Review of ITV Networking Arrangements

Statement

Issued: 9 June 2005

Contents

Section 1

Summary

1.1 The ITV Networking Arrangements (the 'NWA') are a set of arrangements between ITV Network Ltd ('ITV') and the 15 regional Channel 3 licensees (now under the ownership of ITV plc[1], SMG plc[2], Ulster Television plc ('UTV') and Channel Television Ltd ('Channel')). They are designed to coordinate the provision of a national television service capable of competing effectively with other broadcasters in the UK.

1.2 The NWA are currently comprised of five principal documents:

- the Network Supply Contract (the 'NSC') - specifies each regional licensee's share of contribution to the Network Programme Budget;
- the Network Programme Licence (the 'NPL') – is the standard form of contract for use by the Network Centre ('NWC') when it commissions a programme from a regional licensee;
- the Tripartite Commissioning, Production and Compliance Agreement ('the Tripartite Agreement') – is the contractual arrangement used by the NWC when it commissions a programme from an independent producer;
- the Network Centre Statement of Principles - deals with the control of network policy by the licensees, the implementation of that policy by the NWC, the selection of programmes, the budget and the supply of a network schedule and provides for the NWC to be organised within the management structure of ITV Network Ltd; and
- the Network Centre Code of Practice - ensures that information about above procedures is disseminated fully to guarantee an even-handed treatment of in-house and independent producers with respect to programme commissioning.

1.3 Under section 293 of the Communications Act 2003 (the 'Act'), Ofcom has a statutory duty from time to time to carry out a general review of the Networking Arrangements currently in force. The first such review must be carried out no later than six months after the date when the digital replacement licence offers close. These offers were closed at the end of November 2004.

1.4 As part of its review process, Ofcom published a consultation on 28 February 2005 (the 'February Consultation')[3] which set out proposals for the future of the ITV Networking Arrangements. The February Consultation offered sets of options for issues affecting arrangements in relation to external third parties ('external arrangements'), and issues relating to arrangements or agreements between the licensees ('intra-ITV arrangements').

1.5 In relation to external arrangements, Ofcom put forward a series of options and invited responses. In relation to intra-ITV arrangements, Ofcom set out more generally a set of issues rather than specific proposals and invited ITV as a whole to come forward with proposals to address these issues.

1.6 In relation to the external arrangements, Ofcom proposed:

- amendments to the Network Centre Code of Practice to incorporate explicitly either the 2004 Code of Practice for commissioning from independent producers or the principles contained in it;

- ensuring that the Network Centre Code of Practice provides for an independent dispute resolution mechanism;
- enshrining the principle of an independent commissioning process into the NWA;
- requiring that core functions of the ITV Network Centre are carried out by employees of ITV Network Centre rather than employees of ITV Broadcast or ITV plc; and
- requiring that the ability of Network Council to amend the Statement of Principles without Ofcom's approval is removed.

1.7 Ofcom also advised that depending on which option(s) Ofcom ultimately selects following completion of the review, changes may be needed to be made by the regional Channel 3 licensees to their existing arrangements. Accordingly, Ofcom advised that it would need to review such arrangements in advance of giving its formal approval.

1.8 Ofcom's February Consultation invited the views of industry stakeholders including, but not limited to, the Channel 3 licensees, independent producers of programming and other free-to-air broadcasters on its proposals. Ofcom received seven formal responses, all of which are confidential. Ofcom also attended discussions on the matters raised by the February Consultation involving all the licensees, and has subsequently also accepted documents jointly submitted by licensees as a result of these meetings.

1.9 Ofcom has now taken account of all submissions provided in response to the February Consultation, and concludes the following:

For External Arrangements

1. The proposals set out in Option 2 of the February Consultation are appropriate, namely the following changes to the NWA:

(a) ITV Network Centre incorporating the 2004 Code of Practice for commissioning from independent producers or the principles contained within it into the NWA and extending it to cover all producers, both Channel 3 licensees and external qualifying and non qualifying independents, to ensure that they would be treated on an equivalent basis;

(b) ITV plc incorporating the commitments made to the ITC at the time of the Carlton-Granada merger in relation to the independence of the commissioning process, including the arms-length nature of the process for programme price negotiations between the ITV Network Centre and all programme suppliers into the NWA. This could be done through incorporating the principle of an independent commissioning process into the ITV Network Statement of Principles, and removing the ability of Council to amend the Statement of Principles without Ofcom's approval;

(c) Ensuring that the Code of Practice provides for an independent dispute resolution mechanism;

(d) Measures to ensure that employees within the core functions of ITV Network Centre are employees of ITV Network Centre and have clear management reporting lines within Network Centre; and

(e) Simplification of the reporting arrangements for the operation of the Networking Arrangements to require quarterly reports on only the contracts signed,

subject to the following caveats:

(i) That Ofcom will consider whether the approach adopted of extending the 2004 Code of Practice to cover all producers should also be applied to other PSBs. This will be covered in the Review of the Programme Production Sector; and

(ii) Ofcom considered ITV's proposal to remove the Tripartite Agreement (TA) and Network Programme Licence (NPL) from the NWA, but concluded that at this time such removal would be inappropriate. However, once agreed, the new Terms of Trade may then provide scope for the removal of the TA and NPL, if requested by licensees.

For Intra-ITV Arrangements

1. Four high level principles should underpin the arrangements:

(a) non-consolidated licensees should be safeguarded against unfair treatment by ITV plc in respect of arrangements for the sharing of costs for services purchased from third parties;

(b) non-consolidated licensees should be safeguarded against unfair treatment by ITV plc in respect of arrangements for the fees charged for services purchased from ITV plc;

(c) non-consolidated licensees should be safeguarded against unfair treatment by ITV plc in respect of the sharing of programme costs between ITV1 and ITV plc owned channels, and the provision of ITV Network services to ITV plc owned channels; and

(d) commitments to support regional programming obligations should be strengthened.

2. The following actions by the ITV licensees are sufficient to address our concerns regarding cost sharing transfers:

(a) A new version of the Statement of Principles so that it articulates the principles outlined by Ofcom, which will then apply generally to all cost sharing arrangements;

(b) Continuation of the provision of the core functions by ITV Network to all licensees. If paid for on a QR basis, rather than on the basis of a fixed fee, the non-consolidated licensees should be provided with fully transparent budget information and audit rights. This would include details of any cross-charging arrangements.

(c) Introduction of a service agreement, to sit outside of the NWA, which the licensees will collectively negotiate. The agreement will be between ITV Network, ITV plc and the non-consolidated licensees and will outline the non-regulated activities that ITV Network (potentially via ITV plc) will carry out on behalf of all licensees. The non-core services will be provided at a fixed price, subject to increases in line with RPI.

3. For regional programming obligations, the NSC should be amended to reflect the principle of “no play, no pay”. This revises current arrangements within the NSC under which, licensees in the Nations opting out of the national network schedule in order to comply with their regional licence obligations pay for programmes whether or not they broadcast them. In future where a national licensee opts out of the network schedule in order to meet its regional programme licence obligations, and does not subsequently transmit the programme concerned in an alternative slot, the licensee will not be required to pay for the programme concerned.

4. For programme compliance, the choice of compliance licensee should be made by the producer, whilst the compliance fee should be cost-oriented so that an efficient competitor or new entrant would be able to compete.

Section 2

Introduction

Background

2.1 Channel 3 is a free to air commercially funded national television broadcast channel. Channel 3 is made up of 15 regional licensed areas, the licences for which are currently held by four companies: ITV plc (11 licences), SMG (two licences) UTV and Channel (throughout this document, SMG, UTV and Channel are referred to collectively as the 'non-consolidated licensees').

2.2 A key public policy objective of Channel 3 is to provide competition to other national broadcasters such as the BBC.

2.3 The Channel 3 licensees were mandated under section 39 of the Broadcasting Act 1990 to conclude a set of arrangements that would enable them to work together to produce a national television service. This set of arrangements is known as the ITV Networking Arrangements (the 'NWA'). The Broadcasting Act 1990 did not dictate the structure or content of the arrangements.

2.4 The NWA are excluded from the application of the Chapter I Prohibition under Schedule 2 to the Competition Act 1998 to the extent that they fulfil the relevant competition tests set out in Schedule 11 of the Act (previously Schedule 4 of the Broadcasting Act 1990). However, the licensees are still prevented from engaging in any practice which is prejudicial to fair and effective competition (towards external parties and to each other) by conditions in their licences. The licensees also remain subject to the Chapter II prohibition in the Competition Act 1998.

2.5 ITV Network Ltd ('ITV Network') is a company limited by guarantee with a membership composed of the 15 licensees. The board of ITV Network is known as the Network Council and was set up to agree the ITV strategy and budget. A separate management structure known as the ITV Network Centre ('NWC') was created as a result of the initial NWA as the body to execute the instructions of the Network Council (to run the ITV network on behalf of all the licensees). The NWC is a part of ITV Network Ltd.

2.6 The Independent Television Commission ('ITC') reviewed the initial NWA in line with the procedure set out in the Broadcasting Act 1990. This procedure included a requirement on the ITC to refer the proposed arrangements to the Director General of Fair Trading (the 'DGFT'), who would then review the arrangements to ensure that they satisfied the competition test set out in Schedule 4 of the Broadcasting Act 1990. The DGFT concluded that the arrangements referred to it did not pass the prescribed competition test and proposed various changes. The matter was then referred to the Monopolies and Mergers Commission ('MMC'). In 1993, the MMC published its report, in which it broadly concurred with the DGFT and recommended a set of amendments to the Networking Arrangements to rectify the competition issues identified[4]. These amendments concerned:

- the ability of independent programme producers to compete on equal terms with licensees' in-house production facilities for commissions from the ITV network; and

- discrimination between broadcaster's internal production companies and independent producers related to secondary transmission rights.

2.7 Since these amendments in 1993 the Networking Arrangements have remained largely unchanged. The NWA currently comprise five documents:

- Network Supply Contract ('NSC') - specifies each regional licensee's share of contribution to the Network Programme Budget ('NPB');

- Network Programme Licence ('NPL') – is the standard form of contract for use by the NWC when it commissions a programme from a regional licensee;

- Tripartite Commissioning, Production and Compliance Agreement (the 'Tripartite Agreement' or 'TA') – is the contractual arrangement used by the Network Centre when it commissions a programme from an independent producer;

- Network Centre Statement of Principles - deals with the control of network policy by the licensees, the implementation of that policy by the NWC, the selection of programmes, the budget and the supply of a network schedule, provides for the NWC to be organised within the management structure of ITV Network Ltd; and

- Network Centre Code of Practice - ensures that information about all procedures is disseminated fully to guarantee an even-handed treatment of in-house and independent producers with respect to programme commissioning.

Market consolidation

2.8 On 16 October 2002, Carlton Communications plc and Granada plc announced a proposed agreed merger. This proposed merger was referred by the Secretary of State for Trade and Industry to the Competition Commission on 11 March 2003. The Competition Commission presented its report to Parliament in October 2003[5].

2.9 The Competition Commission recommended that the merger should be allowed, subject to undertakings. Pursuant to a request by the Secretary of State for Trade and Industry, the Office of Fair Trading consulted with Carlton and Granada with a view to obtaining from them undertakings aimed at addressing the competition concerns identified by the Competition Commission[6]. A subset of the undertakings, outlined below, given by Carlton and Granada is related to the operation of the NWA and in particular to ITV plc's position as the majority voter in the ITV Network Council. These undertakings were intended to protect the non-consolidated licensees.

2.10 The 2003 Carlton-Granada merger led to the creation of ITV plc and a step change in the relative positions of the Channel 3 licence holders, with ITV plc holding 11 licences, SMG holding two licences and UTV and Channel with one licence each. ITV plc also added ITV3 to its existing portfolio of digital channels (ITV2 and the ITV News Channel). The relationship between these channels and ITV Network Centre has implications for the non-consolidated licensees.

2.11 Moreover, in 2004 ITV adopted a Code of Practice for dealing with qualifying independent producers, pursuant to a licence condition imposed on it by Ofcom under section 285 of the Act. This Code of Practice, which has been approved by Ofcom, has some overlap with and relevance to similar practices already covered by the ITV Networking Arrangements.

Purpose of this review

2.12 The provisions in the Broadcasting Act 1990 relating to the NWA have now been superseded by equivalent provisions in the Act. Section 293 of the Act requires Ofcom from time to time to carry out a general review of the NWA that are in force. The first such review must be carried out no later than six months after the date on which the offers of digital replacement licences (‘DRLs’) to all the regional Channel 3 licensees closed, which was at the end of November 2004. This final statement sets out Ofcom’s conclusions on how the current ITV Networking Arrangements must be revised in order to address concerns identified by Ofcom. Following this final statement, the regional Channel 3 licensees are required to re-draft the existing NWA by end July 2005 to incorporate Ofcom’s amendments. The final set of revised NWA will then be approved by Ofcom.

2.13 The framework for this review is set out in Schedule 11 of the Act. This sets out a number of statutory tests which Ofcom must take into account alongside its wider statutory duties when carrying out this review. Ofcom has reviewed the ITV Networking Arrangements from the perspective of these statutory tests and duties, as well as its other policy objectives. Ofcom has also taken into account the issues raised by stakeholders in responses provided to the February Consultation. This includes taking account of feedback provided by industry meetings involving all of the licensees and subsequent joint and individual submissions from the licensees to Ofcom.

2.14 In order to inform its analysis in this review, Ofcom has taken into account a number of issues which go beyond the current scope of the NWA and potentially fall outside the definition of ‘networking arrangements’ in the Act, but which nevertheless facilitate the creation and broadcast of the ITV channel. These include issues raised by key stakeholders regarding the workings of ITV and issues arising from certain commercial agreements in place between the licensees.

Structure of this document

- In Section 3 we begin by setting out the regulatory background of the ITV Networking Arrangements and the key developments that have occurred since that are relevant in this review.

- In Section 4 we go on to outline the statutory tests in Schedule 11 of the Communications Act 2003 as well as Ofcom’s wider statutory public policy objectives, which set the context for this review.

- In Section 5 we provide a description of the markets and arrangements that are currently in place between the Channel 3 licensees and between the licensees and third parties that together facilitate the production of the ITV1 channel.

- In Section 6 we set out our assessment of the current arrangements against the tests outlined in Section 4.

- In Section 7 we summarise the responses we received to our consultation and set out Ofcom's views on the issues raised in those responses. We then set out our conclusions on what modifications are required to be made to the NWA, before concluding with a summary of the next steps and timing of the implementation of the required changes.

Section 3

Background

The Broadcasting Act 1990

3.1 The ITV Networking Arrangements were conceived as a requirement under section 39 and Schedule 4 of the Broadcasting Act 1990. The Broadcasting Act 1990 required the 15 regional Channel 3 licensees to come together and draw up a set of arrangements allowing them to provide a nationwide broadcast channel capable of competing effectively with other broadcasters in the UK.

3.2 The Broadcasting Act 1990 did not specify the form that the ITV Networking Arrangements should take. The licensees themselves collectively developed a set of arrangements. However, under the Broadcasting Act 1990, the licensees were required to ensure that the set of networking arrangements proposed was approved by the ITC before they could become operational and before the start of licensed services. In addition, the ITC was required to refer the proposed arrangements to the DGFT, so that the DGFT could assess whether the arrangements satisfied the competition test set out in Schedule 4 of the Broadcasting Act 1990.

The 1993 Monopolies and Mergers Commission inquiry

3.3 In 1991, the initial ITV Networking Arrangements proposed by the licensees were approved by the ITC. The Director General of Fair Trading, however, concluded that the NWA did not pass the Competition Test set out Schedule 4 of the Broadcasting Act 1990. The matter was thereafter referred to the MMC who required changes to be made to the arrangements to ensure its competition concerns were mitigated.

3.4 As part of the monitoring and review of the NWA, the MMC also recommended that the ITC should receive from ITV Network Centre and licensees, at least at quarterly intervals, a summary of all the letters of intent and contracts entered into for the provision of programmes for the ITV network.

3.5 Full details of the changes to the initial NWA as a result of the MMC inquiry can be found in Annex 1 of this document.

The current ITV Networking Arrangements

3.6 In the late 1990s the ITV Association was renamed ITV Network Ltd. Its board - known as the Network Council - has the responsibility for agreeing the strategy and budget for the national broadcast channel (referred to hereon as ‘ITV1’, to distinguish it from the wholly ITV plc owned channels ITV2 / ITV3). Within ITV Network Ltd, a separate management structure known as the ITV Network Centre (‘NWC’) is the body which executes the instructions of the ITV Network Council i.e. acts as agent for the licensees, commissioning, acquiring programmes and creating the nationwide schedule on a centralised basis on behalf of all the licensees.

3.7 Since the revisions to the arrangements following the MMC inquiry in 1993 the arrangements have been substantially unchanged. The ITV Networking Arrangements comprise five documents:

- Network Centre Statement of Principles - deals with the control of network policy by the licensees, the implementation of that policy by the NWC, the selection of programmes, the budget and the supply of a network schedule, the process for the appointment of compliance licensees, and generally provides for the NWC to be organised within the management structure of ITV Network Ltd;

- Network Supply Contract (the 'NSC') - specifies each regional licensee's share of contribution to the Network Programme Budget ('NPB'). There are two different formulae used to calculate each licensee's contribution to the NPB. They were devised originally by the ITC based on each licensee's share of total ITV qualifying revenue, depending on whether this share is above or below four percent. A licensee's qualifying revenue is defined as the sum of its net advertising revenue and sponsorship income from the preceding year. The formulae provide a subsidy in the contributions to the NPB in favour of the smaller licensees, reflecting their differing ability to pay. Because the formulae are contained within the NWA they can only be modified with Ofcom's consent. The formulae have in fact been modified on two occasions since 1993, based on a consensus reached among licensees and approved by the regulator, slightly increasing the amounts payable by the smaller licensees. The NSC also establishes the basic functions and authority of the Network Council and the Schedule Review Group as well as laying out the executive role of the NWC directors;

- In addition, the NSC provides a framework for the commissioning of programmes from licensees on terms specified in the Network Programme Licence and from independent producers on terms specified in the Tripartite Agreement. Finally, the NSC provides for adherence to the Code of Practice and the Statement of Principles in the commissioning process;

- Following the creation of a devolved Scottish Parliament in 1999, opt-out provisions from certain contributions to the NPB were put in place for Scottish Television. Further requests for exemption from contributions to certain sports rights contracts were also granted to Scottish Television. These opt-out provisions represent an amendment to the NSC, the 'Devolution Agreement';

- Network Programme Licence (the 'NPL') - the standard form of contract for use by the NWC when it commissions a programme from a regional licensee. Each programme or series is subject to a separate NPL and contains the terms and conditions relating to the programme specification, price, delivery, rights granted, licence period, licence renewal and further series options. In practice, this is now only relevant to ITV plc's Granada Productions and SMG plc's TV production division, since UTV and Channel do not currently have production businesses which produce for ITV's network schedule. Details of these agreements are submitted to Ofcom;

- Network Centre Code of Practice - ensures that information about all procedures is disseminated fully to guarantee an even-handed treatment of in-house and independent producers with respect to programme commissioning. The NWC Code of Practice also sets out the process by which licensees are appointed for programme compliance and production monitoring (these have subsequently been amended and fleshed out by agreement at the Network Council); and

- Tripartite Commissioning, Production and Compliance Agreement (the 'Tripartite Agreement' or 'TA') - the contractual arrangement used by the ITV Network Centre when it commissions a programme from an independent producer. It is a three way agreement between the NWC, the independent producer of a programme proposal and a nominated compliance licensee. The terms of trade contained in the Tripartite Agreement and the NPL are the same, aside from the inclusion in the Tripartite Agreement of the third party licensee compliance and production monitoring role.

The ITV Network Council

3.8 The ITV Network Council (the 'Council') meets at least biannually to determine the overall programme strategy, network hours and programme budgets for ITV and also provides an annual report to Ofcom. In addition, the Council decides the level and timing of payment of each licensee's share of the Network Programme Budget.

3.9 Until 1997, the Council was required to appoint an executive director, the Network Director, to have overall executive responsibility for the network, the network schedule and the commissioning and acquiring of network programmes. ITV Network Ltd would delegate to the Network Director the power and authority to both ensure that the overall strategy of the network as determined by the Council was administered, and to commission and acquire network programmes using the Network Programming Budget. The Network Director would exercise this power in accordance with his duties and obligations as set out in the Statement of Principles, an annex to the Network Agreement that can be amended from time to time by the Council.

3.10 In 1997 however, the functions of the Network Director were divided between two executive directors known as the Chief Executive and the Director of Programmes. The Director of Programmes subsequently filled the role of the Network Director at the Schedule Review Group (see paragraph 3.15 below) while the Chief Executive took over the overall direction of the ITV Network Centre and ITV Network Ltd.

3.11 The Council is composed of the CEO (or any other representative) of each licensee company, the Chief Executive, the Director of Programmes and any other person appointed by the Council.

3.12 In 2002, the role of the Chief Executive was replaced by the CEOs of the respective broadcasting divisions at Carlton Communications plc ('Carlton') and Granada plc ('Granada') who both sat on the Council as joint managing directors of ITV Network in an attempt to improve the efficiency of ITV.

3.13 At Council meetings, all matters are determined by a simple majority of the voting members on a one member, one vote basis unless it is a question for which the Network Agreement explicitly requires WQR voting[7], or which concerns the request for the resignation of a member. Among those sitting on the Council, only representatives of the licensees may vote.

3.14 Following the Carlton-Granada merger in 2003, the newly created ITV plc now has over 90 per cent of the vote and is therefore able to pass any resolution at the Council, including those requiring WQR voting. The Chief Executive role is now occupied by the CEO of one of the operating divisions of ITV plc, ITV Broadcasting, who is also the Managing Director of ITV Network.

The Schedule Review Group

3.15 Under the NWA, the Network Council is required to delegate certain functions to the Schedule Review Group (formerly the Broadcasting Sub-Group). This group is responsible for implementing the overall network strategy as determined by the Council, administering the network, supervising the broadcast strategy and business performance of the network and agreeing the network programme schedule. It is, however, prohibited from drawing up the network schedule and from commissioning network programmes and considering matters relating to any licensee's production operations.

3.16 The Schedule Review Group is to comprise one senior executive from the broadcast division of each licensee and the Director of Programmes (formerly the unified post of Network Director). Voting at the Schedule Review Group is on the basis of one vote per member of the Group with a two-thirds majority required to pass a resolution. This can however be varied by the Council with the approval of Ofcom. Again, ITV plc can now outvote the non-consolidated licensees.

3.17 In practice, despite the terms of the NWA, the Schedule Review Group seldom, if ever, meets. Its functions are carried out by the Director of Programmes of ITV Network, who also commissions and schedules ITV1.

The ITV Network Centre

3.18 The NWC is required by the Code of Practice and the Statement of Principles to fairly and impartially consider proposals from licensees or independent producers on an equal basis. The creation of the network programme schedule and the commissioning of programmes were the responsibility of the Chief Executive (formerly the unified post of Network Director) who headed the NWC. The current Director of Programmes for ITV Network now heads the NWC commissioning process, operating within the limits of delegated financial authority.

The 2003 Carlton-Granada merger

3.19 On 16 October 2002, Carlton Communications plc and Granada plc announced a proposed agreed merger. This proposed merger was referred by the Secretary of State for Trade and Industry to the Competition Commission on 11 March 2003. The Competition Commission presented its report to Parliament in October 2003.

3.20 In its report of October 2003, the Competition Commission recommended that the merger should be approved, but subject to undertakings to be given by Carlton and Granada (or ITV plc) to address certain competition issues identified. The Secretary of State for Trade and Industry subsequently accepted undertakings from Carlton and Granada to directly or indirectly:

(a) convene the Network Council at least twice a year to: (i) consult the other non-consolidated licensees; and (ii) ensure that the non-consolidated licensees are properly and fully informed of the Channel 3 Network's broadcasting and programme strategy, as presently referred to in Clause 4 of the Network Supply Contract. Minutes from such meetings should be circulated to Ofcom in a form approved by it from time to time;

(b) ensure that any other non-consolidated licensee's contribution (net of any discount, rebate or abatement currently provided in the NSC) to the Network Programme Budget in any year does not increase from such net contribution to the 2003 NPB[8] by more than the cumulative rate of RPI inflation since December 2002[9]. This undertaking does not, however, apply to the licensees brought under the common ownership of ITV plc;

(c) not make the commissioning or broadcasting of a programme conditional on using ITV plc for programme compliance;

(d) at no extra cost provide Grampian, Scottish TV and UTV [10] with a clean broadcast feed from the Channel 3 Network to the extent and on the same basis as it is now provided[11];

(e) offer the licensee for Ulster (currently UTV) equivalent terms to those made available to Scottish TV following devolution in Scotland, if its local programming obligations set out in its licence change as a result of devolution in Northern Ireland;

(f) report to Ofcom on a monthly basis and in a form specified by Ofcom, the volume and value of network hours by genre and producer; and

(g) use their best endeavours to procure any changes to the NWA required to enable them to comply with the undertakings.

3.21 It is worth noting that these undertakings are not part of the NWA and Ofcom does not have the power to amend them.

3.22 In addition to the undertakings agreed with the Secretary of State, ITV plc also gave certain 'informal' undertakings to the ITC, in the form of written assurances about the continuation of existing arrangements providing for subsidies to smaller licensees. Specifically, these assurances were:

- the continuation of the small companies funding formula (subject to any changes associated with giving effect to the undertakings);
- the continuation of the devolution contract for Scottish TV as set out in the Network Supply Contract at that time; and
- the continuation of the subsidy arrangements which gave relief in certain cost areas (such as ITV viewer marketing costs) and subsidies on the cost of the MCPS blanket licence and transmission costs.

3.23 ITV plc also gave written assurance to the ITC that the independent commissioning function of ITV Network Centre would be maintained, including the arm's length nature of the process for programme price negotiations between ITV Network and all programme suppliers.

3.24 At the time of these informal undertakings, it was recognised that in the event that Carlton-Granada were to move away from these assurances, the ITC (and now Ofcom) would consider formalising the arrangements.

The 2004 ITV Code of Practice

3.25 Under section 285 of the Communications Act 2003, the regulatory regime for every licensed public service broadcaster ('PSB') channel is required to include conditions, to be set by Ofcom, that ensure the PSBs draw up, maintain and comply with codes of practice governing the commissioning of independent productions for broadcast on their networks. Accordingly, Ofcom published in 2003 a set of guidelines for broadcasters to draft codes of practice for commissioning programmes from independent suppliers.

3.26 The ITV Network Limited Code of Practice for Commissioning Programmes from Independent Producers (the '2004 Code of Practice') was published by ITV Network Limited in January 2004. The 2004 Code of Practice sets out the principles that ITV Network will follow for negotiating terms of trade with independent producers over programme commissions. It ensures the transparency of the NWC commissioning process with respect to independent producers. The 2004 Code of Practice is not formally part of the NWA and does not replace any of the NWA documents. It is a statutory obligation that sits alongside the current arrangements.

3.27 Under the terms of the 2004 Code of Practice, both licensees and independent producers will have equal and direct access to the NWC and the relevant Programme Controller, according to the genre of the submitted programme proposal. The NWC will act impartially and ensure even-handed dissemination of programme requirements. As a signatory to the 2004 Code of Practice for the Protection of Programme Proposals, it will also take the necessary measures to conduct itself in accordance with the provisions for the confidentiality of proposals.

3.28 Upon receipt of a proposal, the Programme Controller may either reject the proposal, decide that it is to be offered for consideration for commission to the Director of Programmes or ask the independent producer to make any modification deemed necessary to make the proposal suitable for commissioning. The NWC will select and commission programmes from the range of proposals submitted.

3.29 Once an independent programme proposal has been accepted, an agreement specifying the terms and conditions for primary transmission rights to that programme is struck between the NWC and the independent producer. In addition to this, the broadcasting division of a licensee is appointed and paid by the NWC to carry out compliance and production monitoring for that programme, in accordance with regulatory requirements. The commissioning process is completed by the Tripartite Agreement. The NWC contracts with the independent producer for programme production and licensing and with a licensee for regulatory programme compliance.

3.30 As mentioned above, the 2004 Code of Practice does not replace any of the NWA documents, most notably the Network Centre Code of Practice. The purpose of the Network Centre Code of Practice is to provide guidance on both the practices adopted for the selection and commissioning of programmes by the NWC, and the terms and conditions on which these programmes are licensed to the NWC for broadcast on ITV1.

3.31 The most notable difference between the Network Centre Code of Practice and the 2004 Code of Practice is that the Network Centre Code of Practice applies to all producers commissioned by ITV Network Ltd, whereas the 2004 Code of Practice applies only to qualifying independent producers[12].

Section 4

Scope of Ofcom's review

Ofcom's statutory duty

4.1 Under section 293 of the Act, Ofcom has a statutory duty to carry out a review of the ITV Networking Arrangements in a number of different circumstances. In particular, and relevant to this review, Ofcom is bound by section 293(2) of the Act to carry out a review of the ITV Networking Arrangements no later than six months after the date when the Channel 3 digital replacement licences offers close. These offers closed at the end of November 2004. In addition it is worth noting that Ofcom may also, at any other time, carry out a review of the ITV Networking Arrangements if prompted to do so by a licensee and must, in any event, carry out a review of the arrangements in force at least annually.

4.2 The framework for this review is set out in Schedule 11 of the Act. The review is structured along the lines of three statutory tests that the NWA must pass before any existing or revised arrangements can be agreed upon by Ofcom. In addition Ofcom must also be mindful of its wider statutory duties and public policy objectives. As a general rule, Ofcom must not propose, impose or approve arrangements or modifications to the arrangements unless it considers that such arrangements or modifications are satisfactory.

4.3 This statement sets out Ofcom's conclusions on the amendments that Ofcom considers necessary to the current ITV Networking Arrangements. In the light of the conclusions in this statement, the Channel 3 licensees will need to re-draft the current set of NWA, in consultation with Ofcom, to incorporate Ofcom's amendments. Ofcom will then need to review the proposed set of revised ITV Networking Arrangements before giving its final approval.

4.4 This section outlines the statutory tests in Schedule 11 of the Communications Act 2003, as well as Ofcom's wider statutory duties and public policy objectives. In Section 6 we discuss in more detail how Ofcom has applied these tests in practice when we present our assessment of the current arrangements in place.

Ofcom's application of relevant tests

THE "COMPETITION TEST"

4.5 The statutory Competition Test set out in paragraph 6 of Schedule 11 of the Act is in two parts:

1. Arrangements satisfy the first Competition Test if they do not have as their object or effect the prevention, restriction or distortion of competition within the United Kingdom. If the arrangements satisfy this test, there is no need to consider the second test; and

2. Arrangements satisfy the second Competition Test if (a) they do have such an object or effect; but (b) they would satisfy the criteria set out in section 9 of the Competition Act 1998[13].

4.6 Before making a decision about whether a competition test is satisfied or not, Ofcom must consult the Office of Fair Trading. In determining whether arrangements or modified arrangements would satisfy either of the tests, Ofcom must ensure the principles it applies and the decisions it reaches are consistent with the EC Treaty and any relevant decisions of the European Court. In addition, it must have regard to any relevant decisions or statements of the European Commission.

THE “EFFECTIVENESS TEST”

4.7 Ofcom must not approve, impose or propose arrangements and/or modifications unless Ofcom considers those arrangements / modifications to be satisfactory for the purpose of enabling regional Channel 3 services (taken as a whole) to be a nationwide system of services which is able to compete effectively with other television programme services provided in the United Kingdom.

THE “REGIONAL PROGRAMMING TEST”

4.8 Ofcom must not approve, impose or propose arrangements and/or modifications unless Ofcom considers those arrangements/ modifications to be satisfactory, including the likely effect of the arrangements/ modifications on the ability of Channel 3 licensees to maintain the quality and range of regional programmes and other programmes which contribute to the regional character of the services.

4.9 It should be noted that the second and third statutory tests relate to public policy rather than specifically to competition law.

4.10 In addition to the above statutory tests, paragraph 8 of Schedule 11 of the Act states that Ofcom must not approve, impose or propose arrangements and/or modifications if such arrangements/modifications would be likely to be prejudicial to the ability of the Channel 3 licensees, or any of them, to comply with:

(a) their public service remits;

(b) their regional production obligations[14];

(c) their regional programming obligations; or

(d) conditions imposed on them following a change of control.

Ofcom’s other statutory duties and public policy objectives

4.11 Section 3 of the Act sets out Ofcom’s general duties and the matters that Ofcom must take into account in performing its duties. These matters include:

(a) the desirability of promoting the fulfilment of the purposes of public service television broadcasting in the United Kingdom;
(b) the desirability of promoting competition in relevant markets;
(c) the desirability of promoting and facilitating the development and use of effective forms of self-regulation; and

(d) the desirability of encouraging investment and innovation in relevant markets.

4.12 Ofcom also has a general regulatory principle that it will always seek the least intrusive regulatory mechanisms to achieve its policy objectives.

4.13 In Phase 3 of Ofcom's review of Public Service Television Broadcasting[15] (the 'PSB3 review'), Ofcom stated that one of four PSB purposes is "to reflect and strengthen our cultural identity through original programming at UK, national and regional level, on occasion bringing audiences together for shared experiences". In addressing this policy objective, Ofcom advised that ITV1 has a special additional responsibility for the provision of regional news, current affairs and other regional programming and specifically required that Channel 3 licensees continue to provide regional news and current affairs.

4.14 The statement on Programming for the Nations and Regions, published in parallel with this statement, has concluded that the ITV English regions will be required to produce 1.5 hours per week of non-news regional programming from 2005, and that there will be a reduction to 0.5 hours per week when the first UK region achieves digital switchover. For the Nations, the statement concludes that non-news regional programming should be maintained at a higher level than in the English regions. There will be a minimum requirement for each of the licensees in the Nations to broadcast at least four hours per week of non-news regional programming, until the first UK region switches over to digital, after which Ofcom's current intention is that the minimum requirement for the licensees in the Nations for non-news programming will reduce to three hours per week.

4.15 In order to help support the provision of this increased volume of regional programmes, the PSB3 Review has stated that the National licensees should not have to pay for network programmes that they do not broadcast in order to meet their regional programme licence obligations. The PSB3 Review has further stated that the ITV Network Centre should take into account the higher level of opt-out in the three Nations when devising its network schedule. Ofcom is reflecting such a 'no play – no pay' approach in this ITV NWA review in order to support its wider public policy objective arising from the PSB review.

4.16 Ofcom also believes that the following public policy objectives are appropriate guiding principles to follow in this review:

- the documents that together comprise the NWA should continue to reflect accurately the actual operational arrangements;
- organisational arrangements should be robust to changes in corporate ownership;
- the non-consolidated licensees should be able to continue to meet their specific licence obligations efficiently and effectively;
- the principles which underlie the relevant cost sharing arrangements should be transparent and clearly understood by all parties to the NWA; and
- there should be an appropriate degree of non-discrimination between parties to the NWA and (where appropriate) any relevant third parties.

Section 5

The ITV Network Supply Chain

Background

5.1 This section provides a description of the markets and arrangements that are currently in place between the Channel 3 licensees and between the licensees and third parties which together facilitate the production of the ITV1 channel.

5.2 To characterise these arrangements we use the framework of an ITV Network "supply chain" that encompasses three areas of activity. These are:

1. programme commissioning and acquisition which are the content inputs into the ITV Network;
2. channel operation services that are required to produce a national schedule and to broadcast it; and
3. viewers, advertisers and programme sponsors who are the ultimate consumers of the ITV Network output.

5.3 At the outset it is important to note that only a subset of all the different arrangements described in this section are formally captured in the current ITV Networking Arrangements. In fact the different types of arrangements range from informal arrangements, commercial contracts, and undertakings given following the Competition Commission's 2003 merger inquiry, to the current ITV Networking Arrangements themselves.

5.4 There are a number of reasons why we believe that this review should consider arrangements currently outside the ITV Networking Arrangements. Firstly, the circumstances under which the current set of ITV Networking Arrangements were developed have changed significantly (as we have already discussed) with the merger of Carlton-Granada and the launch of ITV plc's new channels ITV2, ITV3 and the ITV News Channel. These developments have led to new relationships between the licensees that impact on the existing Networking Arrangements.

5.5 Secondly, Ofcom's statutory public policy tests i.e. "effectiveness" and "regional programming" require us to ensure that licensees produce a nationwide channel able to compete with other national broadcasters and in particular are all able to discharge their obligations with regards to regional programming. All the arrangements currently in place, to different degrees, facilitate the licensees' achievement of these goals. The costs of the services associated with all these arrangements are borne by all licensees and are shared on a number of different bases, but in general are in approximate proportion to their shares of qualifying revenue. Moreover the revenues that licensees derive from the ITV1 national broadcast are generated and collected jointly. Therefore it is difficult to look at the current ITV Networking Arrangements in isolation of all the other arrangements which they depend on and are in fact tied to in a mutually co-dependent manner.

5.6 Ofcom recognises that the definition of 'networking arrangements' in section 290(4) of the Act may not extend to cover all of the arrangements discussed in this section[16]. Nevertheless, Ofcom considers that its statutory powers are sufficiently broad to enable it to regulate these activities by means of imposing licence conditions on the Channel 3 licensees under section 3 of the Broadcasting Act 1990.

5.7 We begin in this section by describing the governance of the ITV Network i.e. how decisions are made by the ITV Network and who third parties contract with. We then go on to describe the different arrangements taking each ITV supply chain activity in turn.

ITV Network governance

5.8 In Section 3 we discussed the functions of the ITV Network Council and ITV Network Centre. We now provide further detail of the relevant reporting lines and day-to-day processes of the ITV Network Centre. This is to inform our assessment in the next section of the potential competition and policy concerns that could be raised with regards to the current structure.

5.9 The ITV Network Centre undertakes three core activities associated with the creation of the ITV1 schedule:

(a) Commissioning and acquisition – decisions are made centrally on behalf of all licensees and the processes and contracts are governed by the NWA. The Director of Programmes is responsible for all commissioning and scheduling.

The commissioning team all report to the Director of Programmes. All work solely on ITV1 commissions, with the exception of the current Controller of Factual Programmes who is also responsible for all of ITV2 and ITV3's original commissions. All of the team are ITV Network employees;

(b) Scheduling – the ITV Network Centre schedules ITV1. The planning and strategy team, who schedule ITV1, report to the Director of Programmes. All are ITV Network employees. The ITV2 and ITV3 schedulers report to the ITV plc Controller of Digital Channels, but have a dotted line report into the ITV1 Director of Programme Strategy who leads the planning and scheduling team. The ITV2 and ITV3 channel management, who are housed within ITV Network Ltd, also have access to ITV1 schedule data which enables them to create complementary schedules: to schedule programme extensions on ITV2 and to schedule "catch up" programming on ITV3.

We understand that in order for the non-consolidated licensees to meet their regional programming obligations they are able to opt out of the national schedule at any time in order to schedule regional programmes. Currently there is limited coordination of the scheduling of regional programming between licensees, and in particular the higher volumes of regional programmes shown in the Nations as compared with the English regions are scheduled independently by the three National licensees; and

(c) Rights and Business affairs – This team negotiates the terms of commissions and acquisitions for ITV1 on behalf of all licensees. It effectively acts as an agent for the licensees and importantly all programme rights are held by each licensee, with each licensee valuing the rights in its balance sheet based on the share of costs it has contributed for them. ITV Network Ltd holds no rights itself. It is worth noting that when programmes are purchased from Granada Productions, the ITV Network Centre is effectively negotiating with its most significant stakeholder.

The Rights and Business Affairs team is also responsible for the negotiation of sports rights deals, which may be shared between ITV1 and ITV2 or ITV3. It also negotiates the terms for programmes commissioned by ITV2 or ITV3 and the contracts and commercial arrangements associated with ITV's on-line activities and interactivity. The team as a whole reports to ITV Network's Commercial Director, but his own reporting line is unclear, it may be into ITV plc. Possibly for historic reasons, the members of the team are employed variously by ITV Network, ITV plc, Granada and Carlton. It would appear that not all of the team members with clear responsibility for ITV1 commissioning are ITV Network employees.

5.10 The other areas of activity within ITV Network, which are outside the current Networking Arrangements, include research, corporate affairs, finance, marketing (on and off air), IT, support services, ITV Online and ITV Interactive. For the most part, finance and support services have been outsourced to ITV plc. The research, corporate affairs and marketing teams as well as the other support teams provide services to ITV2, ITV3 and the ITV News Channel as well as to ITV1.

5.11 The current managing director of ITV Network Ltd is also Chief Executive of ITV plc Broadcasting.

5.12 There are cross charges between ITV plc and ITV Network, and between ITV Network and ITV2, ITV3 and ITV News Channel to cover the costs of the services provided. ITV plc has indicated that these cross charges are based on the time spent by, and the salary and employment costs of the individuals providing the service (and exclude overhead apportionment).

Programme commissioning and acquisition

5.13 Content for the ITV1 channel is sourced from new commissions and acquisitions (existing programmes).

5.14 New commissions (or programme production) can be purchased from a range of sources. These include the licensees' in-house production divisions, which are limited at present to ITV plc's Granada Productions and SMG's in-house production (neither UTV nor Channel currently produce network programmes for ITV), as well as external sources, e.g. qualifying and non-qualifying independents (larger independent producers include the likes of Talkback Thames, Endemol and Tiger Aspect) and the in-house production of other broadcasters (if they were to be willing to make programmes for a rival broadcaster).

5.15 Annex 1 of this document describes measures that have previously been taken to address competition concerns over the treatment of independent producers in the commissioning process, namely the requirement to provide direct access for independent producers to the ITV Network Centre (recommended by the Monopolies and Mergers Commission in its 1993 Report on the ITV Networking Arrangements). This requirement, in practice, provides for equal access to the ITV Network Centre for all producers.

5.16 In addition, the 2004 Code of Practice described at the end of Section 3 above provide a set of principles for negotiating terms of trade with independent producers for programme commissions, although as mentioned, this currently only applies to qualifying independent producers. The 2004 Code of Practice also provides for a dispute resolution process in the event that an independent producer considers that ITV Network have not complied with the Code of Practice. The final stage in that dispute resolution procedure is for the matter to be referred to the Chair of Network Council and his decision in the matter is considered to be final. Given that the Chair of ITV is not employed by ITV Network it was considered that this provided for a sufficient degree of independence for the final stage in the dispute resolution process. The current Chair of Network Council is the Chief Executive of SMG Television.

5.17 Further to these safeguards in the commissioning process, section 277 of the Act provides that every licensed public service channel includes the conditions that Ofcom consider appropriate for securing that, in each year, not less than 25 per cent of the total amount of time allocated to the broadcasting of qualifying programmes included in the channel is allocated to the broadcasting of a range and diversity of independent productions. In other words, there exists a wider public policy measure to stimulate competition in programme production.

Compliance

5.18 Whenever a broadcaster commissions a programme it must ensure that the programme complies with the Broadcasting Code[17]. If, after broadcast, the programme is found to be in breach of the Code then the broadcaster risks sanctions and, potentially, a fine of up to 5 per cent of the broadcaster's qualifying revenue for its last complete accounting period[18]. As explained in Annex 1 of this document, in its 1993 report, the MMC acknowledged that it was difficult to separate responsibility for regulatory compliance and the associated production monitoring from the production contract, but ultimately decided that a tripartite agreement between all three parties would achieve the twin objectives of direct contracting with the NWC and licensee responsibility for compliance. As set out in Section 3, such a Tripartite Agreement forms part of the current NWA.

5.19 In line with the current ITV Networking Arrangements, when the NWC commissions a programme from an external producer (a non licensee production business) it does not carry out the programme's compliance. The responsibility for compliance (and hence the liability for a potential fine) is undertaken by one of the licensees. The licensee receives a fee for carrying out this role which is a fixed percentage of the programme's cost and is paid by the NWC. Producers are informed of potential Compliance Licensees as part of the programme negotiation process and are asked whether they have a particular preference, although according to the 2004 Code of Practice the ITV Network Centre can "commend" a particular licensee for the role. In the case of programmes commissioned from Granada Productions or SMG, the compliance is carried out by ITV plc and SMG respectively. In general, the compliance of independent programmes is carried out by either ITV plc or Channel.

Channel operation services

5.20 A number of different arrangements exist that we define as "Channel operation services". These are arrangements either between the licensees, and/or between the licensees and third parties, that are the "nuts and bolts" of producing a national broadcast. They exist as both formal and informal arrangements, established contractually, through stated principles and arrangements, or captured within the NWA. They cover areas such as:

- marketing and outsourced services (e.g. support services);
- interactive and on-line services;
- transmission;
- sharing of services with other ITV plc channels (ITV2, ITV3 ITV News); and
- payments to third parties (e.g. talent unions).

5.21 The purpose of many of the arrangements is to coordinate the provision or purchase of services that benefit all the licensees. Importantly, as we have already explained, the type and hence permanency of these arrangements are different (e.g. informal to formal undertaking). However, whilst the type of arrangements are different, the basic principles that they apply are broadly similar (i.e. equitable treatment of licensees in relation to, for example cost sharing which tends to be based on each licensee's share of QR).

5.22 The sharing of the cost of the network schedule, which is by far the largest of the licensees' shared costs, is covered in detail by the NWA and the undertakings given to the OFT by ITV plc, which between them specify exactly what proportion of each programme's cost each licensee will bear. Scottish Television has specific rights to opt out of the network schedule without paying for the network programmes it does not broadcast, under the terms of the Devolution Agreement (see paragraph 3.7). However, the general rule is that licensees must pay for network programmes irrespective of whether or not they transmit them in their regions.

Sharing of Programme Costs between Channels

5.23 With respect to programmes making up the ITV1 nationwide schedule the sharing of programme costs between the licensees is enshrined in the current ITV Networking Arrangements and the Carlton-Granada merger Undertakings. As we have discussed in Section 3, the Network Supply Contract determines how programme costs will be shared based on formulae set out in the NSC and depending on the size of the licensee's QR. In addition this has been augmented following the merger Undertakings which imposed a RPI cap on the increase in each non-consolidated licensee's contribution to the programme budget for ITV1. Therefore, effectively each non-consolidated licensee contributes the lower of the amount that would be paid according to the Network Supply Contract and the merger Undertakings. ITV plc contributes whatever is required to make up the full programme cost after the non-consolidated licensees make their contribution.

5.24 Since the launch of ITV2, ITV3 and ITV News Channel there has been some sharing of programme costs between the channels. Rights to sports events and some acquired programming may be purchased for use across ITV1 and other channels. More rarely programmes may be commissioned for use across multiple channels.

5.25 Where rights are acquired there is no standard or formalised approach for cost sharing between the different channels, which is undertaken on a case-by-case basis. However, the broad principle used for cost sharing appears to be that the share of costs borne by each channel is related to the audience size or revenue generating potential of that channel. ITV1 therefore bears the great majority of costs for shared programme rights. However, over time it is likely that an increasing share of costs will be borne by the ITV plc owned channels as their audience shares and revenues increase relative to ITV1.

5.26 ITV2 and ITV3 also purchase repeat transmissions of programmes commissioned by and previously shown on ITV1. In this case, the right being purchased is separate from that originally acquired by ITV1 and is negotiated for separately with the producer. ITV2 and ITV3 pay a ratecard based price with two elements: firstly a payment to the producer based on the original licence fee for the programme; and secondly a payment to ITV1 in compensation for its release of its 5 year exclusivity window to enable the programme to be repeated on another channel, this payment also being on based on the level of the original licence fee. The ratecard was established in 2001 and has been unchanged since then.

Viewers, airtime sales and programme sponsorship

5.27 The ITV channel is broadcast on a nationwide basis with relatively minor differences in schedule due to specific obligations for hours of regional programming. Each licensee “owns” the viewers within its regional boundary as defined in its licence conditions.

5.28 Licensees earn revenue from selling airtime to advertisers and from programme sponsors who pay to sponsor national networked programmes. Licensees are able to arrange separate sponsorship for regional programming although they are mandated within the ITV Networking Arrangements to ensure that network programmes are sponsored on a nationwide basis.

5.29 Following the merger of Carlton and Granada in 2003 there is only one airtime sales house for all Channel 3 licensees. The non-consolidated licensees have chosen to secure a commercial deal which is underpinned by the merger Undertakings, that the unified sales house of ITV plc will sell the network’s airtime on behalf of all licensees. The same arrangements, although not underpinned by the Undertakings, apply to programme sponsorship and the ITV plc unified sales house sells all network programme sponsorship.

Section 6

Assessment of existing arrangements

6.1 This section sets out Ofcom's analysis of the potential competition issues that relate to the arrangements described in Section 5. This includes an analysis of some arrangements currently outside of the ITV Networking Arrangements. We believe this is particularly important given the significant developments that have taken place since the ITV Networking Arrangements were last updated in 1993 i.e. the consolidation of 11 licensees to form ITV plc and the launches of ITV plc's digital channels: ITV2, ITV News Channel and ITV3.

6.2 The analysis in this section has been used to inform Ofcom's decision on the changes that are required to the ITV Networking Arrangements that are set out in Section 7.

6.3 This section begins with a discussion of the general framework for Ofcom's assessment and goes on to set out in more detail the potential competition issues that Ofcom has identified in each area of activity described in the previous section.

The general framework for Ofcom's assessment

6.4 Ofcom must not approve revised ITV Networking Arrangements (or propose modifications to the existing arrangements), unless it is satisfied that the revised arrangements (or proposed modifications) satisfy the competition test set out in paragraphs 6(3) and 6(4) respectively of Schedule 11 of the Communications Act 2003. This statutory duty has already been discussed in Section 2.

6.5 The statutory competition test is focused on restrictions of competition arising from the arrangements themselves, as opposed to restrictions of competition arising from the unilateral behaviour of one of the parties to the arrangements. When this test was conceived, the Channel 3 licensees were not so unevenly matched. In 1992 there were 15 independently licensed broadcasters and the maximum number of licences which could be owned by any one party was two. As already outlined, ITV plc now owns 11 of the 15 licences. This affords ITV plc a position of strength within the ITV network and creates different competition issues, which we believe are not covered by the statutory competition test, but which are nevertheless relevant to this review. The analysis in this section therefore considers both the narrower competition issues relevant to the application of the statutory competition test, as well as broader issues stemming from ITV plc's position of strength within the ITV network.

6.6 Ofcom also notes that the statutory competition test is only applicable to arrangements which fall within the scope of the ITV Networking Arrangements. To the extent that Ofcom's analysis in this section discusses areas not within the scope of the ITV Networking Arrangements, Ofcom has not carried out a detailed analysis of whether such arrangements as are in place would satisfy the statutory competition test. If such arrangements were brought within the scope of the ITV Networking Arrangements, Ofcom would need to carry out this analysis.

6.7 Ofcom has set out below the main competition issues it has identified in relation to each area of activity described in Section 5 of this document. Where relevant, Ofcom has separated out its analysis according to whether the arrangements govern the relationships between the Channel 3 licensees and third parties ('external arrangements') or whether they relate solely to the relationships between the licensees themselves ('intra-ITV arrangements').

6.8 Ofcom intends to carry out two market reviews during the course of the next 18 months with respect to the airtime sales market and programme supply market. Therefore, in the absence of a specific complaint, issues of ITV behaviour in these areas of activity would be addressed in these market reviews and are outside the scope of this review of the ITV Networking Arrangements. Nevertheless, these areas of activity remain subject to the Chapter I and II prohibitions of the Competition Act 1998.

Programme commissioning and acquisition

External arrangements

6.9 The licensees commission and acquire programming from their internal production arms and from independent producers collectively through the ITV Network Centre, which programmes are then put together to create a national TV schedule for broadcast on ITV1.

6.10 The existence of the ITV Networking Arrangements means that the regional Channel 3 licensees do not commission or acquire programmes independently for inclusion in the national schedule. In the absence of such arrangements, the regional Channel 3 licensees might do so.

6.11 On this basis, the collective arrangements between the Channel 3 licensees in relation to the commissioning and acquisition of programmes are arrangements between potential competitors. Ofcom has therefore considered whether such arrangements have as their object or effect the restriction of competition.

6.12 The purpose of the ITV Networking Arrangements is to enable the regional Channel 3 services (taken as a whole) to be a nationwide system of services which is able to compete effectively with other UK broadcasters. This is achieved through the central commissioning and acquisition of programmes by the ITV Network Centre on behalf of the regional Channel 3 licensees. In these particular circumstances, Ofcom does not consider that these arrangements have the object of restricting competition[19], nor, for the reasons set out below, does Ofcom consider that the arrangements have the effect of restricting competition.

6.13 In order to consider whether a particular agreement has as its effect the restriction of competition, it is normally necessary to take into account the economic context in which the parties to the agreement operate, the products or services covered by the agreement, the structure of the market concerned and the actual conditions in which it functions[20].

6.14 The European Commission has published a Notice "*Guidelines on the applicability of Article 81 of the EC Treaty to horizontal cooperation agreements*", which sets out certain principles for assessing horizontal cooperation agreements[21]. The Commission's guidelines indicate that a relevant factor in assessing the effect of a particular agreement might be the market position of the parties to the agreement relative to each other, i.e. if the collective share of all cooperating undertakings is not significantly greater than the share of the largest single participating competitor, the agreement would not normally be seen as having a restrictive effect on competition[22].

6.15 In looking at the effect of the arrangements between the Channel 3 licensees relating to the collective commissioning and acquisition of programmes, it is notable that the market has changed significantly since the ITV Networking Arrangements were looked at by the MMC in 1993. As noted above, ITV plc now holds a considerable position of strength within the ITV network compared to the non-consolidated licensees. In the case of commissioning and acquisition, ITV plc contributes approximately 92% of the ITV Network programme budget.

6.16 In view of ITV plc's position relative to the non-consolidated licensees, Ofcom does not believe that the incremental impact on competition of the coordination of ITV plc's and the non-consolidated licensees' activities compared to the impact on competition of ITV plc alone is likely to be material. Therefore, we would not expect the arrangements relating to the collective commissioning and acquisition of programming to result in a restriction of competition and, as such, the statutory competition test is likely to be fulfilled.

6.17 This view is supported by analysis Ofcom has carried out in relation to original programme commissioning and programme acquisition. This analysis, which is set out at Annex 2, considers the potential relevant markets and the incremental impact that the coordination of the licensees' activities is likely to have in these markets.

6.18 Furthermore, Ofcom notes the changes made to the ITV Networking Arrangements as a result of the MMC's inquiry in 1993. Ofcom believes that these changes are sufficient to address any concern about potential unequal treatment of independent producers, in particular in relation to their ability to gain the opportunity to compete for ITV Network Centre commissions. For example, the Network Centre Code of Practice ensures that information is disseminated fully to guarantee an even-handed treatment of in-house and independent producers. Separately a new ITV Code of Practice was issued in 2004 and approved by Ofcom. Whilst this only applies to qualifying independent producers, its principles are very similar to those already incorporated in the 1992 Code of Practice in the ITV Networking Arrangements.

6.19 Ofcom notes that there is a potential new competition concern, which arises from the fact that ITV plc holds the majority vote at the Network Council, thereby affording it significant influence over commissioning decisions, whilst at the same time owning a programme production business, Granada Productions. Ofcom believes that there are two key potential conflicts of interests ITV plc faces as a result.

6.20 Firstly, whether ITV plc has the incentive to ensure that the ITV Network pays a fair price for programmes made by Granada Productions. Given ITV plc's control of the ITV Network Centre, it may have the ability to pay an excessive price for Granada commissions. From ITV plc's perspective this would be a benign transfer payment. However, from the non-consolidated licensees' perspective this is a cost and effectively a transfer of value from the non-consolidated licensees to ITV plc.

6.21 Ofcom believes that ITV plc's incentive to act in this way is limited because, under the terms of the Carlton-Granada merger Undertakings, the increase in the non-consolidated licensees' contribution to the programme budget is capped i.e. based on a limited rate of increase from its current level. If ITV Network Centre were to spend more on commissioning from ITV plc, the licensees whose programme budget contribution is capped would not bear this cost in its entirety. ITV plc would bear 92% of the costs of any increase up to the rate of inflation and all of the costs of any increase over and above the rate of inflation. Therefore the extent to which ITV plc profits from inflated commissioning prices paid to Granada is likely to be low. It is also the case that were ITV Network to pay inflated prices for ITV plc produced programmes, this might tend to drive up the benchmark prices for all commissions including commissions from independent producers. The cost of this price inflation would be borne largely by ITV plc. We have undertaken a limited analysis of the prices paid for commissions to Granada and SMG's respective production arms compared to external producers. This analysis suggests that there does not appear to be any consistent over or under paying for commissions to either category of producer. Additionally, under the terms of the 2004 Code of Practice, ITV must publish indicative tariff prices, broken down by genre and day part. Producers must submit an offer price which must be within the indicative tariff range unless exceptional circumstances apply. Details of the indicative tariff prices and the prices paid for all commissions are made available to Ofcom, which is able to monitor the actual prices paid relative to the published indicative tariffs. Notwithstanding the above, Ofcom recognises that, at the margin, there may still be an incentive on ITV plc (through its control of the ITV Network Centre) to act in such a way as to favour itself by either, commissioning from its own production arm rather than a third party producer or by 'over-paying' for Granada commissions and/or under-paying for commissions from other licensees' productions houses or external producers.

6.22 Secondly, whether the ITV Network, driven by ITV plc would favour commissioning Granada rather than other licensees' production houses and external producers. This issue only arises where there is a tension between commissioning the best programme for the ITV Network (e.g. one that delivers the greatest advertising sales revenue) and instead preferring to commission a programme from Granada, sacrificing to some extent a portion of ITV Network sales revenue for Granada production profits.

6.23 We believe that ITV plc's incentive to follow this strategy is low given the relative scales of profits delivered to ITV plc from their sales and programme production businesses. We believe that the interests of ITV plc and the non-consolidated licensees are aligned in that we would expect ITV plc to always aim to commission programmes that are optimal for the ITV Network.

6.24 The 25% independent quota to which all public service licensees including ITV are subject requires that at least 25% by volume of ITV1's qualifying programmes are commissioned from qualifying independents. ITV1 currently commissions about one third of its qualifying hours from qualifying independents, and a total of c. 40% of qualifying hours from non-ITV sources. The volume of independent commissions has risen slightly over the past three years. Ofcom monitors the level of independent commissioning on an annual basis and will be alert to any changes in the level of independent commissioning. Additionally, Ofcom will review the operation of the independent quota as part of its Review of the TV Production Sector and may propose changes to it. Notwithstanding the above, Ofcom recognises that, at the margin, there may still be an incentive on ITV plc (through its control of the ITV Network Centre) to act in such a way as to favour commissioning Granada rather than other licensees' production houses and external producers.

6.25 If the two potential conflicts of interest outlined above were considered to be material, this would tend to indicate that the ITV Network should be entirely independent from the outside interests of the licensees. Ofcom does not believe that these two issues described above are material enough to warrant such an obligation. It is also worth noting that we find it difficult to envisage a situation where this independence could be practically achieved given ITV plc's ownership of 11 of the 15 regional licences and its likely unwillingness to divest its production business.

6.26 However, the fact that the reporting lines of the NWC Rights and Business Affairs team are blurred, and the team are employed by a variety of companies risks creating a lack of clarity in whose interests commissioning and pricing decisions must be made. Ofcom therefore considers that these arrangements should be reviewed and amended. This is discussed further in the following section

Independent Commissioning and Programme Compliance

6.27 As explained in Section 5, whenever a broadcaster commissions a programme it must ensure that the programme complies with the Broadcasting Code. If, after broadcast, the programme is found to be in breach of the Code then the broadcaster risks sanctions and, potentially, a fine.

6.28 When the ITV Network Centre commissions a programme from such an external producer (a non licensee production business), it does not carry out the programme's compliance. The responsibility for compliance is undertaken by one of the licensees appointed by the ITV Network Centre. The rules governing the appointment of such a licensee are contained within the 2004 Code of Practice.

6.29 Section 6.1 of the 2004 Code of Practice states that "ITV will commend a Compliance Licensee to the Producer to carry out compliance and production monitoring in respect of that programme."

6.30 Arguably, the restriction to ITV Network Centre selecting the compliance licensee limits the choice, and potentially, competition for such compliance work, as ITV Network Centre may favour the compliance business of ITV plc. Indeed, the Carlton-Granada merger Undertakings make the choice of compliance licensee a matter which cannot be linked to the decision to commission a programme. This undertaking was given in order to protect access to the compliance business by Channel which currently undertakes much of the compliance for independent programmes.

6.31 We understand that in practice the independent producer is able to express a preference in the selection of compliance licensee and that in general it is only in the absence of an expressed preference or in exceptional circumstances that the Network Centre 'commends' a particular compliance licensee. This might suggest that the independent producer's right to choose a compliance licensee should be made more explicit within the 2004 Code of Practice.

6.32 However, it might equally be argued that by ITV Network Centre retaining ultimate control of the appointment of a compliance licensee, it is able to exercise impartiality and provide added quality control through the ability to draw on expertise in order to appoint a licensee best suited to the type of programme in question.

Intra-ITV arrangements

6.33 The intra-ITV arrangements relevant to this category are discussed below under the heading 'Channel operation services'.

Channel operation services

External arrangements

6.34 Aside from commissioning and acquiring programmes for ITV1 the ITV Network Centre and ITV Network Ltd purchase a range of services from third parties and ITV plc on behalf of ITV1 and/or the non-consolidated licensees. These arrangements are discussed in Section 5. Such arrangements do not fall within the scope of the existing ITV Networking Arrangements. Therefore, the statutory competition test does not apply (although it should be noted that this statement provides no formal decision about the application of the Chapter I prohibition of the Competition Act 1998 to such arrangements). Nevertheless, Ofcom believes that its reasoning in relation to the commissioning and acquisition of programming should also apply in relation to other areas of common action between the licensees (although again, this does not amount to any formal decision on the applicability of the Chapter I prohibition). The relative size of ITV plc compared to the non-consolidated licensees means that the incremental impact on competition of the coordination of the licensees' activities compared to the impact on competition of ITV plc alone is not likely to be material.

6.35 Ofcom does not consider that any additional competition issues arise in relation to external arrangements within this category.

Intra- ITV arrangements

6.36 This includes cost sharing between the licensees in respect of payments to third parties or another licensee; payments to ITV plc for services it undertakes on behalf of all the licensees; the relationship between the ITV Network Centre and the Channel 3 licensees' own internal network production businesses; and the relationship between the ITV Network Centre and the compliance licensee (i.e. the Channel 3 licensee who is responsible for ensuring that any independently commissioned programme complies with the Broadcasting Codes etc.)

6.37 The principal competition issues around these relationships stem from the position of strength ITV plc holds relative to the non-consolidated licensees. This is in terms of its effective control of the ITV Network, the fact that it is the only effective provider of certain outsourced activities relating to the ITV

Network Centre and the size of its programme production business which is by far the largest supplier of commissioned programming to the ITV Network.

6.38 Aside from commissioning and acquiring programmes for the ITV Network, the ITV Network Centre purchases a range of services from third parties and ITV plc. Moreover the ITV Network undertakes services for ITV plc in relation to its channels ITV2, ITV3 and ITV News Channel.

6.39 We begin by discussing the competition issues with those arrangements that deal with purchasing services from third parties and go on to discuss the issues around services purchased or outsourced between the ITV Network and ITV plc.

Sharing costs of services purchased from third parties

6.40 The incentives of the non-consolidated licensees and ITV plc are aligned in relation to their treatment of third parties, when the ITV Network Centre purchases services from a third party. However, the key issue associated with this type of arrangement is how the costs borne by the ITV Network are shared between the licensees. The cost sharing arrangements may not be fair because ITV plc has effective control of the ITV Network Centre which potentially allows it to dictate cost sharing arrangements.

6.41 Ofcom would deem cost sharing arrangements to be fair if each licensee contributed no more than a share of costs which was directly proportional to the benefit it gains from the service that is being purchased. Ultimately, the benefit licensees gain from the ITV broadcast is monetised in airtime sales revenue. Therefore Ofcom believes a fair cost sharing basis for all activities undertaken to facilitate the ITV channel is to base contributions on the share of Qualifying Revenue (or 'QR') that each licensee attracts.

6.42 To safeguard the interest of the non-consolidated licensees a fair cost sharing basis could be encapsulated by a simple principle to cap the proportion of total costs paid by each unconsolidated licensee. As explained above a fair level for this cap could be a licensees' share of qualifying revenue.

6.43 Although we note that currently the licensees as common practice contribute towards costs based on QR shares, we also note that this practice is often based on informal agreement. Therefore this principle could be applied formally in the ITV Networking Arrangements or in a commercial contract to safeguard the interests of the non-consolidated licensees.

6.44 In the case of the ITV Network Programme Budget, some licensees contribute lower share than their QR share would suggest and consequently other larger licensees pay more in order to fund the extra subsidy. This cost sharing arrangement is covered in detail in the Networking Arrangements and Carlton-Granada merger undertakings and we believe it is not in need of amendment. Although we note that this is not in line with the principle of fair cost sharing enunciated above, it was based on an overall policy objective that the smaller licensees need to be cross subsidised to enable them to meet their licence obligations associated with regional programming.

6.45 However, a potential issue with the licensees' contribution to programme budgets is that with very limited exceptions, licensees are required to pay for all network programmes whether they broadcast them or not. Given that following Ofcom's Review of Public Service Broadcasting, national licensees will be required to broadcast higher volumes of regional non-news programmes than the English regions, Ofcom considers it appropriate that the ITV Networking Arrangements should be updated in order to maintain the viability of regional non-news programmes in the Nations for as long as possible, by exempting licensees from the requirement to pay for network programmes that they do not broadcast in order to show regional programmes.

6.46 In addition, the changes in regional programme obligations increase the requirement of the non-consolidated licensees to opt out of networked programmes. The Network Centre Code of Practice could usefully be extended to incorporate an obligation to have regard to the need for regional opt out slots in the construction of the network schedule. However, we believe that it would not necessarily be advisable to go beyond this and impose a requirement to create specific half hour opt out slots, as the Welsh, Northern Irish and Scottish licensees currently broadcast their incremental regional programmes in different schedule slots to meet their differing markets' needs.

6.47 Separately, with the launch of ITV plc's digital channels ITV2, ITV3 and ITV News Channel the way in which ITV1 content is shared by these channels could raise potential competition concerns:

- Programme commissioning and acquisition costs are shared between the ITV Network and ITV plc's channels who we understand in some cases may provide a contribution; and
- ITV plc's channels acquire the rights to show programmes originally commissioned or acquired for broadcast on ITV1 by the ITV Network.

6.48 Ofcom is not aware of any issues with current practice in this area, however, there may be a need for greater codification and transparency in the arrangements for cost sharing between channels.

The fee charged for services purchased from ITV plc

6.49 In addition to buying services from third parties, the ITV Network Centre out-sources activities to ITV plc. These include certain administrative functions. In return, ITV plc receives a fee which is paid by all the licensees in accordance with informal cost sharing agreements. The incentives of the unconsolidated licensees and ITV plc are conflicting when ITV Network Centre makes a payment to ITV plc.

6.50 The issue of how these costs are shared between the licensees is the same as discussed above. The more salient issue concerns the price ITV plc charges the ITV Network Centre for the services it undertakes. This could be a concern from the perspective of the non-consolidated licensees if ITV plc is the only available supplier of these services since this may afford ITV plc the ability and incentive to inflate its fee for services it carries out for the ITV Network Centre.

6.51 The particular outsourced services have already been described and include administration related to: (i) Commissioning/acquisition; (ii) Scheduling; (iii) Finance; (iv) IT; and (v) the Support Services for ITV Network itself. Ofcom believes it is possible that at least some of these services could be purchased from a third party, however, for some (like finance), ITV plc could be the only effective supplier. Moreover, it is worth noting that even if ITV plc is not the only possible supplier of these services, ITV plc through its voting rights controls the decisions made at the Network Centre and could ensure that all of these services are purchased from ITV plc even though there may be cheaper or better quality alternatives elsewhere.

6.52 From our preliminary analysis of the costs of the Network Centre we believe that at present there is very limited transparency of the costs charged to ITV Network by ITV plc. Ofcom believes that the licensees may wish to consider the creation of service agreements between ITV Network and ITV plc to specify the services to be provided by ITV plc and the basis of charging.

6.53 The ITV Networking Arrangements could also formalise the currently informal sharing of costs on a QR basis. Additionally, to safeguard the interests of the non-consolidated licensees, Ofcom could mandate adequate transparency of the ITV Network Centre's costs to enable non-consolidated licensees to monitor for the existence of any artificial inflation of ITV plc charges and raise a complaint to Ofcom as appropriate. Ofcom could go further and impose a more detailed obligation such as the price ITV plc charges the ITV Network Centre must not exceed, for example, fully allocated cost, incremental cost or some other cost orientated benchmark. Such an obligation would obviously impose significant additional burdens on ITV plc in order to demonstrate compliance and, depending on which benchmark is chosen, could lead to an increase in costs paid by the ITV Network Centre.

6.54 As an alternative to the above approach, rather than monitoring the recharges and then allocating costs between the licensees on a continuing basis, it would be open to the licensees to agree some fixed basis of cost sharing between them, for example a set lump sum annual contribution to ITV Network costs from the non-consolidated licensees which inflates with RPI from the agreed base. This approach would avoid the need for detailed ongoing monitoring of cost allocations and allow ITV plc to take full advantage of potential overhead costs savings between ITV plc, ITV plc owned channels and ITV Network.

6.55 Ofcom notes that in the case of informal or commercial arrangements there is no assurance that arrangements will continue in their current forms. Given ITV's effective control of the network centre, it has the ability to make changes to common practice (i.e. to stop providing services to the licensees, to change the basis of cost sharing and to change the costs of services it undertakes on behalf of licensees).In particular, in the event of a change of control of ITV plc, it has been suggested that a new owner might decide unilaterally to change the basis of current informal arrangements.

6.56 These concerns have not materialised in practice and therefore Ofcom does not consider it necessary to impose change at this time. However, Ofcom notes that it is able to review the operation of the Networking Arrangements under Schedule 11 of the Act at any time and also has the power to impose licence conditions upon the Channel 3 licensees to regulate activities related to networking. In the light of these powers, Ofcom is of the view that any issues arising, or expected to arise, from a potential change of control of ITV plc could be dealt with at that time and need not be addressed in advance.

6.57 There are two further arrangements outside of the context of the discussion above. First, in the case of programme commissioning the existing NWA include a duty imposed on licensees to make written programme proposals for offers to the Network. This obligation dates back to a period when the then regulator (ITC) believed that all licensees should have the ability to offer programme proposals to the network for commissioning. Ofcom believes that this should no longer be a requirement for all licensees and this duty should therefore be deleted from the Networking Arrangements.

6.58 Second, as discussed earlier in this section, programmes produced by a non-licensee require compliance by a licensee to ensure the programme complies with the Broadcasting Code and that broadcast of the programme will not result in a breach of the law (e.g. copyright, libel etc). The Carlton-Granada merger Undertakings make the choice of compliance licensee a matter which cannot be linked to the decision to commission a programme. This free choice of compliance licensee protects the ability of any licensee to compete for compliance business with all other licensees and should prevent ITV plc influencing the Network Centre to place compliance business with ITV plc. However, as discussed in paragraphs 6.27 to 6.32 above, it may be that a change is needed to the Code of Practice to make that free choice more explicit.

Viewers, airtime sales and sponsorship

External arrangements

6.59 When considering competition issues in relation to viewers it is a salient point that the regional Channel 3 licence conditions mandate a national ITV broadcast schedule (with regional variations to meet regional programming obligations). Therefore the regional franchises do not actually compete with each other for viewers, other than in the limited transmission overlap areas. It is therefore difficult to identify competition concerns in this area because the coming together of the licensees is not the coming together of competitors.

6.60 Concerning the pooled arrangements for generating and sharing advertising revenue, Ofcom notes that these do not fall within the ITV Networking Arrangements and are therefore not subject to the statutory competition test (although it should be noted that the this statement provides no formal decision about the application of the Chapter I prohibition of the Competition Act 1998 to such arrangements). In any event, such arrangements are critical to the viability of all the licensees. Advertisers buy airtime on a region by region basis and the non-consolidated licensees' shares of airtime are underpinned by the contractual arrangements for sales between them and ITV plc.

6.61 ITV plc's relationship with advertisers and its relationship with the unconsolidated licensees as airtime sales agent has recently been the subject of review by the Competition Commission in its report into the Carlton-Granada merger.

6.62 In relation to ITV plc's market power as a seller of airtime, the Competition Commission's report concluded that prior to the merger, competition between the Carlton and Granada sales houses limited what advertisers or media buyers could be charged for airtime slots. Post merger, there were concerns that less attractive terms could be imposed as a result of the merged entity's enhanced market position. The CRR remedy, which was put in place as a remedy, specified that advertisers should have the fallback option of renewing their contracts based on the terms of their 2003 contracts.

6.63 The CRR remedy and the merger Undertakings are already aimed at remedying the potential competition problems in this market. In our opinion there have been no new material developments to the way in which the licensees operate with respect to airtime sales and therefore it would not be appropriate to carry out any further analysis in this market as part of this review. However, it is worth noting that Ofcom is likely to carry out a full review of the airtime sales market in the course of the next 18 months.

6.64 Under the terms of the Networking Arrangements, the sale of programme sponsorship for networked programmes was made subject to the approval of ITV Network, in effect ensuring sale on a national basis, while allowing licensees the opportunity to opt out of a sale of programme sponsorship (although we understand this opt out right is never exercised in practice).

6.65 We believe that is it appropriate to exclude sponsorship from the scope of the ITV Networking Arrangements and this review. We understand that programme sponsorship is similar to airtime sales in the way in which it is currently sold. Notwithstanding, going forward it is plausible that programme sponsorship and airtime sales may become more closely related becoming in some cases complementary forms of advertising or indeed even substitutes in other circumstances. Therefore we believe that any issues in relation to programme sponsorship are likely to be similar to potential issues with the arrangements for airtime sales. In a review of airtime sales Ofcom would intend to cover programme sponsorship.

Intra-ITV arrangements

6.66 As with the external arrangements outlined above, Ofcom believes that the intra-ITV arrangements relating to the sale of airtime have already been addressed by the Competition Commission's inquiry into the Carlton-Granada merger. The Competition Commission concluded that unless the non-consolidated licensees could continue to sell their airtime through the ITV plc sales house on terms similar to those they already enjoyed, the merger would have an adverse effect on them. Therefore, ITV plc was required to give an undertaking to the ITC that the unconsolidated licensees should have the option to carry forward the terms of their existing contracts with the Carlton and Granada sales houses. Ofcom does not believe that the market has changed materially to warrant re-looking at this issue in the context of this review.

Section 7

Conclusions and next steps

Introduction

7.1 In this section we set out the conclusions to the review. This section summarises the responses we received to our consultation and sets out Ofcom's views on the issues raised in those responses. We then set out our proposals for any modifications that will be needed to be made to the NWA before concluding with a summary of the next steps and timing of the implementation of the required changes.

7.2 In the February Consultation we set out different options for changes to the NWA. With the exception of the "do nothing" option, these proposals were based on ensuring that the NWA reflected current working practices as well as addressing the competition issues and the public policy objectives set out respectively in Section 6 and Section 4 of the February Consultation and repeated again in this statement.

7.3 As already explained (in Section 6), the scope of activities carried out by ITV Network Centre on behalf of the licensees extends beyond the formal scope of the NWA. In considering proposals to ensure that that the ITV network is able to operate efficiently going forward, we considered that it would not be appropriate in this review to ignore those arrangements which fall outside the formal scope of the NWA.

7.4 We also considered that because of the range of activities carried out by ITV Network, it was appropriate to draw a distinction between two separate categories of arrangements: arrangements or agreements between the ITV licensees ('intra-ITV arrangements') and arrangements in relation to external third parties, such as external programme producers ('external arrangements').

7.5 In relation to external arrangements we proposed three options for changes to the NWA. These were relatively more prescriptive than our treatment of the intra-ITV arrangements. Our intention for the intra-ITV arrangements was to motivate the licensees to work together to reach a set of proposed changes based on the high level principles which we articulated in the consultation document. This was the case, in particular, in respect of those intra-ITV arrangements falling outside the formal scope of the NWA.

Summary of responses received to the consultation document

7.6 We received formal confidential responses from ITV plc and each of the other regional ITV licensees, plus a further confidential joint response from all the Channel 3 licensees summarising points of agreement and disagreement between them. In addition we received responses from PACT and Channel 4.

EXTERNAL ARRANGEMENTS

Option 1: Do Nothing

7.7 We gave a clear indication that the option to "Do Nothing" was in our view not an appropriate way forward. This option would not involve any change to the existing arrangements, with the underlying documentation being left unchanged and the existing combination of formal and informal arrangements continuing. Despite this option incurring the lowest direct costs there would be continuing indirect costs, particularly for the non-consolidated licensees owing to deficiencies in the current documentation:

- There are a number of areas where underlying documentation, such as the Network Supply Contract, no longer accurately reflects the actual operation of ITV Network Centre, the range of activities that it carries out and the current cost sharing arrangements; and

- There is some potential for confusion regarding the way in which the NWA are currently set out, with two overlapping Codes of Practice (1993 and 2004). As such, we believe that clarity could be provided by aligning the two.

7.8 All stakeholders agreed that doing nothing is not an option. There are deficiencies in the current set of arrangements and some changes are required to the NWA. Views on the degree to which changes should be made varied according to the stakeholder, ranging from minimal updating to reflect changes in practice and no more, whilst at the other extreme, some changes were mooted beyond our original proposals (discussed below).

Option 2: Updating the Networking Arrangements to reflect current practice and to strengthen existing commitments

7.9 Option 2 set out a number of changes that could be made to the NWA:

(a) ITV Network Centre incorporating the 2004 Code of Practice for commissioning from independent producers or the principles contained within it into the NWA and extending it to cover all producers, both Channel 3 licensees and external qualifying and non qualifying independents, to ensure that they would be treated on an equivalent basis;

(b) ITV plc incorporating the commitments made to the ITC at the time of the Carlton-Granada merger in relation to the independence of the commissioning process, including the arms-length nature of the process for programme price negotiations between the ITV Network Centre and all programme suppliers into the NWA. This could be done through incorporating the principle of an independent commissioning process into the ITV Network Statement of Principles, and removing the ability of Council to amend the Statement of Principles without Ofcom's approval;

(c) Ensuring that the Network Centre Code of Practice provides for an independent dispute resolution mechanism;

(d) Measures to ensure that employees within the core functions of ITV Network Centre are employees of ITV Network Centre and have clear management reporting lines within Network Centre; and

(e) Simplification of the reporting arrangements for the operation of the Networking Arrangements to require quarterly reports on only the contracts signed.

7.10 The objective of the measures outlined above was to ensure that the various elements that make up the NWA formed a coherent package in terms of relevance, robustness, transparency and non-discrimination with respect to outward facing arrangements. We did not consider that these proposals would require ITV Network to make fundamental changes to the way in which it currently operates with respect to third parties meaning that implementation should be neither disruptive nor costly. It should also be noted that these proposals for consolidating the existing linked set of commercial and regulatory arrangements would not preclude the parties coming forward with new proposals at a later date. Our initial view on these changes was that these were the minimum set of measures which should be implemented.

7.11 Generally speaking, stakeholders' views have tended to align with our suggested option of incorporating the new 2004 Code of Practice into the NWA and extending it to cover all producers, enshrining an independent commissioning process, providing for an independent dispute resolution procedure, clear employment status and reporting lines for ITV Network Centre staff and simplification of reporting arrangements. However, there were some areas of contention which are worth noting:

- There was some disagreement as to whether potential deficiencies existed in terms of the treatment of non-qualifying independent producers although there was no opposition to incorporating the 2004 Code of Practice (or its principles) into the NWA and applying it to all producers;

- One respondent noted that in the interests of equivalence across broadcasters, if the 2004 Code of Practice was to form part of the NWA, the same approach should be applied to the Codes of other Public Service Broadcasters which should in future cover all producers. We note that this is a point for further investigation and is one which will be considered as part of Ofcom's Review of the Programme Production Sector;

- The issue was raised as to whether it was appropriate to remove the Tripartite Agreement and Network Programme Licence from the NWA. The main principles contained within these documents would still be reflected within the Code of Practice and Statement of Principles, but the actual contractual documentation would fall outside the scope of the NWA. Since Ofcom already indirectly regulates PSB channels' terms of trade through enforcement of the Codes of Practice, incorporating the terms of the Tripartite Agreement and Network Programme Licence within the NWA was felt to be a duplication of regulation. We note that ITV and PACT are still in the process of negotiating new terms of trade. In these circumstances, we do not consider that it would appropriate at this time to remove the Tripartite Agreement and Network Programme Licence from the NWA. Once the new terms of trade have been agreed, there may be scope for the Tripartite Agreement and the Network Programme Licence to be removed from the NWA. If requested by licensees Ofcom will consider whether this would be appropriate as part of its next review of the NWA;

- Whilst most respondents agreed with the approach of enshrining the principle of independent commissioning in the Networking Arrangements rather than alternative structural solutions, one respondent did argue for physical separation of the commissioning team from ITV's production business. Our view is that given the proposals for separate employment status of ITV NWC staff carrying out the core functions, or formal secondments, and given that ITV NWC staff are already based in separate premises from Granada Productions' London base (in LWT's Television Centre), to a significant degree "physical" separation has already been achieved;

- Further proposals to strengthen separation put forward by respondents included introducing production quotas for different sources of commissions (including non-qualifying independents) which could be monitored by Ofcom and sharing audience information and research with programme suppliers so that producers themselves could be more informed about the decision processes behind commissioning at the ITV Network Centre. Ofcom is not proposing to adopt these further proposals. At this stage we believe that ensuring clear reporting lines and employment status of ITV Network Centre staff carrying out the core functions, alongside the effective broadening scope of the 2004 Codes of Practice and the incorporation of clear principles into the Network Centre's Statement of Principles, are sufficient measures to address issues around independence of the commissioning process; and

- The ITV licensees have also agreed that the incentive schemes for ITV Network Centre employees carrying out the core functions will be based on goals relating to the effective delivery of the core functions for ITV1, for example, maximising commercial impacts for ITV1.

Option 3: Dissolution of the NWC and the creation of new regulatory structures to guarantee independence of commissioning by ITV plc

7.12 This was the most radical of the options we considered and would involve the dissolution of ITV Network Centre and the integration within ITV plc of all programme commissioning, acquisition, scheduling and price negotiation functions currently undertaken by the ITV Network Centre. Such a change would recognise that ITV plc now controls 92 per cent of the voting rights in the ITV Network Centre and would attempt to build alternative arrangements which better reflect today's commercial reality. Adopting this approach may allow ITV plc and hence the ITV licensees to realise some further cost savings from the rationalisation of all ITV Network's functions within ITV plc, although on the other hand this would be a significant change with difficult and costly implementation issues.

7.13 None of the respondents supported this proposal (unless ITV plc ultimately became the 100% shareholder of ITV Network). One respondent put forward the proposal of limiting the proportion of commissions from ITV plc to 50%. In the context of a review of the NWA, we take the view that such a radical change, which would require further regulatory intervention, is not a proportionate remedy to the issues of independence of commissioning and ITV plc's incentive to act against the interests of the non-consolidated licensees. The changes set out under Option 2 are less burdensome and provide adequate protection for producers and licensees.

INTRA-ITV ARRANGEMENTS

7.14 We believe that the existing system of informal relationships is proving more difficult to manage in the context of the leadership by one company within the

ITV Network Centre rather than a number of equal sized companies. Therefore we believe that safeguards are required to protect the non-consolidated licensees' interests. The assessment of current arrangements in Section 6 highlights a number of issues, which we believe should be addressed by certain high-level principles underpinning the intra-ITV arrangements. Specifically, these principles can be summarised as:

(a) non-consolidated licensees should be safeguarded against unfair treatment by ITV plc in respect of arrangements for the sharing of costs for services purchased from third parties;

(b) non-consolidated licensees should be safeguarded against unfair treatment by ITV plc in respect of arrangements for the fees charged for services purchased from ITV plc;

(c) non-consolidated licensees should be safeguarded against unfair treatment by ITV plc in respect of the sharing of programme costs between ITV1 and ITV plc owned channels, and the provision of ITV Network services to ITV plc owned channels; and

(d) commitments to support regional programming obligations should be strengthened.

7.15 ITV plc has already made some efforts to put in place unregulated bilateral commercial arrangements with the non-consolidated licensees. ITV plc has an agreement in place with SMG and has negotiated the form of an agreement with UTV. A rather older commercial agreement is in place with Channel, but both parties agree that this is in need of updating. However, Ofcom believes that further steps are required to ensure that the principles outlined above are met. Specifically, in the consultation document we commented on three areas where we would expect these principles to be applied and where the licensees should make proposals for change:

- Cost sharing/transfers - in relation to activities carried out by the ITV Network Centre and by ITV plc;
- Regional programming obligations - fair treatment regarding core opt-outs; and
- Programme Compliance - fair processes for appointing compliance licensees.

7.16 In the consultation document we noted that in the event that the licensees were unable to agree on proposals relating to the intra-ITV arrangements, Ofcom had backstop powers to propose changes to the NWA and/or impose new licence conditions upon the regional licensees.

Cost sharing/transfers

7.17 In the consultation document we put forward the view that existing arrangements for cost sharing lack transparency and/or certainty for non-consolidated licensees. As discussed in Section 6, current practice is for non-consolidated licensees to make contributions on the basis of the share of Qualifying Revenue that each licensee attracts. This basis for cost sharing, in general, raises no concerns from Ofcom's perspective – for instance, it would be an appropriate measure of a licensee's ability to pay. However, the practice of basing these arrangements on informal, undocumented agreements creates a lack of certainty for the non-consolidated licensees and does not safeguard their interests. We believed that this issue needs addressing.

7.18 Existing cost sharing arrangements include a range of administrative functions carried out by ITV Network Centre on behalf of the Channel 3 licensees. We consider this to be relevant because it has an impact on the operations and total cost of ITV Network Centre and therefore potentially on the cost to the licensees of providing the ITV1 service. These administrative functions relate to the operation of the ITV Network Centre itself and the provision of ancillary services such as off-air marketing and payment to collecting societies.

7.19 At the same time, some activities of the ITV Network Centre are carried out not only on behalf of the Channel 3 licensees but also on behalf of other channels owned and operated by ITV plc, including ITV2, ITV3 and ITV News.

7.20 Ofcom is keen to ensure that there should not be a rigid set of arrangements which could constrain the ITV Network Centre's ability to respond to a changing business environment. For instance, we do not want to rule out the possibility of ITV plc and the non-consolidated licensees coming to an arrangement by which the non-consolidated licensees simply pay a fixed sum as their contribution to the costs of ITV Network Centre, rather than a payment based on QR share. However, in the absence of such an agreement it is appropriate to ensure both that the non-consolidated licensees have adequate transparency of the nature and costs of the services provided by ITV Network to ITV plc owned channels, and that the principles used to determine cost sharing are safeguarded by proposals to provide a degree of future proofing through an explicit framework for any revisions to cost sharing arrangements in the future. It is also the case that the informal commitments given to the ITC at the time of the Carlton-Granada merger provided for the continuation of the existing cross-subsidy arrangements between licensees. Those informal commitments could be put on a more formal footing.

7.21 Similarly, where ITV plc carries out certain functions on behalf of ITV Network Centre there should be provisions for the recharge of costs between ITV Network and ITV plc on a fully transparent basis.

7.22 During the course of the consultation the licensees have discussed amongst themselves what changes need to made to address the concerns described above. The licensees' final proposals, which in our view are sufficient to address our concerns, are to:

- Amend the Statement of Principles so that it articulates the principles outlined above, which will then apply generally to all cost sharing arrangements;

- Continue the provision of the core services by ITV Network to all licensees. The licensees have not yet agreed as to whether the costs of these services will be shared on a QR basis or whether the non-consolidated licensees will pay a fixed price. If the former is the case, Ofcom's view is that the non-consolidated licensee should be provided with fully transparent budget information and audit rights. This would include details of any services provided by those ITV Network employees providing core functions to ITV plc owned channels; and

- Introduce a service agreement, to sit outside of the NWA, which the licensees will collectively negotiate. The agreement will be between ITV Network, ITV plc and the non-consolidated licensees and will outline the non-regulated activities that ITV Network (potentially via ITV plc) will carry out on behalf of all licensees. The non-core services will be provided at a fixed price, subject to increases in line with RPI.

Regional programming obligations

7.23 In the February Consultation we highlighted that there is not a consistent pattern of opt-outs across the different Nations and regions of the UK, and there may be merit in licensees reaching broad agreement as to an appropriate pattern of core opt-outs. Our view stated in the consultation document was that we believed that a further internal consultation process would not impose significant additional costs on ITV, as the formal merger Undertakings already require some consultation in respect of the strategic direction of the Network, and to the extent that a more stable network schedule would enable ITV1 to retain viewers or even allow more scope for the optimisation of the sale of airtime, all parties to the NWA would benefit.

7.24 In addition we noted that where licensees in the Nations opt out of the national network schedule in order to comply with their regional licence obligations, we would expect that there would be a mechanism in place to compensate them for this by enabling them to receive a rebate on their contributions to the network programming budget or by reducing their contributions to it. Where such licensees choose to opt out of the Network schedule other than to meet licence obligations, and where not covered by the merger Undertakings (such as those in respect of increased devolution in Northern Ireland), then under the terms of the Network Supply Contract licensees would (as now) pay for programmes whether or not they broadcast them.

7.25 We noted that such a “no play-no pay” arrangement could impose certain additional costs on ITV plc in that it would have to pay a higher proportion of the costs of programming where licensees in the Nations opt out of the network schedule.

7.26 Certain respondents have highlighted to Ofcom the difficulties in coordinating regional programme opt-outs from the network schedule. In addition, some respondents have taken opposing views to the principle of “no play-no pay”. A further issue raised by certain respondents is that Ofcom’s PSB review is proposing changes to the hours of regional programming which will affect licensees differently and that this is a relevant consideration in determining whether it is appropriate to implement a policy of “no play-no pay”.

7.27 In order to come to a view on this issue we have sought to quantify the potential cost of “no play-no pay” (i.e. the cost that arises from licensees opting out of the Network schedule and making no contribution to the cost of production of the networked programme). In order to understand this cost in the context of the changes to regional programme obligations set out in the Statement on Programming for the Nations and Regions published simultaneously with this statement, we have modelled a number of scenarios based on average cost per hour figures for the ITV1 schedule at different times of day and by programme type.

7.28 We also invited the ITV licensees to provide us with information on the benefits or costs to them of the proposed “no pay-no play” arrangements basing their calculations on the proposed regional programme obligations in the Nations set out in Phase 3 of the PSB Review, proposals which are being implemented without significant change.

7.29 ITV plc provided average slot prices for the time slots which the Nations were most likely to opt out of in order to meet regional programme obligations of an extra 2.5 hours per week. SMG and UTV also estimated the value to them of such an opt out.

7.30 Based on the average slot prices provided by ITV plc and a mixture of slots, Ofcom’s estimate is that the national licensees might opt out of programmes valued at up to a maximum of £200,000 per week or £10.4m per year. The net cost to ITV plc of such an opt out would be up to £0.75m per year. The estimates provided by SMG and UTV were lower than this figure, totalling just under £0.5m per year.

7.31 In addition, it is worth noting that the potential additional cost that ITV plc would face only arises if there is a lack of co-ordination about the timing of opt out slots from the Network schedule. If there were better co-ordination and certainty of the timing of the opt-outs then ITV Network Centre could commission programmes for the opt-out slots of the schedule based on a reduced budget (or by using more repeats in these slots to minimise the cost). Therefore, it is possible that further coordination between licensees could reduce the net cost to ITV plc. In our view the net cost to ITV plc is not sufficiently material when set in the context of the overall network programme budget and ITV plc’s contribution to that budget for Ofcom to reconsider the introduction of a “no play-no pay” principle. Therefore we take the view that the NSC should be amended to reflect the principle of “no play-no pay”.

7.32 A further issue arises as to how the existing cost sharing arrangements should be amended in order to reflect the principle of “no play-no pay.” At present, the merger Undertakings given by Carlton and Granada limit the non-consolidated licensees’ contribution to the Network Programme budget to the lower of: the share of costs arising from application of all discounts; rebates and abatements currently provided in the NSC (at the time of the merger); and their contribution to the 2003 NPB adjusted by the cumulative rate of RPI inflation since December 2002.

7.33 Since the national licensees’ regional programme obligations have been decided post merger, and post Undertakings, in Ofcom’s view the “no play-no pay” rebate should be applied after the national licensees’ NPB contributions have been determined in accordance with the Undertakings. In other words, the national licensees’ contribution to the NPB should first be calculated in accordance with the Undertakings. If national licensees have opted out of the network schedule in order to meet their regional programme obligations, and have not transmitted the displaced network programme in an alternative slot, their contribution to the cost of the programmes not transmitted should then be deducted from the figure calculated in accordance with the Undertakings. Ofcom will require the licensees to amend the NSC to reflect this principle.

Programme compliance

7.34 Section 6 of this document sets out the basic process for compliance with the Broadcasting Code for independently-produced programmes. Specifically, when the ITV Network Centre commissions a programme from an external producer (a non licensee production business), the producer does not carry out the programme's compliance and responsibility for compliance is instead undertaken by one of the ITV licensees.

7.35 Section 6.1 of the 2004 Code of Practice states that "ITV will commend a Compliance Licensee to the Producer to carry out compliance and production monitoring in respect of that programme."

7.36 An argument that has been put forward to Ofcom is that this process could act to restrict competition between ITV licensees for such compliance work, with a suggested alternative that it should instead be the external producer's choice, rather than the choice of the Network Centre. Most responses to the February Consultation supported this view. Ofcom was told that this is what tended to happen in practice in any case.

7.37 In the February Consultation we pointed out that perhaps the most efficient outcome from a competition perspective would be that the choice of compliance licensee and the price paid for compliance work should be freely negotiated with the external producer. However, we also considered that this approach could potentially raise new risks concerning the quality control of the compliance process. Allowing the producer unfettered choice of compliance licensee may risk the producer selecting the licensee which, it considers, will comply with the "lightest touch" or at least cost and could prevent Network Centre drawing on its experience and expertise in order to recommend a licensee better suited to the type of programme in question.

7.38 Respondents to the February Consultation did not support the idea of the price paid for compliance being freely negotiated between producer and licensee. One respondent made the point that the choice of compliance licensee should be passed to the Producer, or that a specific requirement be placed on ITV Network Centre to ensure that the allocation of, and the level of payment for, compliance work is made on a fair, reasonable and non-discriminatory basis. This view was echoed by another respondent, although one respondent did argue for the continued role of the ITV Network Centre in commending a compliance licensee for reasons of quality control. However, the risk of poor quality control rests ultimately with the compliance licensee, since it is that licensee which would bear the cost of any statutory fine levied by Ofcom for a breach of the Broadcasting Code. Our view is that the choice of compliance licensee should be made by the producer without any influence from the ITV Network Centre and we will therefore require the Network Centre to amend the 2004 Code of Practice accordingly.

7.39 In relation to the fee for compliance work which is paid to the compliance licensee by the ITV Network Centre on behalf of all the licensees, we understand from some respondents that there is a desire to reduce this fee. Ofcom does not propose in the context of this review to determine what the scale of compliance fees should be. However, our view is that the compliance fee should be cost orientated, which means that it should reflect the long-run incremental costs of the compliance business plus an appropriate mark-up for common costs, and also include an allowance for a reasonable return when the risk of a fine for the breach of the Broadcasting Code is taken into account, so that an efficient competitor or new entrant would be able to compete in this area.

7.40 If the ITV licensees decide to review the tariffs paid by ITV Network for compliance work in order to redirect funding into purchasing programmes for the network, Ofcom would expect ITV Network to assess the costs and risks of delivering compliance services and to discuss this issue with licensees in a transparent fashion. If, based on the recommendations of ITV Network, the Network Council decides to amend compliance tariffs in accordance with the principles set out in paragraph 7.39, the new agreed tariffs would be applied to any programmes commissioned after an agreed future date.

OTHER ISSUES

7.41 Two licensees raised concerns about issues outside those covered in the consultation document and outside the core NWA terms. These related to the principle of a first exclusive ITV transmission in each licensed area and to the timing of first transmission in non-UK territories in cases where there is no scheduled ITV broadcast within 6 months of acceptance of the programme by ITV NWC. In the former case, we have invited the licensees to provide Ofcom with information on the extent of the problem and the harm being caused to them. Since this information is not yet available, and since it is possible to separate out consideration of this issue from the rest of the review of the Networking Arrangements Ofcom will deal with this issue after publication of this statement and will incorporate any drafting changes needed into the Code of Practice in summer 2005 when it is revised to reflect the conclusions of this review.

7.42 In the latter case we recognise the issue raised but consider that it should be dealt with in ITV's Terms of Trade which will, de facto, apply to programmes produced by all producers, including licensees.

NEXT STEPS

7.43 In order to implement the changes discussed above it is now the responsibility of the licensees to draft the amended NWA and the relevant documents that are to stand outside the NWA. The actual changes required will be discussed with the licensees and because these documents are confidential full details of these changes are not disclosed in this statement. Overall the following documents will need to be redrafted, amended or introduced:

- the Statement of Principles will be wholly redrafted;
- the Network Supply Contract will be amended where necessary;
- the 2004 Code of Practice will be amended where necessary;
- a service level agreement will be introduced between ITV Network, ITV plc and the non-consolidated licensees. (This document will fall outside the scope of the NWA); and

- a new commercial agreement will be introduced between ITV plc and Channel, and potentially limited amendments made to the existing bilateral commercial agreements between ITV plc and SMG and ITV plc and UTV. (These documents will fall outside the scope of the NWA).

7.44 The Statement of Principles will cover:

- A definition of the Core Functions of ITV Network
- The principle of independence of ITV Network from all producer interests in carrying out the Core Functions
- Adherence to the 2004 Code of Practice
- The operation of the Core Functions by ITV Network in the interests of all licensees and based on the needs of the Network schedule, within the constraints of the Network programme budget
- Provision of information to Ofcom and all licensees
- Recognition of the regional programme obligations and public service obligations of all licensees
- The choice of compliance licensee
- High level principles for the exercise of non-core functions by ITV Network on behalf of all regional licensees
- High level principles for the exercise of functions by ITV Network on behalf of ITV plc owned channels.

7.45 Amendments to the Code of Practice will cover:

- Extension of the Code to cover all producers
- Selection of the compliance licensee
- Establishment of an independent dispute resolution mechanism
- A relaxation of reporting requirements to Ofcom, to collect data only on contracts issued, and not on letters on intent.
- Such other amendments as are required in view of the decision reached by Ofcom on the principle of first exclusive ITV transmission in each licensed area.

7.46 Amendments to the Network Supply Contract will cover:

- Incorporation of the merger undertakings given to the OFT
- Provisions for sharing of ITV Network core function costs, budgeting, transparency and licensee audit rights. Note: These provisions may be amended or deleted if the licensees agree alternative fixed lump sum cost based arrangements.

- Updating of programme cost sharing arrangements between licensees to reflect undertakings, no play-no pay arrangements and other agreed changes

- A requirement for consultation on the scheduling of slots for regional programmes in the English regions and Nations.

- No play-no pay arrangements

- Updating to reflect current ITV Network organisational structures

- Deletion of references to sponsorship approval and of the obligation on all licensees to make programme proposals

- Such other changes as are necessary to implement the new proposals agreed by the licensees for intra-ITV arrangements.

7.47 We are taking no action on the Tripartite Agreement or Network Programme Licence as these will need to be updated in line with the new Terms of Trade, once they have been agreed between ITV Network and PACT. We understand that this process is well underway. Whilst Ofcom is not directly involved in the process, it will approve the final agreements.

7.48 We would expect these changes to be made by the end of July at which time we will seek confirmation from the licensees that the Service Agreement and new commercial arrangements have been fully negotiated and will review the drafting of the regulated agreements to ensure that what we expect to see in these documents based on what has been agreed between ourselves and the licensees is appropriately implemented.

Annex 1

Background to ITV Networking Arrangements

The initial ITV Networking Arrangements

A1.1 The initial ITV Networking Arrangements established the ITV Network Centre (the 'NWC') which was a division of the Independent Television Association, the licensees' trade association. The function of the NWC was to compile the network programme schedule and acquire and commission programmes for it. Programmes could be commissioned from a Channel 3 licensee, using in-house production resources, or from independent producers. The Independent Television Association has since been renamed ITV Network Ltd.

A1.2 The initial arrangements precluded an independent producer from contracting directly with the NWC. The independent producer was required to enter into a production agreement with one of the Channel 3 licensees who would acquire the UK broadcasting rights to the programme. The chosen Channel 3 licensee would then contract with the NWC for the network transmission of the commissioned programme. By contrast, a Channel 3 licensee selling a commission to the ITV Network could contract directly with the NWC.

A1.3 The reason for this different treatment of independent producers and Channel 3 licensee productions was to ensure the Channel 3 licensee acting as "agent" for the independent producer would assume responsibility both for carrying out programme compliance in line with the ITC's requirements and for supervising production. However, it is worth noting that a Channel 3 licensee with an in-house production capability was also a potential competitor to the independent producer whom it might be contracting with as agent.

A1.4 In addition, the NWC would normally acquire UK broadcasting rights from Channel 3 licensees for a period of ten years with the option of a further five year extension. An independent producer, however, would generally have to assign in perpetuity the copyright of the programme to the Channel 3 licensee with whom it had agreed a production contract.

The Director General of Fair Trading

A1.5 After examining the initial arrangements, the DGFT concluded that they failed the competition test set out in Schedule 4 of the Broadcasting Act 1990. The decision was made based on concerns over the requirement for independent producers to contract with a licensee and not directly with the NWC, and the nature of the rights that were retained by the independents compared with those retained by licensees. It was believed that these two issues were likely to restrict and distort competition in programme production.

A1.6 The DGFT specified two main modifications to the arrangements. The first allowed an independent producer to contract directly with the NWC for the commissioning of a programme. The ITV Network Centre would then conclude a separate contract with a licensee to ensure the programme's compliance with the ITC's regulatory requirements. The second change required the rights necessary for the provision of the Channel 3 service to a maximum of five years, with an option for the broadcaster to extend the duration of this licence period by a further two years. The acquisition of all other broadcasting rights would be prohibited.

The Monopolies and Mergers Commission

A1.7 Following the DGFT's report, the Channel 3 licensees, and subsequently also the ITC, made a reference to the MMC to carry out its own investigation into whether the arrangements satisfied the competition test and whether the modifications specified by the DGFT were required and satisfactory in addressing the competition concerns identified. In addition the MMC was free to specify its own modifications.

A1.8 In 1993, the MMC published its report. The MMC concurred with the view of the DGFT that the initial ITV Networking Arrangements failed the prescribed competition test and recommended its own set of amendments which centred on two issues:

- the ability of independent programme producers to compete on equal terms with licensees' in-house production facilities for commissions from the ITV Network Centre; and
- the possibility that competition between broadcaster's internal production companies and independent producers might be distorted if independents were unable to exploit the secondary transmission rights to their programmes.

Competing on equal terms

A1.9 The MMC recommended that independent producers should be allowed to negotiate directly with the NWC for the price to be paid for the programme, and the package of rights to be acquired. The NWC would set out in detail a letter of intent to be issued to the independent producer. This letter would also act as evidence of a firm proposal in order to aid the independent in securing funding for the costs of production. The NWC would then send a deal letter to a nominated compliance licensee. The role of the compliance licensee would be limited to supervising programme production, verifying the financing of the project and carrying out its programme compliance function for the ITC. The licensee would receive a fee for undertaking the compliance work and the whole arrangement would be agreed in a tripartite agreement entered into by the NWC, the independent producer and the licensee.

A1.10 The MMC acknowledged that it was difficult to separate responsibility for regulatory compliance and the associated production monitoring from the production contract but ultimately decided that a tripartite agreement between all three parties would achieve the twin objectives of direct contracting with the NWC and licensee responsibility for compliance. As a further safeguard for independent producers, the agreement would include provisions protecting programme proposal confidentiality and restricting the licensee's role to its broadcasting, rather than production, division.

A1.11 Alternatively, independent producers could still be commissioned indirectly through a licensee if they wished but, in such a case, the NWC would contract with the licensee only.

Guidelines for Rights Acquisition

A1.12 The MMC concluded that it would be appropriate to leave the duration of the UK transmission rights open to negotiation. This was because it appeared inadvisable to be too prescriptive at this early stage of the NWA.

A1.13 The MMC did however specify a code of practice according to which the licence period would not normally exceed five years and the NWC would have the option of renewing the rights for a further two years. The option to acquire further programme and format rights would not be excluded. If longer rights were required, they would normally be purchased through additional options to extend the period. A producer would also have the ability to reacquire the rights if they were not being used by the NWC. The code of practice would apply to all programme proposals submitted to the NWC. Finally, the NWC would be required to treat independents and licensees impartially with respect to commissioning decisions.

A1.14 The MMC concluded that the imposition of the above modifications to the NWA would allow the competition test to be satisfied. Moreover, it recommended that the working of the NWA should be monitored by the ITC. In 1993, the revised NWA incorporating the MMC modifications were published following approval by the ITC. The revised NWA are referred to as the Network Agreement.

A1.15 These arrangements for programme commissioning have been in place and unchanged since 1993. They have represented a very successful model for the relationship between broadcaster and independent producer, and in 2004 when Ofcom issued guidelines for the development of Codes of Practice for the commissioning of independent producers by PSB channels, the existing ITV structure was used as a basis for these guidelines.

Monitoring of the operation of the NWA

A1.16 The MMC recommended that in relation to the monitoring and review of the networking arrangements the ITC should receive from network centre and licensees at least at quarterly intervals a summary of all the letters of intent issues and contracts entered into for the provision of programmes for the ITV network. The MMC recommended that the information should relate to programmes produced by independent producers or by licensees and should include particulars of price, rights and specifications. The MMC indicated that it hoped that the ITC would find a vehicle for publishing an analysis of this data at annual intervals so that there could be public scrutiny and comment on the working of the networking arrangements.

A1.17 Since the MMC Report the ITC has published an annual report on the operation of the networking arrangements which has considered not just the overall split of commissions between independent producer and licensees but has also looked at the commissioning process in terms of letters of intent and contracts signed on a genre by genre basis.

Annex 2

The application of the statutory competition test to original programme commissioning and programme acquisition

A2.1 In this Annex we set out in more detail the analysis which underpins Ofcom's conclusions in Section 6 that the collective arrangements in relation to the commissioning and acquisition of programmes are not likely to have as their effect the restriction of competition and therefore do not fail the statutory competition test set out in Schedule 11 of the Act.

Programme Commissioning

A2.2 Programme production can be organised by a broadcaster as an in-house function or it can commission programmes from an external programme producer – either an independent producer or the production division of another broadcaster. In the UK a number of different organisational structures exist. For instance, at one end of the spectrum the BBC is a vertically integrated broadcaster with its own production division. At the other end, Channels Four and Five operate as broadcaster/publishers where they commission all their programming from third parties (other broadcasters and independent programme producers).

A2.3 The major commissioners of original UK programming are the terrestrial public service broadcasters (BBC, ITV, Channel 4 and Five). Other commissioners of original programming include the digital channels owned by the PSBs (e.g. BBC3, BBC4, ITV2, E4, etc) and a number of cable and satellite channels (e.g. Sky One).

A2.4 The BBC and ITV each own substantial in-house production arms. In particular, ITV plc controls Granada Productions and other production businesses while SMG, a non-consolidated ITV licensee, owns SMG TV productions. Granada and SMG do provide commissions for other broadcasters. The BBC has to date only produced programmes for itself.

A2.5 External producers or the independent sector comprises a large number of producers most of which are relatively small companies with many specialising in particular genres (e.g. Factual or drama). However, there are relatively larger independent producers who produce programmes across all genres.

A2.6 Both the BBC and ITV production businesses operate across a broad range of genres. Although the BBC and ITV own substantial in-house production capability each commissions a significant number of programmes from external programme producers. It may be the case that the entire commissioning budgets of all broadcasters, vertically integrated or not are in principle fully contestable between internal and external producers.

Relevant market(s)

A2.7 Ofcom's initial analysis of this sector suggests that there is a national market for the commissioning of original programmes across all UK broadcasters. Ofcom has not sought to give a definitive view on the relevant market but instead we present our analysis from the perspective of several possible views of the market definition. Our reason for doing this is to highlight how our analysis of a potential restriction of competition arising from the collective commissioning of programmes by the licensees, arrives at the same conclusion from a number of different market perspectives. The market definitions we have included in this analysis are:

a) external and in-house commissioning across all genres – this is the commissioning spend of all broadcasters BBC, ITV, Channel 4, Five and digital broadcasters. This includes commissioning of in-house and external producers. This would be appropriate if integrated broadcasters commissioning budget was wholly contestable from the perspective of external producers;

b) external commissioning across all genres – this is the commissioning spend of all broadcasters excluding in-house production. This would be appropriate if integrated broadcasters earmarked a specific proportion of their commissioning budget for internal production i.e. implying that external producers were competing for a smaller share of a producers total spend on programme commissioning;

c) external and In-house commissioning of drama – this is the commissioning spend of all broadcasters on drama productions, both in-house and externally. This would be appropriate if as in a) the commissioning budget of broadcasters was wholly contestable but in addition producers of a specific genre could not supply a different genre of programme; and

d) external commissioning of drama - this is the commissioning spend of all broadcasters on drama productions from external producers. This would be appropriate if as in b) a proportion of the commissioning budget of broadcasters was wholly contestable but in addition producers of a specific genre could not supply a different genre of programme.

A2.8 Note: We have included the narrow market for commissioning of drama programmes separately since this is a possible definition of the market in which ITV's share is the greatest compared to other possible genre specific market definitions.

Does the collective commissioning of original programmes have as its object or effect the restriction of competition?

A2.9 As set out in Section 6, the existence of the ITV Networking Arrangements means that the regional Channel 3 licensees do not commission or acquire programmes independently for inclusion in the national schedule. In the absence of such arrangement, the Channel 3 licensees might do so. On this basis, the collective arrangements between the regional Channel 3 licensees in relation to the commissioning and acquisition of programmes are arrangements between potential competitors. Ofcom has therefore considered whether such arrangements have as their object or effect the restriction of competition.

A2.10 The purpose of the ITV Networking Arrangements is to enable the regional Channel 3 licensees (taken as a whole) to be a nationwide system of services which is able to compete effectively with other UK broadcasters. This is achieved through the central commissioning and acquisition of programmes by the ITV Network Centre on behalf of the regional Channel 3 licensees. In these particular circumstances, Ofcom does not consider that these arrangements have the object of restricting competition, and have therefore considered whether the arrangements have the effect of restricting competition.

A2.11 In order to assess the effect of the existing arrangements relating to original programme commissioning, we have considered the market position of the parties (assuming they would be competitors without the arrangements) both absent the arrangements and with the arrangements in place. This is based on the Channel 3 licensees' existing share of the programme budget.

Table A2.1: The relative market shares of the parties with/without the agreement

	Absent NWA		NWA
	ITV plc	SMG +UTV + Channel	Combined
External and In-house commissioning across all genres	26.4%	2.3%	28.7%
External commissioning across all genres	17.6%	1.5%	19.1%
External and In-house commissioning of drama	44.0%	3.8%	47.9%
External commissioning of drama	41.7%	3.6%	45.3%

A2.12 We have also considered the degree of market concentration and how this is affected by the existing arrangements. We have used the Herfindahl-Hirschman Index ('HHI') to measure the degree of market concentration because it captures the significance of asymmetry in market shares. Our intention is that the HHI measure is not taken literally but as a guide to the impact of the "coming together" in a situation where the players are very different in size.

Table A2.2: The change in market concentration as a result of the agreement

Market	Market HHI absent NWA	Market HHI with NWA	Increase in HHI
External and In-house commissioning across all genres	3051	3172	121
External commissioning across all genres	2360	2414	54
External and In-house commissioning of drama	3565	3903	337
External commissioning of drama	2844	3174	302

A2.13 The analysis above suggests that the Networking Arrangements do not have a significant effect on the nature of competition within the relevant market. The incremental market share of the non-consolidated licences is low and the change in the degree of market concentration is also low.

Programme rights acquisition

A2.14 As well as commissioning new programmes, broadcasters also acquire the rights to show programmes that have already been produced. The sellers of existing programmes range from the production companies referred to above, film producers and other media content companies.

Relevant market(s)

A2.15 Ofcom's initial analysis suggests that there is a national market for the acquisition of programme rights for existing programmes across all broadcasters. As in the case of programme commissioning we have not sought to give a definitive view on the relevant market but present our analysis from the perspective of several possible views of the market definition. The market definitions we have included in this analysis are:

a) Programme acquisitions across all genres; and
b) Programme acquisitions of Children's programmes.

A2.16 Note: We have included the narrow market for acquisition of Children's programmes since this is a possible definition of the market in which ITV's share is the greatest compared to other possible genre market definitions.

Does the collective acquisition of programme rights for existing programmes have as its object or effect the restriction of competition?

A2.17 There are broad similarities between programme acquisition and programme commissioning such that the comments earlier around the extent to which the licensees are potential competitors in respect of original programme commissioning applies equally to programme rights acquisition.

A2.18 Further, following the same analysis as above i.e. in order to assess the effect of the existing arrangements relating to programme rights acquisition, we need to consider the market position of the parties both absent the arrangements and with the arrangements in place. This is based on the Channel 3 licensees' existing share of the programme budget.

Table A2.3: The relative market shares of the parties with/without the agreement

Market	Absent NWA		NWA
	ITV plc	SMG +UTV + Channel	Combined
Programme acquisitions across all genres	2.7%	0.3%	3.0%
Programme acquisitions of Children's programmes	20.4%	1.8%	22.1%

A2.19 We have also considered the degree of market concentration and how this is affected by the existing arrangements.

Table A2.4: The change in market concentration as a result of the agreement

Market	Market HHI absent NWA	Market HHI with NWA	Increase in HHI
Programme acquisitions across all genres	6340	6342	2
Programme acquisitions of Children's programmes	2648	2720	72

A2.20 The analysis above suggests that the Networking Arrangements do not have a significant effect on the nature of competition within the relevant market. The incremental market share of the non-consolidated licences is low and the change in the degree of market concentration is also low.

Annex 3

Glossary

A

Act, the	Communications Act 2003

C

Channel	Channel Television Ltd: Owner of the Channel Islands regional Channel 3 licence
Channel 3	Free-to-air, commercially funded, national television broadcast channel, made up of 15 regional licence areas
Code of Practice	(1993) - Network Centre Code of Practice: NWA document intended to guarantee an even-handed treatment of in-house and independent producers with respect to programme commissioning
Code of Practice	(2004) – ITV Network Limited Code of Practice for Commissioning Programmes from Independent Producers: Code of Practice concerning the commissioning from independent producers, drawn up in line with requirements under section 285 of the Act. Not formally part of the NWA
Competition Test	Statutory Competition Test set out in paragraph 6 of Schedule 11 of the Act
CRR Remedy	Contract Rights Renewal remedy: Remedy designed to give all existing customers (advertisers and media buyers) of the Carlton and Granada airtime sales houses the fallback option of renewing the terms of their 2003 contracts without change for the duration of the remedy, with the exception that where a contract specified a share of broadcast, this share would vary in direct proportion to ITV's share of commercial impacts, subject to a cap at the initial share

D

Devolution Agreement	Amendment to the NSC to allow for opt-out provisions for certain contributions to the NPB granted to Scottish Television
DGFT	Director General of Fair Trading
DRL	Digital Replacement Licence: Licences offered by Ofcom to replace the current analogue broadcasting licences for Channel 3 and Channel 5 with digital broadcasting licences, as required under section 215 of the the Act

E

Effectiveness Test	Statutory Public Policy Test set out in Schedule 11 of the Act
External Arrangements	arrangements in relation to external third parties, such as external programme producers

I

Intra-ITV Arrangements	Arrangements or agreements between the ITV licensees
ITC	Independent Television Commission
ITV1	ITV national broadcast channel comprising the Channel 3 licensees (as distinguished from ITV plc wholly-owned channels ITV2 and ITV3)

M

MCPS	Mechanical Copyright Protection Society: Body representing writers and publishers of music
MMC	Monopolies and Mergers Commission

N

Non-consolidated Licensees	SMG, UTV and Channel
NPB	Network Programme Budget: Budget for the ITV1 network programming made up from contributions from each Channel 3 licensees
NPL	Network Programme Licence: the standard form of contract for use by the NWC when it commissions a programme from a regional licensee
NSC	Network Supply Contract: Part of NWA, specifying each regional licensee's share of contribution to the Network Programme Budget
NWA	Networking Arrangements: Set of arrangements between ITV and ITV plc, SMG, UTV and Channel to coordinate the provision of a national television service capable of competing with other broadcasters in the UK
NWC	ITV Network Centre: Management structure within ITV Network Ltd, responsible for executing instructions of the Network Council

Network Council (‘Council’): The Board of the NWC, responsible for agreeing the strategy and budget for ITV1

P

Programme Code A code set up by statute that sets out the editorial standards which audiences are entitled to expect from commercial television services in the UK

PSB Public Service Broadcaster licensed under the Act

PSB3 Review Phase 3 of Ofcom’s review of Public Service Television Broadcasting

Q

QR Qualifying Revenue:

R

Regional Programming Test Statutory Public Policy Test set out in Schedule 11 of the Act

RPI Retail Price Index

S

SMG SMG plc: Owners of Grampian Television Ltd and Scottish Television Ltd, the two Scottish regional Channel 3 licensees

Statement of Principles Network Centre Statement of Principles: NWA document dealing with the control of network policy by the licensees, the implementation of that policy by the NWC, the selection of programmes, the budget and the supply of a network schedule and provides for the NWC to be organised within the management structure of ITV Network Ltd

T

Tripartite Agreement Tripartite Commissioning, Production and Compliance Agreement: Contractual arrangement as part of the NWA, used by the NWC when commissioning a programme from an independent producer

U

UTV Ulster Television Plc: Owner of the UTV regional Channel 3 licence

Footnotes

[1] ITV plc brings under common 'ownership' the seven regional licences held by Granada plc and the four regional licences held by Carlton Communications plc ('Carlton'). Granada Group plc ('Granada') obtained its first commercial television licence in 1954, registered as Granada, and later acquired London Weekend Television Ltd ('LWT'), Yorkshire Television Ltd ('Yorkshire TV'), Tyne Tees Television Ltd ('Tyne Tees TV'), Anglia TV, Meridian TV and Border. Carlton Communications Ltd acquired its first commercial television licence in 1991, registered as Carlton Broadcasting Limited ('Carlton TV'), and later acquired Central Independent Television Ltd ('Central'), HTV Group Ltd ('HTV') and Westcountry Television Ltd ('Westcountry').
[2] SMG plc owns Grampian Television Ltd ('Grampian') and Scottish Television Ltd ('Scottish TV'), the two Scottish regional licensees.
[3] Ofcom consultation *Review of ITV Networking Arrangements* 28 February 2005: http://www.ofcom.org.uk/consult/condocs/itv/
[4] Channel 3 Networking Arrangements: A report on whether the arrangements satisfy the competition test contained in the Broadcasting Act 1990, 6 April 1993. A summary of this report is available at: http://www.competition-commission.org.uk/rep_pub/reports/1993/331.htm

[5]http://www.competition-commission.org.uk/rep_pub/reports/2003/482carlton.htm#full
[6] http://www.oft.gov.uk/nr/rdonlyres/61de8508-dc91-4ad0-a4f2-d3688d1c63b8/0/granada.pdf
[7] Under WQR voting, each licensee has a percentage share of the votes proportional to the share of their contribution to the Network Programme Budget ('the NPB') for the calendar year in which a WQR vote takes place.
[8] Excluding the costs incurred by exceptional events and excluding the discount relating to the Premier League.
[9] Except to the extent required to meet a fair and reasonable share of the increased costs incurred by exceptional events, which is now deemed to be the agreed share as defined in the NSC.
[10] And any future licensee for the respective regional Channel 3 services.
[11] Save as amended from time to time by mutual agreement.
[12] Qualifying independent producers refers to producers of independent productions as defined in Regulation 3 of the Broadcasting (Independent Productions) Order 1991 (as amended). These are independent producers in whom a UK broadcaster holds no more than a 25% ownership stake.
[13] The arrangements would satisfy the criteria set out in section 9 of the Competition Act 1998 if they:

(a) contribute to –
  (i) improving production or distribution, or
  (ii) promoting technical or economic progress,

while allowing consumers a fair share of the resulting benefit, but

(b) do not –
  (i) impose on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives, or
  (ii) afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the products in question.

[14] In addition to the above statutory tests, paragraph 8 of Schedule 11 of the Act requires Ofcom to take into account the impact of the arrangements or modifications to the arrangements on the ability of the Channel 3 licensees to comply with certain of their licence obligations
[15] *Ofcom review of public service television broadcasting Phase 3 - Competition for Quality,* 8 February 2005 http://www.ofcom.org.uk/codes_guidelines/broadcasting/tv/psb_review/psb3/?a=87101

[16] Section 290(4) of the Act states as follows:
"*Arrangements are networking arrangements for the purposes of this Part if they-*

(a) apply to all the holders of regional Channel 3 licences;
(b) provide for programmes made, commissioned or acquired by or on behalf of one or more of the holders of such licences to be available for broadcasting in all regional Channel 3 services; and

(c) are made for the purpose of enabling regional Channel 3 services (taken as a whole) to be a nationwide system of services which is able to compete effectively with other television programme services provided in the United Kingdom."

[17] See Ofcom publication *The Ofcom Broadcasting Code, 25 May 2005*, which comes into force on 25 July 2005 http://www.ofcom.org.uk/tv/ifi/codes/bcode/#content

[18] This is determined in accordance with section 19(2) to (6) of the Broadcasting Act 1990 and Part 1 of Schedule 7 of that Act.

[19] In general, the cases in which it has been held that the 'object' of the agreement is to restrict competition are cases where the primary purpose of the agreement is price fixing or market sharing of one form or another. Such agreements 'by their nature' restrict competition and it is not necessary to examine whether the agreement in fact has the effect of restricting competition. However, if it is not plain that the object of the agreement is to restrict competition, it is necessary to consider the effects of the agreement. See Case Nos. 1002/2/1/01, 1003/2/1/01 and 1004/2/1/01, *The Institute of Independent Insurance Brokers v. The Director General of Fair Trading* and *Association of British Travel Agents v. The Director General of Fair Trading*, at paragraphs 169 and 170.

[20] Case 56/65, *Société Technique Minière*, [1966] ECR 235, at 249-250.

[21] OJ [2001] C3/2.

[22] Paragraph 28 and footnote 21.