DO-CH/NL/0214
PART A

Part. A.

CONFIDENTIAL

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COMMERCIAL-IN-CONFIDENCE

Begins: 29/1/88.

Ends: ~~28~~ 21/~~1~~ 12/88.

PO -CH /NL/0214

PART A

Chancellor's Lawson Papers:

THE INDEPENDENT TELEVISION LEVY FOR CONTRACT EXTENSION PERIOD

Disposal Directions: 25 Years

12/9/95

PO -CH /NL/0214

PART A

CABINET OFFICE PAPER

The following Cabinet Office papers have been taken off the file. If you require access to these papers please contact the Cabinet Office.

Reference	Date Of Paper
MISC 128 (88) 1st Meeting	10 FEBRUARY 1988

142/14

CONFIDENTIAL

FROM: B T GILMORE

DATE: 29 January 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Kemp
Mr Monck
Mr Burgner
Mr Odling-Smee
Mr Spackman
Mr Burr
Miss Sinclair
Mrs Pugh
Mr Cave
Mr Tyrie

Ch/ content?

MPW 29/1

OK on substance, but I have slightly redrafted. N.

ITV SYSTEM, REVENUE LEVY

We have used the postponement of the MISC 128 meeting on the new ITV system to do a good deal more work on the question of the ITV revenue levy when new franchises are let from 1993. This was partly because I wanted to be sure that Professor Griffiths agreed with our analysis; but also because there is a real problem here which will be significant not only for the revenue take from the ITV system in future but also for its efficiency.

2. The results are set out in Mr Bolt's submission below. The short point is that, in the light of our further work, we now recommend a more pragmatic approach to the structure of this levy.

3. It remains clear -

a. that a levy based on revenue is better than a levy based on profit;

b. that a revenue levy needs to be progressive;

c. that a uniform progressive levy on revenue will not apply as much downward pressure on costs as we would wish (because of the very different qualities of the regional francises to be offered).

The problem lies in finding a basis for levy which achieves a better "fit" across the different franchises concerned. There is no doubt that on present costs a levy based on revenue-per-household would give a better fit. But I do not believe that we can be confident that that result is structural, rather than accidental. I have been confirmed in this view by discussing with LWT how their costs are in practice driven. And the case for the practical approach set out below is reinforced by the prospect of new services. If there are many such, and relatively little increase therefore in advertising revenues, the levy problem may turn out to be a minor one. Conversely, however, the prospect that the levy may have to apply effectively not only to the basic ITV franchises but also to an unpredictable set of new services, of very different commercial structures, strongly reinforces the case for avoiding commitment to a particular complex structure now, and for looking again at the details later.

4. We do not of course have to settle the details of levy immediately. The immediate question is what the Government should say about a levy in a White Paper this Spring. In the light of our further work I recommend that the White Paper should set out the Government's commitment to a levy as part of the new franchise system; to basing that levy on revenue rather than on profit and to making it progressive. It should then say simply that further details of the structure of the levy would be decided in the light of consultations with the IBA and the ITV companies.

5. If you agree, the paper on the new ITV arrangements as a whole (which the Home Secretary has to produce for MISC 128 on 9 February) could report as in the draft paragraph immediately below. I have discussed this with officials in Home Office and DTI, and they will support it. Professor Griffiths has also told me that he agrees. If you are content, I will arrange accordingly.

B T GILMORE

CONFIDENTIAL

ITV LEVY

REVISED PARAGRAPH FOR HOME SECRETARY'S PAPER TO MISC 128

X

13. Combining a tender with a revenue levy has two main purposes. It will share the revenue risks with bidders, and thus encourage more enterprising bids. But because, once franchises are let, ~~decisions affecting~~ the level of costs will be fully reflected in ~~directly affect~~ companies' profits, it will also exercise continuing downward pressure on costs during the lifetime of the franchise, as the present system does not. The Official Group proposed a progressive levy on the revenue per television household. In the light of further consideration, I have concluded that, while a progressive levy structure is ~~the minimum requirement, but that~~ desirable, further work is required on the precise form of progressive levy best calculated to achieve our objective of maximising the pressure for efficiency on ITV companies. Y This work would most appropriately take place after the White Paper has been published, so that the effect of all the changes we are proposing on the likely future cost structure of the industry can be taken into accocount. It would be sufficient for the White Paper to indicate in general terms our intentions about the levy, without settling at this early stage on its precise structure or rates.

2506/22/27

CONFIDENTIAL

FROM: C W BOLT

DATE: 29 January 1988

1. MR GILMORE Approved in draft CWB

2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Kemp
Mr Burgner
Mr Gilmore
Mr Spackman
Mr Burr
Miss Sinclair
Mrs Pugh
Mr Cave
Mr Tyrie

ITV SYSTEM: REVENUE LEVY

In my submission of 14 January, I indicated that we would consult you further about the structure of the ITV levy to apply from 1993, following further discussion between officials. These discussions have now been held, on the basis of a revised paper by the Treasury (attached at annex A). This submission invites you to endorse the approach recommended in the paper, and to approve a draft paragraph for inclusion in the Home Secretary's paper for the next meeting of MISC 128.

Background

2. Ministers have already agreed that the tendering process for ITV contracts should be supplemented by an annual levy related to the net advertising revenue (NAR) of the contractor. Combining a tender and a levy in this way is intended to ensure that contractors have an incentive, right through the contract period, to operate efficiently; because of uncertainty about the likely growth in NAR over nearly a decade (tenders will be sought in 1991 for contracts to run from 1993 to 2000) there is thought to be a significant risk that tenders by themselves would be too low to provide a sufficient incentive to cost efficiency, leading to the possibility of high monopoly profits towards the end of the contract period. In order to provide an incentive which operates equally on all contractors, irrespective of their size, it seems to be necessary to adopt a levy structure which not only taxes NAR at a progressive rate, but which does so on the basis of tax bands which vary between different companies. For example, amongst the existing contractors NAR for the largest

company is 20 times that of the smallest; and while it is not possible to know their composition of contracts that will actually be advertised by the IBA, it is most unlikely that this divergence will be sufficiently narrowed to allow a levy to be charged on the basis of uniform NAR bands.

Basis for Non-Uniform Levy Bands

3. The paper attached to Mr Gilmore's submission of 16 December proposed that bands should be proportional to the number of households in each contract area; this formulation appeared to provide a sufficiently good "fit" to ensure that the levy would equalise the pressure on all companies to restrict costs, irrespective of their size and expected growth in NAR.

4. Postponement of the MISC 128 has enabled us to consider this analysis further, and to discuss it with Professor Brian Griffiths at No.10. As a result, we have revised our earlier paper: a copy is annexed to this submission. The conclusion reached in the paper is slightly different, and more tentative than before. It is still our view that a levy structure which is based on the same NAR bands for all companies will run a serious risk of either putting smaller and less profitable regions into deficit or of leaving costs relatively unconstrained in more profitable ones. However, we do not feel sufficiently confident about the likely future costs structure of the industry, taking account of all the other changes that will be taking place in the ITV system before 1993, to settle firmly for levy bands related to the number of households in each region.

5. What we would propose - and officials in other departments are content with this - is to undertake further work on this question <u>after</u> publication of the White Paper, so that it can take account of consultation with the IBA and ITV companies. This further work would be aimed at determining more accurately the likely range in growth rates of NAR for different regions, and whether costs are related to households, to the number of viewers (perhaps weighted by income), or simply to NAR itself. It will be sufficient to indicate in the White Paper that the tender would be supplemented by a levy on NAR, and that the form of the levy would be announced in time to allow potential contractors to put together their bids (in 1991).

MISC 128

6. We would propose a paragraph on the following lines for the paper on the ITV system to be taken at the next meeting of MISC 128 (on 9 February):

> "13. Combining a tender with a revenue levy has two main purposes. It will share the revenue risks with bidders, and thus encourage more enterprising bids. But because, once franchises are let, decisions affecting costs will directly affect companies' profits, it will also exercise continuing downward pressure on costs during the lifetime of the franchise. The Official Group proposed a progressive levy on the revenue per television household. In the light of further consideration, I have concluded that a progressive levy structure is the minimum requirement, but that further work is required on the precise form of progressive levy best calculated to achieve our objective of maximising the pressure for efficiency on ITV companies. This work would most appropriately take place after the White Paper has been published, so that the effect of all the changes we are proposing on the likely future cost structure of the industry can be taken into account. It would be sufficient for the White Paper to indicate in general terms our intentions about the levy, without settling at this early stage on its precise structure or rates."

same as Gilmore's above

7. MISC 128 might be invited to note this conclusion.

Recommendation

8. Our recommendation is that the position set out in the previous paragraph provides the best basis for drafting the White Paper. If you agree, we will:

(1) pass the draft paragraph to the Home Office for insertion in the Home Secretary's MISC 128 paper;

(2) undertake the further work indicated in this submission following publication of the White Paper.

C W Bolt

C W BOLT

ANNEX A

CONFIDENTIAL

STRUCTURE OF A LEVY ON ITV COMPANIES' ADVERTISING REVENUE

The Problem

The reason for changing the way ITV franchises are awarded is that the present arrangements encourage inefficiency, high costs and restrictive practices. ITV companies at present have a monopoly in the sale of television advertising time. Although the levy on profits is intended to remove the monopoly profit that results, figure 1 below (reproduced from the Peacock Report) shows how the levy has failed to capture the growth in net advertising revenue (NAR) between 1972 and 1984. Buoyant NAR has been able to fuel similar increases in costs.

2. One reason why the levy yield has remained relatively low, and apparently failed to put pressure on ITV companies' costs, is that it results in a marginal tax rate on domestic profits (corporation tax plus levy) of 64%, which leaves little profit incentive to save costs, rather than to spend. With this marginal tax rate, a reduction in costs of £1 would increase retained profits by only 36p; if only corporation tax was charged on profits, the company would benefit by 65p.

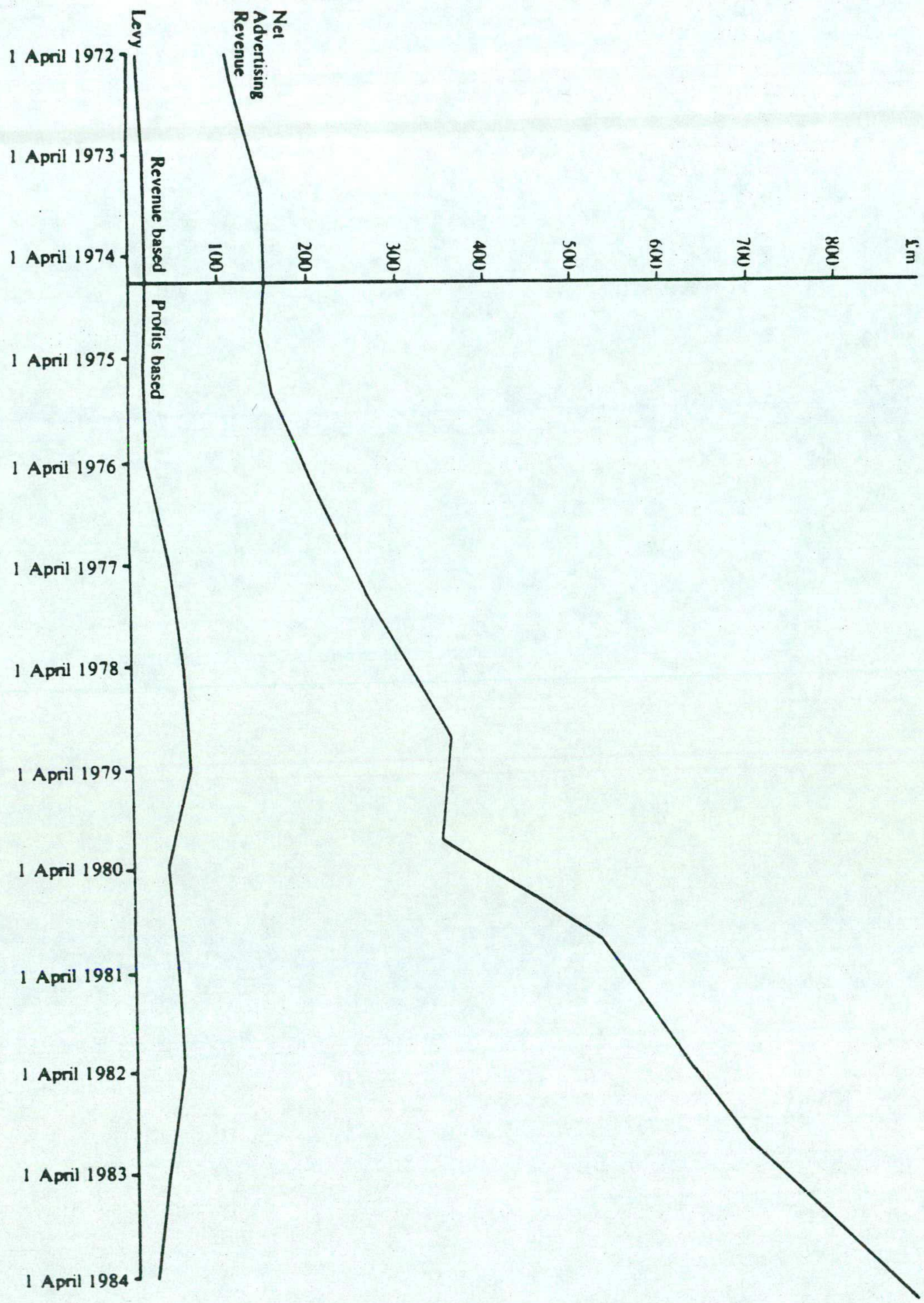
3. It therefore appears that there is considerable scope to improve efficiency by increasing the downward pressure on costs exercised by the arrangements for taxing away undue monopoly profit. For these reasons, Ministers have accepted the Peacock recommendation that ITV contracts should be awarded by competitive tender.

Competitive tendering

4. In theory, a competitive tender alone might achieve the objective of maintaining pressure on ITV companies' costs by taxing away any undue monopoly profit. But in practice that seems unlikely. Even allowing for the effects of new programme services, it seems likely that ITV companies as a whole will enjoy a substantial increase in NAR in real terms over the 8 years of the contract period, from 1993 to 2000. However, companies bidding for the contracts might allow for only a small growth in real NAR over the franchise periods in their cash

Figure [illegible].1

Annual levy receipts and net advertising revenue 1972-1984



Source: National Audit Office, HC 358, 1985 bids, because of uncertainty about the rate of growth of nar. In theory again, this problem might be avoided if companies tendered to pay a percentage of NAR, rather than a cash sum. But in practice there still remains a distinct risk that bids will generally be low, particularly if there is limited competition for each particular franchise.

5. For this reason, and because cash bids are simple to evaluate, Ministers have decided to combine a competitive tender for cash payments with a levy on revenue. Competitive bidding will exercise some pressure for efficiency. Its transparency will reinforce that, by encouraging new bidders. Combining it with a revenue levy will reinforce this in two further ways. It will share the revenue risk with bidders, and thus encourage more enterprising bids. But because, once franchises are let, decisions about costs will directly affect companies' profits, it will also exercise continuing downward pressure on costs during the lifetime of the franchise.

Combining Competitive Tendering with a Revenue Levy

6. In such a combined regime, the precise balance between the yield of a revenue levy and the cash bids would be determined by the companies, because the structure and rates of levy would be set in advance of tenders being invited, and bids would take account of them. In setting the rates of levy, the Government would have to take account of acceptable marginal tax rates on advertising revenue, future uncertainty about advertising revenue, and the extent to which the levy structure could allow for differences between regions. The numerical examples used in this paper are intended only to illustrate the structural effects. The actual rates would clearly have to be reconsidered nearer the event, and would need to take account of the franchises actually being advertised by the IBA.

7. A further consideration affecting the rates of levy is their effect on management incentives. A levy on revenue, instead of weakening the profit incentive to minimise costs, would reinforce it. On the other hand, it would to some extent tax the success of companies which earn more advertising revenue than others through more attractive programming. But the negative

effect on incentives would probably be small, because the demand for advertising is to a large extent determined by GDP growth, and ITV companies have a very large share of the total supply of advertising time, and relatively few competitors for it.

8. A levy on advertising revenue would probably increase prices for advertising time. But the effect would probably be small, largely because ITV companies' supply of advertising time is more or less fixed. In that situation, advertising rates are largely determined by demand, rather than by costs falling on the ITV companies.

Objective

9. The objective of a revenue levy, therefore, is to put the most effective downward pressure on costs consistent:

(a) with minimising any disadvantages to incentives for enterprise or on the price of advertising;

(b) with applying a levy structure should apply to all companies which can be defended as equitable.

Assumptions

10. The rest of this note considers possible levy structures in terms of how well they are likely to serve this objective. Starting from a single rate of levy, it considers the advantages and disadvantages of a progressive structure with bands defined in terms of total NAR, applied equally to all contractors; and of a progressive structure where the bands are defined differently for the different contractors. It does this with the aid of numerical examples. The examples are based on the current franchises (separating out Channel 4 costs and NAR). Basic financial data for the companies is given in Table 1. This shows, for 1986, the net advertising revenue for each company, operating costs, a subscription to finance Welsh Channel 4 (included in the current overall subscription for Channel 4), income from overseas sales; the resulting profit for levy, and profit as a percentage of NAR. In projecting forward to the franchises that will run from 1993 to 2000, it is assumed that

TABLE 1

ITV LEVY - 1986 BASE DATA

1986	NAR	Costs	S4C sub	Total costs	Profits	Sales income	Total profits	Profits/ NAR
THAMES	166	132	4	136	31	11	42	25
CENTRAL	140	127	4	130	10	7	17	12
GRANADA	113	82	3	85	29	5	34	30
LWT	106	94	3	96	10	3	13	12
YORKSHIRE	92	78	2	80	12	2	14	15
TVS	109	87	3	89	19	3	22	20
HTV	68	56	2	57	11	8	19	28
SCOTTISH	60	47	1	48	11	0	11	19
ANGLIA	58	45	1	46	11	2	13	23
TTT	40	35	1	36	3	1	4	11
TSW	26	22	1	23	3	0	3	11
ULSTER	16	16	0	16	0	0	0	-1
GRAMPIAN	16	17	0	17	-1	0	-1	-7
BORDER	8	7	0	7	1	0	1	13
TV-am	42	26	1	27	15	0	15	36
CHANNEL 4	173	180	4	184	-11	3	-8	-5
CHANNEL	3	4	0	4	-1	0	-1	-32
TOTAL	1235	1052	31	1083	152	45	197	16

NAR Growth rates (in real terms):

6% pa Thames, LWT, TVS, HTV, Anglia, TSW, Channel, TV-am

5% pa Channel 4

4% pa Central, Granada, Yorkshire

2½% pa Scottish, TTT, Ulster, Grampian, Border the average rate of growth of NAR will be 5%, and that costs will be held constant in real terms. An average annual rate of growth of NAR of 5% seems a reasonable central projection, even allowing for new services, given the past relationship between the demands for TV advertising revenue and growth in incomes, and future expectations of GDP growth. It is broadly consistent with the estimates in Professor Alan Budd's report on Channel 4, and in the CSP report on subscription. Past experience suggest, however, that different regions will experience different growth rates in NAR. In this paper, it is assumed that NAR grows at the average rate for Channel 4; at above average rates for the more prosperous southern areas; at a rate slightly below average for the Midlands and North; and a much lower rate for the North East, Scotland and Ulster. The actual rates assumed for individual companies are shown in the table. A zero real change in costs would be a break from recent experience, but it does not seem implausible that the tendering procedure, and the continuing pressure on costs that the levy would represent, would result in this outcome.

<u>One rate, or a progressive levy?</u>

11. Given differences in the rate of growth of NAR in different areas, profits before levy will increase very much faster in those areas with high growth of NAR than in those areas with low growth. A single rate of levy applied to all NAR would therefore have to be set at a low level in order not to push the companies experiencing lower NAR growth into deficit. But this would fail to remove from the more profitable companies the substantial growth in NAR that they experienced. This suggests that some form of progressive levy.

<u>Uniform progressive levy</u>

12. A uniform progressive levy would comprise a free slice - by which NAR up to a certain value was exempt from the levy - with one or more rates of levy for NAR above the free slice. The bands for different rates of levy would be defined in terms of total NAR, and would be common across all companies. The structure illustrated in Table 2 comprises a free slice of £150 million, levy at 25% on NAR from £150 million to £175 million,

levy at 50% on NAR from £175 million to £200 million, and levy at 75% on NAR above £200 million. The effects of such a levy are illustrated in Table 2: to isolate the effects of the levy (as distinct from the tender) over the 8 year period of the contracts, it is assumed that the tenders are sufficient to equalise the initial profit rate on the contracts (defined as profit before levy as a percentage of NAR).

13. Table 2 illustrates the difficulties that arise if a uniform progressive levy is applied to all companies. Because only the largest companies pay the top rate of levy, even at the end of the contract period, small companies enjoying a high rate of NAR growth are able to retain a substantial proportion of this growth in NAR and to achieve a very high rate of surplus (after levy and tender payments) as a proportion of NAR. Examples are Harlech (HTV) and Anglia. The general problem is that profits of the different companies do not increase uniformly with their size, measured in terms of NAR, whereas it is total NAR which would determine the marginal rate of levy paid.

14. The wide divergence in the growth of profits relative to NAR for the different companies, as illustrated in Table 2, would significantly reduce the pressure for efficiency on the more profitable companies. However, with the uniform levy, the additional monopoly profits of the more successful companies could only be taken away if the rates of levy were increased, and this would risk putting the smaller or less successful companies into deficit. Although Table 2 is based on the assumption that growth rates vary between different regions, this result does not depend on this particular assumption. Even if NAR grew at a uniform rate across the country, the smaller companies would retain a larger proportion of NAR growth if there was a uniform progressive levy. It is the different size of the companies that causes profits (after levy and tender) to grow at different rates; different growth rates of NAR may exacerbate this situation.

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TABLE 2

NON-UNIFORM GROWTH SCENARIO
UNIFORM GRADUATED REVENUE LEVY

1993	NAR	Profits/ NAR	Revenue levy	Profits after levy (PAL)	PAL/ NAR	Tender sum	Profits after levy & tender	PALT/ NAR
THAMES	250	51	56	71	28	46	25	10
CENTRAL	184	34	11	51	28	33	18	10
GRANADA	149	47	0	71	47	56	15	10
LWT	160	42	2	65	40	49	16	10
YORKSHIRE	121	36	0	43	36	31	12	10
TVS	164	47	3	74	45	58	16	10
HTV	102	53	0	54	53	44	10	10
SCOTTISH	71	32	0	23	32	15	7	10
ANGLIA	87	49	0	43	49	34	9	10
TTT	47	26	0	12	26	7	5	10
TSW	39	41	0	16	41	12	4	10
ULSTER	19	15	0	3	15	1	2	10
GRAMPIAN	19	10	0	2	10	0	2	10
BORDER	10	27	0	3	27	2	1	10
TV-am	63	57	0	36	57	30	6	10
CHANNEL 4	243	26	51	11	5	0	11	5
CHANNEL	5	12	0	1	12	0	0	10
TOTAL	1732	41	124	578	33	418	160	9

2000	NAR	Profits/ NAR	Revenue levy	Profits after levy (PAL)	PAL/ NAR	Tender sum	Profits after levy & tender	PALT/ NAR
THAMES	376	68	151	105	28	37	68	18
CENTRAL	242	50	50	71	30	27	45	18
GRANADA	197	60	17	102	52	45	57	29
LWT	240	62	49	99	41	40	60	25
YORKSHIRE	159	51	2	79	50	25	54	34
TVS	246	65	53	107	44	47	60	25
HTV	154	70	1	107	69	36	71	46
SCOTTISH	84	43	0	36	43	13	23	28
ANGLIA	130	67	0	87	67	28	59	45
TTT	56	38	0	21	38	6	15	27
TSW	58	61	0	35	61	10	26	44
ULSTER	22	29	0	6	29	1	6	25
GRAMPIAN	22	24	0	5	24	0	5	24
BORDER	11	38	0	4	38	1	3	27
TV-am	95	72	0	68	72	24	44	46
CHANNEL 4	343	47	126	37	11	0	37	11
CHANNEL	7	42	0	3	42	0	3	40
TOTAL	2443	58	449	974	40	340	635	26

Levy structure

Free slice £150m NAR
£150m – £175m 25%
£175m – £200m 50%
over £200m 75%

Non-uniform levy structures

15. The difficulties of a uniform progressive levy might be avoided or eased by applying a common progressive structure of rates to individual companies on a basis which reflects the size of individual companies. It would, for example, be possible to keep the structure of rates (a free slice and subsequent bands levied at 25%, 50% and 75%) unchanged, with the points at which different rates come into operation in the same proportional relationship (for example the 50% band coming into effect at a level of NAR 50% higher than the start of the 25% band). The difference would be that the free slice would vary between different companies. There are three basic ways in which the free slice for each company might be determined: by the Government (or IBA) on the basis of the expected financial position of each franchise holder; by an objective formula relating the free slice for each company to some measure such as the number of households in the region concerned; or by inviting competitive tenders also for the free slice.

16. Although the first approach (determining the free slice on an ad hoc basis for each company) has a significant element of flexibility, there seems little attraction in requiring officials to second-guess the likely financial strength of successful bidders in each franchise area.

17. The third approach, (inviting bidders to specify a free slice as well as (or instead of) tendering a cash sum) would in contrast rely entirely on commercial judgements which, as discussed above, may be unduly risk averse. This approach would, in addition, make the evaluation of bids very much more complex: it would require assumptions to be made about the growth rate of NAR in different contract areas, rather than leaving this judgement entirely to the bidders with the evaluation simply consisting of comparing cash bids.

18. On the second approach (to determine an objective formula for a free slice which takes account of the different situation of different contractors) it would be necessary to examine in some detail the cost structure of ITV companies. One obvious method of distinguishing between companies would be to use the

number of households in each area. This would be a reasonably convenient measure, because the figures are objective and available and the present costs of ITV companies are broadly proportional to the number of households. Figure 2 below shows the costs per household for existing contractors. Most companies lie in a fairly narrow band: the three regions lying above the £40 per household (LWT, Thames and TVS) all have relatively high levels of NAR per household suggesting that in these cases unusually high profitability has resulted in unusually high costs. Conversely, TV-am has both exceptionally low costs and low NAR per household, reflecting the off-peak nature of its programming. Channel 4 is in a broadly comparable position to TV-am; although it covers all households, its costs per household are very much lower than for most ITV companies, reflecting its lower average audience size.

19. But it is more difficult to establish whether this cost structure is durable or in some sense accidential. The current cost structure of ITV companies is, to a large extent, an outcome of the networking arrangements now in force, which result in some cross-subsidy between different regions. Changes in networking arrangements currently being considered, and the opening up of the market for programmes resulting from the independent production initiative, will tend to change the current distribution of costs. In a relatively free market, it would perhaps be implausible to expect costs to be proportional to the number of households in a region. Costs proportional to the average number of viewers, with perhaps some weighting to reflect the average income of viewers, seems more plausible. The price at which American television programmes are sold overseas, for example, largely reflects the number of viewers.

20. In order to illustrate the possible operation of a progressive levy which starts at different levels of NAR for different regions, it is convenient to use the number of households as the basis for determining the relative size of free slice for each company, given that the illustrative calculations in this paper are based on cost structures in 1986 of the existing ITV contractors. The results of such a levy are shown in Table 3. This is based on a free slice calculated at £50 per household (that is, for a region with 1 million

Figure 2 ITV companies costs per household

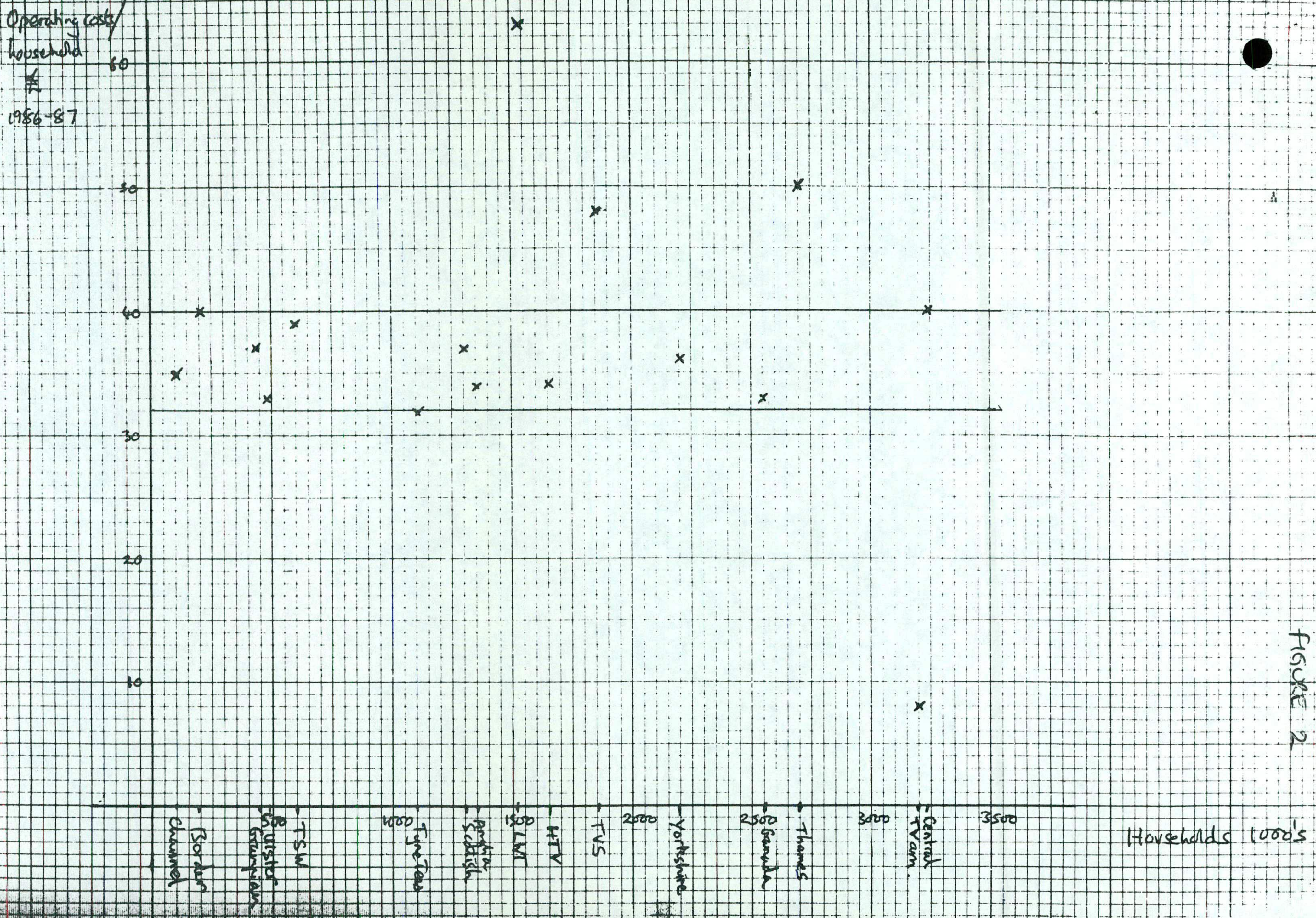

FIGURE 2

TABLE 3

NON-UNIFORM GROWTH SCENARIO
"PER-HOUSEHOLD" GRADUATED REVENUE LEVY

1993	NAR	Profits/ NAR	Revenue levy	Profits after levy (PAL)	PAL/ NAR	Tender sum	Profits after levy & tender	PALT/ NAR
THAMES	250	51	71	56	22	31	25	10
CENTRAL	184	34	5	57	31	38	18	10
GRANADA	135	42	2	54	40	41	13	10
LWT	160	42	52	15	10	0	15	10
YORKSHIRE	121	36	3	40	33	28	12	10
TVS	164	47	41	36	22	20	16	10
HTV	102	53	6	48	47	38	10	10
SCOTTISH	71	32	1	21	30	14	7	10
ANGLIA	87	49	7	36	41	27	9	10
TTT	47	26	0	12	26	7	5	10
TSW	39	41	3	12	32	9	4	10
ULSTER	19	15	0	3	15	1	2	10
GRAMPIAN	19	10	0	2	10	0	2	10
BORDER	10	27	0	3	27	2	1	10
TV-am	63	57	0	36	57	30	6	10
CHANNEL 4	243	26	0	63	26	38	24	10
CHANNEL	5	12	0	1	12	0	0	10
TOTAL	1717	40	192	495	29	324	171	10

2000	NAR	Profits/ NAR	Revenue levy	Profits after levy (PAL)	PAL/ NAR	Tender sum	Profits after levy & tender	PALT/ NAR
THAMES	376	68	166	90	24	25	65	17
CENTRAL	242	50	40	82	34	31	51	21
GRANADA	160	52	11	71	44	33	38	24
LWT	240	62	112	36	15	0	36	15
YORKSHIRE	159	51	23	58	37	23	36	22
TVS	246	65	103	57	23	16	41	17
HTV	154	70	42	65	42	31	34	22
SCOTTISH	84	43	7	29	34	11	18	21
ANGLIA	130	67	39	48	37	22	26	20
TTT	56	38	0	21	38	6	15	27
TSW	58	61	18	18	30	7	11	18
ULSTER	22	29	0	6	29	1	6	25
GRAMPIAN	22	24	0	5	24	0	5	24
BORDER	11	38	1	4	34	1	3	22
TV-am	95	72	0	68	72	24	44	46
CHANNEL 4	343	47	0	162	47	31	131	38
CHANNEL	7	42	1	2	34	0	2	33
TOTAL	2407	58	562	825	34	264	561	23

Levy structure

Free slice NAR of £50 per household
NAR £50/hh – £58/hh 25%
NAR £58/hh – £67/hh 50%
NAR over £67/hh 75%

households, the free slice would be £50 million) with the 25% rate ending at a level of NAR $16^{2/3}$% above free slice, and the 50% band ending at a point 33½% above the free slice.

21. Figure 3 illustrates the effects of such a non-uniform progressive levy. It illustrates how the structure is able to extract a large proportion of the growth in NAR for those companies with high rates of growth without pushing those with low NAR growth rates into deficit.

Further work

22. A formula based on the number of households presents some practical problems where contracts are defined by time as well as (or instead of) by geographic area. Dividing the number of households in such situations purely on the basis of shares of total broadcast hours (as is done in the calculations in Table 3) creates problems in the case of companies which operate largely off-peak (such as TV-am) or at only peak hours (such as LWT). But our knowledge about the likely long-run cost structure of ITV companies is not at present sufficiently well developed to allow a judgement about whether it is in any case the most appropriate formula. If Ministers judge that the benefits to efficiency of achieving equivalent pressure on costs between different companies justify the extra complexity, then further work (perhaps in consultation with the industry) is necessary before the best structure for that purpose can be chosen.

23. An alternative to the search for a formula which would distinguish equitably between regions of different sizes would be to ensure that contract areas for the 1993 contract rounds were of broadly similar sizes - "redrawing the map". In that situation, a uniform progressive levy, combined with a tender, might well be adequate. But such a change would have other major implications for broadcasting policy, and might not in any case deal with the problem of franchises based on time allocations. It does not at present seem sensible to rely on the likelihood that companies will be of sufficiently similar size for a uniform progressive levy to be acceptable.

RANGE OF PROFIT/NAR RATIOS WITH UNIFORM AND NON-UNIFORM LEVIES

(YEAR 2000)

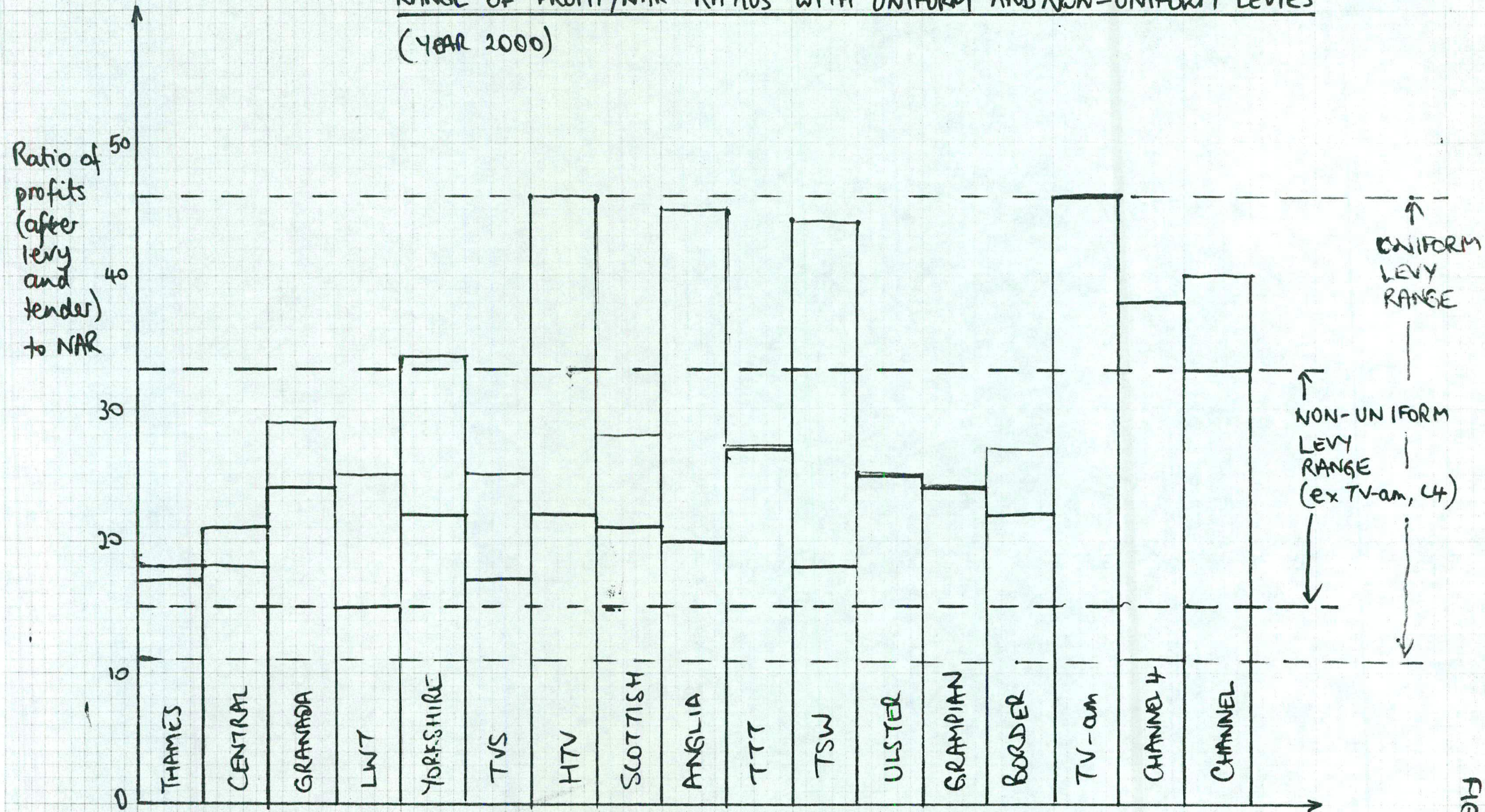

FIGURE 3

E.R.

Summary and conclusions

24. The objectives of a levy are best served by a levy structure which is based on net advertising revenue - so that companies have the greatest incentive to control costs - but which ensures that, after the levy, the surplus of NAR over costs is likely to be broadly comparable for all companies, irrespective of their size and rate of growth of NAR. Otherwise the rate would have to be reduced to keep small and poor companies in business, and that would release the pressures for efficiency on large and rich companies.

25. For this purpose, a uniform progressive levy, which has a free slice defined in terms of total NAR which applies equally to all companies, does not seem adequate. It would work only if companies were all broadly the same size (so that their costs were broadly the same). The alternative is to construct a levy which has a uniform structure in terms of rates and levy bands, but which has a free slice calculated individually for each company. Such an approach - illustrated in this paper by a free slice related to the number of households in each region - does appear to achieve a better result, albeit at the cost of more complexity.

26. It might be argued that all differences in profit rates - resulting largely from different rates of growth of NAR - might be evened out by competitive bidding. But in practice it does not seem likely that competitive bidding could be relied on to even out the degree of disparity involved. In that case there would be a loss of the desired pressure for efficiency. In principle, therefore, the alternative approach of adopting a uniform <u>structure</u> applied at <u>different levels</u> to different companies, seems preferable. But the question how, in that case, the free slice should be determined cannot be reliably answered without further work on the underlying cost structure of ITV companies, probably in consultation with the IBA and the companies themselves.

pnp

FROM: MOIRA WALLACE
DATE: 1 February 1988

MR GILMORE

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Kemp
Mr Monck
Mr Burgner
Mr Odling-Smee
Mr Spackman
Mr Burr
Miss Sinclair
Mrs Pugh
Mr Cave
Mr Tyrie

ITV SYSTEM, REVENUE LEVY

The Chancellor has seen your minute of 29 January. He agrees with your recommendations, although he has slightly amended your draft paragraph for the Home Secretary's paper to MISC 128, as follows:

> "Combining a tender with a revenue levy has two main purposes. It will share the revenue risks with bidders, and thus encourage more enterprising bids. But because, once franchises are let, the level of costs will be fully reflected in companies' profits, it will also exercise continuing downward pressure on costs during the lifetime of the franchise, as the present system does not. The Official Group proposed a progressive levy on the revenue per television household. In the light of further consideration, I have concluded that, while a progressive levy structure is desirable, further work is required on the precise form of progressive levy best calculated to achieve our objective of maximising the pressure for efficiency on ITV companies."
> [Continue as drafted.]

MPW.

MOIRA WALLACE

CHANCELLOR OF THE EXCHEQUER

pmp

Ch/

You queried X. Submissions by Messrs Bolt & Gilmore flagged recommended further work on whether <u>formula</u> of NAR per household needed sophistication. But <u>no question of it being anything other than a formula</u>, no question of naming specific contractors, hybridity etc. X overleaf pretty sloppily put in the circs!

MPW. 10/2

2507/7/28

BF 4/2

CONFIDENTIAL

FROM: C W BOLT

DATE: 3 February 1988

I agree. [illegible] 3/ii

1. MR GILMORE

2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Kemp
Mr Burgner
Mr Gilmore
Mr Spackman
Mr Burr
Miss Sinclair

Mrs Pugh
Mr Cave
Mr Tyrie

Ch/ Content to write as drafted? MPW

Letter OK, — but I am not @ all happy with X. Not only is this contrary to the principles of taxation, but [illegible] do [illegible] how [illegible] avoid the hybridity trap. I do not recall y. [illegible]

ITV LEVY FOR CONTRACT EXTENSION PERIOD

The present ITV levy is paid on profits. Ministers have already decided that, for the next round of ITV contracts to commence operation in 1993, a levy on revenue should be paid by contractors in addition to tenders. This submission considers the case for also switching the levy from profits to revenue for the agreed extension of the current contracts from end-89 to end-92. We recommend that you write to the Home Secretary, proposing this change in principle, and suggesting that officials should be asked to work up proposals.

Background

2. When the ITV levy was introduced in 1964, it was based on net advertising revenue (NAR), with an initial tranche of NAR exempt from levy ("free-slice"), and subsequent bands levied at 25 per cent and 45 per cent. Because these bands were fixed in cash terms, and applied equally to all companies irrespective of size, frequent adjustments were required to prevent the smaller companies going into deficit. This was a particular problem in the early 1970s, and the levy was changed three times in one year to compensate. In 1974, the basis of levy was changed from revenue to profits, with profits on domestic activities being subject to a levy of 66.7 per cent. This remained unchanged until 1986, apart from minor amendments to the free slice.

3. In 1984 officials from the Home Office, Treasury and Independent Broadcasting Authority (IBA) undertook a major review of the levy, reporting in May 1985. This review considered a wide range of options including a return to a revenue levy. The recommended option, which was brought into effect

392

the 1986 Finance Act, involved retention of the profits based levy, but with a lower rate (45 per cent) of levy on domestic profits, with a new levy (at 22.5 per cent) on profits arising from overseas sales.

4. Two main arguments were presented in the review against a return to a revenue levy. The first was a concern that, because different companies had different costs (mainly reflecting their different sizes), the level of revenue did not necessarily correlate with ability to pay levy. (This objection is, of course, removed if the levy bands are not uniform, but are set individually for each company, as is now being considered for the levy to apply from 1993.) The second argument against changing to a revenue levy was that "companies might validly a claim that it would be unfair to make such a radical change in the rules halfway through their franchise periods."

Changing the Basis of the Levy in 1990

5. There is an option to change the basis of the levy at the end of the current contracts, to apply during the contract extension period 1990 to 1992. Arguments in favour of making the change are: that a revenue based levy puts better pressure on costs and the sooner this pressure is brought to bear the better; that making the change in 1990 rather than 1993 will provide some experience of operating such a system, and ~~provided~~ a better basis for potential contractors constructing their bids for 1993 contracts; that this is a change to the ITV's system that can be introduced fairly soon whereas the major other changes must wait until 1993. The main argument against making the change is that the existing contractors might refuse to accept contract extensions; but this is in any case a possibility in the light of the other changes that are being proposed to the ITV system. The balance of advantage seems to lie clearly in favour of making the change in 1993.

Basis of Revision

6. As indicated above, the review by officials of the levy, completed in 1985, identified a number of options for changing the basis of the levy. One was a straightforward revenue levy (although the form considered was a uniform levy applied to all revenue, with a profits safeguard), or a two-part levy combining a levy on NAR and a levy on profits, again with a profits safeguard. Given the complexities involved in administering a levy which is related in any way to profits (since this requires the IBA to lay down the principles by which profits are to be measured), there seems to be a significant advantage in moving directly to a revenue-based levy, with the profits position being

safeguarded by adopting levy bands which reflect the relative size of different companies. (This is the approach recommended in my submission of 29 January concerning the form of the levy to apply from 1993.) If levy bands are applied uniformly to all companies, and if they are indexed in line with the RPI or some other general measure of inflation, we do not envisage that the problems experienced in the early 1970s will reoccur.

Timing

7. We understand that the IBA intend to invite ITV companies to apply for extensions to their contracts in April of this year and to award contracts by the end of the year. It would, therefore, be necessary to decide the levy structure that will apply from 1990 by April or soon afterwards, so that it could be taken into account by contractors in their application. The 1989 Finance Bill would provide a suitable legislative opportunity for changing the basis of the levy.

Recommendation

8. I attach a draft letter which you might send to Mr Hurd proposing that the basis of the levy to apply from 1990 to 1993 should be considered by officials as a matter of urgency.

C W Bolt

C W BOLT

2507/9/28

CONFIDENTIAL

pse type final for Ch's signature

DRAFT LETTER FROM CHANCELLOR TO THE HOME SECRETARY

Copies: Other members of MISC 128

M.

ITV LEVY FOR CONTRACTING EXTENSION PERIOD

When I agreed in Autumn 1986 to your proposal to extend the existing ITV contracts so as to give time to consider properly the basis for fundamental changes to the broadcasting system, I suggested that we should not lose sight of the possibility of moving to a levy based on revenue rather than profit for the period of the ITV contract extensions. pp2. There is in any case a strong case for making this change in 1990, and our decision that contracts from 1993 should be awarded on the basis of tender plus revenue levy makes it all the stronger.

2. A revenue levy will provide a better incentive on companies to be more efficient. Introducing the change in 1990 would not only bring this effect to bear sooner, but would provide potential bidders for the contracts to run from 1993 with a better basis for constructing their bids, given that they would be able to see how such a levy structure worked in practice.

3. Although we would not need to introduce legislation to make this change for some time - the 1989 Finance Bill would provide a suitable opportunity - we need to decide on the policy soon, as I understand that the IBA will be inviting contractors to apply for the contract extensions in the near future, and hopes to award contracts by the end of this year. I ~~believe~~ suggest, therefore, that we should invite officials to examine, as a matter of urgency, the basis on which a revenue levy which could be applied from 1990. We could consider such proposals in a future meeting of MISC 128.

4. I am copying this letter to the Prime Minister and to other members of MISC 128.

ps2/2M

cc PS/Chief Secretary
PS/Financial Secretary
Sir P Middleton
Mr Anson
Mr Kemp
Mr Burgner
Mr Gilmore
Mr Spackman
Mr Burr
Miss Sinclair
Mr Bolt
Mrs Pugh
Mr Cave
Mr Tyrie

CHANCELLOR OF THE EXCHEQUER

Treasury Chambers, Parliament Street, SW1P
01-270 3000

11 February 1988

The Rt Hon Douglas Hurd CBE QC MP
Secretary of State for the Home Dept
Home Office
50 Queen Anne's Gate
LONDON
SW1H 9BW

Dear Douglas

ITV LEVY FOR CONTRACTING EXTENSION PERIOD

When I agreed in Autumn 1986 to your proposal to extend the existing ITV contracts so as to give time to consider properly the basis for fundamental changes to the broadcasting system, I suggested that we should not lose sight of the possibility of moving to a levy based on revenue rather than profit for the period of the ITV contract extensions.

There is in any case a strong case for making this change in 1990, and our decision that contracts from 1993 should be awarded on the basis of tender plus revenue levy makes it all the stronger. A revenue levy will provide a better incentive on companies to be more efficient. Introducing the change in 1990 would not only bring this effect to bear sooner, but would provide potential bidders for the contracts to run from 1993 with a better basis for constructing their bids, given that they would be able to see how such a levy structure worked in practice.

Although we would not need to introduce legislation to make this change for some time - the 1989 Finance Bill would provide a suitable opportunity - we need to decide on the policy soon, as I understand that the IBA will be inviting contractors to apply for the contract extensions in the near future, and hopes to award contracts by the end of this year. I suggest, therefore, that we should invite officials to examine, as a matter of urgency, the basis on which a revenue levy which could be applied from 1990. We could consider such proposals in a future meeting of MISC 128.

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

Yours ever
Nigel

NIGEL LAWSON

dti

the department for Enterprise

BF ~~29/2~~ ~~3/3~~ ~~8/3~~ BF ~~14/3~~

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

Department of
Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Switchboard
01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
SW1P 3AG

CH/EXCHEQUER	
REC.	22 FEB 1988 22/2
ACTION	MR BOLT
COPIES TO	CST FST SIR P. MIDDLETON MR ANSON MR KEMP MR BURGNER MR GILMORE MR SPACKMAN MR BURR MISS SINCLAIR MRS PUGH MR CAVE MR TYRIE

Direct line 215 5422
Our ref DC4ADZ
Your ref
Date 19 February 1988

BF ~~14/3~~ ~~17/3~~ pmp

Dear Nigel,

ITV LEVY FOR CONTRACTUAL EXTENSION PERIOD

Thank you for copying to me your letter of 11 February to Douglas Hurd.

I agree that it seems sensible to move to a revenue levy, for the period of the ITV contract extensions, and to ask officials to work up more detailed proposals for consideration in MISC 128. I would welcome an opportunity for my officials to be involved in the discussions.

Yours,
David

the Enterprise initiative

~~PPS 1 A?~~

HOME SECRETARY

CH/EXCHEQUER	
REC.	23 FEB 1988 24/2
ACTION	MR BOLT
COPIES TO	PS/CST PS/FST SIR P. MIDDLETON MR ANSON MR KEMP MR BURGNER MR ... MR GILMORE MR PACKMAN MR BURR MISS SINCLAIR MRS PUGH MR CAVE MR TYRIE

QUEEN ANNE'S GATE LONDON SWIH 9AT

23 February 1988

25/2

~~BF 24/2~~

~~BF 1/3~~

~~3/3~~ 8/3

Dear Nigel,

ITV LEVY FOR CONTRACT EXTENSION PERIOD

Thank you for your letter of 11 February. I agree that there is a good case for changing the present levy system for the period of the ITV contract extensions. That case has, of course, been further strengthened by the recent critical report by the National Audit Office, which we can expect to be amplified by the Public Accounts Committee. So long as we have a wholly profits-based levy it will be very difficult to address the Public Accounts Committee's concerns without either raising the basic levy rate - which would clearly run counter to the policy of bringing marginal tax rates down in the interests of encouraging efficiency within ITV - or increasing the levy rate on overseas profits - which would be represented as creating disincentives to exports.

My officials have accordingly already started work on an assessment of the options for changing the levy base to incorporate a revenue element. I think that we may need to consider for the contract extension period only levy arrangements which apply in part on profits and in part on revenue. My officials will be in touch with yours shortly to take this work forward. I understand that the IBA is due to offer the ITV companies their extended contracts in April, and we shall clearly need to work fast against this deadline. I agree with you, however, that provided we give notice to the companies before then of the revised levy arrangements which we propose to put in place, the changes themselves can be given effect in either broadcasting or finance legislation as convenient.

Subject to the outcome of work by officials it may be possible to settle this in correspondence without the need for a meeting.

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

Yours,

Douglas.

The Rt Hon Nigel Lawson, MP.

Mr Lyons

with compliments

M

X pt BF 29/2

dti

the department for Enterprise

CH/EXCHEQUER
REC. 23 FEB 1988 23/2
ACTION MR BOLT
CST FST
SIR P. MIDDLETON
MR ANSON MR HAYDEN PHILLIPS
MRS CASE MR MONCK
MR BURR MR BURGNER
MR TYRIE

BC 3/3

CONFIDENTIAL

BF 24/2 25/2

PRIME MINISTER

THE ITV SYSTEM : ITN

23/2/88.

X At MISC 128 on 9 February, during the discussion of the future of ITN, concern was expressed that a weakening of ITN's position might lead to the BBC developing a monopoly in the provision of news programmes. I was asked whether, if the need arose, the BBC news service could be the subject of a monopoly reference to the Monopolies and Mergers Commission (MMC).

My legal advice is that a monopoly reference relating to the BBC would seem to be possible. There is an element of uncertainty, which stems not from the BBC's possessing a Royal Charter, but from the issue of whether the BBC "supplies services" within the meaning of the Fair Trading Act 1973. The Office of Fair Trading took Cousel's opinion in 1979 and were advised that the BBC could be referred but there must, however, remain an element of doubt - which ultimately could only be resolved if the reference were challenged in the courts.

A monopoly reference could deal with the straightforward economic issues of monopoly abuse if many ITV companies were forced to rely on the BBC for their news service. These could be subject to remedies of the kind that the legislation provides for, such as controls on prices and terms of contracts. But there would also be issues of quality and variety of news presentation. It is harder to envisage suitable remedies for these, except to the extent that barriers to entry into the market for news could be removed. I also doubt whether we would want to leave questions of the accurate and impartial presentation of news to the MMC, rather than dealing with them ourselves.

dti

the department for Enterprise

CONFIDENTIAL

An MMC reference could only deal with a dominant position which had been established. If we wish to make sure it does not come about in the first place, the most direct method might be a provision in ITV contracts, preventing the use of BBC news services or those of any body in which they or another broadcasting authority had an interest. Although, at the meeting, it was suggested that this might be rather obtrusive, this might prove the simplest course, and, since our objective is to foster competition in news provision, might not seem unduly onerous.

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

D Y

23 February 1988

Department of Trade and Industry

PS6AEI

Tony → not any more! I have now found ppt chucked out to you. Sorry

M.

AWAITING MLI WORD

CH/EXCHEQUER
REC. 03 MAR1988 ✓ 3/3
~~ACTION~~ MR BOLT
COPIES TO CST FST
SIR P. MIDDLETON
MR ANSON
MR H PHILLIPS
MRS CASE
MR RMORE MR BURR
MR BURGNER
MR TYRIE

From: THE PRIVATE SECRETARY

HOME OFFICE
QUEEN ANNE'S GATE
LONDON SW1H 9AT

PPP P1

1 March 1988

Dear Andy,

ITN

The Home Secretary has seen Lord Young's minute of 23 February. He agrees with Lord Young that the more direct and reliable course would be to legislate specifically to prevent ITV contractors from obtaining news services from the BBC or any other broadcasting authority.

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

Yours ever,

Colin

C R MILLER

P A Bearpark, Esq.,

COMMERCIAL IN CONFIDENCE

HOME SECRETARY

CH/EXCHEQUER
REC. 18 APR 1988
ACTION Mr BOLT
COPIES TO PS/CST, PS/FST, Sir P. MIDDLETON, Mr ANSON, Mr KEMP, Mr BURGNER, Mr GILMORE, Mr SPACKMAN, Mr BURR, MISS SINCLAIR, MS PUGH, Mr CAVE, Mr TYRIE.

QUEEN ANNE'S GATE LONDON SW1H 9AT

18 April 1988

Dear Nigel,

ITV LEVY FOR CONTRACT EXTENSION PERIOD

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

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

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

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

/Finally,

The Rt Hon Nigel Lawson, MP

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

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

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

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

not so urgent,
Home Office now say.

Yours,

Douglas

DETAILS OF PROPOSED ALTERNATIVE LEVY SCHEMES

1. The straight revenue scheme

A progresive levy on net advertising revenue, as follows:

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

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

2. The mixed scheme

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

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

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

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

3. <u>The existing scheme</u>

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

4. <u>The pre-1986 scheme</u>

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

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

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

COMPARISON OF PROPOSED NEW SCHEMES WITH EXISTING SCHEME

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

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

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

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

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

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

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

Revenue only scheme - 6, 12, 18% revenue

Existing scheme - 45 and 22.5% on profits

Pre-1986 scheme - 66.7% on profits

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

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

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

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

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

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

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

Levy File

(13)

(24)

INDEPENDENT BROADCASTING AUTHORITY
70 Brompton Road, London SW3 1EY
Tel: 01-584 7011 Telex: 24345
JOHN WHITNEY Director General

24th February 1988

Dear Brian

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

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

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

/...

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

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

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

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

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

/...

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

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

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

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

/...

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

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

As ever

John.

JOHN WHITNEY

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

2518/?/28

FROM: C W BOLT

DATE: 29 April 1988

1. MR ~~BURR~~ RJB 29/4.

2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Burgner
Mrs Case
Mr Spackman
Miss Sinclair
Mrs Pugh
Mr Cave
Mr Tyrie

Ch/ content to write as drafted? MPW 29/4

OK (on a WS ...)

ITV LEVY FOR CONTRACT EXTENSION PERIOD

The Home Secretary wrote to you on 18 April setting out proposals for changes to the ITV levy for the contract extension period, running from 1 January 1990 to 31 December 1992. The attachment to his letter examines two basic options, a revenue levy and a mixed revenue and profits levy. Mr Hurd concludes that the mixed levy is preferable; he also indicates that the IBA are strongly opposed to the revenue only scheme. We are not convinced by the arguments in favour of a mixed scheme, and this submission recommends that you write to Mr Hurd pressing the case for a revenue only levy.

Background

2. In order to give time to allow decisions to be taken on the future arrangements for the Independent Television system, it was agreed by Ministers in 1986 that existing contracts should be extended, and expire on 31 December 1992 rather than 31 December 1989. You wrote to the Home Secretary on 11 February 1988 suggesting that, in the light of the decision by MISC 128 to combine competitive tendering with a revenue levy for the new contracts to commence in 1993, there was a case for an earlier change, with a revenue levy being applied also during the contract extension period in place of the existing profits levy. Mr Hurd agreed that this question should be examined by officials. Lord Young also expressed support for a change to a revenue levy.

BOLT TO CX 29 APR

The main advantage that a revenue levy is seen to have over a profits levy as currently applied is that it increases incentives to efficiency (since the marginal tax rate on profits is simply corporation tax). In that way, it will reinforce current initiatives to improve working practices in ITV companies. Adopting a revenue levy in 1990, in advance of the new contract round commencing in 1993, would also have the advantage of providing some experience (both to the IBA and contractors) of the operation of such a levy, and would thereby help to secure its acceptance as part of the regime for the longer term.

4. Another relevant factor is the recent NAO report and PAC hearing on the effects of the changes in the existing profits levy which were introduced in 1986. These changes reduced the levy on domestic profits, while introducing a lower rate of levy, for the first time, on overseas profits. The NAO criticised this change, arguing that the change had reduced the yield of the levy (an argument not accepted as it stands by the Treasury or Home Office). This has also increased pressure for introducing a change in the levy before 1993.

Options

5. The attachment to Mr Hurd's letter sets out details of two possible levy schemes. The first is a progressive levy on net advertising revenue (NAR), with rates rising from 6 per cent on NAR above a free slice of £15 million to 18 per cent on NAR above £100 million. The second option is a mixed scheme with lower levy rates on revenue (going from 5 per cent to 12 per cent), plus a flat rate levy on both domestic and overseas profits of 22.5 per cent (the rate currently applied to overseas profits). Under the mixed scheme, leviable profits would be profits after revenue levy had been deducted. The marginal rate of tax on profits would be 50 per cent under the mixed scheme, compared with the corporation tax rate of 35 per cent which would apply under the revenue levy.

6. The Home Office have examined the effects of the two options, under different assumptions of cost and revenue growth, on the level of post-levy profits, both in aggregate and for individual companies. They have also compared the effects of these two schemes with the profits levy currently in force, and with that which applied before 1986. In the Home Office's "most likely" scenario (with NAR and profits and therefore costs all increasing at 10 per cent a year in cash terms), the revenue only levy would yield £173 million, and the mixed levy £170 million, compared with £126 million under the existing levy and £166 million at the rates in force before 1986 (Annex 1).

7. While both options would, therefore, help to deflect PAC criticism that the levy yield was lower than it might have been, Mr Hurd believes that the mixed option has a number of advantages over the revenue only option. The main one is that a mixed scheme is less redistributive in its impact on individual companies, and is less susceptible to profit fluctuations. IBA have expressed concern about the effects of a revenue only levy for this reason. Mr Hurd argues that a mixed scheme would be more analogous to the arrangements proposed for 1993 contracts, which would combine competitive tendering with the revenue levy. Given that both systems would help to put pressure on costs, Mr Hurd argues that a mixed scheme would be preferable.

Discussion

8. These concerns deserve serious consideration, since it would clearly not help to secure acceptance of a revenue levy in the longer term if it was seen to have the same sort of instability as when such a levy was last in force, before 1974. We have examined in some detail the effects of the two schemes on individual companies and how they are influenced by different movements in costs and revenues. The following conclusions emerge:

(i) a mixed scheme generally appears to give contractors a level of profits after levy closer to that applying under the current profits levy than would a revenue only levy. However, the difference is generally small: in the Home Office's "most likely" scenario, in which NAR, costs and profits grow at the same rate, (Annex 1), the greatest difference is £3.5m, for Thames, representing less than 2 per cent of NAR, and about 10 per cent of pre-levy profits.

(ii) if the increase in NAR is less than the increase in costs, so that profits fall, some companies may go into deficit by 1990. For example, if NAR growth is reduced from the 10 per cent assumed in Annex 1 to 6 per cent, but cost growth only falls from 10 per cent to 9 per cent, three companies would be in deficit before levy. A mixed levy would push a further three companies into deficit; a revenue levy, by comparison, would push a further six companies into deficit (Annex 2). However, the absolute difference in post-levy profits is again relatively small (the largest difference, again for Thames, is about £6m); but the assumptions do not in any case appear plausible.

(iii) given that NAR is responsive to GDP growth, and ITV costs are now being put under considerable scrutiny, it seems more reasonable to assume that cost growth will be less than growth in NAR. On the assumptions used in Annex 3 (NAR growth of 10 per cent, cost growth of 7 per cent), profits would be lower with a revenue only levy, but would all be positive.

Concerns about the redistributive effects of a revenue levy and its instability therefore appears to be overstated. On the latter point, it is worth noting that the problems which arose before 1974 took place against the background of high inflation rates; instability is much less likely in a period of relatively high economic growth and low inflation.

9. We also believe that Mr Hurd has overstated the analogy between competitive tendering and a profits levy. As has become clear over the past few years, a profits levy (with the resulting high marginal rate of tax) does not produce strong incentives on ITV companies to hold down cost increases. This was, indeed, the main reason for reducing levy rates and extending the profits base on which levy was charged in 1986. Retaining a profits levy alongside revenue levy would, therefore, serve essentially as a profits safeguard in the levy system. Competitive tendering, by contrast, allows individual tenders to assess the value of them of a franchise, taking into account their expectations about revenue and costs. Its purpose is quite clearly to encourage innovative approaches to the provision of programmes and to seek to minimise the amount of monopoly profit retained by ITV contractors.

10. Given that the regime to apply from 1993 has yet to be announced, moving to a revenue only levy in 1993 might be seen by ITV companies as representing a more severe regime than they expect to apply from 1993. (Although the decision to award contracts by competitive tenders has been widely anticipated, there has, yet, been no speculation about the continuation of a levy). On the other hand, agreeing to a mixed scheme in 1990, given that the precise structure for the revenue levy in the longer term has to be agreed, might be something of a hostage to fortune - in the sense that we might find it difficult to get away from the mixed levy post-1993.

Conclusion

11. Apart from the IBA position, all these factors point, if only weakly in some cases, to preferring a revenue levy to a mixed levy. Although Mr Hurd takes the opposite view, he has certaintly not ruled out a revenue only scheme. Lord Young has also expressed support for a revenue levy, although his officials has not been involved in subsequent discussions about the details of possible schemes. Although a mixed scheme would certainly be preferable to the continuation of the present profits only levy, it does seem worth pressing the case for a revenue only levy. I attach a draft letter in this sense. It would also be worth enquiring about the mechanics of the contract extension exercise, which have not all been exposed by the IBA or the Home Office. It is, however, clear that we are not being asked at this stage to agree to levy rates, but simply the structure.

pp Rus Kesley

C W BOLT

2518/24/28 COMMERCIAL IN CONF

pl type final

RAFT LETTER FROM CHANCELLOR OF THE EXCHEQUER TO HOME SECRETARY

cc: as indicated

ITV LEVY FOR CONTRACT EXTENSION PERIOD

Thank you for your letter of 18 April setting out your proposals for the form of the ITV levy to operate in the contract extension period from 1990 to the end of 1992. Our officials have discussed the details in the attachment to your letter.

2. I welcome your agreement that we should move away from the existing profits-based levy, to secure ~~both~~ an increase in the total amount of revenue raised by the levy and, above all, to increase incentives to cost efficiency. While I understand your concern to minimise the risks that existing contractors will decline an extension to their contract, I do find the arguments in favour of a mixed revenue and profits levy as convincing as you do. ~~more finely balanced than you suggest.~~ The further work which our officials have undertaken suggests that, while there is a risk that under certain combinations of revenue and cost growth some companies might go into deficit in the contract extension period, it does not appear that a revenue only scheme would increase this risk significantly. At the same time, a revenue only scheme has clear advantages in terms of reducing marginal effective tax rates, and thus encouraging contractors to improve their efficiency.

I do not believe, moreover, that the analogy between a mixed levy and the combination of competitive tendering and revenue levy which we envisage for 1993 is as close as you suggest. The purpose of the competitive tendering element is to encourage innovative bids and to ensure that monopoly profits are as far as possible eliminated ~~insofar as possible~~. As we know from past experience, a profits levy has other effects: if anything, it discourages innovation and its role as part of a mixed scheme would be more in the nature of a profits safeguard, although it is not clear that it will even fulfil this role very effectively. There is also the risk that if we adopted a mixed levy in 1990 it would be more difficult to move to a revenue levy in 1993 than otherwise.

straight

4. I am, therefore, led to the conclusion that we would move direct to a revenue levy in 1990. As for the risks of instability stated ~~forseen~~ by the IBA, many of the problems experienced in the early 1970s with the revenue levy then in force arose because of the very much higher levels of inflation then than now. With inflation at its current level, it should be possible to keep rates stable for at least the three years of the contract extension period, but if this was thought a problem then the threshholds could be indexed, as we envisage for the levy to apply from 1993. straight

5. On a more general note, it would be helpful to know more about the way the IBA will be conducting the contract extension exercise. I understand, for example, that they intend to give contractors, in the draft contracts, only a preliminary indication of the levy rates to be applied, with the precise rates being determined later. It would be helpful to know when we will actually need to determine the rates. We ought also to know ~~Also,~~ what ~~is~~ the IBA is intending to tell the contractors about the likely development of the broadcasting environment over the period? And, although the presumption is that all contractors will be awarded an extension, what would the position be if other potential contractors expressed interest in any of the franchises, or if any of the existing contractors declined to renew?

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

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

COMPARISON OF PROPOSED NEW SCHEMES WITH EXISTING SCHEME

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

Mixed scheme: 5, 10, 12% on revenue of £15m–£40m; £40m–£100m; £100m+
22.5% on profits

Revenue only scheme: 6, 12, 18% on revenue (bands as above)

Existing scheme: 45% on domestic profits; 22.5% on overseas profits

Pre-1986 scheme: 66.7% on domestic profits

Assumptions: NAR growth 10 per cent
cost growth 10 per cent

251[illegible]4

ANNEX 2

POST LEVY PROFITS WITH A REVENUE-ONLY AND MIXED LEVY, 1990

£ million, cash

'Pessimistic' assumptions

	Revenue only	Mixed
Thames	-1.8	4.1
Central	-2.8	0.7
Granada	8.4	10.4
LWT	-2.1	0.9
Yorkshire	-7.3	-4.5
TVS	0.7	4.1
HTV	7.4	6.3
Scottish	0.6	1.6
Anglia	3.0	3.5
TTT	-0.8	-0.2
TSW	-1.0	-0.9
Ulster	-0.7	-0.6
Grampian	-0.7	-0.7
Border	-0.9	-0.9
TV-AM	11.4	9.5

Assumptions: NAR growth 6 per cent
cost growth 9 per cent

2518/24

ANNEX 3

POST-LEVY PROFITS WITH A REVENUE-ONLY AND MIXED LEVY

'Central' assumptions

	Revenue only	Mixed
Thames	19.2	26.8
Central	7.7	18.3
Granada	27.3	27.9
LWT	12.2	20.9
Yorkshire	9.9	11.7
TVS	19.4	20.8
HTV	8.3	12.5
Scottish	14.3	12.3
Anglia	12.8	12.5
TTT	6.8	6.5
TSW	5.1	4.4
Ulster	3.2	2.7
Grampian	3.3	2.6
Border	1.4	1.4
TV-AM	19.9	16.2

Assumptions: NAR growth 10 per cent
Cost growth 7 per cent

mjd 3/128m

COMMERICAL IN CONFIDENCE

PWP

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

HO
Dclerk
+ DTI

3 May 1988

cc: PS/Chief Secretary
PS/Financial Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Burgner
Mrs Case
Mr Spackman
Miss Sinclair
Mrs Pugh
Mr Burr
Mr Cave
Mr Bolt
Mr Tyrie

The Rt Hon Douglas Hurd CBE MP
Secretary of State
Home Office
50 Queen Anne's Gate
London SW1

Dear Douglas

ITV LEVY FOR CONTRACT EXTENSION PERIOD

Thank you for your letter of 18 April setting out your proposals for the form of the ITV levy to operate in the contract extension period from 1990 to the end of 1992. Our officials have discussed the details in the attachment to your letter.

I welcome your agreement that we should move away from the existing profits-based levy, to secure an increase in the total amount of revenue raised by the levy and, above all, to increase incentives to cost efficiency. While I understand your concern to minimise the risks that existing contractors will decline an extension to their contract, I do not find the arguments in favour of a mixed revenue and profits levy as convincing as you do. The further work which our officials have undertaken suggests that, while there is a risk that under certain combinations of revenue and cost growth some companies might go into deficit in the contract extension period, it does not appear that a revenue only scheme would increase this risk significantly. At the same time, a revenue only scheme has clear advantages in terms of reducing marginal effective tax rates, and thus encouraging contractors to improve their efficiency.

I do not believe, moreover, that the analogy between a mixed levy and the combination of competitive tendering and revenue levy which we envisage for 1993 is as close as you suggest. The purpose of the competitive tendering element is to encourage innovative bids and to ensure that monopoly profits are as far as possible eliminated. As we know from past experience, a profits levy has other effects:

CX TO HURD 3 MAY

if anything, it discourages innovation and its role as part of a mixed scheme would be more in the nature of a profits safeguard, although it is not clear that it will even fulfil this role very effectively. There is also the risk that if we adopted a mixed levy in 1990 it would be more difficult to move to a revenue levy in 1993 than otherwise.

I am, therefore, led to the conclusion that we should move direct to a straight revenue levy in 1990. As for the risks of instability feared by the IBA, many of the problems experienced in the early 1970s with the revenue levy then in force arose because of the very much higher levels of inflation then than now. With inflation at its current level, it should be possible to keep rates stable for at least the three years of the contract extension period, but if this was thought a problem then the thresholds could be indexed, as we envisage for the levy to apply from 1993.

On a more general note, it would be helpful to know more about the way the IBA will be conducting the contract extension exercise. I understand, for example, that they intend to give contractors, in the draft contracts, only a preliminary indication of the levy rates to be applied, with the precise rates being determined later. It would be helpful to know when we will actually need to determine the rates. We ought also to know what the IBA is intending to tell the contractors about the likely development of the broadcasting environment over the period. And, although the presumption is that all contractors will be awarded an extension, what would the position be if other potential contractors expressed interest in any of the franchises, or if any of the existing contractors declined to renew?

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

Yours
Nigel

NIGEL LAWSON

HOME SECRETARY

WITH
THE COMPLIMENTS OF THE
PRIVATE SECRETARY

HOME OFFICE
50 QUEEN ANNE'S GATE
LONDON SW1H 9AT

HOME SECRETARY

CH/EXCHEQUER

REC. 13 SEP 1988

ACTION MR PERFECT

COPIES TO CST, FST, SIR P MIDDLETON, MR ANSON, MR PHILLIPS, MR BURGNER, MRS CASE, MR SPACKMAN, MR GILHOOLY, MR NICOLL, MR CAVE, MR KAUFMAN / MR TYRIE

~ 13/6

QUEEN ANNE'S GATE LONDON SW1H 9AT

6 June 1988

Dear George,

ITV LEVY FOR CONTRACT EXTENSION PERIOD

As you know, we have been considering the structure of the ITV levy for the period 1990-92. I thought I should give you an indication of the way our thinking has developed before our decisions are finalised.

We have examined a range of possible schemes in consultation with the Treasury, and taking into account the points made in John Whitney's letter of 24 February to Sir Brian Cubbon. On the basis of this work the two main options which have emerged are a scheme based on revenue alone and one based on a mixture of profits and revenue. As between the two, I am inclined on balance to favour a revenue based scheme, which would provide the most direct incentive to companies through lower marginal tax rates to reduce costs and improve efficiency. I recognise that a revenue levy has given rise to problems in the past, but I believe that we can avoid most of these pitfalls. The frequent changes in rates during the period 1964-1974 were a consequence of the much higher levels of inflation then prevailing. With inflation at its present level, we believe that it should be possible to avoid disruptive changes in rates for at least the three years of the contract extensions period. As an additional safeguard, however, I would be prepared to consider indexing the thresholds if you thought there was merit in this.

I accept that a revenue based levy could bite on companies which were incurring trading losses. However, I think this is more a matter of setting the rates at the right level than an argument for a mixed scheme as against a revenue scheme: the former could also, in certain circumstances, give rise to a deficit. Given the very buoyant level of advertising revenues in recent years the possibility of a sudden substantial downturn during the contract extension period is fairly remote; but we would propose to guard against this by providing a substantial "free slice" of revenue which would be zero rated. This would also avoid imposing an excessive burden on companies which made relatively modest profits.

HURD TO THOMSON 6 JUNE

With regard to DBS, I would propose that the new satellite services should be subject to the levy in the same way as terrestrial services, but envisage that they would continue to be zero rated during the period 1990-92.

The Rt Hon Lord Thomson of Monfieth, KT.

/over......

....: I attach some illustrative figures showing how a revenue scheme might operate in practice. I should emphasise that these figures do not necessarily represent our final or considered view as to the proper rates, but are intended simply to demonstrate broadly how we would propose to approach the calculation of the levy rates under a revenue scheme.

I know that the IBA's preference is for a mixed revenue and profits scheme, and I have taken careful account of the representations you and John Whitney have made about this on various occasions. Before reaching a final decision on the structure of the levy, I would naturally welcome any further comments you may have on the direction of our thinking.

As regards timing, I imagine that you will wish to give the companies some indication of the structure of the levy and the likely rates before they decide whether to accept new contracts. Your letter of 15 April indicated that the detailed terms of the contracts were unlikely to be finalised for some months, and we would certainly expect to be able to reach a decision on the shape of the levy in that timescale. I take it, however, that the precise rates and bands need not be determined until we are ready to introduce enabling legislation, in order to take account of the most up-to-date figures for NAR.

I look forward to receiving any comments you may have. Perhaps your officials could also keep in touch with mine on the progress of discussions with the companies about the contract extensions, so that we are able to complete our work on the structure of the levy in good time.

Yours,

Douglas.

ANNEX A

ITV LEVY - 1990-92

1. A levy on the net advertising revenue of ITV companies would be collected on a monthly basis by the IBA on behalf of the Treasury.

2. The scheme would take the form of a progressive structure with higher rates imposed at each successive band, along the following lines:

NAR (£m)		Levy rate	
B1	B2	R1	R2
0-15	0-25	0	0
15-40	25-50	10	8
40-100	50-150	15	14
100+	150+	20	18

3. The estimated levy yields in 1990 resulting from various combinations of these rates and bands can be illustrated as follows, by comparison to the yields from the existing and pre-1986 levy:

		Revenue only	Existing levy	Pre-1986 levy
		£m	£m	£m
Rates and bands:	1) R1, B1	201	133	177
	2) R2, B1	180	133	177
	3) R1, B2	168	133	177
	4) R2, B2	152	133	177

Notes:

Growth assumptions: NAR rising at 6% pa, costs at 3% pa in real terms 1988-90

Database : NAR and profits for ITV companies - 1985/86, 1986/87, 1987/88

Yields : Expressed in 1987/88 prices

<ce>cm/d/let/thom/levy/12/5/enc

20/158

Ch/ ~~ps/ to note~~ ~~over~~ MPW 15/6

CONFIDENTIAL

FROM: C W BOLT
DATE: 10 June 1988

MR FARTHING

cc PS/Chancellor
PS/Financial Secretary
Mrs Case
Mr Spackman
Mr Gilhooly
Mrs Pugh
Mr Cave
Mr R Evans
Mr Kerley

PSP (needed)

ITV LEVY FOR CONTRACT EXTENSION PERIOD

You may have seen the attached cutting from the front page of today's "Times". The correspondent had discussed the story with Mr Evans (IDT), who took the line that changes in the levy were being considered (as part of general consideration of broadcasting issues) but did not confirm (as suggested in the Times) that a change to a revenue levy had been agreed.

Background

2. Ministers agreed in 1986, when they decided to extend ITV contracts to the end of 1992, that the possibility of changing the form of the levy (at present charged as a percentage of profits) from 1990 should be considered. The Home Secretary wrote to the Chancellor on 18 April indicating his preference for changing to a levy based partly on profits and partly on net advertising revenue (NAR); he also indicated that the Independent Broadcasting Authority (IBA) had a strong preference for a mixed levy to one based only on NAR. The Chancellor responded on 3 May restating his preference for a levy based only on revenue.

BOLT TO FARTHING 10 JUN

3. We were subsequently shown by Home Office officials a draft of a letter from the Home Secretary to the Chairman of the IBA indicating that he was "inclined on balance to favour a revenue based scheme". We agreed that the letter should be sent, subject to some minor drafting changes and to some

changes in the illustrative worked example of a revenue levy. Although the Home Office discussed the numbers with Mrs Pugh on the telephone, we were not shown a revised draft of the letter; until we spoke to the Home Office yesterday, we did not know that it had in fact been sent, on 6 June. (Home Office have now shown us a copy of the letter.)

4. The IBA will have been aware of the Home Office's initial preference for a mixed revenue scheme. This fact, and the timing, point to the source of the Times story being the IBA.

The levy for satellite services

5. The only new issue to come out in the story is the rate of levy for satellite services. Although (under the 1981 Broadcasting Act) DBS services are subject to levy on the same basis as terrestrial television services, it was always recognised that BSB would not be in a position to pay levy in its first few years of operation, until it started generating profits. With a profits levy, there would have been no need to establish separate rates for DBS contractors and terrestrial contractors to protect the position of the former; with a revenue levy, this would however be necessary, and we accepted the proposal by Home Office officals that the DBS levy should be zero for the period from 1990-1992. From 1993, the presumption would be that BSB would pay levy.

X

6. We will cover these points in the briefing for the Chancellor's lunch with Mr McCall (whose views are quoted in the Times article) on 26 July.

C W Bolt

C W BOLT

10 JUNE 1988

Treasury wins on ITV levy change

By Richard Evans, Media Editor

After a battle between the Treasury and the Home Office, the Government is set to radically change the levy paid by ITV companies to make them more efficient.

Mr Nigel Lawson, Chancellor of the Exchequer, has insisted the 15 commercial stations should pay a levy based on their net advertising revenue rather than profits, as at present.

ITV confident 2

In spite of a modified plan put forward by Mr Douglas Hurd, the Home Secretary, that would have based the levy on a mixture of profits and advertising, the Treasury view has prevailed.

The new system will be introduced from the beginning of 1990 and will operate until the end of 1992, when ITV franchises are reviewed.

Home Office and Treasury sources confirmed the outcome yesterday. The change is likely to be included in legislation during the next parliamentary session.

It is only two years since the Government last tinkered with the levy system, and last night some senior ITV chiefs expressed surprise and anger at the latest twist.

The levy has been based on profits since the early 1970s, and in 1987-8, the Treasury received £87 million.

It is charged after spending, taking into account costs, Channel 4 subscriptions and IBA rentals.

Although "non-levyable expenses" have encouraged the making of programmes, they have also discouraged cost-effectiveness and efficiency, and resulted in managements accepting costly staff de-

Continued on page 24, col 7

New levy for TV firms

Continued from page 1

mands, including restrictive working practices.

Critics also point out that the annual levy – paid for the privilege of television advertising – has failed to increase at the rate of advertising revenue.

Change was inevitable. However, Mr David McCall, chief executive of Anglia TV and chairman of the ITV Association, said last night he would have preferred Mr Hurd's mixed levy formula because "it is capable of withstanding the ebbs and flows of varying economic circumstances".

It would be unfair for ITV companies to pay such a levy if it did not apply to new satellite TV channels as well, he said.

Another senior ITV chief accused the Government of being out of date. There was now a mass of evidence to show television companies were getting to grips with inefficiencies and restrictive practices, he said.

TIMES PAST THE TIMES

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SKY CHANNELS

Satellite television, until little more than an idea of the future and accessible only to those prepared to spend several thousand pounds, will soon be widely available in Britain. Mr Rupert Murdoch's announcement that his Sky Television company will be beaming four channels to Britain early next year heralds the first of many new rivals to the BBC and ITV. The promise of a £200 dish receiver will make satellite television affordable.

The new freedom of choice it will bring should transform the face of British television to the benefit of everyone. Soon, the advantages of competition and variety will be as accessible to the viewer of television as they are to the reader of newspapers. Nor does it necessarily follow that standards will fall. Mr Murdoch has already said that he will voluntarily comply with the codes drawn up by Sir William Rees-Mogg's Broadcasting Standards Council.

In theory, the satellite companies can ignore the BSC as they would be bound only to comply with the regulations now being drafted by the Council of Europe. The new channels will also be regulated by the Cable Authority. The companies will also be well aware of the views of the Prime Minister, who made it plain in her speech to the Press Association this week that if the companies proved unable to regulate themselves, limitations would be imposed. Any broadcaster who took a cavalier attitude to standards would be taking an unwise commercial risk.

Within the television industry the most worried men will be in the boardrooms of the ITV companies who have enjoyed a commercial monopoly since they went on the air in 1954. This monopoly has led not only to large profits, but also to a complacency in operation that has generated waste and restrictive trade union practices. There was no incentive to efficiency. The television companies have only belatedly recognized the need to streamline their operations, reduce overmanning and become more cost-effective: hence the picket-line at TV-am, and a collection of manning reductions across the network. With the arrival of competition imminent, they will have to speed up this process and look carefully at their own programme standards.

The BBC, for its part, seems confident that it will emerge unscathed from the increase in the number of channels. It takes the noble view that it is in business to provide a public broadcasting service of the highest standard. Less nobly, it can see a possibility of gaining additional income by selling some of its programmes to the satellite companies. This, together with its own cost-cutting exercises, should improve the corporation's finances. More than ever, the public will have a right to expect a more efficient BBC for the licence fee. Recent signs are that they may be getting it.

ITV, where the franchises are to be renewed in 1992, faces far harder decisions. Changes are being planned in the way their levy to the Government is calculated. At present, the levy is charged on profits, but it may in future be charged on advertising revenue. Once the payment had been set, there would be no penalties incurred from the profits made. The question of possible levies charged to the satellite companies has still to be considered. ITV's claim that the companies have no objection to competition provided that it is fair deserves to be taken seriously.

The profits from the satellite channels will come from the advertisers who have been pressing for new outlets for their business. It is to stimulate competition that the industry proposed the privatization of Channel Four and the setting up of a fifth channel. The alternatives they, and viewers, have so long demanded will soon be here

MP

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THE RT. HON. THE LORD THOMSON OF MONIFIETH, KT, PC Chairman

CONFIDENTIAL

28 July 1988

Dear Douglas,

Levy in the extended ITV contract period

1 Thank you for your letter of 6 June.

2 We informed the ITV companies and BSB (as well as Channel 4 and S4C) of the contents of your letter before 30 June, the date set for the ITV area contractors to accept the extension of their franchises on a subject-to-contract basis. As you suggest, the legal formalities will take some time to resolve. It was particularly useful to have some illustrative figures on the sort of revenue-based levy you have been considering. I realise that the precise rates and bands of any revised levy would not be determined ahead of legislation, although a firm policy decision on the form of the levy between 1990 and 1992 will be taken within the next few months. However, I should draw your attention to the effects that uncertainty about the Government's intentions is already beginning to have in the industry.

3 In addition to notifying the ITV companies and BSB of your proposals, we have sought their views. The purpose of this letter is to let you know the companies' response as well as our own. Despite our different standpoints - the IBA as regulator and levy administrators, the contractors as public companies and programme makers - there is a considerable amount of common ground between us.

THOMSON TO HURD 28 JUL

The IBA view

(a) ITV and the fourth channel

4 The degree of monopoly of television advertising which ITV presently enjoys will be reduced significantly in 1989 with the launch of the BSB and Astra satellite services (to be followed by other new services both terrestrial and satellite). I accept that it will take some time for new services to become fully competitive with the established position of ITV in the market place but the result must be that ITV monopoly profits will diminish and then disappear. Levy can no longer be regarded as a permanent feature of the landscape: the point beyond which it cannot be justified will need to be monitored and judged with care.

5 In the meantime, the form of the levy is of great importance. The problem with profit-based levies is that, when they involve high marginal rates, they are held to undermine cost consciousness. I recognise the force of that argument. But the problem with levies based upon advertising revenue (NAR) is that they impose as much downward pressure on the high programme costs involved in news, documentaries and good quality drama - including the substantial support which ITV gives to the struggling British film industry - as they would in relation to some costly, inflexible and indefensible manning agreement. These latter problems can be and are being tackled by the ITV companies in ways that do not jeopardise good quality diverse programming.

6 Revenue-based levies would not be so threatening to programme production, and therefore to the service we provide to viewers, if advertising revenue moved broadly in step with profits - either as between one ITV company and another, or from one year to the next. However, this is not the case, as is demonstrated in the confidential note at Annex 1 attached which is derived from the illustrative figures contained in Annex A to your own letter.

7 The main points to arise from the analysis in Annex 1 are:-

(i) Your illustrative NAR-based levies would differ very substantially in the impact they would have from one ITV company to another. They would however strike at the production base of the industry because the five major companies which are currently responsible for about 85% of the network programmes (including programmes commissioned from independent producers) would be particularly badly hit.

(ii) If revenue growth falls relative to cost, then the burden of revenue-based levies is accentuated, quite possibly to the point at which substantial levy is payable even in the presence of trading losses. Annex 1 shows circumstances in which 8 of the 15 ITV companies would be incurring losses and yet these would be paying levy of some £120m. It was indefensible anomalies of this kind which brought to an end the NAR-based levy which operated up to 1974. Inflation rates were higher then, but this is not central to the problem. It is the relative movement of revenue and cost which does the damage. Given the downward pressure which will be placed on ITV revenues in 1993 and beyond, as new services come on stream, we do not believe that a revenue-based levy could survive into the middle 1990s. It must be regarded as a short life measure. A profit-based levy, or a mixed levy based partly on NAR and partly on profit, would have the necessary resilience to extend beyond 1992.

8 You will see from Table 5 of Annex I that, even on favourable assumptions about revenue and cost movements, your illustrative revenue-based levies would increase the levy liability of the five major production companies by between 43% and 80%. For one company, levy liability would double in your lowest yield option, and increase by two and a half fold in the highest yield case. This would reduce the company's profit from £35m in 1990/91 to between £19m and £12m.

9 The announcement of new levy structures which would have consequences of this magnitude would lead to the most striking deterioration in stock market confidence in ITV, and in the value of their shares. If, in these circumstances, the companies' efforts to reinstate profitability were to be focussed on the need to secure greater efficiency, then even so harsh a change might have merit. But this is not what would happen. Changes of this magnitude and at such short notice (bearing in mind the gestation period for programme production) must strike at programme budgets. The companies would be under considerable financial pressure to focus narrowly on low-cost popular programme types, including imported material. There would be substantial resistance to the production of higher cost British drama and film, documentaries, or to meeting the proper costs of ITN and the fourth channel.

10 It would be unreasonable to impose such radical change in an extended contract period and at short notice.

11 We have experimented with some different forms of revenue-based levy to see if the problems referred to above could be alleviated. For example, in order to soften the impact on the companies we examined a NAR-based levy without a progressive rate structure, i.e. a system with just a free slice and a single rate. We found, however, that modifications of this kind still left intact over 90% of the increased levy liability which fell on the major production companies.

12 Another option, which - if Parliament were to decide on a NAR-based levy - we would strongly support, is that fourth channel subscriptions should be allowed as a deduction from NAR with only the net figure subject to a revenue-based levy. Under the Broadcasting Act, the ITV companies have to pay a subscription in return for the rights to advertise on the fourth channel; Channel 4 is an efficient, low-cost operation with an important programme remit which caters for specialised and minority audiences. The fourth channel subscription also meets the cost of S4C which (bearing in mind that the case for Welsh language broadcasting has never been a financial one) will always impose a net cost on ITV. There might be a case for some exemption of other special activities e.g. support for the Open College.

13 We do, however, find it impossible to see how a wholly NAR-based levy could avoid considerable damage to programme quality and range if it were to yield as much as, let alone more than the existing profits-based levy because it redistributes it in such a way as to have most impact on those who are obliged to produce most of the system's programmes.

14 At the same time I recognise the pressures which exist in the Public Accounts Committee (PAC) for some increase in the levy yield. One option to meet that concern could be a mixed part-NAR, part-profit-based levy. For example, initial modelling, on much the same illustrative basis as your own, indicates that if the existing levy rate of 45% on domestic profits were reduced to the 22.5% rate on overseas profits (so as to give 22.5% across the board), then an additional revenue-based component at about 7%, after allowing for an initial free slice, would give a yield equal to the pre-1986 levy. The principal features would be:-

(i) the introduction of the revenue principle;

(ii) a 50% reduction in the higher marginal levy rate on profits;

(iii) a yield of the kind for which the PAC is likely to press;

(iv) a substantially increased emphasis on cost-consciousness, but with much less risk to programme quality and diversity;

(v) scope, at a later date, if this were considered appropriate, for changing the balance between the revenue and profit components.

15 In summary:

(i) We have no doubt that a high yielding revenue-based levy would lead to a deterioration in programme quality, and in the period 1990 to 1992 that would be a major setback for commercially financed independent television.

(ii) The middle 1990s will see radical change and expansion in commercially financed broadcasting. That will bring in its wake great opportunities as well as risks.

(iii) With skillful management the end of the century will see more and better commercially financed broadcasting than ever before, but that will be jeopardised by a false start if, in the important transitional years between 1990 and 1992, there is a substantial deterioration in programme standards.

(iv) It would be unreasonable to impose such a radical change as a move to a high-yielding revenue-based levy in an extended contract period and at short notice.

(v) If Parliament decides a change is necessary, a move to a mixed NAR/profit based levy would better balance the sometimes conflicting objectives of broadcasting, efficiency and levy yield.

(b) <u>BSB</u>

16 I have dealt so far with ITV, but your letter also referred to BSB. There are three main points here. The first is that at no stage in its existence will BSB enjoy a monopoly profit from television advertising.

17 Secondly, even with a zero rate in the period 1990-1992, the possibility of future levy liability on a NAR basis (which takes no account of profitability) would be particularly damaging to this bold venture as it approaches the period of greatest commercial risk. Given that, in all probability, a wholly NAR-based levy cannot survive beyond the ITV extended contract period, the best course would be to omit BSB from short life legislation.

18 Thirdly, if in principle DBS were to be brought within the scope of a revenue-based levy, it would be indefensible to omit other UK based services broadcast on lower-powered satellites such as Astra. These will carry advertising and could provide strong competition for BSB. It may well be possible for the operators of lower-powered satellite services to put themselves outside the reach of UK taxation, but any levy legislation should be even-handed. The simplest course would be to omit satellite broadcasting of all forms from a revenue-based levy.

(b) Industry consultation

19 I now turn to the views of the ITV contractors. We have had full discussions at meetings with the Managing Directors on 12 and 21 July. They were greatly concerned at the possibility of a wholly revenue-based levy at the sort of yields envisaged in your illustrative figures. Even those who would do relatively well out of such a change recognise the damage to the system as a whole which would be caused by a levy which struck at the industry's production base.

20 If there had to be a revenue-based levy, then the companies would like to see it take a form which did not increase the relative burden on those companies which make and commission most of the network programmes. In this context, the companies would argue for the fourth channel subscription to be treated as a prior deduction from revenue so that levy was charged only on the net amount. Channel 4 have also argued strongly for this approach. There might well be a case for other deductions.

21 The companies consider that levy should remain on a profit basis which they regard as equitable, and which provides the best balance between their commercial and their broadcasting obligations.

22 As regards the yield of the levy, while the companies too recognise the sort of pressures which exist in the PAC for some increase, they believe that the Committee does not take into account the many millions of pounds that have been diverted from that yield to create and sustain Channel 4 and S4C. In spite of that, having got Channel 4 right, the yield is increasing and will continue to increase with the system's profitability.

23 In the course of discussion the following further points were made:-

(i) The companies had been prepared to face competition for new eight year contracts with effect from the 1st January 1990. They had, all along, expressed mixed views and reservations about the desirability and length of the contract extension which had been introduced to meet the needs of Government rather than those of the industry.

(ii) The companies must face the extended contract period essentially with their existing infrastructure, and the changes introduced in this period should therefore be minor rather than major and radical. The new contract period starting on 1 January 1993 would be the right moment to introduce major fiscal change.

(iii) Nearly all the ITV contractors have become public companies in recent years. They are already tackling industrial relations reform in a vigorous way (although in the short-term this involves the extra costs of redundancy etc). They are also adjusting production capacity to cope with access by independent producers, and the networking arrangements are in the process of reform. There is a limit to the amount of major change that can be absorbed at any one time without damage to investors' confidence, or the quality of the service provided to viewers. A radical change in the form of the levy at this stage and/or an increased yield on the scale recommended by the PAC, could have a disastrous effect on the market capitalisation of ITV companies, and consequently on their programme plans, their capital expenditure, their support of independent producers and their encouragement of the UK film industry.

(iv) The period of notice for a levy change which would become effective in January 1990 is too short. Many of the more expensive programmes take over a year to produce, and commitments have already been made on the basis that the production costs will attract levy relief when the programmes are actually transmitted in 1990 and beyond. This applies particularly strongly to the support given to feature films which have a three year period of cinema release before they are televised. Apart from the considerable equity problem this raises, the reconstruction of programme budgets, including programme cancellations, would begin as soon as a change in levy were announced. The present uncertainty is already producing cancellations and charges.

(v) The companies believe that the statements made by Mr. John Nott (the Treasury Minister) and Sir John Eden (the Minister of Posts and Telecommunications) when the end of a NAR-based levy was announced on 31 January 1974, apply just as forcefully today. (Hansard vol. 868 No. 54).

(c) BSB

24 We have also consulted BSB who share the IBA views expressed earlier. BSB have, however, laid particular stress on the following points:

(i) A revenue-based levy would lead to inequitable and capricious results between different contractors.

(ii) BSB will operate in a highly competitive environment from the outset.

(iii) The DBS venture involves investment in the order of £625m. The operating period needed to see this investment repaid is a lengthy one.

(iv) BSB investors need an assurance that levy would not be introduced at a positive rate before cumulative breakeven had been achieved, and this must necessarily be beyond 1992.

(v) Operators on Astra and Eutelsat will see the UK as amongst their prime target markets. A levy on BSB which was not extended to these other operators, or which did not recognise the major differences in start-up costs between them, would introduce a gross distortion in competition.

25 I have written at length, since the issues you have raised are of fundamental importance to the quality of the programme services which commercial television will be able to provide over the coming years. I hope that, before final decisions are taken, there will be an opportunity for us to meet and to discuss these issues further, perhaps on the basis of additional modelling carried out jointly by our respective officials.

Yours sincerely,

George

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COMPARATIVE ANALYSIS OF NAR

AND PROFIT BASED LEVIES

IN ITV

COMPARATIVE ANALYSIS OF NAR AND PROFIT BASED LEVIES IN ITV

SUMMARY AND CONCLUSIONS

1. The starting point for this note is Annex A to the Home Secretary's letter of the 6th June to Lord Thomson. This set out estimated total levy yields of four illustrative revenue (NAR) based levies, the existing profits based levy, and the pre-1986 profit based levy.

2. The following analysis:-

(i) reviews the numerical model which the Home Office have used to make their estimates;

(ii) shows the impact of the illustrative levy options on the individual ITV companies.

3. The main conclusions are:-

(i) Home Office figures for the yield of the existing and pre-1986 profit based levies are over stated by about 10%.

(ii) Had the yields for the profit based levies been more accurately stated, then the yields of the four illustrative NAR based levies would probably have been pitched 10% lower.

(iii) Projections into the early 1990s which are based on the latest NAR and cost figures for 1987/8 are probably better than averages over the three years 1985/6 to 1987/8.

(iv) The Home Office illustrative figures for NAR based levies would shift the burden of levy so as to take more levy from the larger companies which make or commission most of the expensive network programmes.

(v) The relationship between profit and revenue (ie, the profit margin) varies considerably between one ITV company and another.

(vi) The introduction of a NAR based levy would cause major disturbance in the cost and profitability of a number of ITV companies, including most of the larger ones. TV-am would be the main beneficiary.

(vii) NAR based levies respond poorly to a squeeze on profitability which arises from different growth rates for revenue and cost. This is not simply a phenomenon associated with high rates of inflation.

(viii) A NAR based levy is a limited life option which would not last beyond the three year extended contract period from 1990 to 1992. A longer life would lead to significant risk of substantial levy liability being associated with trading losses.

(ix) A profit based levy or a mixed profit/NAR based levy could, if necessary, survive until the competitive environment of the middle 1990s eliminated any remaining monopoly profit in ITV.

(x) The illustrative NAR based levies would depress the profits of some companies very substantially. It is inconceivable that these companies would not seek to reinstate their profitability by cutting costs, and this must include programme budgets. The lower programme expenditures would be visible on the screen.

THE HOME OFFICE MODEL

The Free Slice

4. All numerical modelling involves simplification, and therein lies both the strength and the weakness of the approach.

5. The main problem with the Home Office model is that when calculating the yield for the two profits based levies it was assumed that the free slice is fixed for each ITV company instead of being the greater of £1m (at 1990/91 prices) or 2.8% of net advertising revenue (NAR). A more accurate approach reduces the yield of the profit based options by about 10%, ie, from £133m to £120m for the existing levy, and from £177m to £158m for the pre-1986 levy.

6. Had the Home Office been aware of these adjustments, doubtless they would have pitched the yield of their illustrative NAR based levies at about 10% lower. For comparative purposes however an adjustment of this kind has not been made in the following tables.

7. Table 1 shows the impact of the various illustrative levy options as they would affect each of the fifteen ITV companies after adjusting the free slice. In order to reduce the amount of figuring however, only the highest (B1:R1) and the lowest (B2:R2) of the four NAR based levy options have been shown.

The Base Period

8. The starting point for the Home Office assumptions was NAR and profit averaged over the three years 1985/6, 1986/7 and estimated results for 1987/8. This averaging approach is probably more satisfactory for profits and costs than it is for NAR. Later information for 1987/8 is now available, and Table 2 shows what changes in revenue and costs (and hence profit) would have to take place between 1987/8 and 1990/91 if the Home Office working assumptions were to prove correct.

9. On average, over the three year period between 1987/8 and 1990/91 there would have to be an annual growth in advertising revenue of only 2.2%, and annual growth in ITV costs of only 0.3% both measured in real terms. These figures must surely be too low.

10. A better course is therefore to take the most recent figures for 1987/8 (which were not available when the Home Office made their calculations) and use them as the basis for producing estimated 1990/91 figures. The results of this alternative approach are set out in Table 3.

THE IMPACT OF THE ILLUSTRATIVE LEVY OPTIONS ON INDIVIDUAL COMPANIES

The Relationship Between Profit And NAR

11. If, within ITV, there were a stable relationship between profit and NAR then it should be possible to move from a profit to a NAR based levy without too much disruption. Table 4 shows for each ITV company the levy payable on the existing profit based system, as shown earlier in Table 3, but expressed as a percentage of NAR.

12. It can be seen from Table 4 that for the industry as a whole the yield of the existing profit based levy accounts for rather less than 9% of NAR. For the five major and the five large regional companies the figure is just over 8.5% of NAR, while for the five small regional companies it is much lower at 4.6%.

13. Within the three groups however there are very substantial differences between one company and another. Starting with the major companies, which produce or commission most of the network programmes, Central Television pays 6.57% of its NAR in levy, while Granada pays very much more at 11.34%. Within the large regional companies HTV pays 6.88% of its NAR in levy while Anglia pays much more at 9.48%. The disparity within the smaller regional companies is even greater ranging from 0.21% for Border to 6.33% for TSW. Finally, TV-am pays as much as 18.86% of its revenue in levy; very much more than any other company.

14. These disparities are not surprising bearing in mind the different obligations of network and regional contractors; the existence of dual regions; a weekend only contractor in London;

and a national breakfast service. But whatever the reasons, there is not a close correlation between revenue and profit as between one ITV company and another. The conclusion must be therefore that a revenue based levy that produces a levy yield equal to, or greater than, the existing profits based levy cannot be introduced without causing considerable disruption to costs and profitability at the individual ITV company level.

A NAR Basis Shifts The Levy Burden Between Companies

15. The scale of the disruption is illustrated in Table 5. This is derived from Table 3 and shows the percentage increase or decrease in yield which would occur for the two NAR based options, and the pre-1986 levy, compared with the existing profit based levy. For example, the highest yielding of the NAR based options (B1:R1) would increase the industry's levy yield by 55.7%, but the increase for the five major companies would be much higher at 80.3%. The increase for the large regional companies would be much smaller at 44.3%, while there would actually be a levy reduction of 12% for the small regional companies.

16. In other words, the illustrative NAR based options shift the burden of levy so as to fall more heavily on the major companies which currently provide over 85% of the expensive network programmes (ie, they either make these programmes themselves or commission them from independents). Despite the reform of the networking arrangements these companies are likely to supply a very large proportion of the network programmes for the foreseeable future. It might be possible to design a NAR based levy which did not shift the burden between groups of companies in quite such a marked way, but the disparities between individual companies within each group cannot be removed by modifying the bands or rates of a revenue based levy. This is an inescapable and damaging feature of NAR based levies.

17. For example, Table 5 shows that, under NAR based option B1:R1, TV-am (which provides a popular national breakfast service) would see its levy fall by 48.1%, while Central Television (which has a dual franchise involving separate studios and separate local programming for the East and West Midlands, which makes a major contribution to expensive and high quality network programming, and which has a strong export performance) would see its levy bill rise two and a half fold from £15m to £38m.

18. The problem is that a NAR based levy applies a single free slice and rate structure to all contracts no matter how different they may be in relation to, for example, size; whether their coverage is regional or national; governed by time of day or time of week; the prosperity of the region; or programming and dual region obligations.

The Relative Growth Of NAR And Costs

19. The analysis so far has been in terms of the disturbance which the introduction of a NAR based levy would create between one ITV company and another. But differential movements over time between the growth of NAR, costs and therefore profit are also important.

20. Table 6 shows levy yields for ITV as a whole on three different sets of assumptions about the growth of revenue and costs (and hence profits). The first assumption consists of 6% annual NAR growth in real terms and 3% annual real growth in costs, ie, the Home Office assumptions which were used as the basis of Table 3. The highest yield revenue based levy option (B1:R1) would lead to a 55.7% increase in levy for ITV as a whole compared with the existing system, while B2:R2 would give a 20.4% increase.

21. The second set of figures are based upon a lower NAR growth rate of 5.0%, with costs growing by 3.0%, ie, equally plausible assumptions, but involving a narrower gap between revenue and costs and thereby lower profitability. The figures in Table 6 show that the yield of the existing profits based levy would be much more responsive to this lower profitability than would the NAR based options. Option B1:R1 would now produce 73.8% more than the existing levy while B2:R2 would yield 33.8% more.

22. The final set of figures in Table 6 is based upon no real growth in NAR, but a 1.5% annual real increase in costs. This may be an unlikely scenario within the extended ITV contract period from 1990 to 1992, but would not be at all unlikely during the middle to later 1990s when competition for revenue from new broadcast services both terrestrially and by satellite is likely to become intense and yet the demand for additional programming will be strong. Again, the yield of the existing levy drops sharply to reflect falling profit, but for the NAR based variants the adjustment is very much smaller. As a result, the levy yield for the NAR based option B1:R1 is more than three times as high as the yield of the existing levy, while even for B2:R2 it is substantially more than twice as high.

23. The conclusion to be drawn from Table 6 must surely be that, at best, a NAR based levy could only be a short life option to cover the three year extended contract period. It could not survive into the more competitive broadcasting environment of 1993 and beyond without giving rise to indefensible anomalies.

..

The Impact On Profits

24. Finally, Tables 7 to 9 show the effect on ITV profitability of the three sets of NAR and cost growth assumptions which were used in Table 6.

25. Table 7 shows that the highest NAR based levy option B1:R1 involves a reduction in profit for ITV as a whole of £83.5m (or 32%). Some £69.8m (a fall of 45%) of this is attributable to the five major companies which make or commission most of the network programmes. At the individual company level, the fall in profit for Central alone would be over £23m (or 66%), while, at the other end of the spectrum, TV-am's profit would actually be increased by £6.1m (35%).

26. Tables 8 and 9 show that, as profit falls in the face of tighter margins, the damage to profits caused by NAR based levies increases very markedly. Indeed, for option B1:R1 in Table 9 it can be seen that eight of the fifteen companies (including four of the five majors) are driven into trading losses, and yet these same eight companies would between them be incurring a levy liability of some £128m. This is, to say the least of it, an anomalous situation, bearing in mind that the main purpose of levy is to deal with excess monopoly profit! It was anomalies of this kind which put an end to the previous generation of NAR based levy which operated in the decade up to 1974.

27. Even setting aside the bleak outlook reflected in Table 9, public companies faced with the sort of sudden and substantial increases in levy liability which NAR based levies would involve from January 1990, cannot be expected to react simply by acquiescing to a reduction in their profit or by rapidly increasing their efficiency. There are now daily reports of efficiency improvements in ITV, and the momentum of reform has taken hold, but this is not a process that can be accelerated at will. It is inconceivable - especially in the short-term of a year or two - that the sort of sharply increased levy liabilities referred to above would not lead to reductions in programme expenditure, quality and diversity of a kind which would be all too obvious on the screen. In the climate of the early 1990s it would be an attractive strategy for companies under commercial pressure to focus on a relatively narrow range of inexpensive but very popular programming. Faced with commercial pressures as powerful as this no regulator can sustain programme quality. Independent television involves a balance between commercial and public service broadcasting objectives. The regulator must work with the grain of commercial realities; he cannot meet commercial pressure head-on and hope to prevail.

PBR/jal/637.cor

TABLE 1

Estimated Yields In 1990/91 From NAR And Profit Based Levies

(Using The Home Office Assumptions)

££m at 1987/8 Prices

Band/Rate Structure	B1:R1	B2:R2	Existing Basis	Pre-1986 Basis
	££m	££m	££m	££m
Thames	37.0	30.0	18.3	23.2
Central	32.5	25.9	12.1	12.6
Granada	23.8	18.1	17.8	25.0
LWT	24.2	18.4	12.1	15.4
Yorkshire	17.9	13.5	8.7	12.1
	135.5	105.9	69.0	88.4
TVS	23.1	17.4	13.9	19.1
HTV	10.7	8.3	5.8	5.2
Scottish	9.3	6.9	7.8	11.5
Anglia	9.4	7.0	7.2	9.6
Tyne Tees	5.1	3.1	3.6	4.9
	57.6	42.7	38.3	50.2
TSW	2.1	0.9	2.2	3.2
Ulster	0.7	-	1.0	1.5
Grampian	0.6	-	0.9	1.3
Border	-	-	0.1	0.1
	3.4	0.9	4.1	6.1
TV-am	4.4	2.4	8.7	12.8
TOTAL	200.8	151.9	120.1	157.6

TABLE 2

Required Changes In 1987/8 NAR And Costs To Achieve

Home Office Figures for 1990/1

	Annual Real Change In NAR	Annual Real Change In Costs
	%	%
Thames	2.4	0.7
Central	1.2	(0.2)
Granada	1.3	(1.1)
LWT	3.6	1.3
Yorkshire	2.3	1.0
	2.1	0.2
TVS	1.7	(0.7)
HTV	3.0	1.3
Scottish	3.8	0.6
Anglia	1.5	(0.1)
Tyne Tees	3.7	3.2
	2.5	0.5
TSW	3.3	0.7
Ulster	3.7	0.4
Grampian	5.4	2.3
Border	3.7	-
	3.9	0.9
TV-am	(2.2)	(2.1)
TOTAL	2.2	0.3

TABLE 3

Estimated Yields In 1990/91 From NAR And Profit Based Levies

(Assuming Annual Growth of 6% in NAR, 3% in Costs From 1987/8)

££m at 1987/8 Prices

Band/Rate Structure	B1:R1	B2:R2	Existing Levy Basis	Pre-1986 Basis
	££m	££m	££m	££m
Thames	42.02	34.47	23.28	30.62
Central	38.49	31.29	15.44	16.47
Granada	26.10	20.14	19.62	28.33
LWT	29.12	22.85	16.42	22.22
Yorkshire	20.92	15.59	12.15	17.29
	156.65	124.35	86.90	114.93
TVS	27.25	21.17	16.31	22.89
HTV	12.15	9.45	7.11	7.68
Scottish	10.10	7.69	7.98	11.82
Anglia	11.20	8.72	9.29	12.89
Tyne Tees	5.71	3.60	5.33	7.69
	66.41	50.64	46.01	62.96
TSW	2.39	1.11	2.46	3.64
Ulster	0.85	0.00	0.99	1.47
Grampian	0.61	0.00	0.90	1.33
Border	0.00	0.00	0.02	0.03
	3.85	1.11	4.37	6.47
TV-am	6.57	4.40	12.66	18.72
TOTAL	233.47	180.50	149.95	203.07

TABLE 4

Levy On The Existing Basis As Shown In Table 3 As A Percentage Of NAR

	%
Thames	9.22
Central	6.57
Granada	11.34
LWT	8.73
Yorkshire	8.26
	8.73
TVS	9.12
HTV	6.88
Scottish	8.80
Anglia	9.48
Tyne Tees	8.68
	8.65
TSW	6.33
Ulster	4.22
Grampian	4.26
Border	0.21
	4.62
TV-am	18.86
TOTAL	8.88

TABLE 5

Percentage Increase (Decrease) In Levy As Shown In Table 3 Compared With The Existing Levy

Band/Rate Structure	B1:R1	B2:R2	Pre-1986 Basis
	%	%	%
Thames	80.5	48.1	31.5
Central	149.3	102.7	6.7
Granada	33.1	2.7	44.4
LWT	77.4	39.2	35.4
Yorkshire	72.1	28.3	42.2
	80.3	43.1	32.2
TVS	67.1	29.8	40.4
HTV	70.9	33.0	8.1
Scottish	26.6	(3.6)	48.2
Anglia	20.6	(6.1)	38.7
Tyne Tees	7.2	(32.5)	44.3
	44.3	10.1	36.8
TSW	(2.9)	(54.9)	47.8
Ulster	(14.3)	(100.0)	48.2
Grampian	(32.3)	(100.0)	48.1
Border	(100.0)	(100.0)	48.2
	(12.0)	(74.6)	47.9
TV-am	(48.1)	(65.3)	47.8
TOTAL	55.7	20.4	35.4

TABLE 6

Levy Yields And Indices For The Industry As A Whole In 1990/91

On Varying NAR And Cost Growth Assumptions

Band/Rate Structure	B1:R1	B2:R2	Existing Levy	Pre-1986 Levy
6% NAR Growth 3% Costs (as in Table 3)	£233.5m 155.7	£180.5m 120.4	£150.0m 100.0	£203.1m 135.4
5% NAR Growth 3% Costs	£224.7m 173.8	£173.0m 133.8	£129.3m 100.0	£172.5m 133.4
0% NAR Growth 1.5% Costs	£184.2m 327.2	£137.8m 244.8	£56.3m 100.0	£69.9m 124.2

Note: Levy yields are shown at 1987/8 prices.

TABLE 7

Estimated Post Levy Profits In 1990/91

For NAR And Profit Based Levies

(Assuming Annual Real Growth Of 6% In NAR,

3% In Costs From 1987/8)

££m at 1987/8 Prices

Band/Rate Structure	B1:R1	B2:R2	Existing Basis	Pre-1986 Basis
	££m	££m	££m	££m
Thames	22.61	30.17	41.36	34.02
Central	12.00	19.20	35.05	34.01
Granada	23.46	29.42	29.94	21.23
LWT	15.79	22.05	28.49	22.69
Yorkshire	11.30	16.63	20.07	14.93
	85.16	117.46	154.91	126.88
TVS	15.92	21.99	26.86	20.28
HTV	10.82	13.51	15.86	15.28
Scottish	10.17	12.58	12.29	8.45
Anglia	13.51	15.99	15.42	11.82
Tyne Tees	8.17	10.28	8.55	6.19
	58.58	74.35	78.98	62.02
TSW	4.18	5.46	4.11	2.94
Ulster	2.35	3.20	2.21	1.73
Grampian	2.39	3.00	2.10	1.67
Border	1.05	1.05	1.03	1.02
	9.98	12.71	9.45	7.35
TV-am	23.53	25.70	17.44	11.38
TOTAL	177.25	230.22	260.77	207.64

TABLE 8

Estimated Post Levy Profits In 1990/91
For NAR And Profit Based Levies
(Assuming Annual Real Growth Of 5% In NAR, 3% In Costs From 1987/8)

££m at 1987/8 Prices

Band/Rate Structure	B1:R1	B2:R2	Existing Basis	Pre-1986 Basis
	££m	££m	££m	££m
Thames	16.95	24.36	37.37	31.53
Central	6.73	13.79	31.35	31.70
Granada	19.58	25.44	27.21	19.52
LWT	11.57	17.73	25.53	20.83
Yorkshire	8.00	13.08	17.75	13.48
	62.83	94.40	139.20	117.06
TVS	11.91	17.88	24.04	18.51
HTV	8.50	11.02	14.23	14.27
Scottish	8.01	10.39	10.86	7.56
Anglia	11.17	13.63	13.88	10.86
Tyne Tees	6.70	8.80	7.58	5.58
	46.30	61.72	70.58	56.78
TSW	3.20	4.46	3.50	2.55
Ulster	1.76	2.54	1.85	1.51
Grampian	1.86	2.41	1.77	1.47
Border	0.74	0.74	0.74	0.74
	7.56	10.15	7.86	6.28
TV-am	21.93	24.08	16.38	10.72
TOTAL	138.61	190.36	234.03	190.84

TABLE 9

Estimated Post Levy Profits In 1990/91
For NAR And Profit Based Levies
(Assuming Annual Real Growth Of 0% In NAR,
1.5% In Costs From 1987/8)

££m at 1987/8 Prices

Band/Rate Structure	B1:R1	B2:R2	Existing Basis	Pre-1986 Basis
	££m	££m	££m	££m
Thames	-1.20	5.54	23.29	22.63
Central	-9.38	-2.93	19.03	21.57
Granada	6.67	11.89	17.31	13.27
LWT	-1.90	3.76	15.06	14.22
Yorkshire	-2.53	1.38	9.57	8.32
	-8.34	19.63	84.25	80.02
TVS	-1.01	4.49	14.03	12.19
HTV	0.73	3.10	9.23	10.23
Scottish	0.84	3.10	5.78	4.35
Anglia	3.42	5.74	8.38	7.38
Tyne Tees	1.87	3.88	4.15	3.42
	5.85	20.31	41.57	37.58
TSW	-0.04	1.12	1.41	1.26
Ulster	-0.16	0.31	0.31	0.31
Grampian	0.13	0.40	0.40	0.40
Border	-0.30	-0.30	-0.30	-0.30
	-0.37	1.52	1.82	1.67
TV-am	15.98	18.04	12.26	8.13
TOTAL	13.11	59.51	139.89	127.40

ANNEX

A) REVENUE ELEMENT

NAR	Rate
£m	%
0-15	0
15+	10

B) PROFITS ELEMENT

Profits (after deduction of revenue levy)	Rate
£m	%
0-1 (or 2.8% whichever is greater)	0
1+	25

Note 1 Rate applies equally to domestic and overseas profits

Note 2 Fourth Channel subscription included as now in expenditure relevant for levy purposes, but calculated as percentage of NAR before revenue levy

C) ESTIMATED YIELD IN 1990-91

£206m, compared to £203m ,under pre-1986 scheme

Note: assumes 6% real annual growth in NAR, 3% on costs from 1987-88 actual figures as set out in IBA letter of 28 July

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COPIES TO CST, FST, Sir P. Middleton, Mr ANSON, Mr PHILLIPS, Mr BURGNER, Mrs CASE, Mr SPACKMAN, Gilhooly, Mrs PUGH, Mr CAVE, Kaufman ~~Mr Bolt~~, Mr Tyrie

BF 16/9

HOME SECRETARY

QUEEN ANNE'S GATE LONDON SWIH 9AT

12 September 1988

Dear Chancellor of the Exchequer,

PSe

ITV LEVY FOR CONTRACT EXTENSION PERIOD

As you know, I wrote to the Chairman of the IBA on 6 June putting to him proposals for changing the levy from a profits to a revenue base from 1990. I enclose a copy of his reply. As expected, it sets out the Authority's concern that the change will produce a number of damaging consequences for the industry and for viewers. This view is also taken by the ITV companies themselves, who have complained to me in strong terms about our proposal to secure a substantial increase in the levy yield: the only support for the changes comes, not surprisingly, from TV-AM, the sole beneficiary of our proposal.

There is obviously a strong element of special pleading in all this and I can see no grounds for changing my view that the levy yield in 1990-92 should be no less than it would have been, other things being equal, had the structure not been modified in 1986. But it does seem to me that some of the points made by the IBA about the structure of the levy are valid, and lend support to my earlier view that we should, in what will be a short period of transition from the present ITV system to the much more competitive conditions of 1993, change to a levy based in part on revenue and in part on profits.

There are two points in particular to which I want to draw your attention. First, the redistributive effect on individual ITV companies. The IBA have worked out how the levy proposals in my letter of 6 June would affect ITV on a company basis. It is clear that the five largest ITV companies would be severely penalised, and this at a time when they will be taking most of the impact of the networking reforms and the moves to independent production which we have urged on them; but at the same time they will still be subject to fixed costs flowing from the obligations laid on them by the IBA when awarding their contracts.

HURD → CHEX 12/9

Second, we need to bear in mind that the ITV companies will be operating against the background of legislation to create new competition from 1993 and to put all franchises to competitive tender. In these circumstances they will obviously have very strong incentives to maximise profits while they can. This could involve, as well as desirable increases in operating efficiency, attempts to cut back on programme standards which would in turn lead to dissatisfaction on the part both of viewers, since there will not yet be new competing services on the 5th and other channels,

The Rt Hon Nigel Lawson, MP.

/over...

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and of advertisers who already think that ITV does not do a good job of attracting audiences. A levy based on revenue alone could distort the balance of incentives for ITV while it still occupies a monopoly position on terrestrial services. It could also produce the result that the yield would be less in proportion to profits during this period than if the present levy - which is after all specifically directed to excess profits - had remained in force. This could in turn expose us to further criticism by the Public Accounts Committee.

A levy based in part on revenue and in part on profits would, I think, strike a better balance. The Annex to this letter sets out a simplified scheme which my officials have discussed with the IBA. The yield will be commensurate with that of the pre-1986 levy; and since the revenue element will make up a major part of the yield, the pressure on costs will be strong. However, the adverse redistributive effects will be mitigated by the profits-based element and, if there is a profits bonanza, the Government will extract its due share in this way.

David Young may want to comment on the extent to which a mixed scheme would also go some way towards meeting the concerns put to him as well as me about the effect of levy changes on the UK film industry.

I hope that you and colleagues can agree that I should announce a scheme on the lines of the Annex, subject of course to any necessary adjustment of the rates before proposals are included in next year's Finance Bill. On this basis I would also conclude that there is no need to bring BSB within the scope of a levy scheme which governed only the period 1990-92.

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

Yours sincerely,

Approved by the Home Secretary and signed in his absence abroad.

BF 29/9 R/P

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From The Secretary of State for Wales

Rt Hon Peter Walker MBE MP

27 September 1988

Dear Douglas

ITV LEVY FOR CONTRACT EXTENSION PERIOD

I have seen a copy of your letter of 12 September to Nigel Lawson, and agree that the White Paper should include details of the scheme for changing the present system.

In his letter of 28 July to you the Chairman of the IBA argues that fourth channel subscription should be allowed as a deduction from NAR with only the net figure subject to a revenue-based levy. With our commitment to safeguard the future funding of S4C in view, and bearing in mind the desirability of treating the commercial sector equitably, I have some sympathy with his argument and I hope that it will receive careful consideration.

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

Peter

Rt Hon Douglas Hurd CBE MP
Secretary of State for the Home Department
Home Office
50 Queen Anne's Gate
London
SW1H 9AT

INDEPENDENT PROGRAMME PRODUCERS ASSOCIATION
IPPA

50/51 BERWICK STREET LONDON W1V 3RA
TELEPHONE 01 439 7034

BF 12/10

7 October 1988

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Rt. Hon. Nigel Lawson MP
Chancellor of the Exchequer
H.M. Treasury
Treasury Chambers
Parliament Street
London SW1

STYLES → CHEX 7/10

Dear Chancellor,

ITV Exchequer Levy

In the light of the government's desire to see 25% of ITV's new programming made by independent producers, we would wish to submit the enclosed document for your consideration.

We conclude that the Exchequer Levy could be changed to a tax upon net advertising revenue without damaging the ITV system. Nevertheless, to ensure the implementation of government policy with regard to regional programming, and the maintenance of Channel 4's revenue base, as well as independent production, it will be necessary to closely monitor the activities of ITV until such time as a genuinely free market in the supply of television programmes exists.

If you wish, we would be happy to expand upon our submission, either to yourself or to your officials.

Kind regards,

Yours sincerely,

Paul Styles
Director

Enc.

INDEPENDENT PROGRAMME PRODUCERS ASSOCIATION
50-51 BERWICK STREET LONDON W1V 3RA
TELEPHONE 01 439 7034

Submission to the Home Office, Department of Trade and Industry and HM Treasury

The ITV Levy and the UK Independent Production Sector

Registered Office: 9 Cavendish Square, London W1M 0DU
Registered in England Number 156 2364 VAT Number 340 5736 68

Overview

The Independent Programme Producers Association (IPPA) represents 620 British independent broadcast television production companies. As suppliers of programming to both ITV and Channel Four, independent producers have an active interest in the levy insofar as ITV revenue is called upon for commissioning programming. Accordingly, IPPA welcomes the opportunity to register its views, wishing to draw attention to the possible ramifications of changes in the levy.

1. Can the ITV Companies Pay More Levy?

The Levy debate has been dominated by bleak statements from the ITV companies regarding their prospects should the basis of the Levy be changed and their payments increased. In order to assess the substance of these and other fears, IPPA has prepared some estimates and projections of television advertising expenditure, net advertising revenue before levy (NARBL) and television expenditure and profits. In Table 1 are set out are projections for total UK television advertising expenditure and NARBL, 1984-1993.

Table 1

Television Advertising Expenditure and NARBL, 1984-1993

Year to 31/12	TV Advertising Expenditure (£m)	NARBL (£) (£m)	NARBL / TV Ad Spend
1984	1,249	911	0.73
1985	1,376	983	0.71
1986	1,675	1,183	0.71
1987	1,877	1,318	0.70
1988	2,083	1,431	0.69
1989	2,312	1,563	0.68
1990	2,566	1,684	0.66
1991	2,797	1,792	0.64
1992	3,049	1,881	0.62
1993	3,323	1,983	0.60

For the years 1984 to 1987, Advertising Association figures have been used. For the period 1988-1990, we have followed Phil Gullen and Laurence Hagan of J Walter Thompson who base their projections on an annual growth in TV advertising expenditure of 11%. Thereafter we have opted for a conservative 9% growth rate per annum, slowing to 6% in 1993. We acknowledge that there will be some migration of television advertising expenditure to the new outlets (Astra and BSB), although we do not feel these will be terribly significant until the end of the period (which is one reason for opting for lower growth estimates).

More significant will be the trend towards increasing production costs for commercials. These have been rising more quickly than advertising expenditure as a whole, for which reason we anticipate that NARBL will rise more slowly than advertising expenditure.

If the ITV companies stop selling Channel Four airtime, ITV NARBL will necessarily be reduced. The anticipated decrease is shown in Table X.

ITV Costs Which Are Pegged to NAR
In line with current arrangements, Fourth Channel subscriptions and, of course, the Levy itself, are functions of NARBL. Since subscription levels and net advertising revenues are broadly equivalent, the loss to the ITV companies of C4 advertising revenue will be offset by a drop in their costs since they will no longer be paying the subscriptions This is shown in Table 2

Table 2

Channel Four and S4C Subscriptions, 1984-1993

Year to 31/12	C4 & S4C Subscriptions (£m)	C4 NAR (£m)
1984	133	n/a
1985	163	75
1986	175	113
1987	183	155
1988	203	213
1989	224	244
1990	243	263
1991	265	280
1992	286	293
1993	305	309

Sources: IBA 1988 Annual Report. Projections for 1989 on are based on funding continuing at the same level. We anticipate C4 advertising revenues to be 15.6% of TV NAR.

For the purposes of comparison, we set out what the Levy would be if the basis were to remain the same as at present (with actual figures for the period 1984-1987) and if it were set in such a way as to represent 10% of NARBL over the whole sector. Since the difference between the present basis and a 10% of NARBL formula is not very significant, we have added a third column showing the effect of a 15% of NARBL formula.

It is assumed that the dramatic shortfalls in levy revenues to the Exchequer in 1984-86 would not be a factor in the subsequent period.

Table 3

Levy Payments by ITV companies, 1984-1993

Year to 31/12	On Current Basis (£m)	As 10% of NAR (£m)	As 15% of NAR (£m)
1984	24	91	137
1985	20	98	147
1986	75	118	177
1987	87	132	198
1988	97	143	215
1989	108	156	234
1990	119	168	253
1991	129	179	269
1992	138	188	282
1993	149	198	297

The effect on Levy, from 1989, of Channel Four advertising revenues ceasing to accrue to the ITV companies is shown in Table 4.

Table 4

ITV Levy Payments if Channel Four Airtime Is Not Sold by the ITV Companies

Year to 31/12	NARBL excl C4 (£m)	Levy at 10% NAR (£m)	Levy at 15% NAR (£m)
1989	1,329	133	199
1990	1,431	143	215
1991	1,523	152	228
1992	1,599	160	240
1993	1,686	169	253

Programme Costs
In July 1987, we prepared a paper, *Estimates and Projections of UK TV Output, 1982/3 to 1992/3*. In calculating and projecting programme costs here we have re-used these figures. Also taken into account here is acquired programming (news programming is included under New Originated Production). The use of acquired programming by the ITV companies is increasing faster than total programme transmissions because the extended transmission hours - daytimes and nights - feature larger proportions of bought-in material than the rest of the schedule. It is also assumed that the average cost per hour of acquired programming will increase as competition intensifies between broadcasters, replacing the cartel system operated between the BBC and ITV Central Buying.

Estimates and projections of programme costs, including transmission costs, are given in Table 5.

Other Costs
ITV companies incur administrative and sales costs in addition to programme costs. Table 5 incorporates estimates for these costs.

Table 5

ITV Programme and non-Programme Expenditure, 1984-1993

Year to 31/12	New Originated Programmes (NOP) (£m)	Other Programmes (£m)	All Programmes (£m)	Other costs (£m)	Total Spend (£m)
1984	525	37	562	155	717
1985	554	38	592	166	758
1986	604	45	649	233	882
1987	629	59	688	291	979
1988	824	77	901	308	1,209
1989	897	100	997	327	1,324
1990	947	120	1,067	347	1,414
1991	1,000	144	1,144	367	1,511
1992	1,056	172	1,228	389	1,617
1993	1,114	207	1,321	413	1,734

Profits
Not all ITV revenues are derived from advertising: programme sales and facilities hire are two other sources of income. If we set these total revenues from TV operations off against the programme and non-programme costs presented in Table 5, as well as the ITV companies Fourth Channel subscriptions (see Table 2 above), we obtain estimates for total expenditure and profits before levy.

Table 6

ITV Companies Revenues, Expenditure and Pre-tax, Pre-levy profits, 1984-1993

Year to 31/12	ITV Revenues (£m)	Total Expenditure (£m)	Pre-tax, pre-Levy Profits (£m)
1984	963	850	113
1985	1,069	921	148
1986	1,317	1,057	260
1987	1,489	1,162	327
1988	1,656	1,412	244
1989	1,851	1,548	303
1990	2,039	1,657	382
1991	2,218	1,776	442
1992	2,379	1,903	476
1993	2,562	2,039	523

The comparable figures if Channel Four costs and revenues are excluded are shown in Table 7.

Table 7

ITV Companies Revenues, Expenditure and Pre-tax, Pre-levy profits, excluding Channel Four, 1989-1993

Year to 31/12	ITV Revenues (£m)	Total Expenditure (£m)	Pre-tax, pre-Levy Profits (£m)
1989	1,617	1,324	293
1990	1,786	1,414	372
1991	1,949	1,511	438
1992	2,097	1,617	480
1993	2,265	1,734	531

The Impact of the Levy

Based on the estimates and projections laid out in Tables 3, 6 and 7, we can demonstrate the effect of the different levels and bases of the levy on ITV company profitability. These are presented in Table 8 (including Channel Four) and Table 9 (excluding Channel Four)

Table 8

Effects of Different Levels and Bases for the Levy on ITV Company Profits, 1984-93 (including Channel Four)

Year to 31/12	Pre-tax, pre-Levy Profits (£m)	Pre-tax profits with Levy on Current Basis (£m)	Pre-tax profits with Levy at 10% NAR (£m)	Pre-tax profits with Levy at 15% NAR (£m)
1984	113	89	22	-24
1985	148	128	50	1
1986	260	185	142	83
1987	327	240	195	129
1988	244	147	101	29
1989	303	195	147	69
1990	382	263	214	129
1991	442	313	263	173
1992	476	338	288	194
1993	523	374	325	226

Table 9

Effects of Different Levels and Bases for the Levy on ITV Company Profits, 1989-93 (excluding Channel Four)

Year to 31/12	Pre-tax, pre-Levy Profits (£m)	Pre-tax profits with Levy on Current Basis (£m)	Pre-tax profits with Levy at 10% NAR (£m)	Pre-tax profits with Levy at 15% NAR (£m)	Pre-tax profits with Levy at 20% NAR (£m)
1989	293	189	160	94	27
1990	372	256	229	157	86
1991	438	310	286	210	133
1992	480	341	320	240	160
1993	531	380	362	278	194

The pattern in Table 8 of steadily rising pre-tax and pre-levy profits is disturbed by the figures for the year to 1988. This is because we do not anticipate advertising revenues to rise as fast as the increase in transmissions; by being allowed by the IBA to exceed quotas on acquired material transmitted in the night-time schedules, the ITV companies will presumably succeed in keeping programme expenditure below the levels indicated here for 1988.

It is a matter of judgement to establish what would be a reasonable return on their investment for shareholders in an ITV company. The pre-tax profits presented in Table 8 are translated into percentages of total turnover in Table 10. The impact of excluding Channel Four is presented in Table 11.

Table 10

ITV Companies' Pre-tax Profits, as a Percentage of Total Turnover, Based on Different Levy formulae, 1984-1993 (including Channel Four)

Year to 31/12	Pre-tax profits with Levy on Current Basis (%)	Pre-tax profits with Levy at 10% NAR (%)	Pre-tax profits with Levy at 15% NAR (%)
1984	9.2	2.3	0.0
1985	12.0	4.6	0.1
1986	14.0	10.8	6.3
1987	16.1	13.1	8.7
1988	8.9	6.1	1.8
1989	10.5	7.9	3.7
1990	12.9	10.5	6.3
1991	14.1	11.8	7.8
1992	14.2	12.1	8.1
1993	14.6	12.7	8.8

In Table 11, the Levy formulae used are to produce, respectively, payments corresponding to 10%, 15% and 20% of NARBL.

2. General Issues

ITV and Channel Four Production Expenditure
Two factors influence the scale and character of the ITV companies' and Channel Four's programme production expenditure.

The first is the view taken by the ITV companies of their financial state. In 1985,

Table 11

ITV Companies' Profits, as a Percentage of Total Turnover, Based on Different Levy formulae, 1989-1993 (excluding Channel Four)

Year to 31/12	Pre-tax, pre-Levy Profits (£m)	Pre-tax profits with Levy on Current Basis (£m)	Pre-tax profits with Levy at 10% NAR (£m)	Pre-tax profits with Levy at 15% NAR (£m)	Pre-tax profits with Levy at 20% NAR (£m)
1989	18.1%	11.7%	9.9%	5.8%	1.7%
1990	20.8%	14.3%	12.8%	8.8%	4.8%
1991	22.5%	15.9%	14.7%	10.8%	6.8%
1992	22.9%	16.3%	15.3%	11.4%	7.6%
1993	23.4%	16.8%	16.0%	12.3%	8.6%

temporary downturns in advertising revenues led to the postponement or cancellation of a number of ITV productions. The decision by ITV companies to commit resources to production, especially of high-priced drama, is based on their assessment of currently and imminently available resources. The alternative, whereby independents are commissioned to produce the high-priced drama productions and ITV in-house resources are adjusted, is not one which the ITV companies seem so far to have entertained. Therefore, all things being equal, we would anticipate that a reduction in ITV revenues, such as would be produced by a levy on Net Advertising Revenue (NAR), would lead to a scaling down of programme commitments, causing a drop in programme quality and diversity.

We would also anticipate that such a reduction would lead to attempts by the ITV companies to lower the amount of Channel Four subscription they pay to the Independent Broadcasting Authority (IBA) or its successor authority, in the case of current subscription arrangements persisting.

The second, countervailing factor is the willingness and ability of the IBA or its successor to enforce programme standards, especially with regard to regional and local interest programming, arts, educational, minority and religious programming. In its currently uncertain state, the IBA is finding it difficult to ensure, against the background of increased reluctance on the part of the ITV companies to abide by IBA stipulations, adequate quality and quantity of these programme categories.
At a time when ITV companies are just starting, albeit reluctantly, to implement the government's policy of commissioning programming from independent producers, the upheaval resulting from the proposed levy changes may lead to new obstacles in the path of the 25% target set by the government. We believe that only by adopting explicit measures aimed at keeping the ITV companies on the 25% course, will the government's wishes in this matter be fulfilled. At the same time, if the levy changes have the effect of depressing total programme production, this will

offset some of the gains already made.

If the ITV companies, under the current arrangements, choose to respond to the revised levy arrangements by threatening to reduce their Channel Four subscriptions, the IBA is unlikely to be able to offer much resistance. If Channel Four is spun off from ITV, it will no longer have access to either the preferential terms offered by the ITV companies for the programmes they supply or the benefits of cross-promotion and complementary scheduling. Whatever changes are implemented regarding Channel Four's ownership and revenue base, it is desirable that the government guarantee the present levels of funding. It is imperative that Channel Four not be starved of resources, especially as the channel is already increasing its programme output faster than its income is rising. Any such reduction in overall resources would result in cutbacks in both the number and the value of commissions, thereby harming programme quality and diversity.

Regional Production

It is the government's stated objective to encourage and extend programme production in the regions. The ten non-network ITV companies have recently obtained from the five network companies greater access to the network. The non-network companies, because of their relative lack of flexibility in production resources, are already finding it hard to commission programmes from independent producers and at the same time maintain adequate production resources in-house. A relatively small drop in the regional ITV companies' programme budgets will adversely affect the level of both their own productions and those commissioned from outside.

In order to avert these threats, the government will be obliged to pay special attention to the status of regional production.

The Value of ITV's Independent Commissions

In his evidence to the Home Affairs Committee, Richard Dunn, speaking on behalf of the ITVA, stated that the current level of annual programme expenditure by the ITV companies was £750 million. If programming output is not to suffer, ITV companies must be encouraged to reallocate resources rather than reduce them. Leaving aside expenditure on news and news magazines,the 25% policy involves the ITV companies commissioning from the independent sector around 1,730 hours of programming costing approximately £135 million*.

We are concerned that, in the wake of the levy changes, regardless of the

*According to the 1987-88 IBA Annual Report, the ITV companies (excluding TV-AM) and ITN produced a weekly average of almost 185 hours of new programmes for transmission on the ITV channel. ITN network news constitutes about 9 hours 30 minutes-a-week; local news and news magazines average about 2 hours 30 minutes-a-week for each of the seventeen or so regions and sub-regions, making a total of about 42 hours 30 minutes-a-week.

On the basis of these estimates, we calculate that new programmes apart from news and news magazines represent 133 hours-a-week on average, or 6,900 hours per year. 25% of 6,900 hours is 1,730 hours. ITV's average cost per hour, based on Dunn's and the IBA's figures, is just under £78,000, hence the total value for the 25% segment of £135 million-per-year.

manœuvres indulged in by the ITV companies, these targets set by the government for 1992 are not reduced.

Funding Channel Four and S4C

The ITV companies have agreed that for the period up to 31 December 1992, funding of Channel Four will not be less than 13.6% of the net advertising revenue of the ITV companies in the previous year. S4C benefits from a similar arrangement, obtaining its monies on the basis of a further 2.4% of NAR in the relevant year. It is vital for both independent producers and the maintenance of programme quality that this agreement is honoured or, if replaced, that the arrangements do not prejudice the health of Channel Four. Programming commissioned from independents currently accounts for 49% of Channel Four's new originated programming hours, 51% of the channel's cost of programme transmissions and 43% of all Channel Four income. Independent producers hope that these percentages are maintained or improved.

Conclusions

From the estimates we have made and which are presented in the first part of this submission, we are confident that the government could increase the rate of Levy and still enforce its policies for programme quality and diversity without reducing ITV profitability to an unacceptable degree.

In Table 12 we show the extent to which ITV companies' profits are reduced with various Levy formulæ. The figures shown, based on those presented in Table 9, assume that ITV expenditure is maintained at its current level. Any reductions in overheads and other savings achieved are added directly to profits and reduce commensurately the impact of the Levy on profitability.

If the net effect of the formula adopted for the Levy is greater than about 10% of NAR, the ITV companies will be compelled to find savings or accept significant reductions in profits. It is not unthinkable that ITV profits be less than the 15% or more of turnover which would be achieved, all things being equal, with a formula corresponding to 10% of NAR. The returns obtained with a 20% of NAR formula might be considered unacceptably low. A formula pitched somewhere in between would produce substantial revenue for the Treasury, encourage greater discipline on the part of the ITV companies, while in no way reducing their ability to meet programme remits and independent access requirements.

Despite our confidence that all the government's broadcasting policy goals could be met in the circumstances of a revised Levy, we do not expect the ITV companies to generate lower profits than they can possibly help. It is likely that they will make determined efforts to reduce or restrict their programme and non-programme costs faster than they succeed in making real gains in efficiency. They will achieve this by reducing programme budgets and the volume of output, at the expense of the quality and diversity of British television.

Table 12

Impact of Different Levy Formula on ITV Companies Pre-tax Profits (excluding Channel Four)

Year to 31/12	Reduction in Pre-tax profits with Levy on Current Basis	Reduction in Pre-tax profits with Levy at 10% NAR	Reduction in Pre-tax profits with Levy at 15% NAR	Reduction in Pre-tax profits with Levy at 20% NAR
1989	35.4%	45.3%	67.9%	90.8%
1990	31.1%	38.4%	57.7%	76.8%
1991	29.3%	34.8%	52.1%	69.7%
1992	29.0%	33.4%	50.0%	66.7%
1993	28.3%	31.7%	47.5%	63.4%

We are convinced that only effective monitoring of ITV expenditure and output will ensure that both the television and the fiscal policy aims of the government are achieved. The price will be, however, lower rates of profit than, left to their own devices, the ITV companies would otherwise achieve.

By virtue of the Fourth Channel's current funding arrangements and the adoption by the government of the 25% target for independent production, the fate of the independent sector is inextricably linked to that of the ITV companies. The spinning off of Channel Four in a commercial television environment so dominated by ITV, does not materially affect this state of affairs. IPPA believes that the government can increase the scale of levy payments without necessarily reducing ITV programme output or expenditure: the ITV companies could meet the higher levy payments by reducing their overheads, enhancing internal efficiency and through increased use of independent productions.

There is, however, a real danger that the ITV companies will attempt to meet their levy obligations at the expense of independent access, regional production and Channel Four. If the ITV companies are allowed to scale down their commitments in any of these three areas, we feel it would be to the detriment of government initiatives to make the UK television sector more competitive, both nationally and internationally, while maintaining and enhancing quality and choice.

4 October 1988

dti

the department for Enterprise

PPS pl

BF 12/10

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

Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
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CHEQUER
10 OCT 1988
Mr PERFECT
CST, FST, Sir P. MIDDLETON, Mr ANSON, Mr PHILLIPS, Mr BURGNER, Mrs CASE, Mr SPACKMAN, MISS SINCLAIR, Ms PUGH, Mr CAVE, Mr BOLT, Mr TYRIE

10/10

L Young → CHEX 10/10

Direct line 215 5422
Our ref PB5AAC
Your ref
Date 10 October 1988

Dear Nigel,

ITV LEVY FOR CONTRACT EXTENSION PERIOD

In his letter to you of 12 September Douglas Hurd invited me to comment on the concerns which have been expressed in some quarters about the effect on the UK film industry of moving to a revenue-based levy for the ITV contract extension period.

I have indeed been lobbied by the film industry, who are worried that the change might seriously reduce, or even put an end to, ITV investment in feature films. The incentive to such investment which a profits-based levy provides is however a distortion; and while we should be prepared for further articulate lobbying on this issue, I do not believe we should allow it to divert us from moving to a revenue-based levy.

It has also been put to me that moving to a revenue-based levy for the contract extension period could undermine progress on independent access to ITV. I would view such an outcome with some conern. But I am reluctant to accept that the achievement of our target on independent access should be dependent on continuing with a tax regime which we otherwise regard as unjustified. If moving to a revenue-based levy does lead to a loss of momentum on independent access we shall simply have to consider whether other means can be brought to bear to ensure that our target is achieved.

In summary, therefore, I am not convinced that the arguments which have been advanced on films and on independent access provide adequate grounds for shifting from our original

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position that a revenue-based levy would be the correct approach for the contract extension period.

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

Yours ever
David

he.ln/Div/Levy

PPS pl..

FROM: R M PERFECT
DATE: 11 OCTOBER 1988

1. MRS CASE AR 11/10

2. CHANCELLOR

cc: Financial Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Burgner
Mr Culpin
Mr Spackman
Mr Farthing
Mr Gilhooly
Mr Cave
Mr Nicol
Mr Tyrie

PERFECT → CHEX 11/10

Ch/ A longish piece of advice which basically amounts to: "keep up the pressure" Draft OK? OK w ...
MPW

ITV LEVY FOR CONTRACT EXTENSION PERIOD

1. Your letter to the Home Secretary of 3 May suggested that the present levy on the profits of ITV companies should be replaced by a revenue levy for the period 1990 and 1992. The Home Secretary's reply of 12 September supports some of the IBA's criticisms of a revenue levy and favours their proposal for a mixed levy system. The Secretary of State for Trade and Industry's letter of 10 October supports the case for a revenue levy system. The Secretary of State for Wales' letter of 27 September argues that the fourth channel subscription should be allowed as a deduction from net advertising revenue for levy purposes.

2. You will recall that at the Independent Television Association's dinner in July, you were told that while the official ITV position was strongly wedded to a profits-based levy, in practice they would accept a mixed system of levies on revenue and "excess" profits. You asked for a progress report on the negotiations. I apologise for the delay in providing it.

Origins of the problem

3. Between 1964 and 1974 a revenue levy was used to extract monopoly profits from ITV companies. This was found to be unsatisfactory because it proved difficult to set at the right level and ignored cost pressures (John Nott, Minister of State, Treasury 31 January 1974 Hansard col 641-2, copy at Annex A). In 1974 a levy on domestic profits was introduced and set at 66.7 per cent. In 1986 this was reduced to 45 per cent and a new levy on overseas profits was brought in at 22.5 per cent. The yield on

the new levy has been less than expected and this shortfall has attracted NAO and PAC criticism. In February this year, you suggested that the opportunity should be taken to switch from a profits to a revenue based levy for the agreed extension of the existing contracts. Despite his earlier preference for a mixed profits and revenue levy, Mr Hurd consulted the IBA in June on the basis of an illustrative reevenue levy scheme. In their responses the Home Secretary and IBA are content to increase the yield back to what it would have been under the pre-1986 levy, (increasing the levy by roughly £40m-£60m depending on changes in profits and revenue). They accept this should be done by introducing a revenue element, but want this to supplement rather than replace the existing profit levy.

<u>Summary</u>

4. A straight revenue levy would do most to increase cost-consciousness in ITV companies. But Mr Hurd believes that, together with other incentives to cut costs, a revenue levy would lead to lower programme standards and dissatisfaction on the part of viewers and advertisers. He is also concerned that a revenue levy will redistribute the burden of the levy between companies, to the detriment of the large companies that produce most of the programmes. We believe there may be some force in the first argument but the second problem is overstated and could be solved by the IBA changing the network agreement and thus the distribution of programming costs.

5. A mixed system of levies on profits and revenues would ensure that the Exchequer benefits from the downward pressure on ITV costs caused by the prospect of having to compete for the new franchises at auction, and competition from satellite TV, local TV and Channel 5. Otherwise it would have similar effects to a revenue levy, but to a smaller degree.

6. The merits of the two approaches are finely balanced. But, given the greater pressures for efficiency from a revenue levy, the arguments against adopting it now appear unconvincing. We therefore recommend you continue to press the case for a revenue levy.

Revenue levy proposal

7. A revenue levy would increase ITV companies' incentive to reduce costs. This incentive has grown substantially in recent years as the main rate of corporation tax, and the levy on domestic profits, have been reduced. But ITV profits are still taxed at a marginal rate of 64 per cent.

Table 1 Incentive to minimise costs for ITV companies

	1982	1986 to 1988	mixed levy proposal	revenue levy proposal
Levy on domestic profits	67%	45%	25%	-
Main corporation tax	52%	35%	35%	35%
Marginal rate of tax on profits*	84%	64%	51%	35%
Incentive to minimise costs (% of cost improvements retained)	16%	36%	49%	65%

*ITV companies pay corporation tax on post-levy profits.

8. Increasing the incentive to minimise costs should encourage ITV companies to improve efficiency eg by reducing overmanning, and excessive overtime payments. There are signs that they are beginning to do this already in response to the competition provided by independent producers and the prospect of competition from satellite, local TV and Channel 5. The companies also know that they are likely to have to bid for the 1993 franchises and they need to reduce their costs so they can compete successfully at the auction. Efforts to improve efficiency are likely to be helped by the Monopoly Commission's report on restrictive labour practices in television, which is expected to be ready by the end of 1988.

9. The pressure to reduce costs may also lead to cuts in programme standards. Once the ITV contractors realise there will be no quality threshold for post 1993 contracts, they will have less incentive to spend on programme quality. In 1985 ITN told the Working Group which reviewed the ITV levy structure that a revenue-based levy would result in a reduction in the funding of ITN. The IBA's letter to Mr Hurd of 28 July repeats this suggestion and implies spending on drama, film and documentaries

would also suffer. If ITV companies adopt a low cost, low audience strategy to maximise profits, this would lead to dissatisfaction for viewers and advertisers in the period before wider choice becomes generally available. But the relationship between costs and popularity appears to be tenuous. Encouraging profit-maximising behaviour could equally well encourage more popular, inexpensive programmes that would benefit both viewers and advertisers.

10. The IBA argue that a revenue levy is likely to redistribute the tax burden between ITV companies. The five major companies currently bear the costs of providing over 85 per cent of the network programmes (either directly or by commissioning them from independents). These costs reduce profits but could not be set against a revenue levy. As a result the large companies would suffer from a switch away from a profits levy, though there is little difference in distribution between a mixed levy as proposed by the IBA and a revenue levy (illustrative figures at Annex B). However the IBA is currently reviewing the networking arrangements, and the allocation of costs, and changes here could ensure costs were more fairly distributed between ITV companies.

11. The British film industry will be adversely affected by any reduction in the levy on domestic profits, because the costs of financing films are used to reduce liability to levy. But the levy on ITV companies is not intended to support the film industry and the Secretary of State for Trade and Industry does not attach much weight to this point. Nor need you. Profitable films will ! continue to be financed. Others are of doubtful value. [So "Rambo" rules, OK!]

Mixed levy proposal

12. The IBA propose a mixed system, including a 10 per cent revenue levy on net advertising revenue (over £15m) and a 25 per cent levy on domestic and overseas profits (over £1m or 2.8% whichever is the greater). The fourth channel subscription would be netted off before the revenue levy was calculated. And the revenue levy would be provided for before liability for the profits levy was assessed. Under this approach about 2/3rds of the levy would be raised by the revenue levy and 1/3rd by the levy on profits.

13. Compared to present arrangements, a mixed levy would increase the incentive to reduce costs, but by less than a straight revenue levy (figures in table 1 above). And, because it has been proposed by the IBA, it would distance the Government from the inevitable criticisms from the ITV companies. The ITV Association has informally suggested to you that something on those lines would be acceptable.

Effects on the Exchequer

14. ITV companies profits may well grow over the period to 1993 as the prospect of competition forces them to reduce costs. Abolishing the levy on profits would ensure recorded profits grew even faster for two reasons:

(i) the levy on profits provides an incentive to attribute extraneous costs to domestic TV operations that would disappear;

(ii) abolishing the levy on profits will increase the incentive to generate them.

15. If the levy on profits is abolished now, the decision may appear mistaken in retrospect, because the Exchequer will appear to have missed out on a share of the growth in profits. On the other hand, if we are certain that real profits are about to increase regardless of the effects of the levy structure, we could increase the target yield from the revenue levy to compensate. This would be unpopular. If maximising the yield to the Exchequer is the overriding priority, a mixed levy structure appears preferable.

Independent Programme Producer's Association (IPPA)

16. IPPA's letter to you of 7 October concludes that a straight revenue levy could be introduced without damaging the ITV system. But they fear that, if the revenue levy is set at round 20 per cent of advertising revenue (as proposed), ITV companies will respond by reducing programme quality and diversity and by attempting to reduce their subscriptions to Channel Four to the detriment of independent producers. They recognise that the ITV companies could respond by reducing overheads, enhancing internal

efficiency and through increased use of independent producers. But they suggest that only by adopting explicit measures will Government keep the ITV companies on course for commissioning 25 per cent of programmes from independent producers by 1992. There is an element of special pleading here. But the thrust of the argument supports the case for a revenue levy and measures could be taken, if necessary, to ensure that the independent productions target was met.

Other Issues: Fourth Channel subscriptions

17. Mr Hurd and Mr Walker favour allowing ITV companies to deduct their subscription to Channel 4 and SC4 from revenue before the revenue levy is calculated. At present ITV companies have to pay 17 per cent of their net advertising revenue as their fourth Channel subscription. The effect of allowing them to deduct the costs before calculating liability to revenue levy would be to give the companies an extra free slice of revenue. So the rate of revenue levy would need to be set 2 per cent or so higher to compensate. We recommend you accept the proposal on that basis.

BSB

18. Mr Hurd proposes that BSB be excluded from the levy scheme which is only intended to cover the period 1990-92. BSB are presently subject to levy at nil rate and are unlikely to have recovered their investment in Direct Broadcasting Satellite of around £625 million by 1992. But in principle we favour keeping BSB within the levy arrangements, subject to a levy at nil rate, until that investment has been recovered. We recommend you seek to maintain the current arrangements for BSB.

Determining the rates of levy

19. The IBA argue that any revenue levy should use 1987-88 figures as a base, rather than the average of the last three years. 1987-88 could turn out to be a peak in revenue income, in which case the yield from a revenue levy would be less than the IBA's figures suggest. Whatever levy structure Ministers prefer, officials need to study the figures further to ensure estimates of future yields are prepared from a reliable base, and that the effect on the levy yield of reasonable variations in the assumptions are taken into account.

Finance Bill

20. The Home Secretary suggests the necessary changes to the legislation will be included in next year's Finance Bill. The levy is a tax and previous amendments have been made in Finance Bills, so we are adding this to the list of possible starters for the 1989 Finance Bill. However there is a Broadcasting Bill planned for the 1989-90 Session and it may be possible to use that opportunity to amend the levy in time for April 1990.

1993 and after

21. The draft Broadcasting White Paper contains proposals for commercial television for 1993 onwards. The draft says that from 1993 the levy will be raised on revenue alone and Mr Hurd is happy with that. He sees a parallel between a mixed levy and the combination of competitive tendering and revenue levy that is envisaged for 1993. But, unlike either a fixed payment made at the competitive tender or a revenue levy, a profits levy discourages cost-consciousness.

22. There is a slight risk that if you do settle for a mixed levy now it may be difficult to move to a revenue levy in 1993.

Conclusion

23. The merits of the argument are finely balanced. But we do not find the IBA's argument against a revenue levy convincing. The choice lies between encouraging cost consciousness by introducing a revenue levy or accepting a broader based mixed system that would ensure the levy yield reflected the likely growth in ITV profits. Since the desired yield can be set independently of the levy structure, we recommend you continue to press for a revenue levy. I attach a draft letter.

Resolving the issue

24. If the Home Secretary continues to oppose a revenue levy, the issue may need to be resolved at MISC 128. Lord Young favours a revenue levy despite the interests of the film industry.

Mark Perfect

R M PERFECT

Annex A

ORDERS OF THE DAY

INDEPENDENT BROADCASTING AUTHORITY BILL

Order for Second Reading read.

4.35 p.m.

The Minister of State, Treasury (Mr. John Nott): I beg to move, That the Bill be now read a Second time.

In introducing the Bill to the House this afternoon I must first pay tribute to my right hon. Friend the Minister of Posts and Telecommunications, who will be winding up the debate. He has been the principal participant in the long and complex discussions which have taken place with the Independent Broadcasting Authority and the Association of Independent Television Companies. It is he, with his knowledge of independent television, who will be dealing with the specific issues which may arise in the course of the debate.

Before dealing with the Bill, I should like also to express the Government's appreciation of the advice and assistance which has been given to us by the authority and the views which have been expressed by the industry.

In this connection I should mention that, before introducing the Bill, my right hon. Friends the Chancellor of the Exchequer and the Minister of Posts and Telecommunications together received a deputation from the independent companies, and the latter were invited to give a full exposition of their own views. All parties have been working for a considerable period with the same ends in view: a change in the system for assessing the levy and the fixing of a rate of levy which should be appropriate to the special circumstances of the industry and which should be regarded as a flexible instrument of control for the future. I am glad to say that we have succeeded in accomplishing this dual purpose, and I am able to commend to the House today a measure which is broadly acceptable to all concerned.

Frequently the mover of the Second Reading of a Bill develops his arguments at some length, and I suppose it is only natural that the author of a Bill should wish to do that. But on this occasion, since I have often, as a back bencher, been precluded from participating in debates by the undue length of Front Bench speeches, I propose to be relatively brief.

My principal themes this afternoon in moving this Bill will be, first, to explain the reasons which have led the Government to decide that the present method of assessing the levy imposed upon the companies should be changed, and, second, to explain how the rate of that levy has been chosen.

I should first like to ask the House to consider for a moment the virtually unique relationship between the Government, the authority, and the independent companies. Under the terms of contracts, which are renewable at regular intervals, the companies enjoy the use of the broadcasting frequencies. Their operations are financed by the sale of advertising time. For the period of their contracts, they have sole use of the franchise. From this, two consequences ensue—first, that the Government have a proper concern to ensure that the public interest is fully recognised by way of payment for the exercise of a public asset; and, secondly, that the companies should be enabled and encouraged to provide to the public a service of high quality in information, education, and entertainment. A balance has to be struck.

All hon. Members recognise the undoubted importance and very great influence of the television media. All those working in television have, at all times, a rôle of great responsibility in our affairs. For this reason alone it is vital that the arrangements for the financing of this medium should be such as to promote a healthy degree of competition between those seeking to enter this sphere and a full opportunity for those in the business to devote funds to the progressive development and improvement of programmes. Moreover, at this of all times, when accurate and unbiased reporting, careful and responsible presentation, and original and creative programmes are of special importance to the strengthening of our democratic processes and institutions, it is right that the arrangements for the financing of the industry should be, and should be seen to be, fair, reasonable and effective.

The programme contractors not only have the duty laid upon them of providing a public service in this country;

in the course of their activities they produce material which finds a market overseas, which makes a useful contribution to the balance of payments. In all this range of business, the programme companies also face the stimulus of competition from the BBC—a friendly rivalry which helps to promote discussion and debate as well as innovation.

I come now to the reasons which led us to propose the present measure and the change in the system for computing the levy on the programme companies. Hitherto, the levy has been imposed on the advertising receipts of the companies. The purpose of the Bill is to impose it upon their profits.

The Bill, in effect, is an amending instrument, and alters and supplements certain of the key provisions of the Independent Broadcasting Act 1973. The case for a change in the form of the levy was made manifest in a number of ways. First, the existing levy on revenue is, for obvious reasons, a very blunt instrument. In seeking to obtain a reasonable charge for the use of the franchise it took account of only one side of the programme companies' accounts. Advertising revenues have fluctuated considerably over the years and it has been necessary to make a number of adjustments in the rate of levy to take account of changing trends and prospects.

As any Treasury Minister and certainly the House would recognise, forecasting is a science which is far from perfect. It has, in practice, turned out in the past that an upward adjustment in the rate of levy was made at a time when the television business was on the point of a down-turn, and a downward adjustment when it was well on the road to a substantial recovery. In this way, adjustments of the present revenue levy can be seen with hindsight to have been somewhat ill-timed.

A second factor is, of course, that the old levy takes no account of the pressure on costs of the companies engaged in this business. Their financial viability would obviously be affected if this pressure was not allowed for in any way by the method used for assessing their liability to the levy—and, as I have said, periodic adjustments to the revenue-based levy raised very awkward problems of timing.

The obvious alternative to the present system is a levy upon profits, but I must make it clear that a levy on profits is not the same thing as a profits tax. The levy is designed, in the same way as a rental, to derive a return for the use of a national asset. After payment of levy, the profits of the companies are, of course, subject to corporation tax, as are the profits of any other companies.

The idea of a profits-based levy was seriously advanced well over three years ago. Why, hon. Members may ask, has it taken so long to make the change? I think that the main reasons are twofold. First, it was thought that such a levy might be difficult to administer and might give scope for avoidance. Second, there was the possibility that it might positively encourage excessive expenditure, in order to limit the profits assessable to tax.

It was with these problems in mind that the Government proposed that a study be made of the issues involved—a move which was welcomed by both the authority and the programme contractors, who had been advocating a change for some time. Last July my right hon. Friend was able to tell the House that the Government had concluded in principle that it was right to change to a profits basis.

The two main doubts about the change had by that time been resolved. First, we are concerned here, as I have said before, with an industry which has a unique relationship with Government, through the aegis of the authority. It consists of a very small number of companies, all of which are intimately known to the authority, which is responsible for monitoring and supervising their activities. The problem of potential levy avoidance in such a situation is, in the view of the authority and of the Government, wholly manageable.

The same goes for the risk of excessive expenditure, or "extravagance". There are powers in the Bill which would enable the Government to require special additional payments of levy in the event of a company's having incurred excessive expenditure. Moreover, the authority will be in a position to keep a close watch on this particular matter.

What are the main advantages of this new system? Quite simply, I believe that

[MR. NOTT.]

it will remove an important and damaging element of unpredictability from the operation of the levy system. As I have said, hitherto changes in rates have been made on the basis of revenue forecasts which frequently proved inaccurate. The new system now proposed incorporates an automatic regulator which increases the amount a company has to pay if its revenue rises disproportionately to its costs, and reduces the amount if the converse be true.

This should have one most important effect upon the programme companies' activities. Not only will it be possible for a company to plan more rationally and confidently its expenditure on programmes but, equally, in the event of a down-turn in profits its programme expenditure will not have to bear the first brunt of the cuts, as would be the case under the present far more inflexible procedure.

I should now like to turn to the rate of the levy which it has been decided to impose under this Bill. The proposal is that there should be a free slice, or tranche, of profits, which would not be subject to any levy. This slice would consist of a fixed sum of £250,000 in terms of profits, or of 2 per cent. of advertising receipts, whichever sum were the larger. The purpose of this arrangement is to give protection and security to the smaller and more potentially vulnerable of the companies. All profits above that level will be subject to a levy of 66·7 per cent. In fixing this figure, we have had regard to the level of the levy yield over past years in relation to the companies' aggregate profits and to the prospects for the future. There is no ideal way of calculating what levy should be paid for the frequencies, while leaving the companies with the funds, and the incentive, to improve programme quality. Last July my right hon. Friend said that a new-style levy would be designed substantially to increase the current yield of the existing system, because the companies had been earning considerable profits over quite a period of time.

We had regard to three criteria. The first was the need to secure an adequate return for the public from the franchise given to the companies. The second, was that, at a time of price and income restraint, the companies' profits should not, in relation to past levels, be excessive. The third, was that the profits-based rate should not be at such a high figure as to make the contracts unattractive and incur a risk of decline in programme quality for existing contractors and must not deter potential new contractors from entering the field, by making it difficult for them to raise the necessary capital.

In the year July to July 1972-73, advertising receipts were about £150 million, and profits before levy, interest and tax were over £50 million. The present levy yielded about £22 million. Over the same period, a profit-based levy at the rates in this Bill would have yielded about £33 million—an increase of about 50 per cent. On the basis of the criteria to which I have referred, our judgment has been that it would be reasonable for post-levy profits to amount to about £20 million in an "average" year. While this is some distance from the companies' view that a 50-50 share would be appropriate, the settlement at two-thirds/one-third, after the added advantage of the free slice, was accepted by the IBA as a sensible outcome.

The future yield of the levy is now uncertain. A short time ago one would have predicted that profits this year and next would have been similar to those in 1972-73, but the companies are encountering a bad patch at present and nobody can tell how long it will last. The virtue of the change to the new system is that it will automatically reflect changes in profitability, and provides greater stability than under the present system.

I must now follow tradition—not something that I always wish to do—and give a brief description of the Bill. Clause 1 substitutes a new section for Section 26 of the Act of 1973. After continuing, in subsection (1)(*a*), the existing provisions requiring payments to be made to the authority to enable them to meet their own expenses, the clause provides for additional payments to be made to the authority and for those additional payments to be calculated by reference to profits and not, as at present, by reference to advertising receipts alone. Some provisions supplementary to this clause are included in Schedule 1 which, among other things, defines profits and accounting periods and provides that the amounts are to be determined by the authority, whose determination is not to be called in

Annex B

FORECASTS OF ITV COMPANIES' POST-LEVY PROFITS IN 1990-91

UNDER DIFFERENT LEVY ARRANGEMENTS

	EXISTING LEVY	— REVENUE LEVY —		— MIXED LEVY —		DIFFERENCE BETWEEN MIXED AND REVENUE LEVIES
	PROFITS (£MS)	PROFITS (£MS)	CHANGE(1) %	PROFITS (£MS)	CHANGE(1) %	(£MS)
THAMES	41.4	26.4	-36.2	30.9	-25.2	4.6
CENTRAL	35.1	15.6	-55.5	21.6	-38.3	6.0
GRANADA	29.9	26.4	-11.7	25.6	-14.6	-0.9
LWT	28.5	18.9	-33.6	21.0	-26.5	2.0
YORKSHIRE	20.1	14.0	-30.4	14.5	-27.7	0.5
TVS	26.9	19.0	-29.4	20.3	-24.3	1.4
HTV	15.9	12.2	-23.3	10.9	-31.5	-1.3
SCOTTISH	12.3	11.4	-7.5	9.8	-20.5	-1.6
ANGLIA	15.4	14.8	-4.4	12.6	-18.6	-2.2
TYNE TEES	8.5	9.2	7.9	7.2	-16.0	-2.0
TSW	4.1	4.8	17.2	3.4	-17.6	-1.4
ULSTER	2.2	2.8	25.5	2.0	-8.9	-0.8
GRAMPIAN	2.1	2.7	28.4	2.0	-2.7	-0.7
BORDER	1.0	1.1	2.1	1.0	1.0	-0.0
TV-AM	17.4	24.6	41.2	18.9	8.5	-5.7
TOTAL	260.8	203.7	-21.9	201.7	-22.7	-2.0

NOTES : (1) PERCENTAGE CHANGES ARE COMPARED TO PROFITS UNDER EXISTING LEVY ARRANGEMENTS
(2) ANNUAL REAL GROWTH OF 6% IN NAR AND 3% IN COSTS ASSUMED

he.ln/Div/Levyl

CONFIDENTIAL

pl type final

DRAFT LETTER TO:

The Rt Hon Douglas Hurd CBE MP
Secretary of State for the Home Department
Home Office
Queen Anne's Gate
LONDON SW1H 9BW

BROADCASTING WHITE PAPER

Thank you for your letter of 12 September, which covered a copy of the IBA's reply of 28 July. I have also seen Peter Walker's letter of 27 September and David Young's letter of 10 October.

The IBA accept that a revenue levy would promote cost consciousness, but oppose it on other grounds. You drew my attention to two particular difficulties. First a move away from a levy on profits would redistribute the burden of the levy between companies. In practice, there does not seem to be much to choose between the revenue levy arrangements which you put to the IBA and their own mixed levy proposals ~~on the basis of central assumptions about cost and revenue grounds~~. And to the extent that the ~~move~~ change in burden reflects differences in efficiency, that is fully ~~this need not concern us~~ justification. Insofar as it reflects the distribution of costs imposed by the IBA, the remedy lies in the hands of the IBA and ITV companies who could improve the distribution by ensuring the costs of programming are fairly shared between the ITV companies.

Second, you suggest there will be a variety of pressures on ITV companies to reduce costs and, if a straight revenue levy is introduced, programme standards may be cut. I agree that if the ITV companies were to adopt a ~~low cost~~ strategy which created

[Indeed, isn't it precisely what we're trying to get at?]

dissatisfaction in the period before wider choice becomes available, there would be cause for concern. But it seems unlikely that any commercial television station would find it profitable to drop programme standards in a way which resulted in lower viewing figures.

I do not therefore find the arguments against a revenue levy convincing. Consequently I continue to favour doing as much as we can to encourage efficiency in the television industry, by adopting a straight revenue levy.

There are two related issues raised in the correspondence. Peter Walker has suggested that subscriptions to the fourth channel should be allowed for when calculating liability for revenue levy, and I am content with that. On BSB, I would hope the current arrangements under which they are subject to levy at nil rate could be continued. This would maintain the principle that television channels broadcast over scarce spectrum are subject to levy, without damaging the prospects of BSB earning a return on their investment.

I am copying this letter to the recipients of yours.

NIGEL LAWSON

MP

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

17 October 1988

The Rt Hon Douglas Hurd CBE MP
Secretary of State for the Home Department
Home Office
Queen Anne's Gate
LONDON SW1H 9BW

cc Financial Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Mr Burgner
Mr Culpin
Mr Spackman
Mr Farthing
Mr Gilhooly
Mrs Case
Mr Cave
Mr Nicol
Mr Perfect
Mr Tyrie

Dear Secretary of State

ITV LEVY FOR CONTRACT EXTENSION PERIOD

Thank you for your letter of 12 September, which covered a copy of the IBA's reply of 28 July. I have also seen Peter Walker's letter of 27 September and David Young's letter of 10 October.

The IBA accept that a revenue levy would promote cost consciousness, but oppose it on other grounds. You drew my attention to two particular difficulties. First a move away from a levy on profits would redistribute the burden of the levy between companies. In practice, there does not seem to be much to choose between the revenue levy arrangements which you put to the IBA and their own mixed levy proposals. And to the extent that the change in burden reflects differences in efficiency, that is fully justifiable. Insofar as it reflects the distribution of costs imposed by the IBA, the remedy lies in the hands of the IBA and ITV companies who could improve the distribution by ensuring the costs of programming are fairly shared between the ITV companies.

Second, you suggest there will be a variety of pressures on ITV companies to reduce costs and, if a straight revenue levy is introduced, programme standards may be cut. I agree that if the ITV companies were to adopt a strategy which created dissatisfaction in the period before wider choice becomes available, there would be cause for concern. But it seems unlikely that any commercial television station would find it profitable to drop programme standards in a way which resulted in lower viewing figures.

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I am copying this letter to the recipients of yours.

Yours sincerely,

Moira Wallace

pp NIGEL LAWSON

Approved by the Chancellor and signed in his absence.

✓ 1/11

HOME SECRETARY
QUEEN ANNE'S GATE LONDON SW1H 9AT

1 November 1988

Dear Nigel,

ITV LEVY FOR CONTRACT EXTENSION PERIOD AND BSB LEVY

This letter seeks your response on the two levy issues above.

ITV Levy

Thank you for your letter of 17 October about the ITV levy for the contract extension period. I have also seen Peter Walker's letter of 27 September and David Young's of 10 October.

I remain concerned about the consequences of moving direct to a levy based solely on ITV revenue for the period 1990-92.

Your letter suggests that the redistributive effects of a revenue levy are not significantly different from those of one based on a mixture of revenue and profits. But we should not overlook the substantial impact on some companies. For example, as figures prepared by your officials show, Central TV would pay an extra £20m a year of its post-levy profits if there was a switch to a revenue levy in 1990, compared with an extra £13m under a mixed levy. In percentage terms, that company could expect a revenue levy amounting to some 70% of its gross profits. It has always been accepted that it would be wrong to introduce fundamental changes affecting ITV investors in mid-contract; and for practical purposes 1990 will be mid-contract. The ITV companies will all have the strongest possible incentives to reduce costs, and I see little prospect of the IBA being able to persuade some to take on others' obligations and associated costs at the same time as it is striving, in accordance with our wishes, to make the networking arrangements more competitive.

You also suggest that ITV would be deterred from reducing programme standards in a way which resulted in reduced viewing figures. But there is of course no direct relationship between the two - nor in the short term between viewing figures and profitability. After 1993 we will have a much more competitive market in which commercial stations who regularly neglect the

/satisfaction of

The Rt Hon Nigel Lawson, MP
Chancellor of the Exchequer

satisfaction of viewers and advertisers will be exposed to the financial consequences. Until then I remain concerned that a revenue-only levy would encourage ITV, at little or no risk to itself, to take money out of programming in ways which would not only make the output less attractive in international markets but would also work against the interests of advertisers who already complain that ITV is not achieving the right size or quality of audiences. At a time when we are promoting such a massive liberalisation of television we must guard against the accusation that we are careless of quality. By contrast a scheme which incorporated a profits element would help to maintain a balance of incentives for ITV companies still occupying a monopoly position in terrestrial services.

[this cuts both ways]

We also have to consider the link between our decision on this point and the general debate about the regime after 1993. The ITV companies, with their supporters in Parliament, are likely to be our sharpest opponents, because of their fears of competitive tender. I would like to avoid sharpening this opposition still further by our decision on the levy in the interim period. We are going to have a hard ride as it is.

I hope therefore that you might feel able to reconsider the arguments advanced in my letter of 12 September for the compromise solution of a mixed levy. It is already a compromise well tilted towards your point of view, since the mixed scheme would consist of three quarters yield from revenue, and only one quarter from profit. It will, I think, be fairer to both ITV companies such as Central and to viewers while still offering the substantial incentives to efficiency which I am as anxious as you should be achieved.

X

BSB Levy

... I enclose a copy of a letter I have received from the Chief Executive of BSB seeking guidance about the Government's intentions with regard to the levy.

You will recall that your letter of 17 October about the ITV levy recorded your hopes that BSB should continue to be subject to levy at nil rate, rather than taken out of levy liability altogether as the IBA had proposed.

After 1992, the levy on DBS services will be based on revenue rather than profits, in line with terrestrial ITC services. There can, however, clearly be no question of imposing a positive rate until BSB has achieved cumulative breakeven: the point at which it would only become subject to levy in principle under the present law.

/Assuming that

Assuming that it does so, I would like to be able to tell BSB that in considering whether there were good grounds for moving from a nil to a positive rate we would take into account the factors mentioned in their letter, especially the existence of competition from satellite channels such as Astra not subject to levy liability in any way. To leave the position entirely open or, worse, to tell BSB that we would aim in principle to assimilate DBS to terrestrial services for levy purposes, would make it much more difficult for BSB to secure their next tranche of investment. I would not think it right to go as far as the IBA has proposed; but I have a good deal of sympathy with the BSB argument that it would create an uneven playing field if they carried levy liabilities which Astra or other non-DBS satellite services escaped.

... I enclose the draft of the reply which I would like to send BSB, which I hope you will agree gives an acceptable steer without offering any unnecessary hostages to fortune.

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

Yours,

Douglas.

BSB

BRITISH SATELLITE BROADCASTING
70 Brompton Road, London SW3 1EY
Telephone: 01 581 1166
Facsimile: 01 589 9493/9494

17 October 1988

Rt Hon Douglas CBE MP
Secretary of State for
the Home Department
The Home Office
Queen Anne's Gate
LONDON SW1

Dear Home Secretary

The ITV Levy

My colleagues and I look forward to the opportunity of presenting our revised Business Plan to you, Lord Young, Tim Renton and a small group of officials on 27 October. In advance of that meeting I wanted to write about BSB's position under the ITV Levy. This has been highlighted by our financial advisers as an element where clarification will be vital in advance of our raising our Second Round Finance.

It is common ground that BSB will continue to be zero-rated, at least up to the end of 1992. I understand the difficulty which the Government may feel about giving assurances as to the future of the Levy or BSB's position under it when the Levy itself may be substantially changed once again after 1992. However, when we come to produce our prospectus for potential shareholders an indication of the Government's longer term intentions and the principles which it would intend to observe in weighing BSB's position under the Levy is of considerable importance.

BSB would submit, especially in the developing competitive climate envisaged for broadcasting in the 1990s, that the arguments normally advanced in support of the ITV Levy do not support changing BSB's zero-rated status. Before going through these arguments I should make a general point about the scale of risk and investment involved in BSB as compared with the risk and start-up costs for an ITV

/2

contractor. I understand that the start-up cost for a new medium sized ITV company at the start of the last franchise period were some £10 million - the basic transmitter network already being in place. The pre-operational costs of TV-AM were £6 million. I understand that, despite the much publicised crises which shook that enterprise, they had only to sustain losses of £20 million before turning the corner into substantial profitability. By way of contrast, BSB will face a far more competitive environment - without the technological advantage of instant access to the full universe of homes - and will have to finance a total investment of some £900 million. Thus, for BSB to be subject to the Levy in the period after 1992 and especially before real terms pay back has been achieved would seem wholly wrong. It would involve paying what is popularly seen as an excess profits tax to the Exchequer before our own shareholders have received their initial funding back. The imposition of Levy would have a major impact on rates of return through the project period and the Government's position is, therefore of major importance to our existing and future investors.

I now turn to the three justifications normally advanced for the ITV Levy and suggest that they have limited relevance to BSB.

i) <u>A tax on monopoly profits</u>: BSB will enjoy no monopoly or dominant position in the sale of advertising. It will face competition from ITV, Channel 4, perhaps Channel 5, Astra and, ultimately, locally-based MMDS services.

ii) <u>Payment for the use of a public asset (the broadcasting frequencies)</u>: While it is true that BSB will use scarce frequencies we are doing so after a competition to determine which potential operator offered the best service for the UK public and using only private investment. I would remind you that the DBS project in France has, for example, absorbed some £300 million in public money and that BSB is the only entirely privately financed DBS project in Western Europe or Japan. The DBS frequencies are virtually without value in advance of a vast investment in satellite hardware and a ground infrastructure. The frequencies will, thus, only be of substantial value after BSB's investors have borne the risk and developed them. It is relevant to note that frequencies for direct to home satellite transmissions are not as scarce as was once envisaged since changing technology has opened telecommunications frequencies for this purpose.

iii) <u>A prompt to greater efficiency</u>: The changes in the Levy which the Government has recently proposed are clearly intended to exact an efficiency squeeze on ITV contractors. Although companies like Tyne Tees, Ulster and Thames have made strides in improving working practices there is still some way to go to ensure that more advertising revenue is spent on better programming rather than being frittered away on restrictive practices. When such practices arise from a monopoly position it may be justifiable in the short term to use taxation as what amounts to an instrument of an interventionist industrial policy. However, extracting Levy from BSB could hardly be justified on such grounds. BSB has indeed, been an instrument for improving efficiency in the rest of the industry - as recent reforms in working practices at ITN have shown. BSB will commission the great majority of its programming out of house. It would be wrong, therefore, to penalise BSB for historic inefficiencies in the rest of the industry.

If, in the longer term, a Levy remains and the Government contemplates changing our zero-rating then there is a further issue which should be addressed. BSB is not only in competition with terrestrial broadcasters but also with other satellite operators either using other nations' DBS frequencies or telecommunications satellites. Operators on Astra and, potentially Eutelsat II, see the UK as amongst their prime target markets. If the Government is to avoid placing BSB, as the UK's official satellite operator, at a disadvantage it will need to devise a Levy to catch such operators whose start-up costs, as well as their commitment to the UK viewer, will be substantially lower than BSB's.

BSB is a uniquely ambitious project which will help to deliver a number of the Government's stated broadcasting objectives. The operating period needed to see investment in the project repaid is already a lengthy one. The potential rewards for investors are good but far from dramatic when seen in the context of the risks undertaken. For there to be uncertainty about the Levy would dissuade a significant number of potential investors when BSB raises its next major tranche of funding.

I am sorry not to have written directly at the time of your consultations with the IBA. It seemed only right, however, for us to precede our representations with a thorough revision of our own Business and Funding Plans. I hope that the Government will be prepared to give publicly useable guidance as to its intentions in regard to BSB and the Levy.

I am copying this letter to the Director General of the IBA.

Yours Sincerely

Anthony Simonds-Gooding

Anthony Simonds-Gooding

Draft letter for signature by the Home Secretary to:

Anthony Simmonds Gooding, Esq
Chief Executive
British Satellite Broadcasting Ltd
70 Brompton Road
LONDON, SW3 1EY

LEVY

Thank you for your letter of 17 October.

I fully understand your wish to have publicly usable guidance about the Government's future intentions with regard to the levy, bearing in mind your need to attract additional investment.

The liability of operators of commercial television services to levy reflects their use of a public resource in the form of internationally assigned and protected frequencies. I therefore see no grounds for amending the present law so as to exempt BSB (or any other DBS contractor) from such liability.

However, I have already made clear, as you know, that if DBS services were to be subject to a levy based on revenue rather than profits they would continue to be zero-rated during the period to the end of 1992. In the light of the points made in your letter I am able to set out the approach we would propose to adopt in the subsequent period. First, we would not contemplate anything other than a zero rate for so long as BSB was not in cumulative profit. The possibility of payment of levy would not

/of course

of course arise under the present law unless this were the case. Second, once BSB had achieved cumulative profit, consideration would need to be given in the circumstances at the time by the Government of the day to the case for moving beyond a zero rate. In considering whether such a move was justified, we for our part would want to have regard to the following factors: the scale of investment required, the time required to achieve breakeven, the levels of risk involved and the existence or otherwise of competition from operators of television services not subject to levy liability.

I hope that this is helpful. It does not give an unqualified assurance that BSB will continue to be zero-rated for levy in all circumstances, but we want to be satisfied that it would be fair and reasonable to depart from this position before doing so.

I am copying this letter to the Director General of the IBA.

SofS/Lawson

BF ~~14/11~~
15/11

CHANCELLOR OF THE EXCHEQUER

Ch/ see Mr Hurd's <u>personal</u> note to you behind, which we have of course not copied round. Are you minded to concede?

MPW.

Is X Correct?

Spoke to AC

HOME SECRETARY
QUEEN ANNE'S GATE
LONDON SW1H 9AT

1/xi/88.

Dear Nigel,

If you can temporarily forgo your $\frac{1}{4}$ lb. of flesh here, it would, I think, be a big help.

Yours,

Douglas.

BF ~~14/11~~
15/11

dti

the department for Enterprise

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

The Rt Hon Douglas Hurd CBE MP
Home Secretary
Home Office
Queen Anne's Gate
LONDON
SW1H 9AT

CH/EXCHEQUER
REC. 11 NOV 1988
ACTION MR PERFECT ✓ 11/11
COPIES TO CST, FST, SIR P MIDDLETON, MR ANSON, MR PHILLIPS, MR BURGNER, MRS CASE, MR SPACKMAN, MR GILHOOLY, MR NICHOL, MR CAVE, MR BOLT, MR TYRIE.

Department of
Trade and Industry

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Direct line 215 5422
Our ref PS4BMR
Your ref
Date 11 November 1988

Dear Douglas,

BSB LEVY

Thank you for sending me a copy of your letter of 1 November to Nigel Lawson.

BSB have a major task ahead of them to raise their £700m second round financing next year. It is clearly right that they should be given some publicly usable guidance about their future levy position. This needs to be as positive as possible, without, as you say, offering any unnecessary hostages to fortune. I therefore fully agree with the line you propose to take.

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

Y.e.
David

he.dc/perfect/sub3

pl BF 15/11

FROM: R M PERFECT
DATE: 11 NOVEMBER 1988

1. MRS CASE AC 11/11

2. CHANCELLOR

cc: Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Phillips
Mr Culpin
Mr Spackman
Mr Farthing
Mr Gilhooly
Mr Cave
Mr Nicol
Mr Tyrie

Ch/ Answer to your question behind on Mr Hurd's letter seems to be that mixed scheme is indeed slanted towards our point of view (see paras 4 ff below). Hence, I assume, Mr Hurd's unShakespearean 1/4 lb of flesh - we have already had 3/4 lb! MPW.

ITV LEVY FOR CONTRACT EXTENSION PERIOD AND BSB LEVY

1. The Home Secretary's letter of 1 November continues to press the case for a mixed levy in the period 1990-92. He also raises a question on the BSB levy.

2. The choice between a mixed or revenue levy is finely balanced and we doubt whether it is worth forcing the issue to MISC 128 to be resolved. Publication of the Broadcasting White Paper has provoked discussions which show there is widespread concern about the Government's commitment to quality television. This strengthens the case for accepting the IBA's proposal for a mixed levy, because a decision to adopt a revenue levy would be portrayed by critics as reflecting an uncaring attitude. Consequently, we <u>recommend</u> you now accept the case for a mixed levy. A draft letter, which also deals with the right legislative vehicle and the BSB levy, is attached.

<u>**The case against a revenue levy**</u>

3. Mr Hurd argues that for some companies the difference between a mixed levy and a revenue levy is significant. The companies most affected are shown in table 1:

Draft ok on as :-

Table 1: Forecasts of ITV companies post levy profits in 1990-91*

£ million

	Profits after existing levy	Profits after mixed levy	Profits after revenue levy	Difference between mixed and revenue levy
Losers				
Central	35.1	21.6	15.6	-6.0+
Thames	41.4	30.9	26.4	-4.6
LWT	28.5	21.0	18.9	-2.0
Winners				
TV AM	17.4	18.9	24.6	+5.7
Anglia	15.4	12.6	14.8	+2.2
Tyne Tees	8.5	7.2	9.2	+2.0
TOTAL	260.8	201.7	203.7	+2.0

* Assumes real growth of 6 per cent in advertising revenue and 3 per cent in costs. Figures for all companies at Annex B to minute of 11 October, agreed with Home Office.

\+ £7 million quoted in Home Secretary's letter reflects inaccurate roundings.

X

4. The proposed mixed profits and revenue levy is weighted towards the revenue element; on the IBA's central assumptions (in footnote to Table 1). 70 per cent of the levy yield comes from the revenue levy in 1990-91. This percentage would be higher if revenues grow faster, or costs grow slower than expected.

5. On the basis of the IBA's central assumptions the distribution between companies of the proposed mixed levy is broadly similar to that of the revenue levy. But Central Television do particularly badly out of a revenue levy because their contract with the IBA requires them to keep headquarters open in both Birmingham and Nottingham. The associated costs reduce their liability to a levy on profits but could not be set against a revenue levy. The Home Office are reluctant to invite the IBA to remove such conditions from contracts at this late stage of the contractual discussions, largely because the IBA would then have to consider representations from other companies seeking to renegotiate elements in their contracts.

6. The Home Secretary also suggests that it is undesirable to change the structure of the levy in mid contract, which for all practical purposes 1990 will be. We do not accept this argument, which could also be used against the mixed levy. The IBA forewarned the ITV companies in June that the Government favoured a revenue levy for the period 1990-91 before the companies decided whether to accept the option to extend their contracts. No company is compelled to accept the invitation.

7. Mr Hurd further argues that a revenue levy would encourage ITV to reduce spending on programmes in ways that will reduce audience satisfaction and hamper overseas sales of programmes. A revenue levy would increase the incentive to reduce costs and ITV companies may respond by lowering quality as well as by increasing efficiency. Spending on ITV programmes is in any event likely to be reduced now that the quality threshold for post 1992 franchises has been set lower than for previous periods and companies no longer see expensive programming as a way to retain their franchises. The Government is proposing to replace centrally imposed quality controls with a greater range of choice for viewers. A few people can already receive Direct Broadcasting by Satellite (DBS) and the numbers will begin to increase in 1989 when ASTRA and BSB begin to broadcast. But it will take a few years for most households to acquire the equipment needed to receive DBS. In practice, most viewers are unlikely to have much extra choice between 1990-92. So there is a case for postponing the introduction of the revenue levy until 1993 when extra terrestrial TV channels will start up, and more people will have access to DBS.

The case for a mixed levy

8. A mixed levy system would improve the incentive to reduce costs compared to present arrangements, but by not as much as a revenue levy. Table 2 below provides the figures.

Table 2: Split of extra revenue/lower costs between Exchequer and ITV companies

	Existing levy on profits (45%)	Mixed levy on revenue (10%) and profits (25%)	Straight revenue levy (20%)
Extra revenue			
Levy yield	45%	33%	20%
Corporation tax**	19%	23%	28%
Residual for company	36%	44%	52%
Lower costs			
Levy yield figure	45%	25%	0
Corporation tax**	19%	26%	35%
Residual for company	36%	49%	65%

* In mixed levy, the profits levy is calculated after the revenue levy has been deducted from profits.

** Corporation tax assessed after levy paid

9. A mixed levy will also ensure the levy yield reflects any growth in profits caused by cost reductions. Regardless of the levy structure, costs are likely to be reduced as ITV companies try and build up surpluses so they can bid successfully for post-1992 franchises. The Government would face criticism if the levy on profits was dropped just when ITV companies began to maximise profits for reasons unconnected with the levy structure. This is particularly relevant in relation to the PAC report on the levy published on Wednesday 9 November.

PAC report on 1986 levy changes

10. The PAC report examines the 1986 changes when the levy on domestic profits was reduced from 66.6 per cent to 45 per cent and a levy on profits from overseas programme sales of 22.5 per cent was introduced. The report notes that the revised levy rates were intended to have a broadly neutral effect on the levy yield. But the yield in 1986-87 was £19 million lower than it would have been under the previous arrangements, largely due to soaring domestic profits caused by a 20 per cent increase in advertising revenue. The report says the IBA and the Home Office failed to test the proposed levy changes against available information about likely changes in revenue and profits and describes this as "a serious error of

judgement". The Report welcomes the current review of the levy arrangements and urges that the review consider a wide range of options and safeguards, based on different profit levels. The Home Office and IBA have done some work on this but we need to check the details before recommending any specific mixed levy scheme.

Legislative options

11. The broadcasting industry and the Home Office expect any changes to the levy to be included in the 1989 Finance Bill - an option offered in your letter of 11 February 1988 (Annex A).

12. There are two other legislative options, neither of which is attractive. The legislation could be postponed to the Finance Bill 1990. But the legislation would then need to be retrospective to January 1990 (unless the introduction of the new levy was delayed) because the levy on each company is assessed according to that company's financial accounting period. So for some companies the new levy could take effect immediately the ITV contracts are extended in January 1990.

13. The legislation could also be included in the Broadcasting Bill planned for the 1989-90 session - the 1974 change to the levy was made in comparable broadcasting legislation. The Broadcasting Bill is expected to be published in November 1989, before the new levy takes effect. But Home Office officials dislike this option for two reasons. First the Broadcasting Bill may not reach the statute book until November 1990 and the IBA may find it difficult to continue to collect the levy on a monthly basis for such a long period without proper statutory authority. Second, the ITV companies need to know the details of the new levy before finally committing themselves to reviewing their contracts. This difficulty also arises if the 1990 Finance Bill is used. It could be reduced if the Government were prepared to commit itself to details of the new levy structure early next year. But there would then be a danger that unforeseen changes in revenues or profits would arise before Parliament considered the legislation. The Government could then only change its proposals to the companies' advantage, and at the expense of the Exchequer. A guess would be that there is about a one in three chance of having to make concessions worth £10-20 million from 1990-91 onwards.

14. In view of your concern about the length of the 1989 Finance Bill you could reasonably ask the Home Secretary whether he is prepared to seek the necessary legislation in his Broadcasting Bill. However he is likely to argue that the legislation must be included in the 1989 Finance Bill as suggested in your letter of 11 February. A decision on the right legislative vehicle should be taken before, or soon after, the Government announces what sort of levy will be used between 1990-92. In the absence of any decision to the contrary, the broadcasting industry will expect the necessary legislation to be included in the 1989 Finance Bill and if it is not their disappointment, and that of their Parliamentary supporters, will be all the greater.

<u>BSB levy</u>

15. The Home Secretary's letter of 1 November also argues that BSB need to be told more about when and how the levy will apply to them, so as to remove uncertainty before they attempt to raise finance for their next tranche of investment. At present BSB have been told the levy will be applied at a nil rate to 1992. And, under the changes to the levy legislation made in 1986, companies can carry forward losses so that the existing levy on profits does not bite until BSB reach cumulative profit. It would be reasonable to assure BSB that any new levy will be applied at a nil rate until they do reach cumulative profit.

16. However the Home Secretary wishes to go further and say that once BSB had reached cumulative profit, consideration would need to be given to the scale of investment required; the time required to achieve break even; the level of risk involved and the existence of competition from operators not subject to levy liability. Most of this is unnecessary - once cumulative profit is reached the past investment and the time taken to recover it will be matters of history as will the level of risk involved. As for the existence of competition from operators not subject to levy, the Channel 3, Channel 5 and local TV companies will also have to face this and there is no reason to treat a BSB in cumulative surplus differently from them. We recommend you resist going beyond an assurance that BSB will not be subject to levy until it is in cumulative surplus.

DTI's views

17. Lord Young is likely to support the case for extending the commitment not to subject BSB to positive levy rates. He will not be briefed to express a further view on the merits of a mixed or revenue levy - his letter of 10 October favoured a revenue levy.

Conclusion

18. Given the fine balance of the argument between a mixed and revenue levy and growing concern about quality, we recommend you accept the case for a mixed levy. The alternative is to take the issue to MISC 128. In view of your concern about the size of the 1989 Finance Bill, we suggest you explore whether the Home Secretary would be willing to include the levy legislation in the Broadcasting Bill although there are good reasons to expect him to refuse. There is also a small risk to the Exchequer in pursuing this course (paragraph 13 above). We also recommend you accept that a positive levy should not be applied to BSB until they make a cumulative profit. A draft letter is attached.

Mark Perfect

R M PERFECT

ps2/2M

Mr Kerley.

cc PS/Chief Secretary
PS/Financial Secretary
Sir P Middleton
Mr Anson
Mr Kemp Annex A
Mr Burgner
Mr Gilmore
Mr Spackman
Mr Burr
Miss Sinclair
Mr Bolt 1st
Mrs Pugh
Mr Cave
Mr Tyrie

Treasury Chambers, Parliament Street, SW1P
01-270 3000

11 February 1988

The Rt Hon Douglas Hurd CBE QC MP
Secretary of State for the Home Dept
Home Office
50 Queen Anne's Gate
LONDON
SW1H 9BW

ITV LEVY FOR CONTRACTING EXTENSION PERIOD

When I agreed in Autumn 1986 to your proposal to extend the existing ITV contracts so as to give time to consider properly the basis for fundamental changes to the broadcasting system, I suggested that we should not lose sight of the possibility of moving to a levy based on revenue rather than profit for the period of the ITV contract extensions.

There is in any case a strong case for making this change in 1990, and our decision that contracts from 1993 should be awarded on the basis of tender plus revenue levy makes it all the stronger. A revenue levy will provide a better incentive on companies to be more efficient. Introducing the change in 1990 would not only bring this effect to bear sooner, but would provide potential bidders for the contracts to run from 1993 with a better basis for constructing their bids, given that they would be able to see how such a levy structure worked in practice.

Although we would not need to introduce legislation to make this change for some time - the 1989 Finance Bill would provide a suitable opportunity - we need to decide on the policy soon, as I understand that the IBA will be inviting contractors to apply for the contract extensions in the near future, and hopes to award contracts by the end of this year. I suggest, therefore, that we should invite officials to examine, as a matter of urgency, the basis on which a revenue levy which could be applied from 1990. We could consider such proposals in a future meeting of MISC 128.

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

NIGEL LAWSON

he.dc/ministers/9 November

CONFIDENTIAL

DRAFT

Ch/ I wonder if there's any pt being sticky about X since ① our officials seem to think all other options v unattractive, and ② Mr H will say 1989 FB was our idea — your letter of 11/2. Better to say need to get moving with work at Y so we don't miss FB, as alternative is Broadcasting Bill? MPn

The Rt Hon Douglas Hurd CBE MP
Secretary of State
 for the Home Department
Home Office
Queen Anne's Gate
LONDON SW1H 9BW

NOVEMBER 1988

ITV LEVY CONTRACT EXTENSION PERIOD AND BSB LEVY

Thank you for your letter of 1 November.

2. I accept that ITV companies will be under pressure to reduce their costs before the post 1992 franchises are auctioned and I continue to see advantages in reinforcing those pressures by adopting a revenue levy that maximises the incentive to reduce costs. But I accept that, until viewers have access to a greater range of channels, we must guard against the accusation that we are ~~careless of~~ indifferent to quality. In view of your concern therefore I am prepared to settle for a mixed scheme consisting of around three quarters yield from revenue and one quarter from profit between 1990 and 1992. Our officials will need to go through the detailed figures proposed by the IBA very thoroughly and ensure that they are likely to deliver a levy yield commensurate with that of the pre 1986 levy for a reasonable range of possible changes in costs and revenues. ~~Moreover decisions will need to be taken~~ Moreover agreement on the details will have to be reached quickly if we are to include the relevant clauses in the 1989 Finance Bill.

Y

X

~~3. We also need to consider the right legislative vehicle for changing the levy. Previous changes have been made in the Independent Broadcasting Act 1974 and the Finance Act 1986. There are advantages in getting the legislation on the statute book as quickly as possible. But it is already clear that the size of the 1989 Finance Bill will have to be restricted by including only essential items. The choice may be between changing the levy legislation in the Broadcasting Bill which you plan to introduce~~

in November 1989 or the 1990 Finance Bill. If it comes to that I hope you would be prepared to include the levy legislation in the Broadcasting Bill so that our proposals for broadcasting could be discussed by Parliament in an orderly fashion.

3 4. ~~Finally~~ Second, you suggested we give BSB an assurance about the Government's future intentions with regard to the levy. I accept that BSB should be zero rated for levy purposes until they reach cumulative profit and that we should tell them so before they have to raise more finance. But I do not believe we should go further. Once BSB do reach cumulative profit, the size of their investment, the time required to achieve break even and the level of risk involved will be historical facts of little relevance in determining what their future levy liabilities should be. And the existence of competition from television services not subject to levy liability would affect all ITV companies, not just BSB. An undertaking not to apply a levy on BSB until they are in cumulative profit should reassure investors that the levy will not stop them earning a return on their finance and will ~~only~~ affect only the split of future profits earned by exploiting scarce spectrum.

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

NIGEL LAWSON

chex.ps/mw/2 CONFIDENTIAL

MP

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

16 November 1988

PS/Chief Secretary
PS/Financial Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Phillips
Mr Culpin
Mr Spackman
Mrs Case
Mr Farthing
Mr Gilhooly
Mr Perfect
Mr Cave
Mr Nicol
Mr Tyrie

Rt Hon Douglas Hurd CBE MP
Secretary of State for the Home Dept
Home Office
50 Queen Anne's Gate
LONDON
SW1H 9BW

Dear Douglas

ITV LEVY CONTRACT EXTENSION PERIOD AND BSB LEVY

Thank you for your letter of 1 November.

I accept that ITV companies will be under pressure to reduce their costs before the post 1993 franchises are auctioned and I continue to see advantages in reinforcing those pressures by adopting a revenue levy that maximises the incentive to reduce costs. But I accept that, until viewers have access to a greater range of channels, we must guard against the accusation that we are indifferent to quality. In view of your concern therefore I am prepared to settle for a mixed scheme consisting of around three quarters yield from revenue and one quarter from profit between 1990 and 1992. Our officials will need to go through the detailed figures proposed by the IBA very thoroughly and ensure that they are likely to deliver a levy yield commensurate with that of the pre 1986 levy for a reasonable range of possible changes in costs and revenues. Moreover, agreement on the details will have to be reached quickly if we are to include the relevant clauses in the 1989 Finance Bill.

Second, you suggested we give BSB an assurance about the Government's future intentions with regard to the levy. I accept that BSB should be zero rated for levy purposes until they reach cumulative profit and that we should tell them so before they have to raise more finance. But I do not believe we should go further. Once BSB do reach cumulative profit, the size of their investment, the time required to achieve break even and the level of risk involved will be historical facts of little relevance in determining what their future levy liabilities should be. And the existence of competition from television services not subject to levy liability would affect all ITV companies, not just BSB. An undertaking not to apply a levy on BSB until they are in cumulative profit should reassure investors that the levy will not stop them earning a return on their finance and will affect only the split of future profits earned by exploiting scarce spectrum.

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

NIGEL LAWSON

he.dc/perfect/minute9

1. MRS CASE
2. CHANCELLOR

FROM: R M PERFECT
DATE: 28 NOVEMBER 1988

cc: Financial Secretary
Mr Anson
Mr Monck
Mr Culpin
Mr Farthing
Mr Michie
Mr Nicol
Mr Shore

28/11

Ch/ OK?

OK

ITV LEVY

Following your letter of 16 November, the Home Office wish to announce that there will be a mixed levy on ITV profits and revenue between 1990 and 1992. The ITV companies have a legitimate interest in knowing Ministers' decision and should be told as much as possible.

2. A draft of the planned announcement is attached, with the changes we suggest shown in manuscript. You are recommended to agree that an announcement on these lines be made.

Progress on details

3. We met IBA and Home Office officials on Wednesday 23 November to ask for the data needed to assess different mixed levies. By Christmas we should have a thorough understanding of the figures and we aim to make recommendations on the detailed structure and rates early in the New Year.

4. Home Office have agreed to take the lead in drafting Instructions to Parliamentary Counsel, and will show us a first draft by Christmas. The IBA are considering recommending minor technical changes to the legislation and have been asked to put any proposals forward in the next week or two to fit into this timetable.

Conclusion

5. We recommend you agree that the Home Secretary make an announcement on the attached lines, as amended in manuscript.

Mark Perfect

R M PERFECT

DRAFT

ARRANGED PQ FOR WRITTEN ANSWER ON ITV LEVY

: To ask the Secretary of State for the Home Department, if he will make a statement on the future of the Independent Broadcasting Authority levy for the period 1990-1992.

DRAFT REPLY

In conjunction with the Treasury, my Department has reviewed the arrangements in the Broadcasting Act 1981, as amended by the Finance Act 1986, for additional payments by independent television contractors (the levy). The review was undertaken ~~because of the need for~~ to consider transitional arrangements in the 1990-92 contract extension period of the independent television contractors prior to the re-structuring of independent television on the lines proposed in the Governemnt's recently published White Paper on Broadcasting. It also ~~takes~~ ook into account the recommendations of the 43rd Report of the Committee of Public Accounts 1987-88.

Following consultation with the IBA, we have decided that the levy for the period 1 January 1990 to 31 December 1992 will be raised both from the net advertising revenue and from the profits of the independent television contractors. It is intended that the overall yield of the levy during this period should now estimated to be of the order of £200m p.a. ~~to~~ produce broadly the same amount of levy as under the arrangements which existed prior to 1986. The structure of the new levy will be such that about three-quarters of

/the...

the total yield is expected to arise from net advertising revenue and the remainder from profits.

The purpose behind these changes is to encourage cost consciousness amongst the independent television contractors and to ensure an adequate return to the Government for use of a scarce national resource during the contract extension period.

~~The precise levy rates and other~~ Further details of the levy structure will be published in the Spring of next year ~~as part of the 1989 Finance Bill~~. The Government's detailed response to the 43rd Report of the Public Accounts Committee will be published in a Treasury Minute early next year.

chex.md/mw/2 CONFIDENTIAL

MP

FROM: MISS M P WALLACE
DATE: 1 December 1988

MR PERFECT

cc PS/Financial Secretary
Mr Anson
Mr Monck
Mr Culpin
Mr Farthing
Mr Michie
Mrs Case
Mr Nicol
Mr Shore

ITV LEVY

The Chancellor was grateful for your minute of 28 November. He is content for the Home Secretary to make the announcement he proposes, subject to the changes you marked in manuscript.

MPW.

MOIRA WALLACE

CONFIDENTIAL

(BF 13/12 or with advice

HOME SECRETARY

QUEEN ANNE'S GATE LONDON SWIH 9AT

6 December 1988

Dear Nigel,

ITV AND DBS LEVIES

Thank you for your letter of 16 November. I am grateful to you for agreeing to an ITV levy for the contract extension period 1990-92 based on a mixture of revenue and profit. Our officials are already in touch about the detailed figures and I shall make an announcement as soon as this work has been completed.

I should also be grateful if you were able to look at a possible compromise on the question of the levy on DBS services. It is, as you say, true that BSB will be in the same position as Channel 3 and 5 licensees in being subject to levy while competing with services such as those carried on Astra which will be outside the levy net. But BSB are in a special position: they will be competing head-on with services carried on Astra in the satellite dish market whereas the other ITC licensees will not. Furthermore, that competition will be one-sided as it is. BSB (and any other UK DBS operators) are financed wholly by the private sector. In contrast the Astra company's operations are being guaranteed by the Luxembourg government to the tune of £75m; without this guarantee I understand that the company would have found it very difficult to secure loans to finance increased project costs.

Once BSB reach cumulative breakeven the size of the initial investment and the time needed to recoup it will, as you say, be historical facts. They are of course crucial to entrepreneurs who are considering now whether to invest in BSB. It is not, I think, unreasonable for them to be reluctant to see levy liability left wholly open-ended when deciding whether BSB offers a satisfactory return on their capital. After all, the Channel 3 and 5 licensees will know what rate of levy we have in mind when deciding whether or how much to bid as competitive tenders. BSB investors will not have this degree of security.

/I would therefore

The Rt Hon Nigel Lawson, MP
Chancellor of the Exchequer
HM Treasury

CONFIDENTIAL

I would therefore like to be able to offer BSB guidance which goes rather further than envisaged in your letter of 16 November. However, I fully take your point about competition, and have ... suggested, in the enclosed draft reply to BSB, a revised statement of our position which draws this out. I hope you will feel able to agree that the revised draft meets your point.

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

Yours,

Douglas.

Anthony Simmonds Gooding Esq
Chief Executive
British Satellite
Broadcasting Ltd
70 Brompton Road
LONDON
SW3 1EY

cc Mr Whitney, IBA

for signature by: S of S

LEVY

Thank you for your letter of 17 October.

I fully understand your wish to have publicly usable guidance about the Government's future intentions with regard to the levy, bearing in mind your need to attract additional investment.

The liability of operators of commercial television services to levy reflects their use of a public resource in the form of internationally assigned and protected frequencies. I therefore see no grounds for amending the present law so as to exempt BSB (or any other DBS contractor) from such liability.

However, I have already made clear, as you know, that if DBS services were to be subject to a levy based on revenue rather than profits they would continue to be zero-rated during the period to the end of 1992. In the light of the points made in your letter I am able to set out the approach we would propose to adopt in the following period. We would not contemplate anything other than a zero rate for so long as BSB was not in cumulative profit. The possibility of payment of levy would not of course arise under the present law unless this were the case. Once BSB had achieved cumulative profit, consideration would need to be given in the circumstances at the time by the Government of the day to the case for moving beyond a zero rate. We for our part would want to take account of all relevant factors; including the existence or otherwise of any form of financial support provided by other governments to satellite or programme services competing with BSB in the market. We would in other words, want to be satisfied that it would be reasonable to depart from a zero rate before doing so, having regard to the interests of fair competition at the relevant time.

I am copying this letter to the Director General of the IBA.

<jg>Sub/CB/Levy/DBS/ENC2

dti

the department for Enterprise

~~BF 13/12~~ ~~14/12~~ 15/12

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

CH/EXCHEQUER
REC. 12 DEC 1988
ACTION MR PERFECT 12/12
COPIES TO CST, FST
SIR P MIDDLETON
MR ANSON
MR MONCK
MR PHILLIPS, MR BURGNER,
MRS CASE, MR SPACKMAN,
MR GILHOOLY, MR NICHOL,
MR CAVE, MR BOLT,
MR TYRIE.

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1P 3AG

Department of Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Switchboard
01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

Direct line 215 5422
Our ref PB1AIV
Your ref
Date 12 December 1988

pse chase advice

Dear Chancellor of the Exchequer,

DBS LEVY

I have seen Douglas Hurd's letter to you of 6 December about the levy on DBS services. As you know, I attach great importance to giving BSB as clear a statement as we can of our levy policy in order to help them raise the substantial sums of money they still require before launching their service.

I therefore support Douglas' suggested text, subject to one amendment. I do not think we should explicitly include the existence of foreign government financial support as a factor that we would take into account in determining the levy. This does run counter to our general policy in this area and, if stated in this way and applied more widely, could be seen to justify domestic subsidies in sectors right across the industrial spectrum.

May I suggest therfore, that the text to BSB is amended so that the last two sentences of the penultimate paragraph are replaced by;

> "We for our part would want to take account of all relevant factors and, in particular, we would want to be satisifed that it would be reasonable to depart from a zero rate before doing so, having regard to the interests of fair competition at the relevant time".

I am copying this letter to other members of Misc 128 and Sir Robin Butler.

Yours Sincerely,

D. [signature]

(Approved by the Secretary of State
and signed in his absence)

the Enterprise initiative

he.dc/perfect/sub7

FROM: R M PERFECT
DATE: 15 DECEMBER 1988

1. ~~MRS CASE~~ AP 16/12
2. CHANCELLOR

cc: Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Burgner
Mr Spackman
Mr Cave
Mr Nicol

(a/ This really is bending over backwards to "reassure" BSB. Do we have to? [illegible])

OK [illegible] [BSB @ [illegible] [illegible] [illegible]]

ITV AND DBS LEVIES

1. The Home Secretary's letter of 6 December says he wishes to offer BSB guidance which goes further than you have previously envisaged. The Secretary of State for Trade and Industry's letter of 12 December suggests an alternative form of words which is acceptable. A draft letter is attached.

Background

2. Your letter of 16 November accepted that BSB would be zero rated for levy purposes until cumulative profit is achieved. Mr Hurd wishes to further reassure BSB that the Government would not depart from a zero rate of levy for BSB until it was reasonable to do so, taking account of all relevant factors. And he wishes to specify financial support provided by other governments as a relevant factor. Lord Young objects to this last feature on the grounds that it could be used to justify domestic subsidies to many different sectors of industry.

BSB finances

3. BSB has already raised £222.5 million which is sufficient to launch its satellite. So there is no danger that refusing to accept Mr Hurd's form of words will imperil the launch in Autumn 1989. BSB needs to raise a further £500 million, to cover costs and purchase programmes; and in particular to finance purchases of rights in US films costing £380 million. These deals are indistinguishable from other commercial TV purchases of programmes.

4. BSB's satellite and rocket are tried and tested. The main imponderable is whether BSB will attract enough viewers, given the need to first invest in equipment costing around £250. If they do, and cumulative profit is reached, BSB should then be very profitable. All the initial fixed investment costs will have been recovered and the recurrent costs - programming, tranmission and selling national advertising should all be cheaper than for terrestrial TV.

5. In these circumstances it would be reasonable to apply a positive rate of levy to BSB. In other circumstances, the Government would need to decide whether or not a positive rate of levy was appropriate. The relevant bit of the draft letter to BSB, as amended by Lord Young, reflects this. It reads:

> "Once BSB had achieved cumulative profit, consideration would need to be given in the circumstances at the time by the Government of the day to the case for moving beyond a zero rate. We for our part would want to take account of all relevant factors and, in particular, we would want to be satisfied that it would be reasonable to depart from a zero rate before doing so, having regard to the interests of fair competition at the relevant time." ~~[illegible]~~ or 'not, of course, apply a positive rate of levy if ~~unless~~ we were not satisfied that it was reasonable to do so.

Conclusion

6. You are recommended to accept the form of words suggested by Mr Hurd, as amended by Lord Young. A draft letter is attached.

Mark Perfect

R M PERFECT

for type
final

DRAFT LETTER TO:

The Rt Hon Douglas Hurd CBE MP
Secretary of State for the
 Home Department
Home Office
50 Queen Anne's Gate
LONDON SW1H 9BW

DECEMBER 1988

DBS LEVY

Thank you for your letter of 6 December. I have also seen David ~~Lord~~ Young's letter of 12 December.

2. I am content with the draft letter to BSB, subject to the amendments suggested by David ~~Young~~. DBS will require a lot of fixed investment and ~~it is right~~ we have agreed that the levy should not apply at a positive rate until the cost of that investment has been recovered. However

3. Once the fixed costs have been recovered, satellite TV may well be ~~very~~ highly profitable. And by then it will be just another means of delivering programmes to the home, in direct competition with terrestrial television. In those circumstances I would expect the levy to apply to BSB in the same way as it applies to terrestrial TV.

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

N LAWSON

chex.md/mw/30

CC Chief Secretary
Financial Secretary
Sir P. Middleton
Mr Anson
Mr Monck
Mr Burgner, Mrs Case
Mr Spackman
Mr Perfect
Mr Care
Mr Nicol

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

21 December 1988

Rt Hon Douglas Hurd CBE MP
Secretary of State for the Home Dept
Home Office
50 Queen Anne's Gate
LONDON
SW1H 9BW

MP

I have kept most relevant pps.

Dear Secretary of State,

DBS LEVY

Thank you for your letter of 6 December. I have also seen David Young's letter of 12 December.

I am content with the draft letter to BSB, subject to the amendments suggested by David. DBS will require a lot of fixed investment and we have agreed that the levy should not apply at a positive rate until the cost of that investment has been recovered. However once the fixed costs have been recovered, satellite TV may well be highly profitable. And by then it will be just another means of delivering programmes to the home, in direct competition with terrestrial television. In those circumstances I would expect the levy to apply to BSB in the same way as it applies to terrestrial TV.

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

Yours sincerely,

Moira Wallace

pp NIGEL LAWSON

(Approved by the Chancellor and signed in his absence.)