

23 May 1988



**YORKSHIRE
TELEVISION**

*From the
Managing Director*

The Rt Hon Margaret Thatcher MP
10 Downing Street
LONDON
SW1A 2AA

Dear Prime Minister,

I have taken the liberty of sending you a paper with my views on television broadcasting. It is my hope that it will help your deliberations on the subject.

I will, of course, be pleased to develop any of the points in my paper, should you so wish.

*yours sincerely
C. Leach.*

Clive W Leach



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TELEVISION BROADCASTING IN THE UK

The Past

1. The ITV companies must begin by pleading guilty to the charge that for many years they have permitted the trade unions in the industry to carry out a variety of expensive and inefficient restrictive practices. One may quibble with the phrase "last bastion", since there are a number of other candidates for that position. For instance, Her Majesty's Stationery Office springs to mind in this connection. But these are debating points. The relevant issue is that the restrictive practices took place and, to some extent still exist, to a degree which has worried many senior managers in the ITV companies, perhaps particularly those with a commercial background, since they have direct contact with many sectors of industry.

2. Before considering recent developments, three points have to be made in what might be considered as a plea in mitigation. The first is that it is simply untrue to argue that the extra costs imposed on the ITV companies by restrictive practices have caused the increase in television airtime which has occurred over the past decade. Prices for television advertising time are influenced almost exclusively by demand conditions. With airtime strictly limited by IBA fiat, the pre-empt system of selling airtime, which is the one used by most television companies, creates a form of auction, whereby any spot goes to the buyer who is prepared to pay most for it. It is difficult to conceive of a better system of allocating a scarce resource than an open auction.

3. However when demand for TV time falls, the ITV companies lack the one significant advantage of the monopolist - they cannot cut back on the sales of their product so as to maintain a price while demand is falling. The IBA insists that all airtime be sold, and both the Authority and the Advertisers keep all television companies under scrutiny to ensure that they comply with this requirement.
4. Thus, the effect of the restrictive practices of the television unions has not been to make advertisers pay more, but to make television companies earn less. This affects their profits and therefore dividends, and, while it is based on profits, also affects the levy paid to the Treasury.
5. The second point of mitigation is that the ITV companies can only work within the structure imposed by the IBA. For many years, the companies have been led to believe that the IBA would not look kindly on labour relations policies which led to confrontation when compromise might be possible. This belief was strengthened by the results of the 1979 strike, when the ITV Companies felt that they were left to fight on their own, and indeed with the suspicion that the Authority was at best neutral between the two parties. This may not excuse the growth in restrictive practices, but it certainly helps to explain it. Rightly or wrongly, the management of ITV companies came to believe that a "bad" (ie confrontational) record of Labour relations would count heavily against them when it came to the renewal of franchises.
6. A third factor encouraging restrictive practices was the relative protection which the ITV companies enjoyed from market predators. Until the last few years, many were not even public companies, but even

those which were, normally had as their most important asset the franchise to sell television time in their area. The IBA made it clear that this had been offered to a particular company and there was therefore no guarantee that if a television company was taken over by outside bidders, the new management would be allowed to retain the franchise. The announcement of IBA displeasure prevented a bid for Granada and Thames some years ago, and the knowledge that the power existed, obviously inhibited and continues to inhibit outside firms from considering takeover bids for ITV companies.

The Present

7. There is general agreement, even among enemies of the ITV companies, that the position on restrictive practices is beginning to change rapidly and to a large extent. I am not sure what ITV Company spokesmen say officially, but off the record, this was obviously due to governmental pressure. I would argue that it was in any case entirely right for the ITV companies to take account of the government's wishes in this area, but in addition, the belief (right or wrong) that the IBA would also be affected by this change in policy made their stand much easier. It is also noticeable that 4 of the 5 networking Company's Managing Directors are executives with commercial backgrounds as against the "public service programming" background of previous incumbents.

8. This is not the place to detail the various moves being made by the ITV companies against restrictive practices. Different companies are adopting different tactics, moving at different speeds and, to a large extent, face different problems. All

that needs to be said is that movement is taking place everywhere, and that it is almost certain that within a year the face of industrial relations within every ITV company will be changed almost beyond recognition.

9. It is understandable that the government should feel that even if its earlier pressure has achieved largely the results required, continuing pressure needs to be maintained, if only to prevent backsliding. But the key question is what sort of pressure, and the key requirement is to ensure that the result of the pressure is to foster those ends which the government believes to be desirable. It has been known in the past for certain policies of certain governments to prove exactly counter productive to the ends they intended to achieve, and every effort should be made to ensure that this does not happen with this government's policies in regard to television.

The Future

10. Perhaps the supreme example where such counter productivity could take place would be in the auctioning of franchises. The case for this method looks deceptively clear and rational. Exactly as with our TV spots, when there is a limited resource, the only way of fixing the "right" price is to allow potential buyers to bid for it. If this is true of television airtime, as I believe it to be, why is it not equally true of television stations? The case is further strengthened by the admitted inefficiency with which the IBA allocated franchises in the last round, leading to Lord Thomson saying "There must be a better way". Auctions, with their appearance of objectivity might well appear to be such a way.

11. Unfortunately, the analogy between selling TV airtime and TV stations is not as close as it appears. At worst, if a mistake is made in permitting the wrong company to show the wrong advertisement in a spot, the damage is limited, and it can rapidly be ensured that it will not be repeated. A company buying a television franchise is in a quite different position, and the rules of auction would only suit the government's purposes if it were not particularly concerned with the subsequent output over what would be bound to be a period of a number of years. Since the government is already highly concerned, and apparently becoming more so about the nature of television output, this cannot be the case. In practice, the government could not permit anything approaching an open auction. Buyers would have to be vetted with great care, and when once issued with the franchise they would have to be monitored to ensure that they lived up to their promises. This may appear remarkably close to the present system, requiring a body very similar to the present IBA, except that in so far as the auction became somewhat more open, the need for monitoring would become even greater than at present, where the IBA has a reasonable degree of confidence in the intentions of the organizations to whom it offers a franchise. The problem with auctions, as with many other aspects of economic theory, is that there are no halfway houses. Auctions work as efficient methods of economic allocation only when there is no non economic interest either in the nature of the buyer or the subsequent fate of the object bought. As soon as these non economic considerations are brought in, an auction no longer achieves its purpose, and might just as well be replaced by a system whereby bidders are judged on the extent to which they meet the non economic criteria governing the operation.

12. This does not of course mean that there could be no improvements on the franchise allocation system used in 1981. The IBA, for instance, could openly tell existing franchise holders how it regards their strengths and weakness, both as a service to them and to other companies which might wish to apply for the franchise. Similarly, when a decision is made, the thinking behind it could and should be made public. But this would correct flaws in the present system, leaving the basic system intact, which may be regrettable from some aspects of economic theory, but which in practice would be needed to meet the requirements of the government, and, as they are increasingly making clear, of advertisers as well.

13. A somewhat similar argument can be made against the case for splitting regional franchises to create competition. This argument too has a sound economic pedigree. After all, competition among sellers must surely bring down prices for buyers. The fallacy here is that such arguments are implicitly based on the assumption that more sellers mean more goods. But the goods sold by competing ITV companies, (audiences) will not necessarily grow in total. The splitting of franchises would only split audiences, still requiring advertisers to use both stations if they wanted to get a full coverage of the population. Furthermore, the splitting of revenue within a region might adversely affect the smaller companies who would have less resources to invest in programmes.

14. Backing for this view can be found by an examination of the position in London, where such competition has been in effect for decades. One may not blame this competition for the fact that London is by far the most expensive television region, but at least

it suggests that it has done little to keep down prices. The competition has also led to a less widely recognized problem. The two London companies do indeed compete, and normally do so by offering discounts subject to preferential share of the advertisers' TV expenditure in the area. This means that advertisers can make advantageous deals either for weekdays or weekends, but not both, which is hardly conducive to efficient advertising planning.

15. The question of competition to ITV from new channels taking advertising has already been discussed at considerable length. Speaking purely for myself, I believe it is right for the public to be offered more choice, and believe that the ITV companies gain nothing by adopting a dog in the manger attitude to new channels, whether terrestrial, cable or satellite. The threat of such channels should also have a salutary effect in forcing the ITV companies to think about their efficiency, as was illustrated by the recent NERA Report which urged rapid and comprehensive reform of ITV's cost and production patterns.
16. It is easy to be negative about proposals to make ITV companies more business like while retaining the public service obligations imposed by various Television Acts. If there was an easy solution to the problem, it would have been found by now. It is almost certainly the case that whatever happens, there is bound to be some trade off between profit maximisation and the sort of public service responsibilities which all governments, not least the present one, feel strongly should be maintained. Nevertheless, there are means by which the worst excesses brought about by lack of competition can be eliminated.

17. One factor working in favour of beneficial economic change is the general climate of opinion within the regulatory bodies. In some ways it is surprising that it has taken so long for the changed economic climate to register with the broadcasting authorities, but there is growing evidence that significant change is taking place now. This can be expected to make a growing impact on both the senior personnel and the policies of the ITV companies.

18. There are also more direct methods of spurring efficiency in ITV companies. The present levy, for instance, is based on profits, which gives those companies paying at the top rates the comforting feeling that the great bulk of any expenditure they make is carried by the Treasury rather than by themselves. This type of thinking is inevitable when taxation levels are exorbitantly high, and it is destructive to efficient business, a point which the Conservative party came to understand in the late 70's, and which has been in no small measure responsible for their electoral success and the success of the nation since. So how can the ITV companies escape from this trap? It would be unrealistic to suggest that the levy be abandoned, and neither would it be fair while the ITV companies continue to reap commercial benefits from holding a government granted franchise. But there is no reason why the tax has to be on profits.

19. The levy on ITV companies was originally on revenue, and was shifted to profits in the early 70's because the former system worked so inequitably. However this was not a function of the revenue levy itself, but the fact that it contained no provision for adjustment as the high inflation rates in effect

increased the incidence of the tax. The advantage of a levy on revenue is that the ITV companies would be encouraged to make themselves more efficient, since the tax they pay would be fixed, and they would be allowed to keep the difference between revenue and costs (except for profit tax) and thus be encouraged to maximise that difference. The earlier problems with a revenue levy could be overcome by making appropriate provisions to adjust for changes in the RPI, the same principle as that on which the BBC licence fee is now to be based.

20. The change of levy from profits to revenue would provide the carrot to encourage ITV companies to be more efficient. Regrettably, most companies also benefit from the use of a stick. For public companies, the most easily available stick is the threat of takeover if their performance falls consistently below acceptable levels. In the past, as mentioned above, this threat has not been relevant to ITV companies, in particular because the IBA was prepared to remove the franchise from any new management of which it did not approve, at least unless the company was in such dire financial trouble that any rescuer was welcome. This knowledge gave any ITV company on reasonably good terms with the IBA, the assurance that it had much wider scope for poor financial returns than similar companies in other industries.

21. The simple solution to this problem would be to open up ITV companies completely to the market, permitting any take over which did not fall foul of the M&MC. Unfortunately, simple solutions rarely work in this area. The problem is once again that just as a completely open auction for franchises might vitiate the continuing public service

requirements of ITV companies, so might an equally open subsequent auction for shares when a particular company had been awarded the franchise. So is it possible to combine some form of market discipline with some form of public service safeguard?

22. There are precedents for such combinations. For instance, many private firms in the defence industries recognize, at least tacitly, that defence contracts from the British government would dry up if they came under the control of doubtful foreign interests. In practice, the main onus would once again lie with the IBA to pay somewhat more attention to commercial considerations when considering hostile takeover bids, as well as considering merely the public service success of the existing contractor. One accepted hostile takeover bid for a poorly run ITV contractor would have a very considerable educational impact on the remainder.

CONCLUSIONS

23. For a number of reasons, economic efficiency came low on the list of priorities of ITV companies for the past 15 years. Contrary to a widely held belief, this did not increase the cost of advertising, but it made production less profitable and flexible than it ought to have been and was generally bad for morale. Thanks largely to government pressure and the beginnings of a change of heart in the IBA, this position is beginning to improve rapidly, and will certainly have changed beyond recognition in almost all ITV companies within the next year. Nevertheless, these improvements will not be adopted equally effectively by all companies, and, like all good resolutions,

are susceptible to backsliding unless constantly reinforced.

24. The problem is that many of the solutions for maintaining this pressure would not work in the way intended. For reasons explained above, this includes the auctioning of franchises and the introduction of competition within regions on the London model. The most likely methods to encourage ITV companies to maintain efficiency are the standard pressures of the market. These would certainly be assisted by changing the levy from a profits to a revenue base (with adjustments for inflation), thus encouraging companies to keep their costs down. Since all ITV companies are now public, they should also benefit from the pressures which the stock market puts on inefficient performers - the fear of a hostile takeover. There are problems here, since some potential buyers would defeat the public service objectives which this government is anxious to maintain, but the precedent of the defence industries with its safeguards, suggest that it should be possible to produce a more competitive environment for ITV companies in the future, which will help to prevent them from slipping back into the errors of the past. This kind of pressure is likely to prove far more effective than more flamboyant gestures which could well have unintended and counter productive effects.

With this scenario in place, the other services, be they Channel 5 and Channel 6, Superchannel or BSB, together with the development of cable, can be given the green light to provide proper and sensible competition to ITV and Channel 4 whilst ensuring the continuation of the high quality of television that our nation is noted for all around the world.