

# Agenda

Advancing economics in business

## Ruling the waves: market impacts from public service broadcasting

**Broadcasting is a rather special activity. In most European countries, at least one company has been entrusted by the state to provide it as a public service. But as commercial broadcasters have been established, and public service broadcasters expand their service provision beyond traditional broadcasting, there are new questions for regulators: what are the limits of the public service remit, and how should its potential impact on competing services in the market be assessed?**

Providing media content at least in part as a public service sets broadcasting aside from many other media-related services, notably print. In print media, issues of quality are safeguarded to a much greater extent by industry self-regulation and the threat of legal action against the supply of mis-information, without the perceived requirement to fund services directly.

One possible explanation for this distinguished position may be that it reflects broadcasting's historical importance to society in sustaining democratic, social and cultural values independently from state influence.

The Treaty of Amsterdam's Protocol on the System of Public Broadcasting in the Member States (the

Amsterdam Protocol) assigns substantial freedom to each Member State in defining the remit of the public service in broadcasting and for the funding to be provided to fulfil this remit (see the box below).

Yet, as public service broadcasters (PSBs) extend their activities beyond traditional transmission of audio-visual content to television sets to activities such as providing digital services over the Internet, tensions with commercial broadcasters and providers of competing services are emerging. Do chatrooms and online games still serve the democratic, social and cultural needs of society? Do PSBs leverage their funding to outbid private competitors when it comes to securing sports rights for events such as the Olympic Games or international football tournaments? Do PSBs distort competition by not charging market prices when providing access to their facilities?

As these questions show, with a number of commercial broadcasters established in the market and the expansion of PSBs into new media services, regulators are forced to shift their attention away from a focus on quality to assessing the likely impact of specific public services on competing services. The debates across Europe centre around the questions: to what level of detail should the scope of the public service remit be defined? Where are its boundaries, and to what degree should the potential impact of the public service activities on the market be taken into account?

This article considers the economic approaches that can be applied when assessing the potential market impact of new media services and how the aim of creating public value could be reconciled with potential detrimental competitive impacts. It compares the

### The Amsterdam Protocol

In 1997, the European Community annexed the following provisions on public service broadcasting to the Treaty establishing the European Community:

'The provisions of the Treaty establishing the European Community shall be without prejudice of the competence of the Member States to provide for the funding of public service broadcasting insofar as such funding is granted to broadcasting organisations for the fulfilment of the public service remit as conferred, defined and organised by each Member State, and insofar as such funding does not affect trading conditions and competition in the Community to an extent which would be contrary to the common interest, while the realisation of the remit of that public service shall be taken into account.'

Source: Treaty of Amsterdam amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts, signed at Amsterdam, 2 October 1997—C. Protocols annexed to the Treaty establishing the European Community (entry into force: 1 May 1999).

approaches taken by the BBC's Public Value Test (PVT) in the UK and the recently proposed Three-step Test in Germany to strike the 'right' balance between the creation of public value of public service broadcasting and its potential competitive impact.

## Assessing competitive impacts

There are two options in terms of the assessment of a potential market impact that could be applied: a competition-based test or a welfare-based test.

The objective function of a competition-based assessment could be to minimise distortion to competition, subject to counteracting welfare gains. The first stage of the market impact assessment (MIA) would be to assess whether the service led to a distortion of competition, and if so, to what extent. In this context, competition could be considered to be distorted (and, at the extreme, the market foreclosed) if the proposed services would lead to a reduction in competitors' incentives and ability to invest and innovate in competing services, or to operators ceasing to provide competing services. If the proposed services were found not to generate a significant distortion to competition, there would be no further requirement to assess the effects of the service on the welfare of individual suppliers. However, if significant distortion were identified, this would trigger a second stage of inquiry within the MIA to examine the welfare impacts for affected stakeholders, thereby enabling an assessment of whether the adverse effects of any distortion are counteracted by the benefits to consumers derived from the new service.

The key difference between a welfare-based approach and a competition-based approach is that the former would always need to explicitly address all the distributional aspects of the proposed service, whereas a pure competition-based assessment would consider these only once a significant distortion had been identified.

From an economics perspective, these two approaches could produce comparable results, provided that the benchmark employed in the assessment of harm arising from changes to producer surplus corresponds to the benchmark for the assessment of distortion of competition. However, one limitation of applying a welfare-based approach would be that adverse effects would be identified even if these did not significantly affect the process of competition. Furthermore, the increased focus on assessing potential harm under a welfare-based approach could result in undue focus on the short-term (and more readily identifiable) effects, rather than the dynamic incentives to innovate.

Given that the provision of new media services is at a relatively early stage of development, it would be

appropriate to focus such assessments more on the impact on the process of competition and innovation, and less on the static welfare impacts on producer surplus. Such an approach would be supported by economics evidence that a major source of consumer welfare improvements over time is innovation and the development of new products and services.

## The BBC's Public Value Test

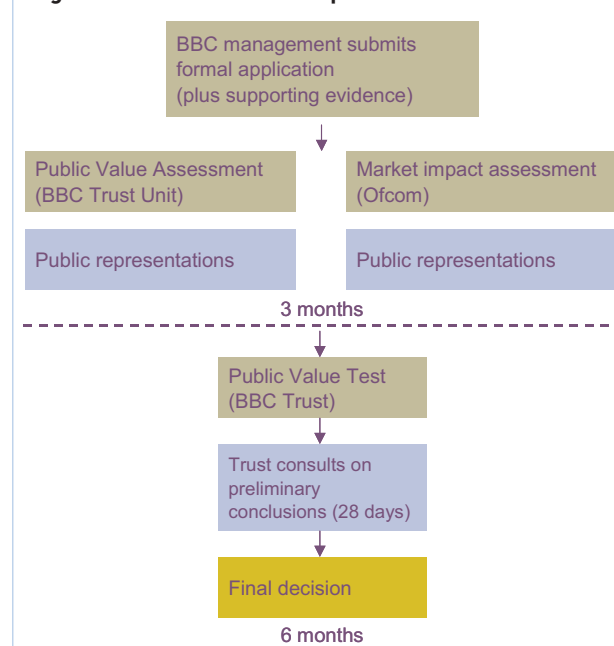
With the new Royal Charter (the Charter) and Agreement between the Secretary of State for Culture, Media and Sport and the BBC (the Agreement), which took effect from January 1st 2007, a new regulatory framework has been put in place for the BBC. The Charter and Agreement established the BBC Trust as the principal regulatory body:

- to set out the purpose remit and service licences for the BBC's public services;
- to set out codes and policies relating to fair trading matters;
- to interact with the BBC's Executive Board.

The Trust sets the overall strategic direction for the BBC, whereas the Executive Board manages its day-to-day operations. The Trust also appoints the chairman of the Executive Board and considers complaints on appeal after the BBC's complaints process has been exhausted.

A major element of the new regulatory framework in the process of the definition and entrustment of new public service activities of the BBC is the PVT (see Figure 1).

**Figure 1 Public Value Test process**



Source: BBC Trust (2007), 'Public Value Test (PVT): Guidance on the Conduct of the PVT', August.

The PVT is a procedure for balancing the public value created by a proposed new BBC service against its potential impact on the wider market. It has to be applied before a decision is taken to make any significant change to the BBC's UK public service. Such services may include introducing a new service or discontinuing an existing one. Whether a proposal meets the criterion of significance is a matter of judgment by the Trust, taking into account its likely impact on users and stakeholders, its financial implications, its uniqueness and its duration.

The PVT has two main elements: a Public Value Assessment (PVA) and an MIA. The PVA is conducted by the BBC Trust, with support from the Trust Unit, an independent advisory unit for the trustees. It includes an assessment of the value of the new proposals:

- to licence-fee payers as individuals;
- to society as a whole through its contribution to the BBC's Public Purpose;
- in terms of value for money and cost.

During the PVA process, public consultations have to be carried out as one method to assess the aspects of public value that might be relevant to the proposal. Consultation will typically be with licence-fee payers, stakeholders, and any particular groups for whom the subject of the proposal may warrant specific input.<sup>1</sup>

MIAs are undertaken by the UK telecoms regulator, Ofcom, and overseen by a joint steering group on which the BBC Trust and Ofcom are equally represented. The MIA assesses the effects of the proposed service on other services in the market. While the provision of the MIA is overseen by the Trust, the substantive findings of the assessment remain a matter of judgment for Ofcom. The MIA is completed within three months, and the Trust and Ofcom aim to publish the final PVA and MIA at the same time.

There is therefore a clear institutional separation within the PVT process, with the Trust defining and entrusting the public service remit and Ofcom assessing the potential market impact of the proposed services. It is the Trust that finally weighs the public value generated by the new services against their competitive impact.

The first PVT the Trust conducted was for the BBC's new on-demand proposals, iPlayer. Although these proposals had been made under the previous Charter, and hence the BBC was not required to apply a PVT, it decided that it would act as though the requirement were already in place. By and large, the proposals have been accepted by the Trust and the services launched, although modifications to the original proposals were required (see box below).

## Public service broadcasting in Germany

Since 2002, the European Commission has received a number of complaints about various aspects of the financing regime for PSBs in Germany, which could allegedly distort competition and have a detrimental impact on competing commercial services. The concerns of stakeholders were primarily related to the following.

- The PSBs' online activities would not be covered by the public service remit and would lead to adverse effects on competition in the market for online services.
- The financial transactions between PSBs and their production companies would not be made on commercial terms.
- Due to the non-transparency of the financing regime it could not be ruled out that the licence-fee funding went beyond what was necessary for the fulfilment of the public service remit; particular concerns were

### The first PVT: the BBC's proposed on-demand services (iPlayer)

On April 25th 2007, the BBC Trust approved the BBC Executive's on-demand proposals (iPlayer). The new services include:

- seven-day catch-up television over cable and the Internet;
- the download and saving of a quota of TV series for a limited period of time (series stacking);
- simulcast television over the Internet;
- non-digital rights management audio downloads over the Internet.

Since the PVT was a new process, and a large amount of information was being released, the Trust extended both the period for public representations and the consultation period. In all, the duration of the PVT was around seven months.

Source: BBC Trust (2007), 'BBC On-demand Proposals: Public Value Test—Final Conclusions', April.

In its decision, the Trust required some modifications to the initial proposals. For example, it decided that series stacking will be limited to an annual quota of 15% of all television content offered on demand, and the storage window was limited to 30 days (from an initial proposal of 13 weeks). Furthermore, audio books and classical music were excluded from the non-digital rights management download service.

These modifications reflected Ofcom's conclusion that the original specification of the services would have led to an undue market impact, and the Trust's decision that these modifications would not lead to a significant reduction in the public value of the services while substantially reducing the risk of a detrimental impact on competing offers.

expressed with regard to the expansion into new media services and the acquisition of sports rights.

- PSBs would not charge market prices for access to their transmission facilities, thereby distorting competition with other operators.

After five years of investigations and negotiations, the Commission reached an agreement with Germany and closed its investigation in April 2007.<sup>2</sup> A key element of the envisaged reform is the establishment of a formal evaluation procedure and criteria for all new or modified digital offers of PSBs. PSBs will be obliged to apply the Three-step Test for all new or modified digital offers. This test will require PSBs:

- to evaluate whether the new digital service is covered by the public service remit and therefore serves the democratic, social and cultural needs of society;
- to evaluate whether it contributes in a qualitative way to 'editorial competition';
- to specify the financial impact of the service.

The evaluation of the contribution to 'editorial competition' will have to take into account the relevant impact of the planned service on the market. The German government has asked the PSBs, ARD and ZDF, to put forward proposals of how the Three-step Test could be implemented.

In December 2007, both broadcasters submitted their proposals to the government, and although the process of finding a suitable implementation of the Three-step Test is still very much in progress, two main areas of debate have emerged. The questions centre around:

- how detailed will the public service remit be?
- should the competitive impact of new services be assessed and, if so, to what extent should it be taken into account?

The German constitution confers on the States the legislative competence in matters of broadcasting. The public service remit of the PSBs is defined in the Interstate Treaty on Broadcasting (Rundfunkstaatsvertrag, RStV). The degree of detail in the definition of the public service remit, however, varies for different services. Whereas PSBs are limited to offering up to three programmes transmitted exclusively in digital format, the content of which has to focus on culture, education and information, other areas of the public service remit are described at only a high level, such as PSBs being comprehensively allowed to offer 'programme-related' telemedia, such as Internet services.<sup>3</sup>

Not surprisingly perhaps, some stakeholders are demanding a more precise definition and specific

entrustment of the particular services that comprise the PSBs' public service remit. However, there is an acknowledged reluctance in German society and politics to allow the state to exert too strong an influence on broadcasting content. A detailed and specific definition of individual broadcasting services increases the perceived risk of a loss of media independence. Such limits on the influence of the state have been reflected in the Constitutional Court's recent decision to rebuff attempts to set the increase of the licence fee by less than the amount suggested by the Independent Commission for the determination of the financial needs of PSBs (Kommission zur Ermittlung des Finanzbedarfs der Rundfunkanstalten, KEF).<sup>4</sup>

A second area of debate concerns the way a potential market impact of new services—ie, their contribution to 'editorial competition', in the words of the Three-step Test—should be assessed. PSBs appear to prefer an assessment by internal committees, and consider that market impacts should not be considered to be undue, short of foreclosure. Other stakeholders, however, have voiced demands for an independent external body to assess potential competitive impacts, along the lines of Ofcom's role in the MIAs in the UK. Furthermore, they consider that the definition of what is considered a tolerable market impact should be more limited.

The two issues merit comment from an economics perspective. First, both regulatory approaches—an external assessment or an internal self- or co-regulatory solution—have the potential for being fit for the regulatory purpose if properly implemented.<sup>5</sup> Self- and co-regulatory schemes work best if the interests of PSBs are closely aligned with society's best interests. In such circumstances, the congruence of interests would be likely to provide sufficient incentives for the companies to comply with the co- or self-regulatory rules.

However, if there is a divergence of interests, regulatory precedent suggests that sufficient monitoring and complaints mechanisms are required to ascertain compliance.<sup>6</sup> In such a regulatory framework, adequate consultation processes with stakeholders and satisfactory complaints mechanisms, as well as a powerful regulatory authority as 'arbiter of last resort', could warrant avoidance of an undue impact of new services of PSBs on the market.

Second, it should be borne in mind that social welfare is contingent on both the public value that public services create as well as the consumer welfare. Should a welfare-based approach be adopted, the assessment could involve consideration of trade-offs between the welfare of different groups, rather than focusing on consumer interest (as with a competition-based test). However, the need to focus more directly on the dynamic incentives to invest and innovate than on static welfare

effects appears to be particularly important in the context of a broadcasting environment in which new digital media services are developing rapidly, and where there is likely to be considerable change in the next few years as a result of innovation in the nature of the services offered.

## Conclusion: an economist's view on PSB regulation

While different approaches seem to have been chosen in the UK and Germany with respect to the regulation of public service broadcasting, some common themes prevail. A clear definition of the public service remit appears to be warranted without putting at risk the independence of broadcasters. Different historical backgrounds may lead to different nuances across the Member States.

Although the German second Chamber of Parliament recently stated that the importance of broadcasting for the plurality of opinion and cultural diversity excludes an assessment primarily based on economic criteria,<sup>7</sup> a fair balancing of society's interest as a whole still warrants a role for economics: to assess the potential market impacts of PSBs' public services. Therefore, either a competition-based or a welfare-based test could be adopted. The former would focus on the dynamic effects on innovation and investment, whereas the latter is primarily static, focusing on the extent to which producer and consumer welfare is affected. Hence, the role of economics will be not so much in guiding the definition of the public service remit—which will be primarily a political decision based on societal consensus—but in safeguarding consumers from potential detrimental market impacts, or, in the words of Alexander Pope, economics is 'here no guide, but still a guard'.

<sup>1</sup> Such representations will generally be sought for a period of 28 days. The PVA is completed within 12 weeks and an analysis of all inputs received is published.

<sup>2</sup> C(2007) 1761 final; 24.04.2007.

<sup>3</sup> The scope of telemedia is not limited to broadcasting in the traditional sense, but covers services such as traditional broadcasting, live-streaming and web-casting, and Internet services such as traffic and weather information, stock exchange data, news groups, chatrooms, e-press, TV and radio text, teleshopping and telegames. Whereas paragraph 11 RStV allows PSBs to offer telemedia which are programme-related, paragraph 18 RStV explicitly excludes teleshopping.

<sup>4</sup> BVerfG, 1 BvR 2270/05, 11.09.2007.

<sup>5</sup> The regulation of the BBC also contains various self- and co-regulatory elements, such as the Fair Trading Guidelines, a code of conduct for the BBC's trading activities.

<sup>6</sup> Campbell, A. (1999), 'Self-regulation and the Media', *Federal Communications Law Journal*, **51**, pp. 711–71.

<sup>7</sup> Bundesrat Drucksache 863/1/07 (Beschluss); 14.03.2008.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email [d\\_holt@oxera.com](mailto:d_holt@oxera.com)

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