FUTURE-PROOFING A GREAT BRITISH SUCCESS STORY

The economics of the audiovisual sector and the implications for the proposed EU-US free trade agreement

Prepared for BSAC

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Executive Summary

Key messages

- The UK's audiovisual sector is a global success story, in terms of creativity, levels of investment in original content, the delivery of public value (in social, cultural and democratic terms) to domestic audiences, and global exports.
- This is achieved through a vibrant ecology comprising both public and private sector organisations, supported by a complex set of policy interventions designed to address market failures and acting increasingly as a counterbalance to the inherent asymmetry between the sizes of the audiovisual markets in the UK and US and the resulting economic disadvantages faced by UK companies.
- The most fundamental challenge facing the sector is how to maintain this success in the future as we move towards a fully digital converged world in which major global technology companies are seeking to control consumers' access to converged devices, including connected televisions.
- In response to fast-changing and uncertain market and technological developments, companies in the UK (and around Europe) need the freedom to adapt their business models, compete in increasingly globalised markets against multi-billion dollar media and technology companies, and innovate with new forms of content and digital distribution. The EC and its Member States need to maintain maximum freedom of manoeuvre to adopt regulatory interventions as necessary to support their audiovisual sectors and meet audience expectations.

Introduction

- This paper was commissioned by BSAC in the context of the proposed EU-US Transatlantic Trade and Investment Partnership (TTIP). It builds on previous work undertaken by BSAC as part of the WTO GATS multilateral trade negotiations, when the EC Trade Commissioner Sir Leon Brittan asked BSAC to establish a European group on behalf of the national film industries.
- The UK audiovisual sector is a global success story, in creative, cultural and economic terms. It punches above its weight in terms of levels of investment in original content and in global exports, whilst providing significant public value to British audiences, through its democratic, social and cultural impact.
- This success may be attributed to a vibrant ecology comprising both public and private sector organisations, supported by a range of policy interventions that are designed to nurture creativity, boost investment in original content, and promote British culture and the delivery of public value more widely.
- Historically the audiovisual sector in the EU has been considered a special case, and the position has been that it should be excluded from international trade negotiations. But the current context is different in important ways. Challenging global economic conditions mean that the potential benefits the TTIP could provide in terms of jobs and growth are more vital than ever. And technological developments mean that some traditional justifications for intervention, e.g. spectrum scarcity, have fallen away to a significant degree.

- In this context, it is more important than ever to make the case for public policy interventions within a robust economic framework.

Economics of audiovisual markets

- Audiovisual markets share certain economic characteristics: they are high-risk hit-based businesses with high fixed costs and low marginal costs of production. The full costs of production – along with significant marketing expenditure – must be borne before any consumer revenues may be earned.
- These economic factors confer an overwhelming advantage to firms that can exploit economies of scale and scope, via a large domestic market and by exploiting their content globally across multiple windows and territories.
- With a population five times larger than that of the UK, US companies benefit from a large home market with a relatively homogenous culture and tastes. This facilitates the development of horizontally and vertically integrated studios that combine production and distribution, and which are capable of sustaining high levels of investment, managing large portfolios and mitigating risk. This explains the historic success of US high-end audiovisual content in the UK and around Europe.
- These economic factors, which shape the characteristics of audiovisual markets and explain the relative success of US companies, are completely unrelated to trade barriers between the EU and US.

Market failure in audiovisual markets

- Market failure occurs in circumstances where the market has not and cannot of itself be expected to deliver an efficient outcome. Audiovisual markets have historically exhibited multiple kinds of market failure, including public goods, externalities, imperfect information and market power.
- Ofcom has argued that given technological advances, the strongest enduring market failure case for public service broadcasting is around positive externalities. It highlighted a number of forms of social value that broadcasting can provide, including promoting informed democracy, cultural understanding, educated citizens, access and inclusion. These forms of social value potentially apply equally to film and other forms of audiovisual content.
- Alongside these social benefits, audiovisual interventions can provide economic benefits: helping to sustain production in the UK, to develop and nurture talent and skills, and to promote jobs and growth. The creative economy is one of the sectors with the greatest potential for future economic growth. In particular, measures that promote inward investment – leading to films and TV programmes locating in the UK that would otherwise be made overseas – can provide substantial benefits in terms of stimulating growth without displacing other activity.

Public policy interventions in audiovisual markets

- Public policy interventions in the audiovisual sector serve two purposes. First, they aim to address market failures, supporting the production and distribution of different kinds of content which generate positive externalities, in the form of economic, social and cultural benefits. And second, they act as a counterbalance to the inherent asymmetry between the sizes of the audiovisual markets in the UK and US, and the resulting economic disadvantages faced by the UK audiovisual sector.

- A wide range of interventions are implemented in the UK, to support production (e.g. Lottery funds, the TV licence fee and fiscal incentives), distribution (e.g. EPG prominence for PSBs and support for film distribution and exhibition), infrastructure (e.g. training levies and support for inward investment) and other measures (e.g. media ownership rules).
- Public policy interventions such as these generate disproportionately large benefits, for two reasons. First, they create a virtuous circle between levels of investment, the volume and quality of content that is produced, audience demand for this content, and the revenues that underpin further investment. As a result, the UK audiovisual sector is far more vibrant and competitive than would be expected of an economy of our size, enabling it to punch above its weight. And second, they help to unlock the huge reserves of creative talent that the UK is endowed with, allowing the sector to realise its true economic and cultural potential.
- Notwithstanding these interventions, the UK remains a highly open market. These measures do not inhibit foreign investment in the UK, as the significant presence of foreign companies in many audiovisual markets attests. The UK audiovisual sector benefits hugely from inward investment by US companies across multiple sectors including film, TV, video games and digital media. And US companies, in turn, benefit from the high quality of skills and infrastructure in the UK, much of which is underpinned by public support.

Future challenges in a converged world

- Convergence is having a dramatic impact on the ways in which audiovisual and other forms of media content are produced, distributed and consumed.
- British audiovisual companies have responded to these new challenges in many ways – adapting their business models by launching new services and developing new revenue streams, competing more actively in global markets, and innovating creatively and technologically. But the continuing success of the UK's audiovisual sector is far from assured.
- Lower barriers to entry – which help to promote competition – are counterbalanced by "network effects", whereby the value of a service rises exponentially with the number of users, leading to "winner takes all" markets. Emerging US companies, with their large domestic population, can take an early lead in new markets by leveraging scale economies, and then exploit network effects to consolidate their position and to expand into digital markets around the world. Start-ups are helped further by the presence of active venture capital and angel investor markets.
- New forms of market failure may arise in digital markets, in relation to search, discovery and trust. This can make it more difficult for high-quality British content to stand out and reach audiences.
- Most fundamentally of all, there is huge uncertainty around the development of markets for distribution of audiovisual content. TV, film and other forms of digital content are converging on the same devices. With markets for smart-phones and tablets dominated by non-European companies, the next big

battle is for the screen in the living room. This battle will be fierce, involving incumbent broadcasters and pay-TV operators, VOD aggregators, telecoms companies, companies with their own content ecosystems (such as Apple, Amazon and Google), device manufacturers (such as Samsung) and others. Large global companies have significant advantages in this battle, given their ability to exploit economics of scale and scope globally to an even greater extent than was possible in traditional audiovisual markets.

- The risk is that connected TVs will be controlled by large non-European companies in the same way that mobile devices are. Such companies are likely to give prominence to their own VOD services and prioritise content with the greatest international appeal. This could limit significantly the visibility of British and European content. As a result, it may become harder for audiences in Europe to access, or even become aware of, content that is specifically made for them, and could also impact the range and diversity of European content that is produced over time.

Implications for the EU's offensive and defensive interests in the TTIP

- The economic analysis presented in this paper has clear implications for the position of the UK and other European Member States, in terms of the offensive and defensive interests of the audiovisual sector, and the need to take into account future market developments.
- There are few restrictions in US markets, which is why it is difficult to identify offensive interests that would bring meaningful benefits to UK companies. This reflects the general openness of the US audiovisual sector and the multiple routes to market that currently exist.
- The audiovisual sector is unusual, therefore, in that its concerns are primarily defensive. It is vital for the sector that existing interventions be preserved. Given the symbiotic nature of the relationship between the UK and US, it is likely that these measures also provide significant benefits to US companies that invest in the UK.
- However, maintaining existing interventions is not sufficient to future-proof the success of the audiovisual sector, and to enable it to continue to provide economic, social and cultural benefits in the future.
- European companies need to have the freedom to adapt their business models, to compete actively and to innovate in new digital markets. Achieving this relies in part on a supportive regulatory framework in the UK and at the European level. It also requires a robust competition regime that can prevent abuses of market power, and which is also capable of keeping up with dynamic fast-changing markets.
- In conclusion, public policy interventions play a crucial role in helping the British audiovisual sector both to thrive globally and to meet audience expectations. With regards to the TTIP, it is vital that not only must existing measures remain in place to secure the economic, cultural and social benefits provided by traditional audiovisual services, but also the EC and its Member States should maintain maximum freedom of manoeuvre to adopt regulatory interventions as necessary across the audiovisual sector, in response to fast-changing and uncertain market and technological developments.

1. Introduction

This paper was commissioned by BSAC in the context of the proposed EU-US Transatlantic Trade and Investment Partnership (TTIP). It builds on previous work undertaken by BSAC in the late-1990s and early-2000s as part of the WTO GATS multilateral trade negotiations, when the EC Trade Commissioner Sir Leon Brittan asked BSAC to establish a European group on behalf of the national film industries.[1]

A great British success story

The UK is renowned for its high levels of creativity across a wide range of art forms. The audiovisual sector in particular is a global success story, in creative, cultural and economic terms. From *Monty Python* and *Brideshead Revisited* to *Downton Abbey* and *Doctor Who*, from Ealing comedies and *The Third Man* to *Slumdog Millionaire* and the Harry Potter films, and from *Manic Miner* and *Elite* to *Grand Theft Auto* and *Tomb Raider*, British TV programmes, films and video games have captivated audiences around the world. The BBC is one of the best-known and respected media brands in the world, and British content and creative talent are regular presences at the most prestigious international awards ceremonies.

In television, British audiences benefit from high levels of investment in original content across a wide range of genres, much of it available via the main free-to-air TV networks. It is estimated that total annual investment in original first-run UK programming exceeds £4 billion. [2] As well as entertaining audiences, TV provides significant public value, in terms of its democratic, social and cultural impact. Consumer research shows that citizens are more reliant on TV than any other form of media for news, and that they trust broadcast media (TV and radio) more than any other source of news.[3] This is particularly important at a time when other traditional news sources, such as local and national newspapers, are in decline, both in terms of the number of titles available and readership levels. Other genres – including documentaries, dramas, soap operas and arts programming – provide cultural and social impact, for example by raising awareness of social issues, challenging people's viewpoints and perspectives, and portraying different cultures and lifestyles.

In economic terms, the UK audiovisual sector punches well above its weight. Headline economic and demographic statistics show that the UK is the seventh largest country in the world in terms of GDP, and the 22nd biggest country by population (according to the latest World Bank data, for 2011).[4] The audiovisual sector outperforms these rankings for the overall economy across multiple measures.

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[1] This paper also draws on a report commissioned by BSAC for the UK Presidency Creative Economy Conference hosted in October 2005, "New business models for audiovisual content".

[2] See "Creative UK: The audiovisual sector and economic success", Robin Foster and Tom Broughton (2011).

[3] See Ofcom reports "News consumption in the UK" (2012) and "Adults media use and attitudes report" (2013).

[4] See data.worldbank.org.

For example:

- Analysis by Oliver & Ohlbaum shows that the UK is the **fourth largest market** in the world in terms of total investment by broadcasters in original content (excluding news and sports), after the US, Japan and Germany.
- The UK performs even better in per-capita terms: it is in **third place globally**, spending more on original content per head than the US.
- The audiovisual sector also has an impressive track record in terms of exports. PACT research shows that the UK is the **world's second most successful exporter** of TV content, behind the USA. Total revenues from the international sale of UK television programmes and associated activities were worth almost £1.5 billion in 2011.
- An international survey commissioned by FRAPA (the Format Recognition and Protection Association) showed that **the UK leads the world** in terms of the number of exported formats.

The success of the audiovisual sector may be attributed to a vibrant ecology comprising both public and private sector organisations, large and small. This includes broadcasters and independent production companies working across TV, film, video games and digital media. These organisations have a variety of business models and funding sources.

The strong performance of the sector is all the more impressive given that British companies must compete in many audiovisual markets with much larger US-based companies, whose scale allows them to invest larger amounts in content, and whose operational scope facilitates the distribution of their content across markets around the world. The UK audiovisual sector's success is attributed in part to a complex set of policy interventions that address market failures in the sector, and which also act as a counterbalance to the asymmetries in market size between the UK and US. These interventions help to nurture creativity, boost investment in original content, and promote the delivery of content that provides public value to British audiences.

The audiovisual sector is a large part of the wider creative economy, which is regarded by the Government as one of the areas with the greatest potential for future economic growth. DCMS estimated that the creative industries accounted for 10.6% of the UK's exports in 2009.[5] However, the audiovisual sector faces major challenges to maintain this success in the future, given market and technological developments. The transition towards a fully digital converged world means that competition is becoming more intense, as markets become more globalised and as major media and technology companies seek to control new markets. A creative industries roundtable convened by the CBI in 2012 expressed concerns that international competitors are chasing the UK's success, noting that creative industry hubs have grown significantly in recent years, with countries such as Dubai, Singapore and Argentina investing heavily to attract new talent. In order to thrive in the future, British companies will need to adapt and innovate, while the regulatory framework will need to evolve to remain effective and fit-for-purpose.

[5] See "Creative Industries Economic Estimates", DCMS (December 2011).

Impact of the TTIP

The purpose of any kind of international trade negotiation is to seek liberalisation by removing trade barriers and other measures that may distort the flow of goods and services between different countries. The TTIP therefore raises important questions about the relevance and continued rationale for the public interventions that support the European audiovisual sector.

The position that has historically been adopted by the audiovisual sector in the EU is that it should be treated as a special case, given its specific cultural and social role, and should be entirely excluded from any kind of liberalisation in trade negotiations. During the Uruguay Round in the early 1990s, the EC and its Member States specified a series of exemptions that protected all activities in the audiovisual sector from the GATS disciplines. This was a compromise solution that fell short of the proposed "cultural exception" that would have provided permanent protection for the audiovisual sector.

At the time of the GATS 2000 negotiations, the industry's negotiating position was underpinned by the fact that technological developments were beginning to radically change the nature and value of revenue streams for audiovisual rights holders in highly uncertain ways. The proposed position, agreed by the feature film industry and participants from other audiovisual sectors, was that the EU negotiating stance should be to safeguard the measures necessary for the achievement of the cultural and economic objectives of European audiovisual policies. This included maintaining the freedom for the Community and Member States to extend existing measures or to develop new ones as the audiovisual sector evolves.

Many of the core issues then – such as the balance between offensive and defensive interests, and between economic and cultural factors – are similar to those that are being raised now by the audiovisual sector. Indeed, the earlier work explicitly focused on future developments, including new technologies such as video-on-demand (VOD) services. As such, many of the core principles underpinning the earlier analysis remain relevant today.

At the same time, it is important to recognise that the current economic, political and technological context is very different from that which applied a decade ago. The state of the global economy, and in particular the persistently low growth rates across much of the EU, means that the potential economic benefits of the TTIP – estimated to be worth more than €100 billion per year for the EU – are more important than ever. In political terms, measures to boost economic growth are top priorities for the UK Government. And of course, there have been significant technological and market changes over the last decade. These developments mean that some of the traditional justifications for intervention in the audiovisual sector are weaker than in the past. For example, digital technologies have lowered barriers to entry (promoting competition), scarcity in spectrum and bandwidth is falling away (extending consumer choice), and charging mechanisms now exist in markets that were previously characterised as being public goods (thereby avoiding the free rider issues that justified intervention). Developments such as these lend weight to arguments that the rationales that previously justified protecting the audiovisual sector no longer apply.

In this context, it is more important than ever for the audiovisual sector to make a strong and coherent case to justify its position, and in particular to explain the rationale for the complex systems of interventions that operate in the sector, within a robust economic framework.

Structure of this paper

This paper begins by setting out the underlying economic characteristics of audiovisual markets, explaining how they lead to asymmetries in market size between the US and EU Member States, as a result of scale and scope economies (Section 2). It goes on to review market failures in audiovisual markets, identifying the areas where they are most persistent (Section 3). The next section describes the public policy interventions that exist in the audiovisual sector, which are justified by the need to address the asymmetries in market size between the UK and US and to correct market failures (Section 4). The penultimate section focuses on the future challenges facing the audiovisual sector as we head towards a fully converged world: as major global media and technology companies fight for control of connected TV sets, the continuing success of the UK's audiovisual sector is far from assured (Section 5). As the concluding section explains, it is vital for policymakers to maintain the freedom of manoeuvre to respond to new technologies that are transforming digital media production and distribution, in order to future-proof the continued success of the audiovisual sector (Section 6).

2. Economics of audiovisual markets

This section describes the particular economic characteristics of audiovisual markets, which account for the relative success of US high-end content around Europe. It explains why British audiovisual firms face an inherent disadvantage when they compete in global markets. This provides the first rationale for public policy interventions in the sector.

A number of audiovisual products – including high-end TV programmes, films and video games – share a number of distinctive economic characteristics that shape the markets in which they operate. Harold Vogel provides a useful list of "frequently observed industry characteristics" across different kinds of audiovisual content, which may be summarised as follows:[6]

- They are high-risk hit-based businesses in which a small number of successes generate the profits that offset the losses from the remainder of the portfolio.
- The sector exhibits high capital costs, resulting in the development of large companies able to access capital, and a tendency towards oligopoly.
- New content tends to have a short life cycle (in the primary window), resulting in the need for substantial marketing expenditure alongside production and distribution costs.
- Ancillary markets play an important role in providing secondary revenue streams.

[6] See "Entertainment Industry Economics", Harold Vogel, Cambridge University Press (Eighth Edition, 2011), Chapter 15.

- Some entertainment products have universal appeal, which cuts across cultural and national boundaries, providing further revenues streams from global markets.
- Public good characteristics are present in many types of audiovisual products, which can lead to market failure.
- Production and distribution are being transformed by technological developments. New and old media co-exist within increasingly complex ecologies.

These industry characteristics result in a distinctive cost profile for audiovisual content, which has implications for risk management. Fixed production costs for individual products can be extremely high compared to typical economic markets: of the order of hundreds of thousands of pounds per hour for high-end TV drama, millions of pounds for independent British films; and tens, and sometimes even hundreds, of millions of pounds for major studio films. The marketing and distribution costs that need to be incurred alongside these production costs are often of the same order of magnitude, and typically need to be tailored to individual territories. Meanwhile, marginal costs of production and distribution are very low, and are rapidly falling towards zero as a result of new digital technologies. Given this cost profile – very high fixed costs and low marginal costs – almost all costs relating to any given content must be borne before any consumer revenues may be earned. Alongside the hit-based nature of the business, this means that, just as in other sectors that exhibit similar cost and risk profiles (pharmaceuticals might be one example), a portfolio approach is necessary to manage commercial risk and sustain viable business models.

This confers an overwhelming advantage to firms that benefit from large homogenous domestic markets, in which audiovisual companies can exploit economies of scale and scope. Companies based in large territories can spread their investments over large audiences with a relatively homogenous culture and tastes in their home market. The industry characteristics confer further advantages to horizontally and vertically integrated studios that operate globally. Companies with a presence across different markets (including secondary distribution windows and other forms of IP exploitation such as merchandising) and territories have direct access to multiple revenue streams derived from the content that they produce. Such companies are best able to access capital, diversify risk and manage exchange rate fluctuations.

These advantages flow most readily to large firms operating in the United States. The US has a population of over 300 million people, predominantly speaking English. This enables the major US studios to recover (all or a large portion of) the costs of major film and TV productions from their home territory. It gives their content inherent advantages in global markets, as the highest-end content benefits from production budgets that smaller countries' audiovisual sectors cannot match. By contrast, with 63 million people, the UK population is just one-fifth that of the US, and so British companies are unable to generate the same economies of scale and scope from their home market.

A simple example helps to illustrate the point. Suppose a British firm can justify investing a certain amount of money X in a particular production that is viewed by Y people. This will generate profits (and represent a viable business model) if the average revenue generated per viewer exceeds the average cost per viewer of X/Y. Now consider an equivalent American firm producing for its home market. Suppose that its production achieves a similar market share in the US as the British one did in the UK. Given that the US market is five times larger, this means that it will be viewed by 5Y people. So the American firm can achieve the same average cost per viewer as the British firm with a production budget that is five times larger: the cost per viewer is then equal to 5X/5Y = X/Y. Thus, economies of scale mean that the American firm can justify much higher levels of investment than the equivalent British firm. Moreover, when the two productions compete in global markets, the American one has a natural advantage – while "bigger" does not automatically imply "better", films with higher levels of investment will typically exhibit higher production standards and have the scope to be more creatively ambitious in some ways, for example in their use of computer-generated imagery (CGI) and other visual effects. Higher production budgets enable US films to capture larger shares in many markets around the world, boosting revenues further and thereby justifying even higher budgets. This explains how the major studios alone can justify making films with such huge production budgets.

While the overall EU market is comparable in scale to the US, it is not a homogenous market, and this undermines the potential to achieve economies of scale by addressing a single audience. There are a multitude of languages and significant cultural and social differences, which impact on audience tastes and also lead to additional costs for dubbing or subtitling, increasing further the costs of distributing content across multiple territories. Distribution can also be complicated by logistical differences: for example bank holidays and school terms vary from one country to another, complicating release patterns, while content also has to be classified to receive age ratings in each country.

To conclude, it is important to stress that the success of US companies described in this section flows from the underlying economic factors in ways that are completely unrelated to barriers to trade between the EU and US. The role of public policy interventions in combating these economic disadvantages is discussed in Section 4.

3. Market failure in audiovisual markets

This section describes the market failures that exist in audiovisual markets. It shows that, while technological developments mean that some kinds of market failure have fallen away to some extent, others remain and will continue to do so in the future. The need to correct these market failures is the second rationale for public policy intervention.

The Treasury Green Book (which provides guidance to public sector bodies on how proposals should be appraised) defines market failure as follows: "Market failure refers to where the market has not and cannot of itself be expected to deliver an efficient outcome; the intervention that is contemplated will seek to redress this." Market failure can occur under a number of circumstances. The typology of reasons for market failure specified in the Green Book is listed in Table 1.

Table 1: Typology of forms of market failure

Type of market failure	Explanation of market failure
Public goods	Goods that are both non-rival (consumption by one person does not prevent someone else using or consuming that good) and non-excludable (goods which, if made available to one consumer, are effectively made available to everyone)
Externalities	Occurs when a particular activity produces benefits or costs for other activities that are not directly priced into the market
Imperfect information	Occurs when buyers are not fully aware of the quality of a good or service to judge its value
Market power	Occurs when there is insufficient actual or potential competition in the market

Source: The Green Book, HM Treasury (Annex 1)

Audiovisual markets have historically exhibited all four of the kinds of market failure, thereby providing a number of rationales for intervention. For example, free-to-air radio and broadcasting using analogue spectrum was a **public good**: consumption by any one person did not in any way deplete the amount of the service available for others to consume, and there was no practical way to exclude any person with a TV or radio receiver from accessing the services. As the ability to free ride undermined the potential to apply payment mechanisms, such services are typically provided free at the point of use and are funded in other ways. As noted in Section 2, the economic factors that characterise audiovisual markets often results in the development of large companies able to access capital, and this can lead to oligopoly. **Market power** concerns can arise in such concentrated markets. **Imperfect information** can exist across a wide range of audiovisual services: since each new TV programme, film or video game is in some ways different, consumers do not know for sure how much they will enjoy it until they have consumed it. This can distort the pricing or levels of production for goods relative to the economically efficient levels. In particular, it can lead to under-production of goods which exhibit **positive externalities** in the form of non-transitory benefits that accrue to the individual or to society more broadly that are not fully recognised by consumers at the point of consumption. Such externalities may include the democratic, cultural or social value of content (e.g. news and current affairs programmes that promote engagement with the democratic process, or content that promotes understanding and engagement with different cultures and lifestyles).

In its second review of public service broadcasting in 2008, Ofcom reviewed the market failure arguments for intervention.[7] Ofcom observed that, as a result of technological developments and the resulting evolution of new markets and digital services, the extent of some of these market failures has fallen away over time. With pay-TV platforms, it is now possible to exclude consumers from accessing TV channels that they have not paid for. As Ofcom put it, "the public good nature of broadcasting caused by non excludability disappears". Ofcom also argued that increased competition meant that market power becomes less likely, and that the

[7] PSB Review, "Annex 11: Market failure in broadcasting", Ofcom, 2008

greater range of ways of accessing content (along with the provision of more information online – a point not made by Ofcom) reduced information problems.

Ofcom's main conclusion was that, given technological advances, the strongest enduring market failure case for public service broadcasting is around externalities. Ofcom highlighted a number of different ways in which broadcasting can provide social value, leading to positive externalities. These forms of social value potentially apply equally to film and other forms of audiovisual content:

- Access and inclusion – for example value derived from universal access and facilitating access to public services
- Quality of life – for example value derived from providing access to services which promote quality of life, perhaps by helping to support or promote work-life balance or family life
- Belonging to a community – for example value derived from allowing people with similar interests to communicate or from participating in your local community
- Educated citizens – for example value derived from services with educational content or child-oriented services
- Cultural understanding – for example value derived from services which reflect and strengthen cultural identities or promote diversity and understanding of other cultures
- Informed democracy – for example value from services which provide information which facilitates democratic debate.

Notwithstanding the technological transformations that have occurred, many kinds of audiovisual content continue to provide social value in these ways, and the enduring positive externalities continue to justify intervention to address what would otherwise be an under-supply of content of this nature.

Alongside the social value externalities described above, purely economic benefits can also flow from intervening in the audiovisual sector: support for UK audiovisual content helps to sustain production in the UK, to develop and nurture talent, and to promote jobs and growth. In particular, measures that promote inward investment – leading to films and TV programmes locating in the UK that would otherwise be made overseas – can provide substantial benefits in terms of stimulating growth without displacing other activity in the UK. A number of organisations – including the BBC, Channel 4, the BFI and PACT – have commissioned studies that estimated the economic impact of various parts of the audiovisual sector.

4. Public policy interventions in audiovisual markets

This section turns to the public policy interventions in the audiovisual sector, and the benefits that these interventions provide, in terms of ensuring that the UK punches above its weight, and unlocking the full potential of the sector's creativity.

As the previous two sections highlighted, there are two key rationales for public policy interventions in the audiovisual sector. First, interventions aim to address market failures, and in particular to support the production and distribution of different kinds of content which generate positive externalities, in the form of economic, social and cultural benefits. And second, they act as a counterbalance to the inherent asymmetry between the sizes of the audiovisual markets in the UK and US, and the resulting economic disadvantages faced by the UK audiovisual sector.

Table 2 lists some of the key types of interventions that exist in the audiovisual sector in the UK. Many interventions aim to support investment in original content production. These are complemented by measures to support distribution and exhibition, to help new content reach target audiences. Other interventions focus on the underlying infrastructure, for example by investing in training and supporting inward investment. A series of additional measures address specific policy aims, such as promoting media plurality (through ownership rules), technical standards and content regulation (to provide appropriate protections for citizens, especially children).

Table 2: Examples of public policy interventions

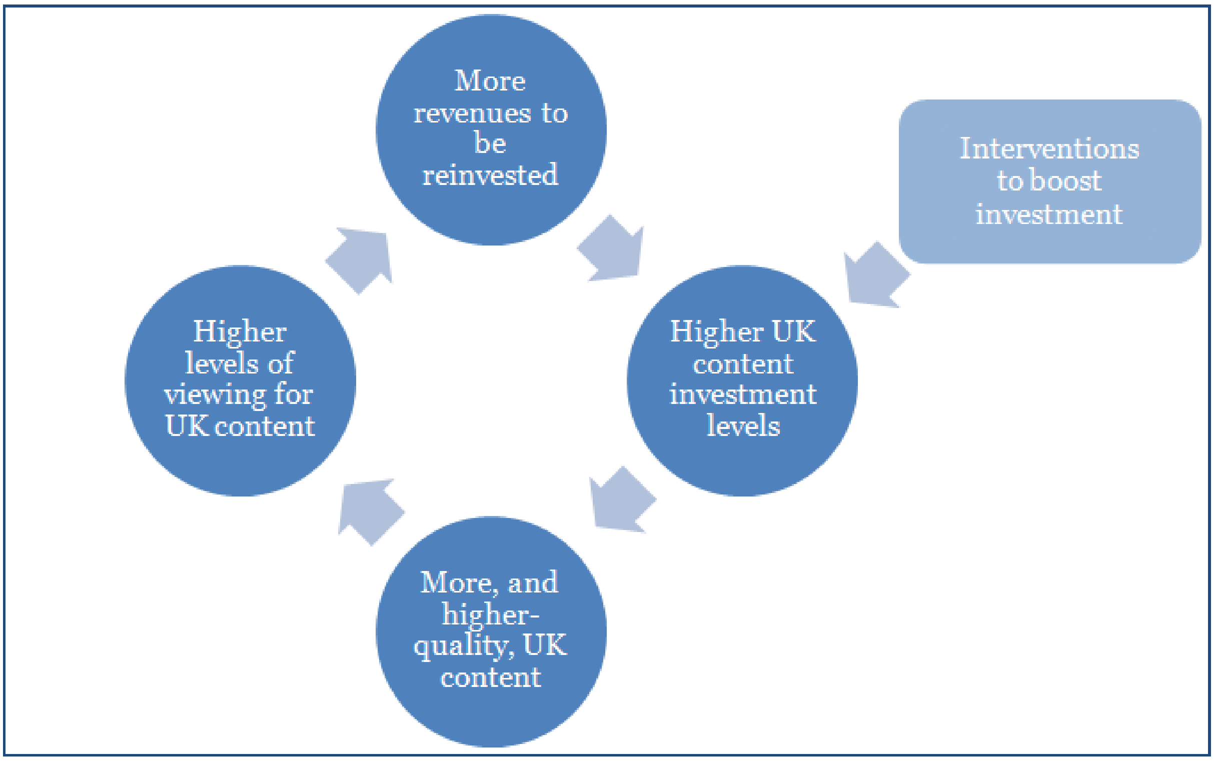
Category	Intervention
Production	Subsidies, including those provided from Lottery funds, to support national or regional production
	Output or investment quotas to support: • Original content • Works of European origin • Works produced by independent producers • Programming in certain genres • Production around the nations and regions
	Public funding, including the television licence fee
	Fiscal incentives (tax breaks) for films, high-end TV, animation and video games
Distribution and exhibition	Rules on access to platforms, e.g. must-carry rules
	Access to scarce spectrum
	Preferential access for public service broadcasters, e.g. EPG prominence
	Open access rules for proprietary technical systems
	Support for the distribution of British and specialised films in cinemas and for the exhibition sector
Economic and infrastructure	Training levies for skills investment
	Support to attract inward investment
	Support for exports of audiovisual goods
Other regulatory measures	Media ownership rules
	Reduced VAT rates for cultural products and services
	Requirements for public service broadcasters to contribute to archive costs
	Content regulation: classification and censorship of content, and child protection measures
	Technical standards for transmissions

Source: BSAC

The public policy interventions used in the audiovisual sector were devised to be targeted, proportionate and effective. It can be argued that they generate substantial benefits relative to the scale of intervention, for two reasons.

First, interventions focused on supporting investment in original UK content create a virtuous circle between levels of investment, the volume and quality of content that is produced, audience demand for this content, and the revenues that underpin further investment (illustrated in Figure 1). This serves to ratchet up the scale at which the industry operates to a higher level than would otherwise be the case. As a result, the UK audiovisual sector is significantly bigger, more vibrant and more competitive than would be expected of an economy of our size. These interventions thus play a pivotal role in enabling the UK audiovisual sector to punch above its weight in terms of levels of content investment, innovation and exports.

Figure 1: Virtuous circle amplifying impact of public policy interventions



The second reason is due to the unusually high levels of creative talent that the audiovisual sector is endowed with. This pool of talent can be seen as a "natural resource" which has the potential to generate substantial economic value, just as other countries benefit from large supplies of oil or gas. It explains why UK films and TV programmes (as well as British musicians, fashion designers, authors, and so on) are exported all over the world, capturing the public's imagination far beyond our shores. As manufacturing has declined in the UK, our cultural exports are increasingly important both in economic terms and as a form of soft diplomacy, in that they represent British values such as fairness, openness and tolerance to the wider world. However, there is a risk that, given the disadvantageous economic factors that the UK audiovisual sector faces, these resources will be under-exploited. The impact of public interventions is to unlock the huge reserves of creativity in the

UK, allowing the sector to realise its true potential. Annex 1 sketches out some examples of how this works for film and TV.

Notwithstanding these interventions, the UK remains a highly open market. It is clear – from the significant presence of overseas companies in many audiovisual markets – that these measures do not inhibit foreign investment in the UK. Indeed, the UK audiovisual sector enjoys a symbiotic relationship with the US. We benefit greatly from inward investment by US companies, across multiple sectors including film, TV, video games and digital media. Long-term investments such as Time Warner's purchase of the Leavesden Studios are evidence of the strength of this relationship. For their part, US companies benefit from the high quality of skills and infrastructure that the UK offers. They particularly value the wealth of British acting, writing and directing talent, much of which was nurtured by British public service broadcasters and on independent British films. In these ways, the attractiveness of the UK to US companies relies on interventions that help to support the high-quality infrastructure and skills base in the production sector.

5. Future challenges in a converged world

This section focuses on the challenges that the audiovisual sector faces in the years ahead. Convergence – that is, the development of new technologies capable of delivering a range of media and communications services that were traditionally available only through separate systems or devices – is having a dramatic impact on the ways in which audiovisual and other forms of media content are produced, distributed and consumed. Network effects encourage the growth of ever more powerful companies in digital markets, while technological developments may generate new forms of market failure – both of which provide additional justifications for public interventions. Meanwhile, as the distribution of audiovisual content is transformed by new technologies, there is an intensification of competition between global media and technology companies.

The key agent of change is convergence. While it long been anticipated, convergence has only begun to have a truly transformative impact over the last decade, with mass-market penetration of fast broadband networks and the development of new kinds of devices such as smart-phones and tablets (along with other technological advances, such as cheaper and faster computer processing power and cloud-based services). This has led to the emergence of new services, new suppliers and new kinds of content. In the audiovisual sector, perhaps the most notable development has been the emergence and rapid popularity of VOD services. Audiences can now catch up with recently-aired TV shows and watch huge archives of films and TV programmes on mobile devices and personal computers and via internet-enabled games consoles. Competing for the audience's attention are broadcasters' own services (such as BBC iPlayer), multi-broadcaster partnerships (e.g. Hulu in the US) and third-party aggregators (e.g. YouTube and Netflix). Other developments in the digital space include film- and programme-related spin-offs such as apps and games, and apps that provide "second screen" experiences to accompany individual TV programmes or which aggregate social media conversations on Twitter and other platforms (e.g. Zeebox), enabling viewers to interact with their favourite shows.

British audiovisual companies have responded to these new challenges in many ways. Companies have sought to adapt their business models, for example by launching new services (e.g. digital TV channels, VOD services, apps for mobile devices), expanding their presence across multiple platforms, and striking partnerships with other digital media players (e.g. YouTube and games consoles). These initiatives have enabled them to extend the reach and impact of their content and to exploit new revenue streams (e.g. more international sales, use of micropayments). Consolidation and acquisitions in the broadcasting, independent production and distribution sectors have enabled companies to grow and compete more effectively by achieving stronger economies of scale and scope. Some production companies have expanded their activities into international markets.

There has also been substantial creative and technological innovation in the sector. The BBC iPlayer now receives more than 250 million requests per month for TV and radio programmes. YouView, a collaboration between the public service broadcasters and telecoms operators, is one of the most ambitious hybrid broadcast-IPTV services that has been developed. TV formats have been reinvented for the 21st century, and sold in huge numbers of territories around the world – talent shows such as *The X Factor* (ITV, Talkback Thames/Syco) and quizzes such as *Million Pound Drop* (Channel 4/Endemol) build on the live experience, using social media to drive viewer engagement. Channel 4 will launch an "always on" second screen app covering its entire schedules later in the year, while the BFI is developing a "BFI Player" that will give unprecedented access to Britain's film heritage online. At the same time, a host of new digital media companies have emerged, engaging directly with consumers with their games, apps and online services, and partnering with existing broadcasters and production companies on multiplatform projects.

But despite all these positive developments, the continuing success of the UK's audiovisual sector is far from assured. There are three important factors that raise concern, relating to the underlying economics of the sector (and in particular the presence of network effects), market failures, and intensifying competition.

First, just as with traditional audiovisual markets, the economics of new digital media markets exhibit highly distinctive characteristics, potentially even more so than those in existing markets. These risk exacerbating the asymmetries in scale between UK and US markets. It might be expected that the opposite should be the case, given that digital technologies significantly lower barriers to entry, enabling anyone to produce content cheaply and to distribute it globally via services such as YouTube – giving more power to individuals and small groups with creative talent than ever before. This would suggest that markets for digital content and services ought to be more open and competitive, and that no one company or country should be dominant. However, in practice, the impact of reduced barriers to entry is counterbalanced by "network effects". This is an economic term that refers to the phenomenon whereby the value of a service rises exponentially with the number of users. Network effects typically apply to communications services: for telephone networks, for example, the number of connections rises exponentially with the number of people in the network. But they also apply to a growing number of digital media services, particularly those that rely on interaction between users, such as social networks. Network effects explain why social media platforms typically have a single dominant operator in each category (as demonstrated by the likes of Facebook and Twitter): the biggest player in each market has disproportionate advantages over its competitors, allowing it to grow faster than its competitors. Network effects thus help growing services grow faster, and make declining ones fall faster, leading to markets in which the "winner takes all". This reinforces the tendency towards oligopoly that characterises many audiovisual markets, and further empowers companies based in the US. Emerging companies there can take advantage of their large domestic population to take an early lead in new markets, by leveraging the usual scale economies, and then exploit network effects to consolidate their position and to expand into new digital markets around the world.

A separate but important issue is that US digital media start-ups also benefit from the presence of large venture capital and angel investor markets, which are particularly active in tech markets. In Europe, by contrast, it can be more difficult to access funds from venture capital and angel investors, making it harder for entrepreneurs to develop and grow new businesses.

For these reasons – primarily the underlying economic factors, but also considerations relating to access to funds – interventions to combat the inherent asymmetry between the sizes of markets in the UK and US may become more, not less, important for digital media.

The second factor relates to market failure. Ofcom's review of market failures in broadcasting (cited above) argued that new and different market failures may arise as a result of technological developments. Ofcom emphasised the growing importance of search, discovery and trust: when there is vastly more audiovisual content available online from a much wider range of sources, consumers may have difficulty locating the most appropriate content that best suits their needs, and when they find content that appears to be suitable, there is no guarantee that it will be trustworthy. While search engines and other navigational aides may help, their incentives may not necessarily be aligned with that of the consumer. The European Audiovisual Observatory recently counted more than 3,000 VOD services in Europe – almost half of which are under US control.[8] There is thus potentially a need for intervention to assist in helping people find what they want, and to give prominence to trusted sources and to British content (just as EPG prominence rules ensure that the main PSB channels occupy the top positions in linear TV programme guides).

The third, and most fundamental, factor is the nature of competition and the evolution of new digital media markets. There is huge uncertainty regarding the development of markets for the distribution of audiovisual content. What is clear is that convergence is transforming the ways in which content is consumed, with TV, film and other forms of digital content increasingly being accessed via on-demand services on new devices. The markets for the earliest generations of converged devices, smart-phones and tablets, have come to be dominated by the likes of Apple, Google and Samsung – all non-European companies – through their control of the hardware and operating systems (iOS and Android).

The next big battle, which is only now beginning to be contested, is for the screen in the living room. Internet-enabled connected televisions and other devices that connect to the TV set, such as games consoles, are turning the main TV set into a gateway to much more than just a finite number of scheduled linear channels. New

[8] See http://www.obs.coe.int/about/oea/pr/mavise2_2013mai.html

platforms offer an expanding range of VOD services, TV-related apps, games, social media and other kinds of content and services. Ease of use will be enhanced further through new kinds of content guides and user controls, as well as integration between connected TVs and other devices within converged ecosystems. Companies like Google and Apple are at the forefront of initiatives that will enable consumers to, for example, start watching a programme or film on one device (e.g. a laptop or tablet) and resume from the same point on another (e.g. the TV set), while Microsoft and others are innovating in the use of voice and hand motions to make choices and control on-screen menus.

On the demand side, market changes will be driven by consumers' demand for choice and flexibility. Consumers will be faced with a plethora of platforms, devices and services offering different variants of content packages, exclusivity, availability across different devices (TV, PC, handheld), pricing options, integration of personal media catalogues (e.g. photos, music, TV and films) across devices using cloud services, and ease of use. With so many dimensions of choice, it is very difficult to predict who the ultimate winners and losers will be, particularly as so many different companies have a stake in the battle for control of the connected TV and access to audiences. These include incumbent broadcasters and pay-TV operators, new VOD aggregators (such as Lovefilm and Netflix), telecoms operators (seeking to create rich bundles of communications services), companies with their own content ecosystems (like Apple, Amazon and Google), device manufacturers (such as Samsung), high-street retailers (Tesco and others have launched their own VOD services), and independent production companies wishing to engage directly with consumers.

Large global companies have significant advantages in this battle. They can exploit economics of scale and scope to an even greater extent than was possible in traditional audiovisual markets. They can leverage their strength in one market to others – as, for example, Apple did when it developed a leading market position around the world in music downloads with the iTunes Store. And companies that control hardware and operating system infrastructure can seek to lock users into their ever-growing content ecosystems across multiple converged devices, including connected TVs. The greatest risk facing the UK audiovisual sector is that connected TVs – and other gateways to TV screens in people's homes – will come to be controlled by large non-European companies in the years ahead in the same way that mobile devices are.

This has important implications for the kinds of content that will be made available, and promoted, to audiences on the content guides and platform interfaces that they see when they switch on their connected TV sets. Large global companies are likely to give prominence to their own services (just as, for example, the iPhone automatically includes Apple's iTunes on the home screen, whereas users must download apps for other VOD services that they wish to use). And they are likely to prioritise pan-regional deals that focus on content that has the greatest international appeal across territories. This will make it harder for local broadcasters and production companies to secure distribution for British and European content, which could limit significantly the visibility of this content. As a result – particularly given the market failures discussed above in relation to search, discovery and trust – audience expectations may not be met if European citizens struggle to access, or even become aware of, content that is specifically made for them. Over time, this could impact the range and diversity of European content that is produced.

6. Implications for the EU's offensive and defensive interests in the TTIP

This paper has argued that the economic factors that characterise audiovisual markets lead to an asymmetry in market sizes, giving significant benefits to US players. The benefits that flow from the huge size of the US domestic market will endure in the future, and may indeed be amplified, as a result of network effects as we move towards a more converged world. These benefits are unrelated to any trade restrictions in the US, and therefore are immune to any liberalisation that may be proposed under the TTIP.

This has clear implications for the position of the UK and other European Member States, in terms of the offensive and defensive interests of the audiovisual sector, and the need to take into account future market developments.

In terms of potential offensive interests, there are few restrictions in US markets, and European companies can freely trade with the US in a number of ways. In television, for example, they can buy production companies (as the likes of ITV and Freemantle have done) and cable stations, sell programming to US networks and co-produce content with US companies. In the few instances where barriers exist, e.g. ownership restrictions for US free-to-air broadcasters (for which foreign owners may control a stake of no more than 25%), in practice these do not appear to be major obstacles to the growth of European companies, who do not regard such barriers as problematic given the number of alternative ways in which they can access US markets.[9] It is important to stress that the absence of offensive interests does not reflect a lack of ambition on the part of the European audiovisual sector; rather, it is due to the general openness of the US audiovisual sector and the multiple routes to market that currently exist.

With so few offensive interests, the audiovisual sector is unusual in that its concerns are primarily defensive. The continuing importance of public policy interventions was described in Section 4. It is vital for the sector that these existing interventions be preserved. Given the symbiotic nature of the relationship between the UK and US, it is likely that these measures also provide significant benefits to US companies that invest in the UK, and there are some indications that US audiovisual companies are unlikely to push for liberalisation of existing measures.

Maintaining the existing interventions is necessary but not sufficient to future-proof the success of the audiovisual sector, and to enable it to continue to provide economic, social and cultural benefits as we head towards a fully converged world.

European audiovisual companies need to have the freedom to adapt their business models and develop new revenue streams. They should be encouraged to compete more actively in increasingly globalised markets against multi-billion dollar media and technology companies, and to keep innovating with new forms of content and digital distribution. Such innovation can come from both the public and private sectors or from combinations of the two – as the examples in the previous section demonstrate. Given the scale disadvantages faced by European companies, there can

[9] See the separate legal analysis commissioned by BSAC.

be significant gains from collaboration between companies in developing new services (YouView is a good example of this).

The ability of European companies to adapt, compete and innovate in these ways relies in part on a supportive regulatory framework in the UK and at the European level that can itself evolve to remain fit-for-purpose in a converging world.

In addition, a robust competition regime is needed to prevent abuses of market power, but which is also capable of keeping up with dynamic fast-changing markets. Failure to recognise the shifting and blurring of boundaries between markets that were once distinct can lead to harmful decisions that place European companies at a greater disadvantage in terms of their ability to compete with large global players.

In conclusion, it is vital that not only must existing measures remain in place to secure the economic, cultural and social benefits provided by domestic companies, but that the EC and its Member States should also maintain maximum freedom of manoeuvre to adopt regulatory interventions as necessary across the audiovisual sector, in response to fast-changing and uncertain market and technological developments.

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Annex 1: Interplay between creativity and public interventions

Film

US studios have a substantial presence in the UK, spanning production, distribution and exhibition. This reflects the fact that the most expensive films typically cost more to produce than any other kind of audiovisual content, so economies of scale and scope play an especially powerful role in shaping business models in the sector. Data on films' performance in cinemas analysed by the BFI shows that, on average over the last decade (between 2003 and 2012), 70% of the UK box office was earned by US films, while UK-qualifying films produced with US studio backing accounted for a further 20%. Overall, films with studio financing took almost 90% of the UK box office. By contrast, British films took a much smaller share of the US box office. In recent years, they have accounted for just 14-16% of the total box office in North America. Moreover, this is mostly attributed to US studio-backed British films: independent British films typically take just 1-2% of the US box office.

Public policy interventions help to sustain independent production and to attract inward investment in the UK. The independent film production sector is highly reliant on public support: the main funding sources are the BFI (using Lottery funds), public service broadcasters (the BBC and Channel 4) and fiscal incentives for film. Together, they finance a wide range of British films each year which, while modestly funded relative to US studio films, achieve high levels of creative ambition, as the number of major international awards that they win attests. They also deliver considerable social and cultural impact, presenting distinctively British stories and values to audiences in the UK and around the world.

At the upper end of the production scale, major UK film brands such as the Harry Potter and James Bond franchises, along with other big-budget US studio films, are shot in the UK, taking advantage of the high quality physical infrastructure and the technical expertise and creative talent of the workforce, both in front of and behind the camera. The ability to attract inward investment, and to maintain such a high scale of production, is underpinned by a range of interventions, both direct (e.g. fiscal incentives for production) and indirect (the world-class skills levels of UK talent are based in part on the training and experience derived from working in other publicly-supported creative sectors such as TV and theatre).

TV

In comparison to UK film's share of the box office, original British TV programmes command a relatively high market share of total TV viewing, particularly on the main network channels. Most original content is produced or commissioned by the public service broadcasters who, even in a multichannel world, still account for almost 75% of all viewing across their digital channel portfolios (according to Ofcom's PSB Annual Report 2012). The high levels of investment and audience demand for British content are underpinned by a range of interventions, including the BBC licence fee, Channel 4's public ownership and remit, PSB obligations imposed on the commercial public service broadcasters, and commitments to secure content from the indie sector. Interventions thus secure high levels of investment in content and create a framework for the UK's creative talent to thrive.

These interventions produce economic and social benefits across a range of programme genres. In drama, for example, where European broadcasters face similar challenges to the film sector, the creativity of the UK's production sector enables it to compete effectively with US programmes with much bigger budgets. Home-grown dramas often attract more viewers than bigger-budgeted US imports, and are sold to broadcasters around the world. The UK's success in developing formats illustrates the considerable economic value that arises in activities that do not require the huge scale of the US market. Teams of highly talented individuals working in production companies can develop new ideas across a range of genres that can be customised to local audiences in different countries. Equally important is investment in genres that are intrinsically local by nature, such as news, current affairs and soap operas. Such programmes provide democratic and cultural benefits to UK audiences.