR P. MIDDLETON
MR ANSON MR WEMP
MR BURGNER MR SCHOLAR
MR SPACKMAN MR CAVE
MRS PUGH MR KAUFMANN
MR FLANNAGAN MR CROPPER
From the Private Secretary



bf 15/12
pmp

10 DOWNING STREET
LONDON SW1A 2AA

14 December 1987

Dear Philip,

INDEPENDENT TELEVISION PRODUCERS

The Prime Minister has seen your letter to me of 11 December to which was attached a draft reply to Mr. Michael Darlow, head of negotiations for the Independent Access Steering Committee. The Prime Minister is content, subject to the views of colleagues, for the Home Secretary to reply as he proposes. If others see difficulties, she would propose to discuss the draft at MISC 128 on Thursday.

I am copying this letter to the Private Secretaries to the other members of MISC 128 and to Trevor Woolley (Cabinet Office).

David

(DAVID NORGROVE)

Philip Mawer, Esq.,
Home Office.

CHANCELLOR

*1. B. H. P. H. C.
G. H. P. H. C.
H. H. P. H. C.
H. H. P. H. C.*

FROM: B T GILMORE

DATE: 16 December 1987

- cc Chief Secretary
- Financial Secretary
- Mr Anson
- Mr Kemp
- Mr Burgner
- Mr Spackman
- Mr Burr
- Miss Sinclair
- Mr Kaufmann
- Mrs Pugh
- Mr Cave
- Mr Tyrie
- Mr Call

ITV SYSTEM AND CHANNEL 4 (C4)

Following your meeting on 18 November we have been asked for comments on the attached draft paper, in which the Home Secretary would report back to MISC 128 on the next round of ITV franchises, ITN and C4, for a meeting early in the New Year. The idea of course is that you and the two Secretaries of State should so far as possible present agreed views, and if you do agree then the paper would say so. This submission -

agreed

a) identifies points on which we recommend that the paper would need to be changed if you are to endorse it;

that

b) reports on the further work on the structure of a levy, on which I sense from their officials that Mr Hurd and Lord Young are likely to be looking to your lead.

ITV Contracts

2. Your meeting noted both the attractions of a "preference for non-producers" to strengthen the independent production industry, and the difficulties of providing for it procedurally. Paragraph 8 seems to me to need a little strengthening on this point. If you agree I would propose to suggest to the Home Office the reformulation of the second indent (in line with the record of your meeting) as -

"- indicate whether and how it was intended that this proportion would be increased over the life of the contract;"

and to add at the end of this paragraph -

"The Government would make it clear that, while making the minimal provision for independent production would not automatically disqualify an application, it saw the encouragement of independent production as an aspect of the quality of applicants' proposals and would prefer the competitive tender stage to involve not only applicants proposing to go substantially further but also applicants proposing to operate with little or no in-house production from the outset."

3. It would of course in strict theory be illogical to "prefer" non-producer bids in a fully competitive market, since their benefits in efficiency would in principle be subsumed in the bidding. But the same could be said of the Government's arbitrary "25%" policy for independent productions now. The fact is that in the matter of independent production the market is not that good, and will not be that good by 1992; so this is a key area for the Government to influence against the inertia of the producer monopolies.

Levy Structure

4. As to the structure of the levy, I attach a note which explains with figures the full sequence of thought which leads to the proposal for a progressive levy on NAR per household. The object is to put pressure on costs by taxing away excessive increases in revenue over underlying costs. That requires a reasonable fit with costs, so as to maintain similar pressure on costs for different regions as NAR changes. A perfect fit is not necessary; and some degree of difference will be catered for by the competitive bidding. But if the disparities are large they will affect the operation of the levy, because rates high enough to constrain profitable regions will break less profitable regions, while rates low enough to accommodate less profitable regions will leave costs relatively unconstrained in more profitable regions.

5. My own recommendation on the basis of these figures is for proposing in the White Paper the progressive levy per household. It is a complicated notion, but the better fit is worth it. If the industry then propose something better the Government can adopt their proposal. But you will obviously want to weigh this

against the alternative of a progressive levy on total NAR per region, which would be one stage simpler and would rely on the competitive tender process to produce correspondingly higher bids for the richer regions and hence compensate for some at any rate of the loss of pressure on costs. Either way, I suggest it would help MISC 128 for this annex to be attached to the Home Secretary's paper.

ITN

6. On ITN the draft takes the line that, if ITN bring in only minority shareholders, they will not be immune from pressures for improved efficiency and the Government "need not intervene". This resiles from the clear sense of your meeting in favour of untying ITV contractors from ITN. It seems unduly optimistic: new shareholders will put more pressure on ITN's prices than on its costs if ITN remains a monopoly supplier. And although no change in the law would be involved either in new shareholdings nor (so far as we can see) in untying, the Government cannot ignore the point since the question whether contractors are or are not positively obliged (as now) to take ITN's News Service will be one of the terms of the new contracts to be tendered for.

7. I recommend that you should continue to argue for untying from ITN in the next round of contracts, though maintaining the duty on IBA to be satisfied with the amount, timing and quality of news service in fact carried. The importance of this change lies more in the signal and in changes at the margin, than in any serious threat to ITN; and we believe the principle is right. I understand Lord Young is being advised in a similar sense. If you agree, I would tell the Home Office that, if the Home Secretary is not willing to take this line in the paper, he cannot say in paragraph 1 that you agree with it.

C4

8. On C4 the draft states the three options, and invites the Committee to choose on the basis of the rather limp observations in paragraphs 24 and 25 that the formulation of a draft remit attached to the paper is not a plausible one to invite Parliament to endorse, but that a competitive franchise would be attractive if a remit could be adequately expressed in statute and adequately policed.

9. Your meeting wanted to look at the enforceability of a draft licence. Translating this into a "statutory remit" seems perverse. Certainly freezing a specific programme package in primary legislation is too rigid. But the remit need not be approved in this detail by Parliament; indeed it need not even be promulgated

in detail by the Government when it seeks tenders. The better course might well be to invite applicants to set out a programming package for the remit as it stands in the 1981 Act - attached at A. The winner could be selected in this case not solely on price but on the quality of his stated intentions; the crucial thing is that his winning package should be precise enough to be embodied in the licence and enforced. And the key argument remains that the IBA's task in enforcing such a licence is no different from its task in enforcing other contracts.

10. It is also rather mischievous to propose that if Ministers cannot agree on one of the three options for change they should settle for the status quo. That would not even free C4 to sell their own advertising, which everyone wants.

11. If you agree I will suggest to the Home Office

- a) that paragraph 24 and the Annex should be omitted for the reasons given above, and paragraph 25 should read -

"One course would be to invite applicants to spell out their detailed programme intentions on the basis of the 1981 Act as it stands; to leave the IBA to choose the winning tender for this particular franchise on quality as well as price; and to embody the full detail of the winning programming package in the licence, for the IBA to police with the same armoury of reviews and yellow/red cards as the other contracts. If we could be confident of IBA's ability to enforce such a contract, this would be the most attractive course."

- b) that the last sentence of the paper should be omitted, because the aim should be to reach agreement on a positive course, not to continue a status quo which no-one supports.

Minor Points

12. The attached draft paper also shows in manuscript for completeness some smaller drafting points. You need not be concerned with these: they are drafting points I would also in any case put to the Home Office at official level so as to clarify their own paper whatever its substance.



B T GILMORE

11.—(1) As regards the programmes (other than advertisements) broadcast on the Fourth Channel it shall be the duty of the Authority—

Nature of
the Fourth
Channel, and
its relation
to ITV.

- (a) to ensure that the programmes contain a suitable proportion of matter calculated to appeal to tastes and interests not generally catered for by ITV,
- (b) without prejudice to so much of section 2(2)(a) as relates to the dissemination of education, to ensure

that a suitable proportion of the programmes are of an educational nature,

- (c) to encourage innovation and experiment in the form and content of programmes,

and generally to give the Fourth Channel a distinctive character of its own.

(2) While the Authority are providing both ITV and the Fourth Channel it shall be their duty to ensure, so far as is consistent with their duties under subsection (1)—

- (a) that, as regards each of those services, the programmes broadcast in that service by the Authority in each area maintain a proper balance and wide range in their subject-matter, having regard both to the programmes as a whole and also to the days of the week on which, and the times of the day at which, the programmes are broadcast ; and
- (b) that, as between the two services, a proper balance of subject-matter is maintained, having regard both to the programmes broadcast in those services as a whole and also to the days of the week on which, and the times of the day at which, the various programmes are broadcast ;

and so long as the Authority are under the duty imposed by this subsection, so much of section 2(2)(b) as relates to the maintenance of a proper balance and wide range in the programmes broadcast by the Authority shall not apply in the case of television programmes so broadcast.

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MISC 128(87) ?

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CABINET
MINISTERIAL GROUP ON BROADCASTING SERVICES

THE ITV SYSTEM AND CHANNEL 4

Memorandum by the Secretary of State for the Home Department

1. At our meeting on 28 October we discussed proposals for the reform of the independent television system and the future constitution of Channel 4. I was asked to bring forward a further paper which took account of the points made in that discussion and of the further consideration of outstanding issues in consultation as necessary with colleagues. This paper summarises my proposals in the light of those discussions. [It also represents the views of the Chancellor of the Exchequer and the Secretary of State for Trade and Industry.]

A. ITV CONTRACTS FROM 1 JANUARY 1993

2. The Group decided in principle, at its meeting on 20 July, that in future ITV contracts should be awarded by a two stage process, with companies which satisfied a quality threshold being selected on the basis of competitive tender.

(i) Ownership of companies

3. As recommended by the Official Group (MISC(87)8), the following existing restrictions should continue to apply to companies bidding for or wishing to take over ITV contracts:-

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(a) no advertising agency should be permitted to hold or have an interest in a contract;

(b) newspaper shareholdings in a contract should not in aggregate exceed 20%; and

(c) the company must be registered within the EC.

4. I also propose the following additional controls:

(d) a company holding an ITV contract for London, or for any services with cross regional coverage should not be permitted to hold or have an interest in any other ITV contract;

(e) apart from this, a company would not be permitted to own or have an interest in more than two regional ITV contracts.

5. Taken together, conditions d) and e) would provide a fair balance between the need to stimulate competition in the supply of programme services and the need to enable companies to enlarge their field of operations if this would provide a more efficient service and meet normal market tests. I propose that conditions d) and e) should be incorporated in subordinate legislation and hence variable if necessary.

6. As an exception to (d) and (e), the IBA would be empowered to invite any or all contractors to participate in a competition for the reassignment of a contract in mid-term, if in the IBA's view this was the only practicable means of maintaining a service.

(ii) Quality threshold

7. The Official Group suggested that applicants to bid for or take over contracts should be required to demonstrate that:-

(a) they have sufficient financial resources to sustain a high quality service as required by the 1981 Broadcasting Act;

(b) their programme plans offer programmes of a high general standard, a proper balance and a wide range of subject matter and are capable of being realised;

(c) they have management resources of sufficient quantity and proven quality to be able to fulfil the terms of the contract; and

(d) they have defined links with the region which it is proposed to serve.

8. I would propose to make it clear in addition that the programme plans at b) must

- provide for at least 25% of original output to be supplied by independent producers at the start of the contract
- be sufficiently flexible to allow this proportion to be increased over the contract in the light of independent producers' performance in supplying programmes at competitive cost and quality
- have regard to the character of and market conditions in the service area concerned.

(iii) Lengths of contract and review of performance

9. I remain of the view that eight years continues to be the right maximum period for ITV contracts. Peacock offered no reason for his recommendation of ten years, and I do not think it would be right to introduce a greater element of fixity into the ITV system at a time when the industry is facing major changes. Within the contract period there would be automatic formal reviews by the IBA of contractors' performance at two years and five years, but the IBA would be able to initiate an additional review at any time if needed. As recommended by Peacock, the IBA would have power, after

a review, to issue a formal warning (a 'yellow card') and to remove a contractor (a 'red card') one year later if performance remained unsatisfactory, for example in failing to deliver their promised programme plans. The idea of performance bonds (under which all contractors would be required to put up a bond at the outset which would be forfeited in part if they received a yellow card) might be worth further study as a possible way of reinforcing the maintenance of programme standards.

10. The exercise of these powers would be subject to judicial review, so I can see no case for a separate right of appeal. This would draw the Government into judgments about the quality of individual programmes which we would regret. A contractor shown a red card could not in practice be debarred from applying again at the start of the next contract round, provided that the quality tests were then fully satisfied.

(iv) Financial terms

11. We have already agreed that contracts would be awarded by competitive tender on the basis of a lump sum payable each year of the contract and of an obligation to pay a levy on advertising revenue at specified rates. Both the tender and the revenue levy payments would (like the existing profits levy) represent the first slice of taxation, with corporation tax payable on subsequent profits.

12. We have now decided that national commercial radio licences should be awarded by competitive tender, with the radio authority having a limited discretion to accept a bid below the highest if this would promote the enhancement of consumer choice (MISC 128(87) 4th Minutes). I believe, however, that we should not confer a similar discretion on the IBA in the case of ITV contracts. Although Peacock advised us to do so (Report, paragraph 656) we have in effect already met the purpose of Peacock's proposal by requiring all prospective contractors to surmount an objective quality threshold.

Progressive

13. As to the revenue levy, the Official Group proposed a levy on revenue per television household. [In the light of the further discussions I have had I have concluded that this may be unduly complicated. A progressive levy on total revenue should be sufficient, as the tender procedure will tend to even out differences in the commercial value of the largest and the smallest contracts. ~~We shall, however, have to accept as a consequence some increase in the uncertainty about the total yield to the Exchequer.~~

Submission

mit anyway: non sequitur.

(v) Networking

14. The post-1992 contracts will need to reflect new networking arrangements which are transparent, competitive and avoid ^{discrimination} ~~subsidy~~. A programme supplied by any company should be available to all, but should not have to be taken provided that the IBA is satisfied that ~~an alternative is available of a kind which is consistent with the overall ITV schedules which it is required by law to approve.~~ ^{are satisfactory.} Access to the network ^{Programmes} should not be tied under a formula to the share of total TV advertising revenue enjoyed by each contractor, but should reflect a competitive ^{market in the quality and cost} ~~process of assessment~~ of programmes ^{quality.} Officials have already been asked to consider how statutory criteria for new networking arrangements might be framed, in case the IBA's own plans for reform fail to go far enough.

Production of

B. ITN

15. At our meeting on 28 October we noted that, while it was important not to undermine the high quality of news services provided by ITN, it would be wrong for ITN to remain immune to pressures to become more cost conscious and efficient. At the same time it is necessary to take account of ITN's wish to continue its diversification into international markets.

16. If ITN were to become independent of the ITV companies (and of the control of the IBA) through a full company flotation then this

would certainly call into question its guaranteed access to the ITV network. The legislation needed to give effect to this option would (if it were to be consistent with our general competition policy and the position on networking outlined above) have to allow the companies taking on new ITV contracts in 1993 the option to obtain news from an alternative supplier on a commercial basis.

17. If, however, the changes adopted by ITN involve no more than the injection of new capital by independent minority shareholders (possibly confined to ITN's high risk activities outside IBA services for which it wants new capital) they do not of themselves provide reason to alter the present statutory framework for ITN (section 22 of the Broadcasting Act 1981). These changes could be implemented (by agreement between ITV, ITN and the IBA) without, and in advance of, new legislation. The indications are that they may well decide to do so.

Subsidiary

18. In this case I see no need for Government intervention. The widening of ITN's capital base will go a good way to meet the objectives as set out in paragraph 15 above. The introduction of a profit margin needed to attract outside investors will generate pressures for efficiency and an enterprise culture. That investment will itself strengthen ITN's ability to compete in international markets.

opting out.

CHANNEL 4

19. We are agreed that Channel 4 airtime should be sold separately from ITV. We are also agreed that Channel 4's distinctive remit should be maintained. The question at issue is how best to achieve these twin objectives.

20. There are the following options:

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- a) the reconstitution of Channel 4 as a separate broadcasting authority, responsible for selling its own airtime (either directly or through a service contract which it would let to a sales company other than an ITV contractor).
- b) as a), but with Channel 4's income determined not directly by the revenue generated by the sale of its airtime but by a defined percentage of the total revenue from advertising on ITV, Channel 4 and S4C.
- c) the operation of Channel 4 on a full commercial basis, under a contract with the IBA, analogous to the new ITV contracts but designed to meet the special remit of the Channel.

21. I first proposed option a). It has the merit of simplicity. There was, ~~however~~, concern on the part of some members of the Group that if advertising revenue remained buoyant this option could undermine our encouragement of efficiency within broadcasting by leaving the Channel with too much money to commit to programme production - even though all production is now contracted out.

22. Option b) - fully developed in MISC 128(87)9 - was intended to address this concern. The formula fixing Channel 4's maximum income could also provide securely for the funding of S4C (on the need for which we are agreed). This option (like option a)) would meet the concern of the advertisers, who have made it clear that they want no change to Channel 4's present programming approach.

23. Option c) would need to incorporate a more precise formulation of Channel 4's remit. That remit is at present expressed in the general language of the 1981 Broadcasting Act, which is appropriate to provide the guidance the regulatory body needs but which the IBA might find it hard to enforce against conflicting commercial interests (bearing in mind that, in line with what is proposed in

This would be partly but not entirely dealt with by applying the same revenue levy as for the contractors.

paragraph 12 above, the IBA would have no discretion to choose between tender bids from companies surmounting the basic quality threshold). For example, the Act does no more than require a suitable proportion of programmes on Channel 4 to be complementary to those on ITV. If the remit were capable of more precise formulation then option c) would involve less risk. At the same time the remit must not be nailed down so precisely that the Channel cannot develop and adapt to changed market conditions and audience preferences. One of the key features of the Channel - required by the Act - is that it should encourage innovation and experiment.

Submission

24. It is not easy to strike a balance between these requirements. The present style of operation of Channel 4 is summarised in the Annex, but this does not add up to a plausible remit which we could invite Parliament to endorse. It is too static, and the figures are all to an extent arbitrary.

25. If we could be satisfied about our ability to express the remit adequately in statute and the IBA's subsequent ability to hold a fully commercial contractor to it then there would be considerable attractions in option c).

Conclusion

25. I invite the Group:

a) on ITV contracts to agree that work should now proceed on the preparation of a White Paper on the basis of the proposals outlined in paragraphs 2-14 above;

b) on ITN to agree that there is no need for Government intervention or a change in the law if agreement is reached by the parties concerned to the incorporation of independent minority shareholdings into ITN within existing statutory provisions; and

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c) on Channel 4 to decide between the options summarised in paragraph 20 above. If no option commands general support then I invite the Group to agree that we retain the status quo.

DH

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DRAFT LEGISLATIVE REMIT FOR CHANNEL 4

1. Channel 4 to have a distinctive character of its own in terms of the totality of its programme output.
2. Not less than [50%] of programmes to contain matter calculated to appeal to tastes and interests not generally catered for by ITV.
3. Programmes to have a proper balance and wide range of subject matter, having regard to programmes as a whole and to times of day and days of week of transmission.
4. Not less than [25%] of programmes to reflect innovation and experiment in their form and content.
5. No programmes to be made by Channel 4.
6. Not more than [15%] of programmes [including feature films] to be of overseas origin.
7. Not less than [10%] of programmes to be of an educational nature (including schools and Open College broadcasts).
8. Not more than [40%] of programmes to comprise light entertainment.
9. Not more than 20% of programmes to consist of repeats.
10. [News to be obtained by competitive tender.]
11. [5%] of Channel 4 revenue to be committed to production of films for cinematic showing before broadcast on Channel 4 [ie continuation of Film on Four].

DRAFT ANNEX

THE STRUCTURE OF A LEVY ON ITV COMPANIES' ADVERTISING

Objectives of a levy

1. The objectives of a levy on ITV companies' net advertising revenue (NAR) would be to put continuing pressure on ITV companies' costs, and to tax any undue monopoly profits from selling restricted advertising time. With the prospect of additional services and hence greater competition for advertising, the first objective assumes greater importance.

2. A competitive tender alone might in theory achieve these objectives. However, companies would be unlikely to allow at all adequately in cash bids for the possibility of more than a small growth in real NAR over the franchise period because of the risk that NAR might turn out to be lower. This problem might be avoided if companies tendered to pay a percentage of NAR. However, there remains a distinct risk that bids will generally be low, particularly if there is little competition for franchises. For this reason, and because cash bids are simple to evaluate, Ministers have decided to combine a competitive tender for cash payments with a revenue levy to put continuing pressure on costs.

3. There is considerable scope for increasing the tax paid by ITV companies, and hence the pressure for efficiency. Figure I attached (reproduced from the Peacock Report) shows how the levy has failed to capture the growth in NAR between 1972 and 1984. Thus buoyant NAR has been able to fuel similar increases in costs. In 1986-87 the profit levy raised around £63 million. If NAR continues to grow at around 5 per cent a year in real terms up to start of the new contract in 1993, a progressive revenue levy might raise over £300 million (in 1986 prices) in the first year of the franchise period.

A progressive revenue levy

4. The main advantage of a progressive structure of levy rates (compared with a single-rate, proportional levy on revenue) is that it taxes more heavily any growth

NAR over the franchise period. For example, suppose NAR increased at 5 per cent a year in real terms*, but efficiently managed costs increased at 1 per cent or less a year. With a single levy rate the increase in post-levy NAR over the eight year franchise period would be over five times the increase in costs, thus relaxing the pressure it is intended to place on costs. A progressive levy (with a top marginal rate of 75 per cent as suggested in the examples in the appendix) could reduce the increase in post-levy NAR on the same assumptions to about twice the increase in costs.

5. A progressive structure also allows richer regions to be taxed more heavily than poorer ones in any one year. However, this advantage is less important as cash bids could be expected to reflect variations in the advertising potential of different regions.

A uniform progressive revenue levy on total NAR

6. If total programme, transmission and other costs were similar for all ITV contract regions then a uniform progressive revenue levy could be applied to each region's total NAR. However, as Table I in the appendix shows, regions' costs (and NAR) vary considerably. This variation raises difficulties for a uniform progressive levy on total NAR. The general problem is that profitability, or NAR relative to costs, does not necessarily increase with total NAR, yet it is the latter which would determine the marginal rate of levy paid. This is illustrated by Figure 2 attached, which shows that, with a uniform progressive structure of rates, the levy paid by the least profitable regions (or those with low (pre-tax) ratios of profits to NAR) would be a greater share of their pre-tax profits.

7. The inability of a uniform progressive structure to allow for variations in regions' profitability is especially severe if, following recent past patterns, regions' NAR grows at different rates. Table II in the appendix shows the ratios of profit before levy (PBL) and profit after levy (PAL) to NAR in 1993 and 2000 (the first and last years of the new contract period) for a uniform progressive levy with variable growth in NAR. The levy successfully taxes the increases in NAR and profits in the richer and larger southern regions, but only at the expense of deficits in the smaller and poorer regions where NAR is likely to grow more slowly. In practice the Government would have to reduce the levy, thus reducing the pressure for efficiency on the larger companies. (If NAR grew at the same rate in all regions then a uniform progressive structure would be less likely to result in deficits in some regions; but in practice NAR growth rates are likely to vary).

* An average annual rate of growth in NAR of 5 per cent seems a reasonable central projection even allowing for new services, given the past relationship between the demand for TV advertising revenue and growth in incomes, and future expectations of GDP growth.

A progressive levy on revenue per ITV household

8. The difficulties of a uniform progressive levy on total NAR might be avoided or eased by applying a uniform progressive structure of rates to NAR per TV household.

9. The advantages of a per household levy follow from the assumption that costs are broadly proportional to the number of households. Although the cost of making a programme is independent of the number of viewers, sellers of programmes often charge according to the expected audience size, as this determines the advertising (or subscription) revenue the buyer can expect from broadcasting the programme. This is how, for example, fees are set at present for programmes imported from the US. It may be expected to become more common in future with increases in international trade in programmes, and as the networking system changes towards a more commercial market-oriented basis. Figure 3 attached shows existing costs per household for the different size regions. The three regions lying above the band of £32 to £40 per household (LWT, Thames and TVS) all have relatively high levels of NAR per household, suggesting that in these cases unusually high profitability has resulted in unusually high costs. Conversely, TVam has both exceptionally low costs and low NAR per household.

10. When costs are broadly proportional to the number of TV households in a region, richer regions will be those with relatively high NAR per household. Thus a logical basis for a tax that treats regions of comparable profitability more or less equally is NAR per household.

11. Figure 2 shows how, in contrast to a uniform progressive structure applied to total NAR, the payments for a per household levy are a larger share of total (pre-tax) profits for the relatively more profitable regions. Table III shows that, again in contrast to a uniform levy on total NAR, a per household levy does not result in deficits in some regions when NAR regional growth rates differ.

Potential problems of a levy on NAR per TV household

12. One potential difficulty with a levy on NAR per TV household concerns the measurement of households where contracts are defined by time as well as (or instead of) by geographical area. In the numerical examples attached, the number of households in the London region is divided between LWT and Thames according to their shares in total broadcast hours. Similarly, TV-am's "households" are the national

total of TV households multiplied by TV-am's share in total broadcast hours. (It would be preferable to adjust these formulae by weighting peak hours more heavily than non-peak hours. This would reduce the relatively favourable taxation of TV-am in Table III, and reduce the relatively large amount of tax paid by LWT. But this sort of detail can be considered in the light of reactions to the White Paper.)

13. A second potential problem is that costs do not entirely depend on numbers of households. There are elements of fixed costs (such as administration and production costs) and others may vary according to factors other than audience size. However, given that contract regions' characteristics do vary, no one levy structure will produce a perfect "fit" with costs, and thus tax comparable regions on an exactly equal basis. The alternative of applying a given structure of levy rates to different NAR bands in different regions, with no clear underlying principle, is unattractive.

Summary of pro's and con's of a levy on NAR per TV household

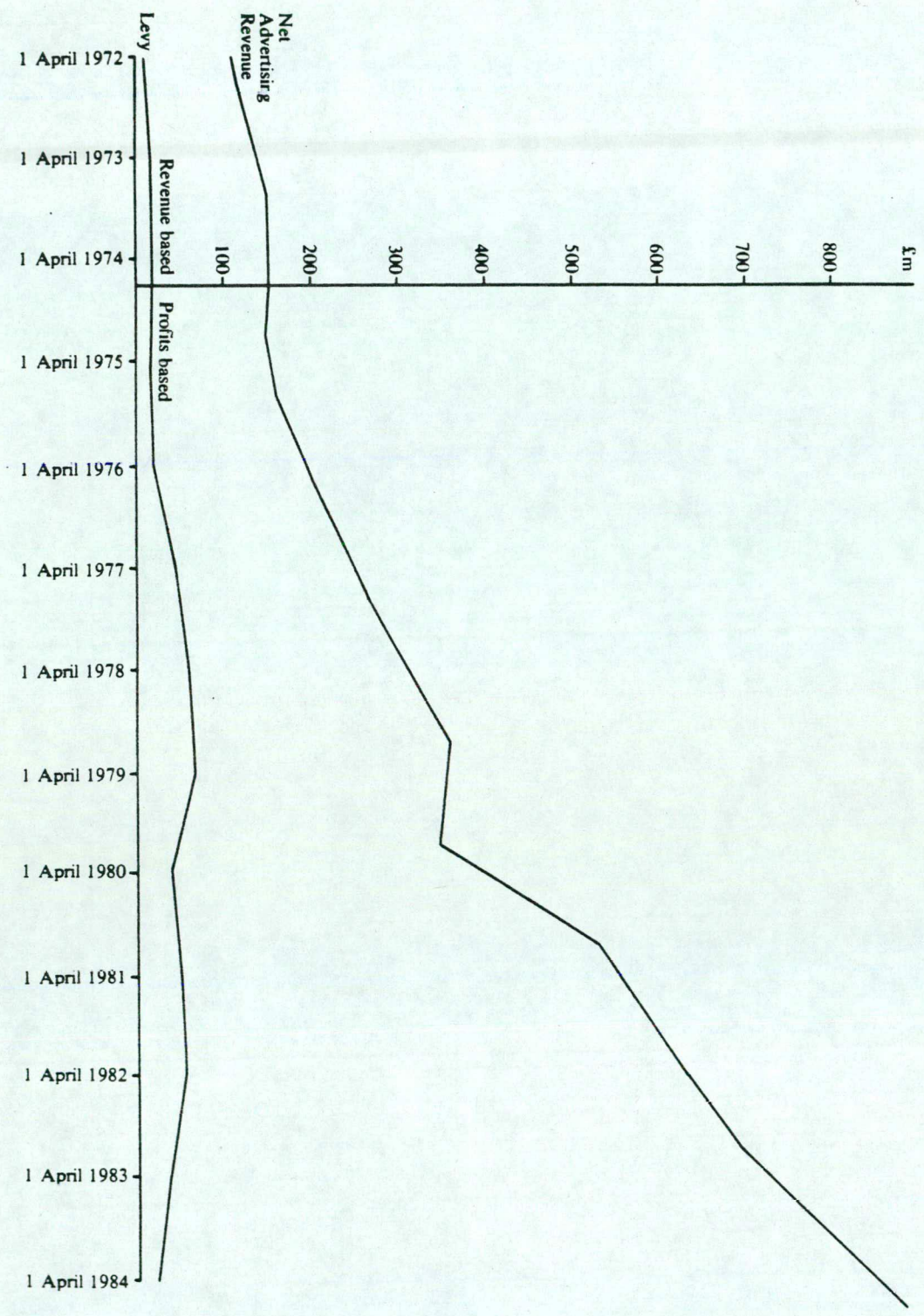
14. The main advantage of a levy on NAR per TV household is that it enables increases in NAR during the franchise period to be taxed at a progressive rate, thus maintaining downward pressure on costs, without arbitrarily discriminating between different regions, and without creating pressures for rates which will accommodate less profitable regions only at the cost of applying too loosely to more profitable ones.

15. The main disadvantages are that the measurement of households is not entirely straightforward when contracts are defined by broadcasting time as well as by geographical area; and that costs do not entirely depend on number of households, though that seems to be the closest approximation available.

16. The objectives of a levy are best served by the levy structure which, while based on revenue, achieves the best "fit" with underlying profitability. To make the revenue levy not only progressive but related to NAR per household achieves this, at the cost of greater complexity. To some extent, a poor "fit" may be evened out by competitive bidding. But in practice it does not seem likely that competitive bidding could be relied on to even out the degree of disparity involved with a progressive levy on total NAR, and that would mean a loss of effective pressure on costs. The balance of advantage turns on one's judgement about the relative importance of this effect by comparison with the added complexity of expressing the levy in terms of NAR per household.

Figure 4.1

Annual levy receipts and net advertising revenue 1972-1984



Source: National Audit Office, HC 358, 1985

Figure 2. ITV contractors burden of levy payments relative to their pre-levy profitability.

(Projections for 1993)

Levy payments/
pre-levy profits

- x Uniform progressive levy on NAR (as in Table II)
- o uniform progressive levy on NAR per TV household (as in Table III).

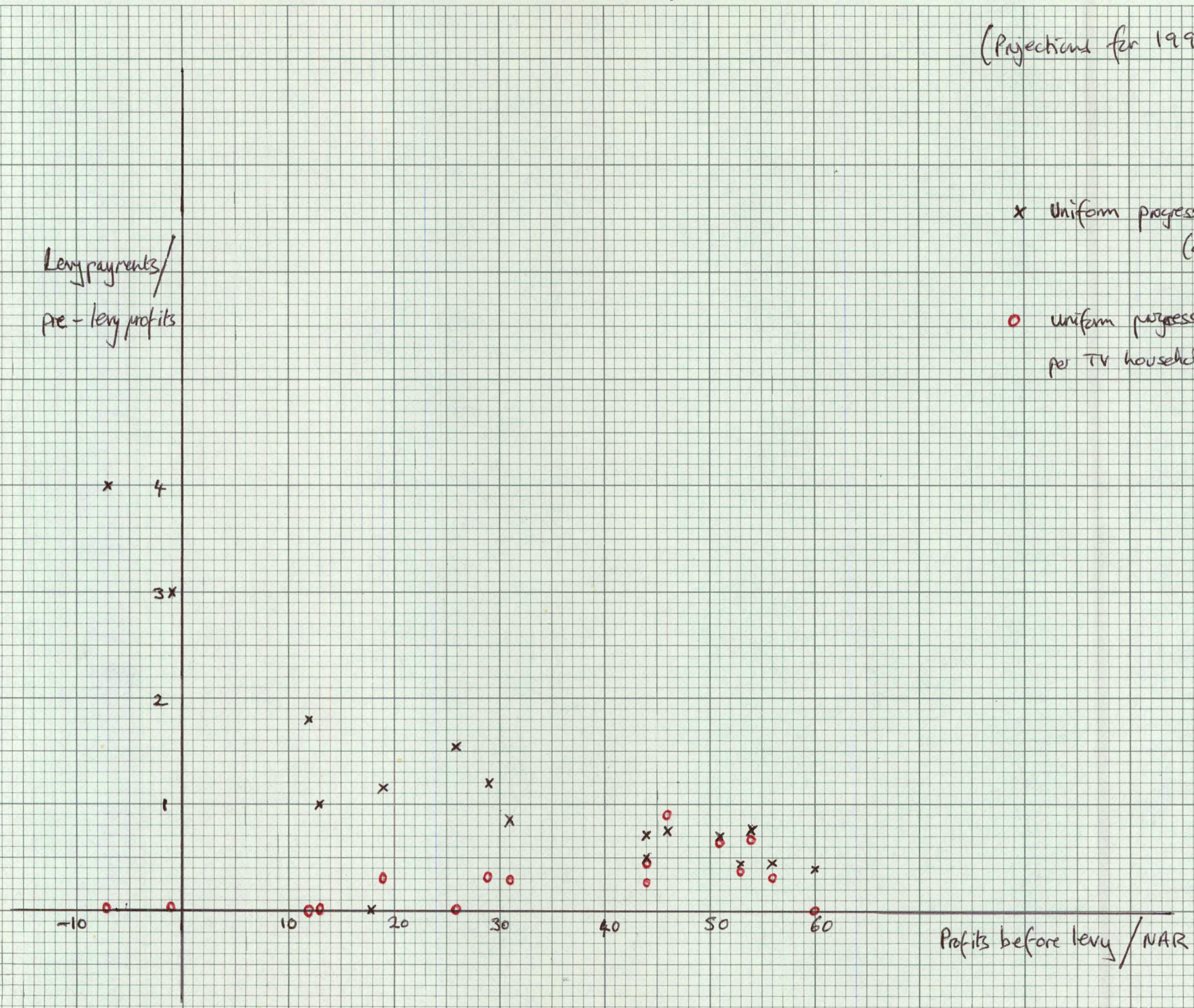
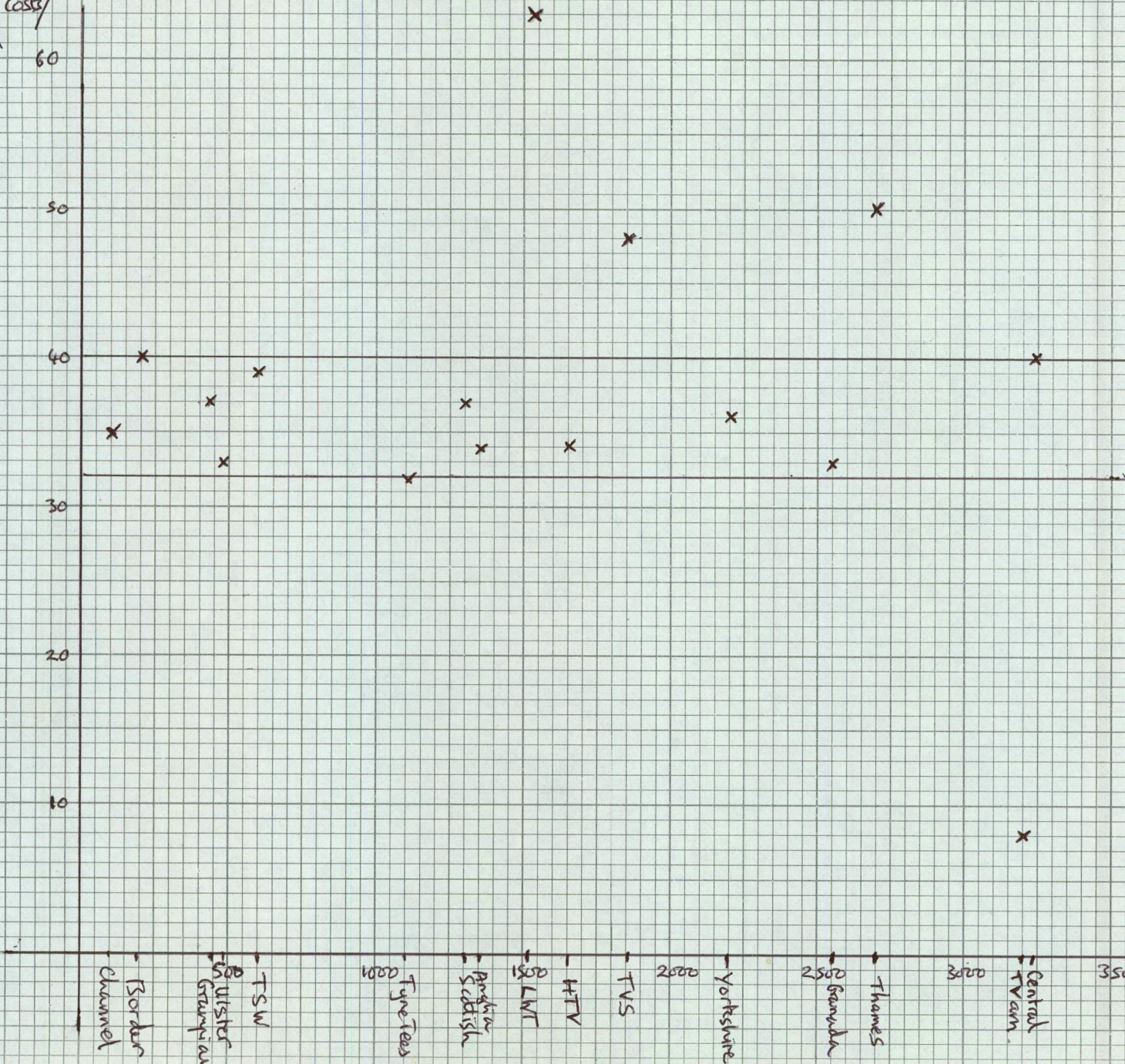


Figure 3. ITV companies costs per household

Operating costs/
household
£
1986-87



Households 1000's.

Costs and NAR for ITV regions 1986-87

£ million

	NAR	Operating Costs
Thames	190	135
Central	165	130
Granada	131	84
LWT	133	96
Yorkshire	107	80
TVS	128	89
HTV	77	57
Scottish	71	48
Anglia	67	46
TTT	47	37
TSW	29	23
Ulster	18	16
Grampian	18	17
Border	9	8
TV-am	42	26
Channel	3	4

A Uniform progressive levy on NAR

	1993		2000	
	Profits before levy (PBL)/NAR	Profits after (PAL)/NAR	PBL/NAR	PAL/NAR
Thames	54	12	72	18
Central	29	-6	43	6
Granada	44	12	55	20
LWT	46	11	66	24
Yorkshire	31	4	44	13
TVS	51	16	70	26
HTV	56	30	74	39
Scottish	19	-4	19	-4
Anglia	53	29	71	38
TTT	12	-10	12	-9
TSW	44	22	65	42
Ulster	-1	-18	-1	-18
Grampian	-7	-24	-7	-24
Border	13	4	13	4
TV-am	60	37	75	49
Channel 4	26	-13	47	-2
Channel	18	18	49	40

Assumptions

(i) Costs remain at 1986-87 levels in real terms

(ii) NAR annual average percentage growth rates, in real terms, 1986 onwards:

Levy Structure

NAR £ million	Levy rate %
5-100	25
100-250	50
250+	75

Average all regions: 5 per cent

Thames, LWT, TVS, HTV)
Anglia, TSW, TV-am) 7 per cent

Channel Four 5 per cent

Central, Granada, Yorkshire 3 per cent

Scottish, TTT, Ulster)
Grampian, Border, Channel) 0 per cent

A Progressive Levy on NAR per TV household

	1993		2000	
	PBL/NAR	PAL/NAR	PBL/NAR	PAL/NAR
Thames	54	16	72	20
Central	29	19	43	26
Granada	44	32	55	35
LWT	46	5	66	13
Yorkshire	31	22	44	28
TVS	51	16	70	19
HTV	56	38	74	34
Scottish	19	13	19	13
Anglia	53	32	71	30
TTT	12	11	12	12
TSW	44	23	65	24
Ulster	-1	-1	-1	-1
Grampian	-7	-7	-7	-7
Border	13	9	13	9
TV-am	60	60	75	75
Channel 4	26	26	47	47
Channel	18	12	49	26

Levy structure

NAR/household	Levy rate
£	%
35-50	25
50-65	50
65+	75

Assumptions on costs and NAR, as
for Table I

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mpw
FROM: MOIRA WALLACE
DATE: 17 December 1987

MR GILMORE

cc Chief Secretary
Financial Secretary
Mr Anson
Mr Kemp
Mr Burgner
Mr Spackman
Mr Burr
Miss Sinclair
Mr Kaufmann
Mrs Pugh
Mr Cave
Mr Tyrie
Mr Call

ITV SYSTEM AND CHANNEL 4 (C4)

The Chancellor has seen and was grateful for your minute of 16 December. He would be grateful if you would proceed as you propose.

mpw.

MOIRA WALLACE

INDEPENDENT ACCESS STEERING COMMITTEE

74 NEWMAN STREET
LONDON W1P 3LA
TELEPHONE 01 323 3220
TELEX 266075 PRODCO-G

Rt. Hon Nigel Lawson, MP
The Chancellor of the Exchequer
The Treasury
Parliament Street
London W1

HM TREASURY - MCU	
RECD	13 JAN 1988
ACTION	MK BURN HER
	cc APS/CHX
	CHX
	1067488

4 January 1988

Dear Chancellor of the Exchequer

INDEPENDENT TELEVISION PRODUCERS

During the Prime Minister's seminar on Broadcasting on 21st September you very kindly said that I might write to you at a future date about the implications for independent producers of the current tax and Levy arrangements governing ITV. As you may know in recent weeks talks between the independent producers represented by my committee and the ITV companies initiated by the IBA and aimed at establishing a voluntary basis for implementing Government policy on 25% access for programmes made by independents have broken down. Similar talks on business guidelines for the period before a genuine competitive market in the supply of television programmes is established have now been brought to a satisfactory conclusion with the BBC. These two events mark something of a watershed for the voluntary implementation of Government policy. This therefore seems an appropriate moment at which to write to you.

ITV must be almost unique in British industry in that the companies within it thrive through making one thing but selling another: they make television programmes, but sell advertising air-time. Where they do sell programmes, overseas or to Channel Four, this remains despite the increasing attention paid to it, an essentially secondary activity. In any case the basis for such programme sales by ITV companies is firmly rooted in the artificial financial regime of their primary function as broadcasters and privileged holders of the right to exploit a public asset - the right to sell advertising air-time.

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The Review of the ITV Levy Structures undertaken by officials from the Home Office, the Treasury and the IBA, published in February 1986, recognised that the Levy, as then structured, might act as a dis-incentive to cost-consciousness within the ITV companies. Even as reformed in the subsequent Budget the Levy structure still provides a degree of disincentive to ITV cost consciousness and certainly results in independent producers (widely recognised as a good deal more cost effective than ITV companies) being at a trading disadvantage in dealings with Channel Four and in competing for overseas markets. One of the annexes to the Review of the ITV Levy Structures contained an illustrative calculation of the effects of the Levy as then structured on the programme making decisions of one ITV company based on real figures seen by the committee. We asked accountants to rework this calculation on the basis of the current reformed Levy structure. The illustration posits the production of a major programme, such as a drama series costing £2m to produce and, in our re-working, assumes overseas sales of £1.3m, a realistic figure in our experience. The 'UK Sales' could either be to Channel Four, or for an ITV company the sum paid or credited to it by the other companies under the network 'pool' system established to facilitate the trade and exchange of programmes between the companies in the network.

Please see photocopy of calculation attached.

As the Annex to the original report upon which the above calculation is based notes, 'the "gross margin" does not include benefits the ITV company receives from the programme. In particular there is no mention of the advertising revenue that might be generated directly or indirectly by a major drama series. Neither does it take into account the cost of buying in an alternative programme to fill up the schedule.' Despite this, the company made a margin of £182,500 above direct costs, even though without the Levy costs exceed revenue by £200,000. An independent producer, of course, enjoys none of the hidden advantages mentioned in the note to the original Annex, but because of the Levy, is placed at a considerable disadvantage vis-a-vis an ITV company when it comes to competing for a Channel Four commission, an overseas sale or establishing international co-production arrangements. In practice the value of the 'UK Sale' to the ITV company may be higher than that shown if the programme is either one made by one of the 'big five' network companies (evidence elsewhere in the report suggests that the illustration was based on figures supplied by one of the regional stations) or is sold by the ITV company to

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Channel Four. In dealings with Channel Four ITV companies offering major programmes, such as the one in the illustration, accept payment by Channel Four of 75% to 80% of the cost in return for granting the Channel the right to one or two showings of the programme. An ITV company, unlike an independent, dealing with Channel Four will normally be allowed by the Channel to retain all rights and 100% of the income from subsequent overseas exploitation of any programme. Clearly this places an ITV company at a considerable advantage vis-a-vis an independent, in that through operation of the Levy the ITV company remains much less dependent on overseas sales than an independent.

Fortunately independent producers are a great deal more efficient than ITV companies and so manage to stay in business. A number of recent calculations of the true total cost of production of network television programmes, taking into account not only the profit margin added by independent producers but also the permanent staff, studio and production related overhead costs of the broadcasters (ITV and BBC), suggest that for every £100 an independent spends on a production, the BBC spends £120 and an ITV company £170. These figures perhaps explain why the independent producers are particularly happy to embrace the Government's commitment to introducing competition into programme supply in television, but are unhappy that the operation of the ITV Levy has the effect of stacking the cards against them. It also accounts for our lack of surprise over the ITV companies opposition to the introduction of competition in the form of independent access as evidenced by their delaying tactics and ultimate refusal to enter into meaningful discussions with the independent sector on establishing business guidelines for dealings between the companies and the independents pending the establishment of real competition and a genuine market in programme supply.

My committee suggested to the ITV companies business guidelines and working structures every bit as flexible as those recently agreed with the BBC. The ITV companies comprehensively rejected such proposals. In this context it is perhaps worth picking out some of the salient features of the arrangements agreed with the BBC. Fundamental to the agreement is the acceptance by both sides of what has come to be known as the 'Runway Principle': that is to say that it anticipates, and provides for, the phasing out of centrally agreed parameters for operating margins and shares of profit from overseas sales as genuine competition in programme supply is established. The guidelines on operating margins and levels of participation in overseas sales income were developed from the existing Channel Four system, but are more flexible and realistic than under that system. Margins are computed not only on

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the size of the production budget, but by assessment of market forces and the exigencies of the specific production. The agreement protects the BBC's right to editorial control over programme content and what it broadcasts, but also recognises and protects the vital intellectual or creative capital for an independent represented by a programme idea. Both sides recognise their shared interest in maximising profits from overseas and other sales. The guidelines also establish that while an independent may use BBC resources and facilities, if available, on a proper businesslike basis, agreement to use BBC facilities or staff must not be a condition of contract.

Of course the ITV companies have recently commissioned some independent production and claim to have quite a lot more 'in the pipeline'. However, just what productions, from what 'independent' producers and in how long a 'pipeline' are all matters over which ITV has so far been less than forthcoming. Of commissions about which something is known, a great many appear to be being made by companies that would not qualify as independents or under conditions imposed by the ITV companies which negate the objective of establishing a separate and competitive third force in programme supply. In order to gain contracts with ITV companies independent producers have frequently had to surrender their rights in the programme's concept or script, have been denied participation in a programme's subsequent overseas exploitation or refused an adequate operating margin. Independents have had to face ITV companies with whom they were trying to negotiate contracts who, often at the last moment, made it a condition of contract that the independent use the ITV company's studios and crews. Even so independents have accepted such contracts, the alternative being the possibility of winding up, liquidation or antagonising a powerful potential future customer.

Such is the background to the failure of talks with the representative body of the ITV companies - the ITV Association. Given the subsequent agreement with the BBC, and assuming that that agreement is successfully implemented, a basis would now seem to exist for the introduction of an element of genuine competition in programme supply into that side of the broadcasting duopoly. However the prospects for the successful implementation of Government policy on the ITV side look much less good. Whereas the experience of my Committee in talking to the BBC in recent months has been of the Corporation's willingness to enter into serious negotiations aimed at the flexible and practical implementation of independent access our experience of ITV has been one of prevarication and rigidity. My Committee is therefore of the view that if Government policy is to be implemented something beyond

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exhortation and leaving it to the IBA is now called for. If Government policy is to be implemented on anything like the timescale suggested by various Government statements then, because of the length of time still to run under the current ITV franchises, some faster acting inducement than the enactment of a new Broadcasting Bill is needed. I would ask you therefore to consider amending the structure of the ITV Levy in the forthcoming Budget.

The purpose of such amendment would be simultaneously to stimulate cost consciousness in ITV and provide an inducement to ITV companies to commission programmes on a realistic basis from genuine independent producers. To this end we would propose that the right to offset the total cost of programme making by ITV companies against their liability to Levy be removed and restricted to costs incurred as a result of certain limited categories of programme production or acquisition. Among the kinds of programme activity for which costs could continue to be offset would be the cost of commissioning or acquiring programmes from genuine independent producers and activities clearly connected with the companies public service broadcasting obligations, such as their financial contribution to the funding of national network news. Alternatively differential rates could be established, calculated to counterbalance the trading disadvantage which the current Levy structure produces as regards the competitive position of independents. The right of ITV companies to offset the cost of making programmes which they sell to Channel Four could also be terminated as this too does nothing to ensure cost-consciousness and has the effect of giving an ITV company an unfair advantage when competing for commissions with independent producers. While Channel Four was a net drain on ITV profits the right to offset their Channel Four programme costs may have been justified, but as the companies now make a net profit from Channel Four the justification no longer seems valid. While legislation will probably still be needed to secure competition in programme supply over the longer term, action of this kind through the Budget would seem to hold out the prospect of being both administratively straight forward and producing quick results.

Please forgive the length of this letter. If there is further information or ideas that I or my colleagues can provide we would be very willing to do so.

Yours sincerely



MICHAEL DARLOW
Head of Negotiations



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HOME OFFICE *M. Bolt*
QUEEN ANNE'S GATE
LONDON SW1H 9AT

Brian Gilmore Esq
HM Treasury
Parliament Street
London SW1

cc. Mrs. High
Mr. Cave

Mr. Bolt

This seems to me broadly OK, now; cd. Mr. Bolt clear a sub 12 January 1988 to go to the Chancellor for the weekend? Action on the levy is with me. BTG 12/1

Dear Brian,

THE ITV SYSTEM AND CHANNEL 4

Thank you for your letter of 17 December containing comments on the draft MISC 128 paper that I had circulated earlier in the month. I was also grateful for Alastair MacDonald's comments in his letter of 23 December.

I have now been able to report the views of the Chancellor and Lord Young to the Home Secretary, and he has asked me to send you a revised version of the paper, copy enclosed, This seeks to take account of their views, and, with some editorial licence, of the more detailed comments you have made. It also includes a couple of points made by Home Office Ministers.

I hope you will find no difficulty with part A of the paper, or with the statement in paragraph 1 that the proposals it contains have the support of the Chancellor and Lord Young. Given the latest exchange of Ministerial correspondence about contracts for independent national radio, we have shortened paragraph 12. We have also shortened paragraph 14 on networking since I hope that we shall be able to circulate some new ideas, fairly soon, at official level.

We await further Treasury advice on the form of the levy (paragraph 13).

As regards ITN, the Home Secretary, having noted the views of your Ministers, is disposed, as you will see, to put two options forward to MISC 128 without a specific recommendation.

The Home Secretary also feels that the paper should not make a specific recommendation about Channel 4. We have, however, substantially revised the description of option (c) to incorporate the Chancellor's suggestion. The paper does not, include any reference to the possibility of a fifth channel being financed by advertising since there are, as you well know, many uncertainties about the fifth channel and the Home Secretary,

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while noting Lord Young's comment, feels that he should now invite his colleagues to take a decision about the future of Channel 4.

The final version of the paper needs to be circulated not later than 21 January for discussion at the MISC 128 meeting now arranged for 28th January. Might I therefore ask for your advice on paragraph 13 by 18 January, and also for any further drafting suggestions that you or Alastair may want to make. I am copying this letter and enclosures to Alastair MacDonald and Anthony Langdon. If necessary let us have a word at the meeting arranged in Anthony's office on 18 January.

Yours
W N Hyde

W N HYDE

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DRAFT : 12 January 1988

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MISC 128 (88) 1

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CABINET
MINISTERIAL GROUP ON BROADCASTING SERVICES

THE ITV SYSTEM AND CHANNEL 4

Memorandum by the Secretary of State for the Home Department

At our meeting on 28 October we discussed proposals for the reform of the independent television system and the future constitution of Channel 4. I was asked to bring forward a further paper which took account of the points made in that discussion and of the further consideration of outstanding issues in consultation as necessary with colleagues. This paper makes proposals which have the support of the Chancellor of the Exchequer and the Secretary of State for Trade and Industry. On two matters (ITN and Channel 4) it invites the Group to decide between options.

A. ITV CONTRACTS FROM 1 JANUARY 1993

2. The Group decided, in principle, at its meeting on 20 July, that in future ITV contracts should be awarded by a two stage process, with companies which satisfied a quality threshold being selected on the basis of competitive tender.

(i) Ownership of companies

3. As recommended by the Official Group (MISC 128 (87) 8), the following existing restrictions should continue to apply to companies bidding for, or wishing to take over, ITV contracts:-

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- a) no advertising agency should be permitted to hold or have an interest in a contract;
- b) newspaper shareholdings in a contract should not, in aggregate, exceed 20%; and
- c) the company must be registered within the EC.

4. I also propose the following additional controls:-

- d) a company holding an ITV contract for any services with national or cross regional coverage should not be permitted to hold or have an interest in any other ITV contract;
- e) if two contracts were let for the same region (as now happens in London) no company should hold or have an interest in both;
- f) apart from this, a company would not be permitted to own or have an interest in more than two ITV contracts.

5. Taken together, conditions d), e) and f) would provide a fair balance between the need to stimulate competition in the supply of programme services and the need to enable companies to enlarge their field of operations if this would provide a more efficient service and meet normal market tests. I propose that these conditions should be incorporated in subordinate legislation and hence variable if necessary.

6. As an exception to d), e) and f), the IBA would be empowered to invite any or all contractors to participate in a competition for the reassignment of a contract in mid-term, if in the IBA's view this was the only practicable means of maintaining a service.

(ii) Quality threshold

7. The Official Group suggested that applicants to bid for, or

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take over, contracts should be required to demonstrate that:-

- a) they have sufficient financial resources to sustain a high quality service as required by the 1981 Broadcasting Act;
- b) their programme plans offer programmes of a high general standard, a proper balance and a wide range of subject matter and are capable of being realised;
- c) they have management resources of sufficient quantity and proven quality to be able to fulfil the terms of the contract; and
- d) they have defined links with the region which it is proposed to serve.

8. I would propose to make it clear in addition that the programme plans at b) must

- have regard to the character of and market conditions in the service area concerned;
- provide for at least 25% of original output to be supplied by independent producers at the start of the contract;
- show how this proportion was likely to increase beyond 25% over the period of the contract.

The Government would make it clear in explaining its proposals that it hoped those bidding for tenders would include contractors proposing to operate with little or no in-house production from the outset, as well as those whose initial plans might make provision for no more than the required minimum of 25% of independent producers.

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iii) Lengths of contract and review of performance

9. I remain of the view that eight years continues to be the right maximum period for ITV contracts. Peacock offered no reason for his recommendation of 10 years, and I do not think it would be right to introduce a greater element of fixity into the ITV system at a time when the industry is facing major changes. Within the contract period there would be automatic formal reviews by the IBA of contractors' performance at two years and five years, but the IBA would be able to initiate an additional review at any time if needed. As recommended by Peacock, the IBA would have power, after a review, to issue a formal warning (a 'yellow card') and to remove a contractor (a 'red card') one year later if performance remained unsatisfactory, for example in failing to deliver their promised programme plans. The idea of performance bonds (under which all contractors would be required to put up a bond at the outset which would be forfeited in part if they received a yellow card) might be worth further study as a possible way of reinforcing the maintenance of programme standards. At present the IBA retains a large degree of influence over contractors because they award contracts when they come up for renewal. Under competitive tendering the ability of the regulatory authority to keep a contractor up to the mark will be slight in the last couple of years of the franchise period when it would be difficult to reallocate the contract; loss of part of the performance bond could be a useful ^{lever} ~~level~~ for maintaining programme standards.

10. The exercise of these powers would be subject to judicial review, so I can see no case for a separate right of appeal. This would draw the Government into judgements about the quality of individual programmes which we would regret. A contractor shown a red card could not, in practice, be debarred from applying again at the start of the next contract round, though it might prove difficult for such a contractor to pass the quality test.

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iv) Financial terms

11. We have already agreed that contracts would be awarded by competitive tender on the basis of a lump sum payable each year of the contract and of an obligation to pay a levy on advertising revenue at specified rates. Both the tender and the revenue levy payments would (like the existing profits levy) represent the first slice of taxation, with corporation tax payable on subsequent profits.

12. The contractor offering the highest bid would receive the contract. Peacock (Report paragraph 656) recommended that the IBA should have a limited discretion to accept a lower bid, but we have, in effect, already met the purpose of the proposal by requiring all prospective contractors to surmount an objective quality threshold.

13. As to the revenue levy, the Official Group proposed a progressive levy on revenue per television household. [In the light of the further discussion I have had I have concluded that this may be unduly complicated. A progressive levy on total revenue should be sufficient, as the tender procedure will tend to even out differences in the commercial value of the largest and the smallest contracts.] [Having looked at this again, I accept their advice for the reasons set out in the Annex].

v) Networking

14. It is not yet clear how any arrangements for networking will operate ~~past~~ 1992 with contracts awarded by competitive tender. We shall have to ensure, by legislation if necessary, that any new networking arrangements are transparent, competitive and work on the basis of programme quality rather than on the present basis of a group of privileged companies having priority access.

B. ITN

15. At our meeting on 28 October we noted that, while it was

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important not to undermine the high quality of news services provided by ITN, it would be wrong for ITN to remain immune to pressures to become more cost conscious and efficient. At the same time it is necessary to take account of ITN's wish to continue its diversification into international markets.

16. If ITN were to become independent of the ITV companies (and of the control of the IBA) through a full company flotation, then this would certainly call into question its guaranteed access to the ITV network. It would not be consistent with our general competition policy and the position on networking outlined above for ITN to retain its monopoly position. We should legislate to allow the companies taking on new ITV contracts in 1993 the option to obtain news from an alternative supplier on a commercial basis.

17. The present indications are, however, that the changes adopted by ITN will involve no more than the injection of new capital by independent minority shareholders (possibly confined to ITN's high risk activities outside IBA services for which it wants new capital). These changes could be implemented (by agreement between ITV, ITN and the IBA) without, and in advance of, new legislation.

18. The existence of even a minority of independent shareholders within ITN should help to promote more entrepreneurial attitudes and strengthen ITN's ability to compete in international markets. It would not necessarily improve efficiency in the core activities. And the monopoly position of ITN would remain.

19. We have two options:-

- a) to retain the present statutory framework (Section 22 of the Broadcasting Act 1981) in the expectation of the introduction of a minority (but not a majority) of independent shareholders;
- b) to alter that framework and allow ITV companies the option of obtaining news from an alternative supplier,

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while remaining subject to the present rules on impartiality etc.

CHANNEL 4

20. We are agreed that Channel 4 airtime should be sold separately from ITV. We are also agreed that Channel 4's distinctive remit should be maintained. The question at issue is how best to achieve these twin objectives.

21. There are the following options:-

- a) the reconstitution of Channel 4 as a separate broadcasting authority, responsible for selling its own airtime (either directly or through a service contract which it would let to a sales company other than an ITV contractor);
- b) as a), but with Channel 4's income determined not directly by the revenue generated by the sale of its airtime but by a defined percentage of the total revenue from advertising on ITV, Channel 4 and S4C;
- c) the operation of Channel 4 on a full commercial basis, under a contract with the IBA, analogous to the new ITV contracts but designed to meet the special remit of the Channel.

22. I first proposed option a). It has the merit of simplicity. There was concern on the part of some members of the Group that if advertising revenue remained buoyant, this option could undermine our encouragement of efficiency within broadcasting by leaving the Channel with too much money to commit to programme production - even though all production is now contracted out. This could be partly but not entirely dealt with by applying the same levy on advertising revenue to the new Channel 4 authority as to ITV contractors.

23. Option b) - fully developed in MISC 128 (87) 9 - was

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intended to address this concern. The formula fixing Channel 4's maximum income could also provide securely for the funding of S4C (on the need for which we are agreed). This option (like option a)) would meet the concern of the advertisers, who have made it clear that they want no change to Channel 4's present programming approach.

24. If, under option c), the award of the contract for Channel 4 was made on exactly the same lines as suggested in part A of this paper, it would be necessary for the quality threshold for this particular contract to incorporate a more precise formulation of Channel 4's remit. That remit is at present expressed in the general language of the 1981 Broadcasting Act, which is appropriate to provide the guidance the regulatory body needs but which the IBA might find it hard to enforce against conflicting commercial interests. It would be difficult to judge if a contractor had satisfied a requirement that his programme plans would (as the present law stipulates) encourage innovation and experiment. A more attractive course would be to invite applicants to spell out their detailed programme intentions on the basis of the 1981 Act as it stands; to leave the IBA to choose the winning tender for this particular franchise on quality as well as on price; and to embody the full detail of the winning programming plans in the contract, for the IBA to police with the same armoury of reviews and yellow/red cards as the other contracts.

Conclusion

25. I invite the Group:-

- a) on ITV contracts to agree that work should now proceed on the preparation of a White Paper on the basis of the proposals outlined in paragraphs 2 - 14 above;
- b) on ITN to note that agreement may be reached by the parties concerned to the incorporation of independent minority shareholdings into ITN within existing statutory provisions; and to consider if, in that

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event,

- i) these provisions should remain; or
- ii) ITV companies should, after 1992, be given the option of untying from ITN;
- c) on Channel 4 to decide between the options summarised in paragraph 20 above.

DH

CONFIDENTIAL

FROM: C W BOLT

DATE: 14 January 1988

1. MR BURR ^{14/1}
2. CHANCELLOR

cc Chief Secretary
 Financial Secretary
 Mr Anson
 Mr Kemp
 Mr Monck
 Mr Burgner
 Mr Gilmore
 Mr Spackman
 Mr Burr
 Miss Sinclair
 Mrs Pugh
 Mr Cave
 Mr Tyrie
 Mr Call

Ch/
 content for
 officials to
 proceed as at
 para 6? OK

ITV SYSTEM AND CHANNEL 4 (C4)

mjan 14/1

The Home Office have asked for our comments on the attached draft paper for MISC 128 on 26 January. This paper has been revised in the light of Treasury comments on a previous version (^{Mr Gilmore's} submission of 15 December) and comments from DTI. This submission recommends that you agree to circulation of the paper with your endorsement, subject to further detailed discussions between officials on the structure of the levy.

ITV Contracts

2. Treasury comments on the earlier draft recorded your concern that the Government should be more positive about a "preference for non-producers". The draft now proposes that applicants for contracts should show how the proportion of independently produced material would increase (beyond 25 per cent) over the contract period, and suggests that the Government would indicate a hope that bids would be made by contractors proposing to operate with little or no in-house production from the outset, as well as by those operating near the minimum for independent productions of 25% (paragraph 8). This is a little weaker than we suggested, but I believe it recognises the thrust of the Treasury concern. We recommend that you accept the terms of the current draft.

3. Paragraph 13, concerning the structure of the levy, remains to be finalised, although the Home Office appears prepared to accept our argument for a levy structure which reflects the different numbers of households - and hence potential advertising revenue - in different contract areas. We are in touch with the No.10 Policy Unit to discuss our proposals, as it seems useful to ensure that they can accept this formulation before it is incorporated as a firm recommendation in the MISC 128 paper.

ITN

4. The section on ITN now contains, as an option, the Treasury preference for untying ITV contractors from ITN (paragraph 19). We recommend that you accept this presentation of the arguments.

C4

5. Under option c (the operation of Channel 4 on a full commercial basis, under a contract with the IBA), our preference for retaining the 1981 statutory framework, and allowing the IBA to award a contract on quality as well as price considerations, has been incorporated in the draft. The option of retaining the status quo has also been removed. This section now fully reflects the Treasury position.

6. If you agree, we will:

(i) discuss urgently at official level the paragraph on the structure of the levy, and report back to you if our preferred structure appears not to be acceptable

(ii) subject to this, inform the Home Office that you are content for the paper to issue with your endorsement.

7. We will, of course, provide full briefing for the MISC 128 meeting on 26 January, including on issues arising from the recently published NAO report on the levy and on two recent letters to you from Michael Darlow (of the Independent Access Steering Committee).

Ch: (only one, that I am aware of, (behind) but earlier ones to PM / Home Sec with replies cleared round MISC128)

C. W. Bolt

C W BOLT

mpw



FROM: MOIRA WALLACE
DATE: 18 January 1988

MR C W BOLT

- cc Chief Secretary
- Financial Secretary
- Mr Anson
- Mr Kemp
- Mr Monck
- Mr Burgner
- Mr Gilmore
- Mr Spackman
- Mr Burr
- Miss Sinclair
- Mrs Pugh
- Mr Cave
- Mr Tyrie
- Mr Call

ITV SYSTEM AND CHANNEL 4 (C4)

The Chancellor has seen and was grateful for your minute of 14 January. He is content for you to proceed as you propose.

mpw

MOIRA WALLACE



Paul

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

21 January 1988

EXCHANGED	
REC.	21 JAN 1988 ✓
AGENCY	Mr Burr
CLASSIFIED TO	CST, FST
	SIR P Middleton
	MR Anson
	MR Kemp
	MR Gilmore
	MR Kerley
	MR Tyme

22/1

Dear Sir,

INDEPENDENT PRODUCTION INITIATIVE

The Prime Minister has seen and is content with the draft letter for the Home Secretary to send to Mr. Darlow, attached to your letter of 19 January.

I am copying this letter to the Private Secretaries to the other members of Misc 128 and to Trevor Woolley (Cabinet Office).

*Yours,
Paul*

Paul Gray

C. R. Miller, Esq.,
Home Office.



pay

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

C R Miller Esq
Private Secretary
Secretary of State's Office
Home Office
Queen Anne's Gate
LONDON
SW1H 9AT

22 January 1988

Dear Colin

INDEPENDENT PRODUCTION INITIATIVE

The Chancellor has seen your letter of 19 January, covering a draft reply from your Secretary of State to Michael Darlow, head of the negotiations of the Independent Access Steering Committee. He is content for the reply to be issued in the form suggested. He has noted that Mr Renton is to meet Mr Darlow again on 25 January, and hopes that the recent initiative from the IBA will result in some positive progress being identified at that meeting.

As indicated in Mr Darlow's letter of 6 January to the Secretary of State for Trade and Industry, Mr Darlow has also written to the Chancellor proposing that changes to the ITV levy should be made in the Budget which would significantly benefit independent producers. The Chancellor thought that this letter would be of interest to the Home Secretary and other members of MISC 128 and I am therefore attaching a copy. This letter is being treated here as a Budget representation, and a reply is being sent accordingly. It is therefore appropriate that no mention should be made of this proposal about the levy in your Secretary of State's letter to Mr Darlow.

Yours,

Moira.

MOIRA WALLACE
Private Secretary



Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

Michael Darlow Esq
Independent Access Steering Committee
74 Newman Street
LONDON
W1P 3LA

January 1988

Mr Michael Darlow

Thank you for your letter of 6 January setting out in detail progress on the negotiations between independent producers and the BBC and ITV companies, and your suggestions for reforming the ITV levy to give ITV companies a greater incentive to use independent producers.

I can assure you that your representations will be carefully considered in the run-up to the Budget. However, I hope that you will understand that it would be inappropriate for me to comment further at this stage.

Nigel Lawson

NIGEL LAWSON

INDEPENDENT ACCESS STEERING COMMITTEE

74 NEWMAN STREET
LONDON W1P 3LA
TELEPHONE 01 323 3220
TELEX 266075 PRODCO-G

Rt. Hon Nigel Lawson, MP
The Chancellor of the Exchequer
The Treasury
Parliament Street
London W1

HM TREASURY - MCU	
RECD.	13 JAN 1983
ACTION	M/S BURN HER
	CL ADS/CHX
SEARCHED	CHX
INDEXED	10829/88

4 January 1988

Dear Chancellor of the Exchequer,

INDEPENDENT TELEVISION PRODUCERS

During the Prime Minister's seminar on Broadcasting on 21st September you very kindly said that I might write to you at a future date about the implications for independent producers of the current tax and Levy arrangements governing ITV. As you may know in recent weeks talks between the independent producers represented by my committee and the ITV companies initiated by the IBA and aimed at establishing a voluntary basis for implementing Government policy on 25% access for programmes made by independents have broken down. Similar talks on business guidelines for the period before a genuine competitive market in the supply of television programmes is established have now been brought to a satisfactory conclusion with the BBC. These two events mark something of a watershed for the voluntary implementation of Government policy. This therefore seems an appropriate moment at which to write to you.

ITV must be almost unique in British industry in that the companies within it thrive through making one thing but selling another: they make television programmes, but sell advertising air-time. Where they do sell programmes, overseas or to Channel Four, this remains despite the increasing attention paid to it, an essentially secondary activity. In any case the basis for such programme sales by ITV companies is firmly rooted in the artificial financial regime of their primary function as broadcasters and privileged holders of the right to exploit a public asset - the right to sell advertising air-time.

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The Review of the ITV Levy Structures undertaken by officials from the Home Office, the Treasury and the IBA, published in February 1986, recognised that the Levy, as then structured, might act as a dis-incentive to cost-consciousness within the ITV companies. Even as reformed in the subsequent Budget the Levy structure still provides a degree of disincentive to ITV cost consciousness and certainly results in independent producers (widely recognised as a good deal more cost effective than ITV companies) being at a trading disadvantage in dealings with Channel Four and in competing for overseas markets. One of the annexes to the Review of the ITV Levy Structures contained an illustrative calculation of the effects of the Levy as then structured on the programme making decisions of one ITV company based on real figures seen by the committee. We asked accountants to rework this calculation on the basis of the current reformed Levy structure. The illustration posits the production of a major programme, such as a drama series costing £2m to produce and, in our re-working, assumes overseas sales of £1.3m, a realistic figure in our experience. The 'UK Sales' could either be to Channel Four, or for an ITV company the sum paid or credited to it by the other companies under the network 'pool' system established to facilitate the trade and exchange of programmes between the companies in the network.

Please see photocopy of calculation attached.

As the Annex to the original report upon which the above calculation is based notes, 'the "gross margin" does not include benefits the ITV company receives from the programme. In particular there is no mention of the advertising revenue that might be generated directly or indirectly by a major drama series. Neither does it take into account the cost of buying in an alternative programme to fill up the schedule.' Despite this, the company made a margin of £182,500 above direct costs, even though without the Levy costs exceed revenue by £200,000. An independent producer, of course, enjoys none of the hidden advantages mentioned in the note to the original Annex, but because of the Levy, is placed at a considerable disadvantage vis-a-vis an ITV company when it comes to competing for a Channel Four commission, an overseas sale or establishing international co-production arrangements. In practice the value of the 'UK Sale' to the ITV company may be higher than that shown if the programme is either one made by one of the 'big five' network companies (evidence elsewhere in the report suggests that the illustration was based on figures supplied by one of the regional stations) or is sold by the ITV company to

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Channel Four. In dealings with Channel Four ITV companies offering major programmes, such as the one in the illustration, accept payment by Channel Four of 75% to 80% of the cost in return for granting the Channel the right to one or two showings of the programme. An ITV company, unlike an independent, dealing with Channel Four will normally be allowed by the Channel to retain all rights and 100% of the income from subsequent overseas exploitation of any programme. Clearly this places an ITV company at a considerable advantage vis-a-vis an independent, in that through operation of the Levy the ITV company remains much less dependent on overseas sales than an independent.

Fortunately independent producers are a great deal more efficient than ITV companies and so manage to stay in business. A number of recent calculations of the true total cost of production of network television programmes, taking into account not only the profit margin added by independent producers but also the permanent staff, studio and production related overhead costs of the broadcasters (ITV and BBC), suggest that for every £100 an independent spends on a production, the BBC spends £120 and an ITV company £170. These figures perhaps explain why the independent producers are particularly happy to embrace the Government's commitment to introducing competition into programme supply in television, but are unhappy that the operation of the ITV Levy has the effect of stacking the cards against them. It also accounts for our lack of surprise over the ITV companies opposition to the introduction of competition in the form of independent access as evidenced by their delaying tactics and ultimate refusal to enter into meaningful discussions with the independent sector on establishing business guidelines for dealings between the companies and the independents pending the establishment of real competition and a genuine market in programme supply.

My committee suggested to the ITV companies business guidelines and working structures every bit as flexible as those recently agreed with the BBC. The ITV companies comprehensively rejected such proposals. In this context it is perhaps worth picking out some of the salient features of the arrangements agreed with the BBC. Fundamental to the agreement is the acceptance by both sides of what has come to be known as the 'Runway Principle': that is to say that it anticipates, and provides for, the phasing out of centrally agreed parameters for operating margins and shares of profit from overseas sales as genuine competition in programme supply is established. The guidelines on operating margins and levels of participation in overseas sales income were developed from the existing Channel Four system, but are more flexible and realistic than under that system. Margins are computed not only on

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the size of the production budget, but by assessment of market forces and the exigencies of the specific production. The agreement protects the BBC's right to editorial control over programme content and what it broadcasts, but also recognises and protects the vital intellectual or creative capital for an independent represented by a programme idea. Both sides recognise their shared interest in maximising profits from overseas and other sales. The guidelines also establish that while an independent may use BBC resources and facilities, if available, on a proper businesslike basis, agreement to use BBC facilities or staff must not be a condition of contract.

Of course the ITV companies have recently commissioned some independent production and claim to have quite a lot more 'in the pipeline'. However, just what productions, from what 'independent' producers and in how long a 'pipeline' are all matters over which ITV has so far been less than forthcoming. Of commissions about which something is known, a great many appear to be being made by companies that would not qualify as independents or under conditions imposed by the ITV companies which negate the objective of establishing a separate and competitive third force in programme supply. In order to gain contracts with ITV companies independent producers have frequently had to surrender their rights in the programme's concept or script, have been denied participation in a programme's subsequent overseas exploitation or refused an adequate operating margin. Independents have had to face ITV companies with whom they were trying to negotiate contracts who, often at the last moment, made it a condition of contract that the independent use the ITV company's studios and crews. Even so independents have accepted such contracts, the alternative being the possibility of winding up, liquidation or antagonising a powerful potential future customer.

Such is the background to the failure of talks with the representative body of the ITV companies - the ITV Association. Given the subsequent agreement with the BBC, and assuming that that agreement is successfully implemented, a basis would now seem to exist for the introduction of an element of genuine competition in programme supply into that side of the broadcasting duopoly. However the prospects for the successful implementation of Government policy on the ITV side look much less good. Whereas the experience of my Committee in talking to the BBC in recent months has been of the Corporation's willingness to enter into serious negotiations aimed at the flexible and practical implementation of independent access our experience of ITV has been one of prevarication and rigidity. My Committee is therefore of the view that if Government policy is to be implemented something beyond

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exhortation and leaving it to the IBA is now called for. If Government policy is to be implemented on anything like the timescale suggested by various Government statements then, because of the length of time still to run under the current ITV franchises, some faster acting inducement than the enactment of a new Broadcasting Bill is needed. I would ask you therefore to consider amending the structure of the ITV Levy in the forthcoming Budget.

The purpose of such amendment would be simultaneously to stimulate cost consciousness in ITV and provide an inducement to ITV companies to commission programmes on a realistic basis from genuine independent producers. To this end we would propose that the right to offset the total cost of programme making by ITV companies against their liability to Levy be removed and restricted to costs incurred as a result of certain limited categories of programme production or acquisition. Among the kinds of programme activity for which costs could continue to be offset would be the cost of commissioning or acquiring programmes from genuine independent producers and activities clearly connected with the companies public service broadcasting obligations, such as their financial contribution to the funding of national network news. Alternatively differential rates could be established, calculated to counterbalance the trading disadvantage which the current Levy structure produces as regards the competitive position of independents. The right of ITV companies to offset the cost of making programmes which they sell to Channel Four could also be terminated as this too does nothing to ensure cost-consciousness and has the effect of giving an ITV company an unfair advantage when competing for commissions with independent producers. While Channel Four was a net drain on ITV profits the right to offset their Channel Four programme costs may have been justified, but as the companies now make a net profit from Channel Four the justification no longer seems valid. While legislation will probably still be needed to secure competition in programme supply over the longer term, action of this kind through the Budget would seem to hold out the prospect of being both administratively straight forward and producing quick results.

Please forgive the length of this letter. If there is further information or ideas that I or my colleagues can provide we would be very willing to do so.

Yours sincerely



MICHAEL DARLOW
Head of Negotiations

dti

the department for Enterprise

*Pse can I see
copy of X (which
I suspect we did not
receive) and
minutes of Y. m.
pnp*

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

Colin Miller Esq
Private Secretary to the Home Secretary
Home Office
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CH/EXCHEQUER	
REC.	15 FEB 1988 ✓ 15/2
ACTION	MR BURR
COPIES TO	CST FST SIR P. MIDDLETON MR ANSON MR KEMP MR SURGNER MR SCHWAR MR SPACKMAN MR CAVE MRS PUGH MR BOLT MR KERLEY MR CROPPER

Direct line
Our ref 215 5422
Your ref PSLAIN
Date 15 February 1988

Dear Colin

MISC 128 : INDEPENDENT PRODUCERS

X We have been discussing how best to meet the concern, outlined in Anthony Langdon's letter of 10 February to Alison Brimelow, that the broadcasting authorities might hear indirectly of the possibility of monitoring the contracts with independent producers.

Y Fortuitously, the Secretary of State has a long-standing meeting with Michael Darlow and some other members of the Independent Access Steering Committee (IASC), at 11 am tomorrow. In accordance with the remit from MISC 128 on 9 February he will therefore be seeking their reaction to the possibility of the Office of Fair Trading's wishing to see some details of their commercial contracts with the broadcasters.

I understand that officials here have been in touch with the Home Office Broadcasting Department and that the Home Office will advise the BBC, IBA and ITV Association informally of the



the department for Enterprise

possibility of OFT monitoring while the Secretary of State's meeting is in progress. This arrangement should forestall the kind of difficulty which Anthony Langdon raised in his letter.

My Secretary of State will be writing shortly to his colleagues on MISC 128 to report on the outcome of his discussions with the independents and on the other points MISC 128 asked him to pursue.

I am copying this letter to Anthony Langdon at the Cabinet Office.

Yours

Jeremy Godfrey

JEREMY GODFREY
Private Secretary

