COMMERCIAL IN CONFIDENCE

QUEEN ANNE'S GATE LONDON SW1H 9AT

18 April 1988

Dear Nigel,

ITV LEVY FOR CONTRACT EXTENSION PERIOD

My letter of 23 February indicated that my officials were conducting an assessment of the options for changing the levy base to incorporate a revenue element, as you proposed. This work has now focused on two principal schemes: one based on revenue alone and the other based partly on revenue and partly on profits. Details of these two schemes are set out in an Annex to this letter. Although further work is still being done to refine the analyses of the two schemes, we do not expect this to change the assessment to any significant extent.

Either scheme should produce substantially higher yields than the present profits-based levy in most circumstances and therefore meets the objective of obtaining a satisfactory return. The principal differences in the operation of the two schemes are as follows. If net advertising revenue (NAR) increases more rapidly than forecast, a scheme based solely on revenue produces higher additional yields than a mixed scheme. The reverse is the case when NAR is static or declining. The mixed scheme is less redistributive in its impact on individual companies, as it takes some account of changes in profits, but the revenue only scheme yields a lower marginal tax rate.

Since the relative financial merits of the two schemes are finely balanced, there are wider factors which should be taken into account. The IBA, which will remain the collecting agency for the levy, is strongly opposed to a revenue only scheme. It points to the instability of the 1964-74 revenue levy, where rates had to be changed frequently; and the fact that companies would be liable to levy even when operating at a trading loss. A copy of John Whitney's letter of 24 February to Sir Brian Cubbon is attached, and explains these points in more detail.

More generally, with increased competition from satellite and other terrestrial channels and the prospect of competitive tendering in 1993, the ITV companies will be under considerable pressure to cut costs regardless of any changes in the levy structure. The screw is tightening on them quite fast. They are in some agitation already and we do not want them to be wholly discouraged.

/Finally,

The Rt Hon Nigel Lawson, MP

Finally, MISC 128, as you know, has already decided that with effect from 1993, ITV contracts will be subject to competitive tendering and a revenue levy. The competitive tendering process would seek to cream off monopoly profits which is analagous to, though better than, the existing levy on profits, and the new revenue levy would exert downward pressure on costs. Accordingly it would seem logical to use the transitional period to move from the existing levy on profits to a mixed levy on both revenue and profits, by way of paving the way for the new arrangements after 1993.

Either scheme should have the positive impact on costs which we are looking for, and provide an adequate response to the PAC's anticipated criticism of the present system. On balance, however, I consider that a mixed profits and revenue scheme would be preferable, and I hope that you will be able to agree to this.

We need to reach a decision urgently on which scheme to adopt, since the IBA is due to offer the ITV companies new contracts at the end of this month. Accordingly I should be grateful if you could let me have an early response.

I am copying this letter to the Prime Minister, other members of MISC 128 and to Sir Robin Butler.

Yours,

Douglas

DETAILS OF PROPOSED ALTERNATIVE LEVY SCHEMES

1. <u>The straight revenue scheme</u>

A progresive levy on net advertising revenue, as follows:

NAR (£m)	Levy rate (%)
0-15	0% zero band or free slice
15-40	6%
40-100	12%
100+	18%

These rates would apply to all companies. In addition, each company would be able to offset its current fourth channel subscription against levy, creating in effect an additional graduated free slice.

2. <u>The mixed scheme</u>

A combination of a progressive levy on net advertising revenue and a flat rate levy on net profits. The revenue levy element would be as follows:

NAR (£m)	Levy rate (0%)
0-15	0%
15-40	5%
40-100	10%
100+	12%

In addition, each company would be able to offset its current fourth channel subscription against levy.

The profits-based element would comprise a flat rate of 22.5% on both domestic and overseas profits. The leviable profits would be net profits ie after revenue levy had been deducted.

3. The existing scheme

A profits-based levy with rates of 45% on domestic profits and 22.5% on overseas profits. Leviable profits are those after deduction of fourth channel subscription but before payment of corporation tax.

4. The pre-1986 scheme

As above, but with a rate of 66.7% on domestic profits only. No levy on overseas profits.

<ak>sub/smith/mil/itv/levy/15/3/annexc

COMPANIES' LEVY PAYMENTS UNDER MOST LIKELY SCENARIO (N1, P1)

COMPARISON OF PROPOSED NEW SCHEMES WITH EXISTING SCHEME

Company	Mixed	Revenue only	Existing scheme	Existing scheme at pre-1986 rates
	£(m)	£(m)	£(m)	£(m)
Thames	30	33.5	20	26
Central	27	29	16.5	19
Granada	20	19.5	17	23.5
LWT	19	21	12	16
Yorkshire	13	15	9	12
TVS	20	21	15	20
HTV	9	8	6	5.3
Scottish	8	7	7	10.5
Anglia	8.5	7	7	9
TTT	4	4	4	5
TSW	1.5	1.5	1.5	2
Ulster	0.5	0.5	0.3	0.4
Grampian	0.5	0.5	0.2	0.3
Border	0	0	0	0
TV-am	9	5.5	11.5	17
Total	170	173	126	166

<ak>sub/smith/mil/itv/levy/15/3/annexd

LEVY YIELDS: COMPARISON OF PROPOSED NEW SCHEMES WITH EXISTING
(£m) SYSTEM UNDER 12 SCENARIOS

Scenario	Mixed	Revenue only	Existing system	Existing system at pre-1986 rates
	£m	£m	£m	£m
N1, P1	170	173	126	166
N1, P2	191	173	164	217
N1, P3	217	173	211	279
N1, P4	140	173	66	87
N4, P1	111	65	126	166
N3, P1	277	345	126	166
N2, P1	212	250	126	166
N2, P2	233	250	164	217
N3, P3	309	345	211	279
N4, P4	78	65	66	87
N5, P1	137	111	126	166
N5, P4	104	111	66	87

N1 = NAR growth of 10% pa
N2 = NAR growth of 20% pa
N3 = NAR growth of 30% pa
N4 = NAR growth of -10% pa
N5 = NAR growth of 0% pa

P1 = Profits growth of 10% pa
P2 = Profits growth of 20% pa
P3 = Profits growth of 30% pa
P4 = Profits growth of -10% pa

Mixed scheme - 5, 10, 12% revenue
22.5% profits

Revenue only scheme - 6, 12, 18% revenue

Existing scheme - 45 and 22.5% on profits

Pre-1986 scheme - 66.7% on profits

<ak>sub/smith/mil/itv/levy/15/3/enc

A CUMULATIVE LEVY YIELDS - 1990-1992: COMPARISON BETWEEN STRAIGHT REVENUE AND MIXED SCHEMES

Scenario	Mixed	Revenue only
	£m	£m
N1, P1	568	673
N1, P3	805	673
N1, P4	452	673
N4, P1	358	210
N4, P3	595	210
N4, P4	230	210

B LEVY YIELD/TOTAL PROFITS RATIO - 1990-1992: COMPARISON BETWEEN STRAIGHT REVENUE AND MIXED SCHEMES

Scenario	Mixed	Revenue only
	%	%
N1, P1	54	64
N1, P3	38	31
N1, P4	94	140
N4, P1	34	20
N4, P3	28	10
N4, P4	48	44

NB See Annex D for explanation of scenario codes and levy rates

<ak>sub/smith/bann/itv/levy/30/3/annexe

Levy file

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INDEPENDENT BROADCASTING AUTHORITY

70 Brompton Road, London SW3 1EY
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JOHN WHITNEY Director General

24th February 1988

Dear Brian

There are two issues arising out of the recent hearing before the PAC that I would like to raise with you. The first concerns the rates of levy, and the second its structure.

At this stage, we do not know what the Committee will conclude. However, the burden of the report by the Comptroller and Auditor General, echoed by much of the questioning on 10th February, was that the rates of levy should now be raised in order to produce the sum that might have been expected if 1986/7 had been used as the basis for revenue neutrality, rather than 1985/6.

This, it seems to me, would be a great mistake. A policy of reducing levy rates in the interests of cost consciousness is not something that can be expected to produce instant results. The policy, once embarked upon, needs to be sustained over a period of several years. As our briefing material for the hearing showed, recovery of the £19m would require rates which would significantly reverse the reduction in the marginal rate of levy from 66.7% to 45% which was achieved in 1986.

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Moreover, if we cannot give precedence to the cost consciousness objective at a time when the levy yield as a whole is rising rapidly, then the government's policy of low marginal tax rates, to encourage business efficiency, would be seriously prejudice.

I would therefore urge that Ministers should not increase the present levy rates.

Might I now turn to the second issue concerning the levy structure. In your evidence to the Committee last week you alluded to the possibility of a change in the structure of levy which would be announced this year (in conjunction with the offer of extended ITV contracts for the period 1990 to 1992) but which would not take effect until 1 January 1990. If there is to be a change for the 1990 - 1992 contract extension period, then I am sure that this represents the most sensible and businesslike approach to the announcement and to the effective date. The crucial question which remains however, is what would be the nature of the change.

Much of the concern expressed about the levy over recent years has focussed on the argument that high marginal rates within a profit based system act as a substantial discouragement to cost consciousness and efficiency. Those who have given most weight to these arguments have usually seen at least some initial attraction in a levy based on net advertising revenue (NAR) rather than profits. But a levy of this type was tried over a 10 year period from 1964 to 1974 and found wanting. The main problems were inequity (some companies were paying a tax intended to cream off excess profits at a time when they were incurring trading losses) and instability (in order to deal with the equity problem the rates were changed several times during the 10 year period).

A wide range of options was considered in the review which was undertaken by Home Office, IBA and Treasury officials in 1985. Much of that work remains as valid as ever, but one substantial constraint under which officials were then working was that they were considering a change in levy structure which would be introduced part way through an 8 year ITV contract period. In the face of the inevitable arguments about moving goal posts half way through the game, this made substantial structural change very difficult unless it were to be accompanied by complicated and expensive transitional measures. But ITV contractors currently have no broadcasting rights beyond

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December 1989. If therefore, structural change is introduced from January 1990, and announced this year in conjunction with the offer of extended contracts, then change can be introduced without the complicating baggage of transitional measures.

In principle there is a wide range of options, but one which is well worth consideration would be a move towards a levy based partly on advertising revenue (NAR) and partly on profit. There are both conceptual and administrative attractions to a levy in this form, not to mention scope for further reductions in the marginal rate of levy aimed at improved cost consciousness.

The levy has generally been seen partly as providing a payment by ITV companies which is akin to a royalty for the use of a scarce resource, i.e. the allocated frequency, and partly as a tax on excess or monopoly profit. The revenue component of a mixed revenue/profit based levy would represent the royalty payment, and might therefore be expected to have a long life into the indefinite future. On the other hand, the profit component would deal with the taxation of monopoly profits. This part of the levy might be expected to decline during the second half of the 1990's as broadcasting became more competitive with, for example, the introduction of, the three DBS channels allocated to BSB, the two DBS channels as yet unallocated, a fifth and possibly sixth terrestrial channel together with MVDS, some 5 or 6 English language channels on Astra, the further development of medium power satellites feeding cable, and three national radio channels.

Turning to the administrative considerations, it should be entirely possible to reduce the present 45% marginal rate of levy on domestic profits down to the present 22.5% overseas rate, by making up the shortfall from the new charge on NAR. In this way, the marginal rate of levy on domestic profits would be reduced by half. As a result, there would no longer be any need for the complicated legislative provisions which govern first and second category levy, and the cost apportionment problem between domestic and overseas activities - about which the PAC has long been concerned - would be resolved.

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The incentive to exports would be retained, simply because the NAR based component of the levy would focus exclusively on domestic as opposed to overseas income. The rate of levy on NAR would however be held down, because the profit component of the levy would be taking part of the burden. In this way the equity and instability problems of the old NAR based levy could be held in check, i.e. companies can be expected to take the rough with the smooth so long as the tax rate is a modest one.

A proposal of this kind would need further development work (which, as stated above, is directed to a possible change of levy structure for the extended contract period). However, I would urge that, whatever change might be contemplated, you should consult the IBA before decisions are taken. If necessary this can be on an entirely confidential basis involving only a very small number of IBA staff. You will appreciate that the IBA has an extensive and unrivalled knowledge of both levy and the operation of the ITV system. The Act requires that we should be consulted before any change is made by Statutory Instrument in the levy rates, but I hope you would agree that it is even more important that we should be involved in the consideration of structural change.

As ever

John.

JOHN WHITNEY

Sir Brian Cubbon, G.C.B.,
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50 Queen Anne's Gate,
London, SW1H 9AT.

BROADCASTING: BBC finances PT6