COMPETITION COMMISSION

REVIEW OF ITV CONTRACT RIGHTS RENEWAL UNDERTAKINGS

Provisional decision as to changes of circumstance

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The Competition Commission has excluded from this published version of the provisional decision information which the Group considers should be excluded having regard to section 244 of the Enterprise Act 2002 (restriction on disclosure of information). The omissions are indicated by [✂].

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1. **Summary**

1.1 This is our provisional decision following our review of the contract rights renewal (CRR) remedy and the undertakings which were given by Carlton Communications Plc (Carlton) and Granada plc (Granada) at the time of their merger in 2003.

1.2 Following a request from ITV plc (ITV), the Office of Fair Trading (OFT) reviewed the CRR remedy and, in May 2009, it advised the Competition Commission (CC) to consider varying the CRR Undertakings. The OFT drew attention to new ways of delivering ITV1's programming and a decline in ITV1's market position, but noted its continuing strength in the supply of mass audiences for advertisers.

1.3 We have validated and considered the evidence provided to us by the OFT and a limited amount of additional evidence submitted to us by ITV and third parties. In doing so we have spoken to ITV and a number of third parties, in particular, to test some of the assumptions on which the parties' analysis has been conducted.

1.4 We have considered whether the changes of circumstance identified by the OFT have led to sufficient change in the competitive environment identified in the CC's 2003 report[1] or in the operation and effect of the CRR Undertakings such that these should be released, varied or superseded.

Competitive assessment

Changes in the market

1.5 There have been significant changes in the television industry since 2003. The penetration of digital television has increased from 42 per cent of households in 2002 to over 88 per cent at the end of 2008. Over this period a large number of new

[1] *Carlton Communications Plc and Granada plc: a report on the proposed merger*, Cm 5952, October 2003, The Stationery Office.

channels have been launched, including free-to-air channels. These free-to-air channels include new channels launched by ITV.

1.6 ITV1's share of commercial impacts[2] (SOCI) fell from 43 per cent in 2003 to 30 per cent in 2008 and its share of net advertising revenue (NAR) [3] fell from 48 per cent in 2004 to 36 per cent in 2008. ITV1 remains by far the largest commercial channel. with advertising revenues for 2008 approximately double those of Channel 4.

1.7 In 2003 the CC had expressed concern about ITV1's unique ability to attract large audiences. The OFT therefore examined changes in the share of such 'mass audience' programming (defined as those with audiences in excess of 3–6 million[4]) and found that, although the number of such mass audience programmes declined by around 30 to 35 per cent between 2003 and 2008, ITV1 had maintained its share of these programmes at greater than 90 per cent (on all definitions).

Substitutability

1.8 ITV argued that the market had changed significantly since 2003 and that media buyers can now achieve their campaign objectives without ITV1. It provided analysis that sought to demonstrate that for a given level of expenditure, a media buyer could expect to achieve a very similar performance for a given campaign with or without ITV1.

1.9 We examined ITV's evidence and similar analyses provided by other parties. We found that, in comparison with 2003, based on ITV's analysis more campaigns could be run satisfactorily without using ITV1.

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[2]A commercial impact (or impact) is the viewing of an advertisement by one viewer.
[3]Net advertising revenue is total advertising revenue, less agency fees and commission.
[4]The OFT looked at several variations of the definition of mass audience programmes, being those with audiences in excess of 3 million, 4 million, 5 million or 6 million.

1.10 However, there are a number of important demographic groups, including Housewives, Adults and ABC1 Adults, for which advertising using ITV1 provided a significant advantage with regard to 'reach'—the number of individuals who would see the advertisement at least once. Campaigns that were required to reach a relatively large audience relatively quickly tended to be less substitutable than others.

1.11 Media buyers argued that ITV1's mass audience programmes were very important to their ability to reach a large audience and that this was especially important for fast-build and time-critical campaigns. ITV argued that its strength with regard to mass audience programmes was not relevant, as advertisers did not buy advertising spots in particular programmes; rather, they bought viewings by members of a particular demographic group which might be provided at any point in ITV1's schedule.

1.12 In our view, ITV1's ability to reach mass audiences allows it to deliver many campaigns' objectives more effectively than other commercial channels.

Constraints on switching

1.13 ITV submitted that the threat of media buyers reducing the amount of revenue they spend with ITV1 was sufficient to prevent it from imposing less attractive terms on media buyers.

1.14 The vast majority of television advertising is bought by media agencies. There has been significant consolidation of media agencies since the merger, but we found no evidence that this had given them countervailing buyer power. The substitutability analysis suggests that some campaigns cannot be run effectively without ITV1. All media agencies are therefore likely to have clients that wish to have the option of using ITV1 and as a result agencies cannot threaten credibly to remove all their expenditure from ITV1.

1.15 Media agencies have contracts with ITV that specify that they spend a specific share of their broadcasting (SOB) advertising expenditure on ITV1. Any reduction in an agency's SOB commitment will lead to a renegotiation of discounts and other contractual terms. A media agency seeking to reduce its SOB commitment to ITV1 would expect to be offered worse terms as a result. As media agencies need to retain access to at least some of ITV1's airtime, ITV is in a very strong negotiating position and in our view has the incentive and ability to deter media agencies from reducing their SOB commitments.

1.16 Because of ITV's very strong negotiating position, we do not think that, in the absence of the CRR remedy, the ability to run some individual campaigns without using ITV1 would act as an effective constraint on ITV.

Unintended effects

1.17 ITV submitted that the CRR remedy had had some unintended effects, inhibiting the launch of new ITV channels, creating undesirable incentives for ITV and other broadcasters, and hampering ITV's ability to react to changing demand.

Inhibiting the launch of new channels

1.18 ITV argued, and the OFT accepted, that the current definition of ITV1 in CRR would not include ITV1+1 or ITV1 high definition (HD)[5] channels and has thus reduced the incentive for ITV to invest in such channels. We agree, broadly, with ITV and the OFT on this point.

Effects on ITV's incentives

1.19 ITV argued that the way the CRR worked created a particular incentive to maximize its advertising performance as measured by SOCI. It said that this encouraged it to

[5]ITV has already launched a partial HD channel on Freesat and has been awarded capacity to carry a peak-hours HD channel on digital terrestrial television.

take actions that were not in the interests of advertisers, such as over-investing in daytime television, allocating its advertising minutes in a suboptimal manner and being risk averse in its programming choices. ITV provided evidence of various decisions it had made in support of its claim.

1.20 We find it plausible that the CRR has affected ITV's incentives to some extent, but we do not consider that the effects have been large or that the decisions that ITV cited were attributable wholly to the CRR remedy. We note that there was little support for ITV's contention from third parties.

Effects on other broadcasters' incentives

1.21 ITV argued that other broadcasters had an incentive to launch extra channels (such as +1 channels) because these could reduce ITV1's SOCI and make additional advertising revenues available to channels other than ITV1.

1.22 We have not seen any evidence on the business cases for launching other new commercial channels but we expect that the effect of CRR on such decisions is likely to be small.

Effect on ITV's ability to respond to changes in demand

1.23 ITV argued that because CRR gave advertisers the right to fall back on contracts negotiated a number of years ago, it was difficult for it to react to changes in demand. It argued that as a result it had found itself unable to deliver the advertising performances that its customers expected and that this had led to serious difficulties.

1.24 We do not think that this type of difficulty is wholly or even largely due to CRR, but we do accept that CRR may have contributed to it.

Provisional decision

1.25 Although ITV1's market position has declined in certain respects, we consider that the competitive environment is still very similar to that identified in the CC's 2003 report. In our view it is not appropriate to release ITV from the CRR undertakings but we will examine possible variations of the undertakings to take account of the changes that have occurred.

1.26 With regard to the unintended effects of the CRR remedy, in our view these are not sufficiently significant to warrant releasing ITV from the CRR undertakings. However, we will consider proposals to vary the undertakings to address these. In particular, we think it appropriate to vary the definition of ITV1 to incorporate possible ITV1+1 and ITV1 HD channels.

2. Introduction

2.1 In October 2003, the CC published its report on the proposed merger between Carlton and Granada. The CC found an adverse effect on future competition for the sale of television advertising airtime and concluded that the merger might be expected to operate against the public interest.[6] The CC concluded that the merger should only be allowed to proceed subject to certain conditions, the main one being that a remedy, described as contract rights renewal and based on a proposal by Carlton and Granada, be put in place to protect the interests of advertisers and the other commercial broadcasters.

2.2 Following the 2003 report, undertakings were given by Carlton and Granada and accepted by the Secretary of State for Trade and Industry (the Undertakings) under section 88(2) of the Fair Trading Act 1973 for the purpose of remedying or preventing

[6]The merger in 2003 was referred to the CC under the merger of provisions of the Fair Trading Act 1973 (FTA). The FTA was based on a public interest test. The CC now takes its decisions using a 'substantial lessening of competition' (SLC) test under the merger provisions of the Enterprise Act 2002.

the adverse effects on the public interest specified in the 2003 report. The full text of the Undertakings, which were effective from 14 November 2003, is set out in Appendix A. In relation to the sale of commercial advertising airtime on the 'Regional Channel 3 Services'[7] (ie ITV1),[8] the Undertakings set out the CRR remedy.

2.3 The merger of Carlton and Granada to form ITV became effective on 2 February 2004.

2.4 In October 2006, ITV asked the OFT to conduct a review of clauses 5 to 11 and the associated clauses and annexes of the Undertakings, covering the CRR remedy (the CRR Undertakings).[9] ITV argued that significant changes in the market for the sale of television advertising airtime had occurred since the CRR Undertakings had been put in place and that these changes made it appropriate for these clauses to be reviewed and for ITV to be released from the CRR Undertakings.

2.5 The OFT reviewed this request and, after extensive consultation, on 29 May 2009, in exercise of its powers under Schedule 24, paragraph 16, of the Enterprise Act 2002 (the Act), it advised the CC to consider varying the CRR Undertakings.[10] Under the Act, power to supersede, vary or release undertakings under section 88 passed from the Secretary of State to the CC, subject to the designation of the relevant undertakings by an order made by the Secretary of State.[11]

2.6 In this report we set out our provisional decision on whether to supersede, vary or release the CRR Undertakings. The remainder of the report is structured as follows:

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[7]'Regional Channel 3 Services' is as defined in Broadcasting Act 1990, section 14(6).
[8]In 2003, the ITV1 channel was known as ITV. We have used ITV1 throughout this decision.
[9]Specifically, clauses 5 to 11 and Annex 1 which relate to the sale of commercial airtime, clauses 12 to 18 and Annexes 2 and 3 which relate to adjudication, and clauses 23 to 25 which relate to the interpretation of words and expressions used in the Undertakings. The Undertakings also have provisions in clauses 2 to 4 in relation to other Regional Channel 3 Services licensees, but these are outside the scope of this review.
[10]A redacted version of the OFT's Advice has now been published on the CC's website. Its advice to the CC is contained in paragraphs 2.1 to 2.3.
[11]The relevant provisions are found in paragraph 16 of Schedule 24 to the Act. The Undertakings were designated in The Enterprise Act 2002 (Enforcement Undertakings and Orders) Order 2004 (SI 2004/2181).

Section 3 Background to this review

Section 4 The process of our review

Section 5 The scope of our review

Section 6 Assessment of competition

Section 7 Unintended effects of the CRR Undertakings

Section 8 Provisional decision

3. Background

The 2003 report

3.1 Carlton and Granada owned companies that operated 11 of ITV's 15 regional licences. The CC found that London was the primary focus of competition within ITV, with the potential to shift advertising between weekday London television (Carlton TV) and weekend London television (LWT, owned by Granada). However, it also noted that 'some switching was possible between ITV licensees in other regions' and that advertisers might be willing to accept a lower level of coverage in one region in return for higher coverage in another.[12]

3.2 Competition between Carlton and Granada was, in the CC's view in 2003, able to limit what advertisers or media buyers could be charged by, in particular, limiting the advertising budget commitment that could be demanded for a given level of discount.[13,14]

3.3 In its competitive assessment of the merger, the CC noted analysis provided by Carlton and Granada in which other commercial channels (those that carry advertising; not the BBC channels) appeared technically capable of providing

[12] CC 2003 report, paragraphs 2.126 & 2.127.
[13] CC 2003 report, paragraph 3.2.
[14] Appendix B of this decision provides an explanation of advertising campaign terms, including discounts.

equivalent levels of coverage[15] to ITV1. However, the CC stated that other commercial channels were not yet sufficiently close substitutes to ITV1 to prevent an increase in the advertising budget commitment to ITV1 that ITV could demand for a given level of discount following the merger. The CC identified the following reasons for this finding:[16]

(a) *barriers to switching,* in the form of the difficulty of purchasing sufficient advertising spots to achieve the required coverage and the likelihood of obtaining a lower sales uplift without ITV1;

(b) *ITV 'must have' features,* including the unique ability to attract large audiences for advertisers, a consistently high audience share in the evening peak, a very high proportion of prestigious programmes and the ability to attract 'light' viewers;[17]

(c) *customers deterred from marginal switching,* as they might be obliged to pay higher prices for their remaining ITV1 advertising; and

(d) *a lack of countervailing buyer power*.

3.4 Given this lack of substitutability, the CC identified three adverse effects that it considered likely to arise post-merger, namely, ITV's ability:[18]

(a) to insist on terms that were generally less attractive to advertisers or media buyers (for example, demanding a greater level of commitment of television advertising budgets for a given level of discount or obliging media buyers to accept worse terms and in particular reduced discounts);

(b) to enhance the degree of price discrimination; and/or

(c) to change the system under which television advertising airtime was sold to the advantage of ITV.

[15]Coverage is the proportion of the target demographic audience viewing the advertisement at least once over the campaign period. Appendix B provides an explanation of advertising campaign terms, including 'coverage'. See paragraph 6.15.
[16]CC 2003 report, paragraphs 2.128 & 2.129.
[17]The CC noted that there were some elements of ITV's performance which no other commercial channels, either individually or jointly, could match (CC 2003 report, paragraph 2.131).
[18]CC 2003 report, paragraph 2.132.

The CRR Undertakings

3.5 The CRR Undertakings set out the CRR remedy in relation to ITV1. The CRR Undertakings:

(a) give all existing customers of ITV1 the option of renewing the terms of their pre-merger contracts: these contracts are known as 'protected contracts' in the Undertakings;

(b) allow customers of ITV1 to negotiate different contract terms and to choose to nominate any new contract as a 'protected contract': ITV is required to offer any variation to existing contracts on fair and reasonable terms;[19]

(c) set out the audience ratchet mechanism (ARM): this mechanism provides for any SOB commitment[20] specified in a protected contract to vary in direct proportion to ITV1's SOCI[21] in the 'base year', weighted by the mix of demographic audience, regions and specific time periods contracted for and subject to a cap of the SOB commitment specified in the protected contract.[22] The calculation of the revised SOB commitment is set out in Appendix A;

(d) prohibit ITV from materially changing its airtime sales system without the consent of the OFT; and

(e) established an independent Office of the Adjudicator (the Adjudicator). The Adjudicator's role is to rule on contractual disputes arising between ITV and customers in relation to whether variations to protected contracts are fair and reasonable. The Adjudicator also provides informal guidance to ITV's customers on questions regarding rights during contractual negotiations within the context of CRR. The Adjudicator is funded by Ofcom which is, in turn, fully reimbursed by ITV.

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[19] All protected contracts in existence at 1 November 2003 were presumed to be 'fair and reasonable'.

[20] SOB commitment is the proportion of a media buyer's television advertising expenditure that it commits to spending with a particular sales house. This commitment is specified in the contract between the media agency and the sales house. (See also paragraph 6.13.)

[21] SOCI is the share of each sales house of total commercial impacts. A commercial impact (or impact) is a single viewing of an advertisement by a member of the target audience.

[22] See the Undertakings for the definition of 'base year'.

3.6 The CC stated in 2003 that it expected the CRR remedy to be in place for a minimum of three years.[23]

The OFT's advice to the CC

3.7 Following its review, the OFT concluded that changes of circumstance since 2003 implied that the CC should reconsider the CRR Undertakings. Its findings stated:[24]

> New means of delivering ITV1's programming such as +1 and High Definition channels have developed. This means that the CRR remedy requires, at least, updating. We recommend that, if the CRR remedy is retained in any form, the CC should change the definition of ITV1 to reflect changes in the way this channel can be delivered. The current definition of ITV1 in the remedy relates to ITV1's licence and not to the ITV1 programme schedule. Thus it does not cover advertising on all the various methods of delivering the programme schedule. We believe that the definition of ITV1 should be flexible enough to cover all methods of delivering the channel, rather than being linked to licensing arrangements. The CC should review the remedy for this reason alone.
>
> We also believe there has been some decline in the market position of ITV1, although its strength in the supply of mass audiences means that some of the CC's concerns about the merger may still remain. Our consultation document suggested a number of potential easements which could be put in place to reflect the decline in ITV1's market position. The responses to the consultation document suggested that these may not be appropriate but neither were any obviously better alternatives put forward. … We recommend that the CC gives further consideration to whether the decline in ITV1's market position means

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[23] CC 2003 report, paragraph 2.149.
[24] OFT advice, paragraphs 2.2 & 2.3.

that the remedy can be varied to provide effective protection against the remaining detrimental effects of the merger arising from ITV's strength in mass audience programming, but impose fewer costs and distortions than the remedy in its current form.

4. The process for our review

4.1 A memorandum of understanding between the OFT and CC on the variation and termination of undertakings sets out the process that the OFT and the CC usually follow in such reviews.[25]

4.2 As a result of the complexity of this review, both the OFT and ourselves have found it appropriate to depart, in some ways, from the usual process set out in the memorandum of understanding. In particular:

(a) the OFT consulted on its provisional view and published its final advice at the same time as sending its recommendation to the CC, rather than delaying publication until our provisional decision;

(b) the Chairman of the CC appointed a separate Group to conduct the review; and

(c) since the OFT's advice, we have received further representations from ITV and some third parties and have taken these representations into account.

4.3 Consistent with the principles of the memorandum of understanding, we have validated and considered the evidence provided to us by the OFT and a limited amount of additional evidence submitted to us by ITV and third parties. We have spoken to ITV and a number of third parties to enable us to clarify and validate the evidence before us; in particular, testing some of the assumptions on which the parties' analysis has been conducted. ITV was given an opportunity to respond on

[25]The OFT and the CC Memorandum of Understanding, published on 17 February 2009, is available at: www.oft.gov.uk/shared_oft/595316/595319/oft1060.pdf.

any significant additional evidence submitted to us by third parties. We have also made enquiries to the Adjudicator regarding the functioning of the CRR remedy and some of the disputes that have arisen since it was introduced.

5. The scope of our review

5.1 The scope of our review is to consider whether the changes of circumstance identified by the OFT (see paragraph 3.7) have led to sufficient change in the competitive environment identified in the 2003 report or the operation and effect of the CRR Undertakings such that they should be released, varied or superseded. In evaluating this, we have considered whether the changes of circumstance have either:

(a) led to a restoration, in whole or in part, of the competition that was lost as a result of the merger between Carlton and Granada (see Section 6); or

(b) resulted in unintended consequences for ITV, other broadcasters or media buyers (see Section 7).

5.2 In relation to *(a)*, ITV submitted that in considering whether it was appropriate to release, vary or supersede the CRR Undertakings, it was necessary to consider whether the adverse effects of the merger identified by the CC still existed, or had diminished. We agree with this.

5.3 In order to consider whether and to what extent the changes of circumstance identified by the OFT have restored the competition lost as a result of the merger we have focused on the implications of observable changes in the market for the sale of television advertising airtime.[26] We have considered changes from the date of the CC's report in October 2003.

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[26]Market definition is discussed in paragraphs 6.22 to 6.24.

5.4 We have only considered those adverse effects that were attributable to the merger. This is different from a general assessment of any market power ITV might hold, especially given that Carlton and Granada may already have held some market power pre-merger.

5.5 In addition to ignoring non-merger-specific aspects, there are other areas that are outside the scope of this review:

(a) the application of the CRR remedy to channels other than ITV1;

(b) issues that relate to concerns expressed regarding possible 'conditional selling' of advertising on the ITV family of channels; these would be a matter for Ofcom to investigate under the Airtime Sales Rules;[27]

(c) aspects of the Undertakings other than the CRR remedy (for example, clauses 2 to 4 relating to licensees other than those controlled by Carlton and Granada) which were not referred to in the OFT's advice; and

(d) wider competition issues in relation to aspects of television airtime sales.[28]

6. Assessment of competition

6.1 In this section we examine whether, and to what extent, the competition lost as a result of the merger between Carlton and Granada has been restored. The section is structured as follows:

(a) an introduction to how television airtime is bought and sold;

(b) the market definition we have used in conducting our assessment;

(c) changes in the market, and how these have affected certain market indicators;

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[27]These rules state that media buyers must be able to purchase airtime on one channel without being required to purchase air-time on other channels. They came into effect from 1 December 2003 and are enforceable by Ofcom via the licence conditions which apply to holders of broadcasting licences. The rules are available at: www.ofcom.org.uk/tv/ifi/guidance/ITV_airtime_sales/Airtime_sales_rules/.

[28]In the 2003 report (paragraph 2.183), the CC recommended a review of the wider market for selling airtime on commercial television. In the OFT's advice (paragraphs 7.15 to 7.19), it was noted that Ofcom did not consider it appropriate to open such an investigation at this time but that Ofcom would closely monitor any market developments and any stakeholder concerns, particularly in the light of any changes resulting from this review.

(d) changes in substitutability of advertising campaigns on ITV1. This is a major section of our analysis and includes:

   (i) the substitutability of individual campaigns;

   (ii) the scale of switching required to constrain prices; and

   (iii) the ability of media buyers to switch from ITV1;

(e) changes in other aspects of the market, including entry and expansion, other 'must have' features of ITV1 and possible market developments; and

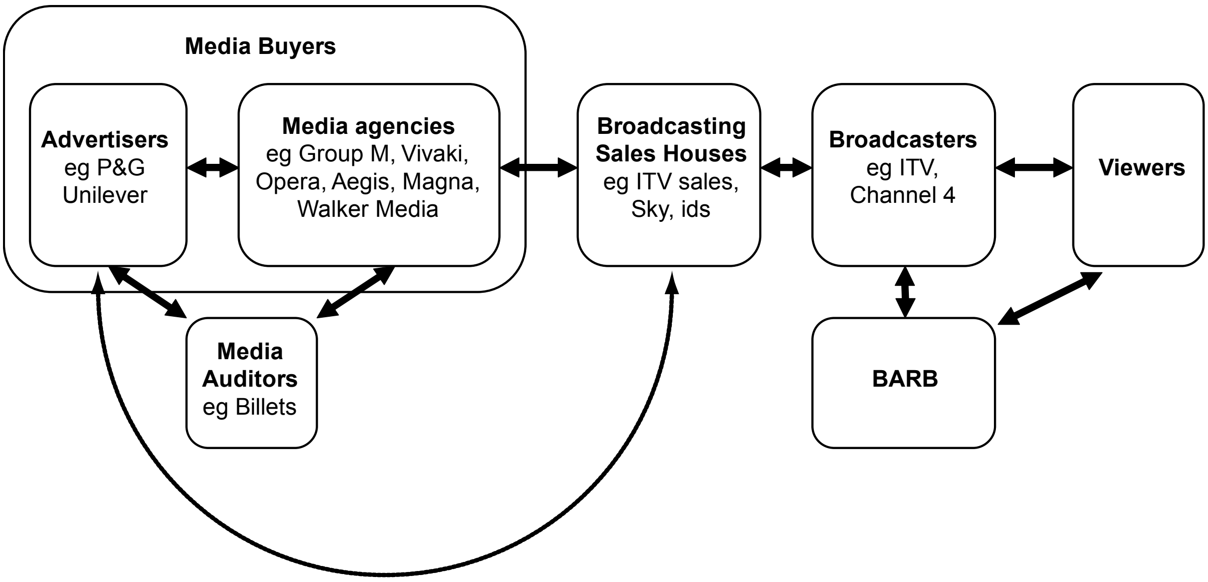
(f) we conclude with an assessment of the change in competition.

How television airtime is bought and sold

6.2 Figure 1 provides an overview of the various stakeholders in the television advertising supply chain. The role of each of these different stakeholders is described briefly below.

FIGURE 1

The television advertising supply chain



Source: CC based on Ofcom material.

6.3 *Advertisers:* The advertising process is initiated by an advertiser. The vast majority of advertisers use media agencies to buy television airtime on their behalf rather than negotiate directly with broadcasters. In 2007, the top 10 media agencies accounted for [✂] per cent of ITV1's revenues. Of the advertisers that negotiate directly with ITV1, Procter & Gamble is by far the largest.

6.4 *Media agencies* are employed by advertisers to negotiate the terms on which advertising is purchased from broadcasting sales houses. Advertisers will often have a multi-year contract with their media agencies.

6.5 *Media buyers:* we use the term ‘media buyers’ to include both media agencies acting on behalf of advertisers and advertisers acting on their own behalf.

6.6 *Broadcasting sales houses:* Television advertising airtime is generally sold on behalf of broadcasters by broadcasting sales houses (sales houses). Sales houses are responsible for managing the relationship with media buyers and negotiating contract terms and conditions. The larger broadcasters have their own sales houses, eg ITV, GMTV, Channel 4, Five, BSkyB, Interactive Digital Services (ids)[29] and Viacom Business Solutions (VBS).[30] Smaller broadcasters often contract to sell some or all of their airtime through one or other of these sales houses.

6.7 *Broadcasters:* The broadcaster shows the advertisements on its television channel. Working with its broadcasting sales house, the broadcaster will determine the schedule for its channels, where to include advertisement breaks and the length and number of those advertisement breaks. [31]

6.8 *Media auditors:* Media auditors are employed by advertisers to assess the effectiveness of advertising campaigns and the performance of media agencies.

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[29]ids is the advertising sales house for Virgin Media Television, UKTV, Virginmedia.com and Virgin Mobile. It is wholly owned by Virgin Media.
[30]VBS represents MTV and also sells Nickelodeon and Paramount.
[31]Subject to regulations, including the code on scheduling of TV advertising (COSTA) described in paragraph 7.11.

6.9 *BARB:* BARB (Broadcasters' Audience Research Board) is the primary provider of television audience measurement in the UK. It covers all channels broadcasting across all platforms—terrestrial, satellite and cable in both analogue and digital.[32]

6.10 Below we discuss the process which underlies the negotiations between media buyers and the sales houses for sale of television advertising airtime. We consider separately the contract negotiations and the purchase of airtime for individual campaigns during the year.

Contract negotiations

6.11 Contracts for the sale of television advertising airtime are typically negotiated between sales houses and media buyers on an annual basis. Negotiations tend to take place between October and December (the 'deal season') prior to the commencement of the new advertising year in January.[33]

6.12 The main types of contracts agreed are:

(a) *Umbrella contracts:* A contract between a sales house and a media agency that encompasses the media agency's expected portfolio of advertising clients. These umbrella contracts can, however, include provisions for specific advertising clients for whom terms are negotiated on a 'line-by-line' basis. Umbrella contracts accounted for [✂] per cent of ITV1's revenue in 2007.

(b) *Line-by-line contracts:* In these contracts, advertisers, or media agencies on advertisers' behalf, agree their own specific terms. Some media agencies offer line-by-line contracts to all their advertising clients.

6.13 Media buyers negotiate contracts with sales houses which invariably specify an SOB commitment from the media buyer in exchange for a discount from the price of

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[32]BARB is jointly owned by ITV, BBC, Channel 4, Five, BSkyB, and the IPA. More detail is available on BARB's website at www.barb.co.uk/.

[33]However, there are no significant barriers to negotiations being undertaken during other periods of the year, or indeed for contracts to cover period of greater or less than one year.

advertising to a particular television audience (known as a traded demographic).[34] Television audiences typically comprise a range of different demographic groups which are identified by age, gender, and socio-economic status.[35] Contracts specify SOB expenditure and the discount against relevant traded demographics and regional shares of broadcast expenditure. Contracts also tend to cover a wide range of other terms, often in great detail. These include:

(a) *Daypart allocations:* media buyers may want to specify the allocation of SOB to particular times of day to reflect their target audience.[36]

(b) *Weekly strike-weight tolerance:* media buyers will want to set parameters for how an advertising campaign is spread over its duration, for example by specifying a minimum spread of ratings per week.

(c) *Position in break:* this refers to specific positions within an advertising break, eg first advertisement, centre advertisement. It is generally believed that advertisements that are broadcast either first or last in a break will be more effective than advertisements in the middle of the break. Therefore some media buyers will try to include a minimum guarantee of first in break and last in break spots. As these spots are considered more valuable, it is likely that they will attract a price premium.

(d) *Programme guarantees ('pick your own' spots):* Television advertising schedules are initially generated by broadcasters' computer systems. However, it may be that it is important for media buyers to have some control over programme selection so that if there are some key programmes that are ideal for a campaign they can be requested. Therefore a media buyer may seek to secure the

[34]The discount is applied to the station average price (SAP). This price is not known (although it can be estimated) until after the advertisement has been shown. Appendix B provides further explanation of SAP and discounts.

[35]For example, a distinction can be made between broad categories such as 'Adults', 'Men', 'Children' etc. The 'Adults' demographic could then be further divided into ABC1 Adults or Adult males, 16–34 etc. Different demographic groupings are not necessarily mutually exclusive, eg the 16–34 Men demographic is a subset of Adult Men and also a subset of 16–34 Adults.

[36]Different dayparts have different values depending on their popularity. For example, the majority of people watch television in peak (1730–2300) and therefore this is the most demanded and also the most expensive daypart. Standard dayparts are as follows: Breakfast time 0600–0859; Daytime 0900–1729; Peak 1730–2259 (Early peak: 1730–1959 and late peak: 2000–2259); Post peak 2300–2429; Night time 2430–0559.

opportunity for a certain degree of programme selection. Most programme guarantees are subject to limits.

6.14 During the deal season, a media buyer cannot know the objectives of all individual campaigns it will need to run during the following year. It must therefore take a view on its likely advertising needs. For a media agency, these needs are based on its portfolio of advertising clients and will vary from year to year if the agency's portfolio of clients changes or the needs of the advertisers in its existing portfolio change.

Individual campaigns

6.15 During the course of a year, media buyers construct media plans for individual campaigns based on specific advertising campaign objectives. An optimal campaign strategy, including the mix of media and television channels, is influenced by the product in question, target demographic, required coverage and frequency, campaign budget and the campaign's timing. Coverage[37] measures how many viewers in an advertiser's target demographic audience see the advertisement; frequency[38] measures how many times the viewers in the target demographic audience see the advertisement. Ideally, an advertiser wants to reach as high a proportion as possible of its target audience with a frequency that is appropriate for its advertisement. The media plans set out the number of commercial impacts (see paragraph 6.17) that each channel must provide in order to meet the advertisers' coverage and frequency objectives, and are based on estimated future costs of impacts across channels.

6.16 To reflect campaign-specific objectives, throughout the year there are continual negotiations between the sales houses and the media buyers regarding airtime

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[37]Coverage is the proportion of the target demographic audience viewing the advertisement at least once over the campaign period. Reach is always expressed in terms of 1+ coverage.
[38]A campaign's frequency is the proportion of the campaign's target audience that has seen the advertisement at least a particular number of times over the campaign period. For example, 4+ coverage of 50 implies that 50 per cent of the target audience has seen the advertisement four or more times during the campaign.

schedules for individual campaigns. These discussions are governed by the terms of the media buyer's contract with the sales house.

6.17 Prior to the advance booking deadline,[39] a media buyer commits a particular amount of money on the basis of what it expects that money will deliver in terms of the number of viewings by members of the target audience over a particular period of time, having regard to its campaign objectives. These viewings are called 'impacts'.[40] Impacts are bought from broadcasters' sales houses against a particular traded demographic taking account of the media buyer's estimate of the relationship between the target audience and the traded demographic. Traded demographics are based on relatively broad characteristics, eg 16–34 Men, Housewives, etc,[41] and are unlikely to match precisely an advertiser's target audience. In some cases the target audience will correspond closely with a traded demographic, but in others the correspondence will be relatively poor. Whilst advertisers purchase the impacts of a particular demographic, their advertisements may actually be seen by a wider number of demographics, and therefore media buyers may receive impacts which are not those relating to the traded demographic.

6.18 In addition to purchasing impacts against a particular traded demographic, a media buyer informs the sales house of any specific requests (for example, with regard to its 'pick your own' spots) as provided for in the terms of its contract.

6.19 Once the advance booking deadline has passed, sales houses use computer systems to aggregate the demands and requirements of the media buyers. Sales houses allocate advertising airtime so that advertisements are shown during programmes that they expect will be seen by the greatest possible number of people in

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[39]For ITV the advance booking deadline is two months before the airing of the programme.
[40]An impact is a single viewing of a television advertisement by a member of the target audience.
[41]ITV trades 15 demographics: Adults, ABC1 Adults, 16–24 Adults, 16–34 Adults, Men, ABC1 Men, 16–34 Men, Women, ABC1 Women, 16–34 Women, ABC1 Housewives, 16–54 Housewives, Housewives, Housewives with Children and Children.

that target demographic, rather than from other target demographics; this process is known as optimization. ITV told us that, although it will often be the case that its optimization process aligns with media buyers' requests on a campaign by campaign basis, a media buyer cannot be guaranteed at the outset that this will be the case.

6.20 Reoptimization occurs continually to accommodate late bookings and to take account of changes in the broadcast schedule and expected audience. The schedule for the media buyer's campaign is sent back to the media buyer, who checks it against its contract (for example, to see if the schedule is in line with the agreed amounts of dayparts and position in breaks). In addition, it checks the schedule against the campaign objectives (for example, the media buyers might want to reach a large proportion of its target demographic quickly at the start of a campaign or just before the expected time of the buying decision, eg at the weekend). Following this, further negotiation between the media buyer and sales house about positioning of advertisements may occur and the schedule continues to be sent back and forth until both are in agreement. However, the sales house usually has the final say on many of these campaign-by-campaign decisions because of the existence of clauses in which the broadcaster's optimization process overrides the vast majority of specific contractual terms (as described in paragraph 6.13).

6.21 Sales houses and media buyers must also ensure that the impacts traded throughout the year, via the individual campaigns, are consistent with the overall contract terms agreed during the deal season and that the overall discount agreed at that time has been delivered. If, in a particular month, the sales house does not deliver the expected number of impacts, then it is considered to have overtraded (or under-delivered) and must give the media buyer extra impacts in a future month.[42] In

[42]Overtrading essentially means that individual advertisers are receiving less than their 'agreed share of impacts' in that month. This means that the sales house owes a 'deal debt' to advertisers/media buyers. If this is carried over into the following month,

contrast, if more impacts were achieved for the advertiser than agreed, the sales house will have undersold (over-delivered), and will have to achieve fewer impacts for the advertiser in a future month.

Market definition

6.22 In 2003, the CC concluded that the relevant market for the purpose of assessing the merger between Carlton and Granada was television advertising in the UK.[43]

6.23 In its advice, the OFT concluded that the most appropriate market definition for this review is the same as that used in 2003.[44] We agree with the OFT's advice on market definition. In particular, we agree that:

(a) The market is no wider than television advertising.

(b) Internet advertising is still not a substitute for television advertising. Although there has been rapid growth of Internet advertising expenditure since 2003, this has been largely driven by classified Internet advertising. Display Internet advertising has increased from 1.1 per cent of total advertising expenditure (by revenue) in 2003 to 4.4 per cent in 2008.[45]

(c) The increase in the number of multi-channel television households[46] has further blurred the boundaries between advertising on free-to-air and pay television. It is therefore not appropriate to segment the market for television advertising by platform.

(d) There is a degree of substitutability between different demographics. Whilst for the purposes of this review we consider it appropriate to consider a single prod-

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the sales house will face an increased difficulty in delivering on all its discount commitments in that month. Sales houses therefore seek to ensure that this deal debt does not escalate.
[43] CC 2003 report, paragraphs 2.88 & 2.89.
[44] OFT advice, section 4.
[45] See Advertising Association, *The Advertising Statistics Yearbook 2009*, table 3.1.1, p14, and table 16.2, p184.
[46] Viewers procure television reception equipment to access analogue and digital television channels and services. Viewers will normally have a choice between different digital television platforms, as well as with the type of television services available on those platforms. Thus, viewers may decide just to procure reception equipment to access free-to-air content on a particular platform (ie a retail platform access service), and/or may also decide to pay subscription and/or pay-per-view fees to access additional content (ie a retail content service).

uct market for all traded demographics, we recognize that the competitive constraints on ITV1 may differ between demographics to some extent.

(e) Although some media buyers require only regional coverage, there is sufficient substitutability between regions to indicate a national market.

6.24 We therefore undertake our competitive assessment within the market for television advertising in the UK.

Changes in market indicators

6.25 There have been significant changes in the television industry since 2003. The penetration of digital television has increased from 42 per cent of households in 2002 to over 88 per cent[47] at the end of 2008. The increased penetration of digital television and corresponding increase in the number of channels available has led to increased fragmentation of viewers across channels. Whereas in 2003 the digital-only channels[48] had 24 per cent of viewing, this figure had risen to 39 per cent in 2008. This change has been driven by the success of Freeview and other digital platforms which have enabled (and also benefited from) the launch of a large number of new channels, including free-to-air channels. These free-to-air channels include new channels launched by ITV (ITV3 and ITV4), a range of channels launched by other broadcasters (Dave and Virgin One, for example) and time-shifted channels such as ITV2+1 and Channel4+1.

6.26 Against this background we consider the change in the four market indicators examined by the OFT in its advice:

(a) SOCI;

(b) share of NAR;

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[47]Source: Ofcom, The Communications Market: Digital Progress Report, Q4, 2008.
[48]The channels other than BBC1, BBC2, ITV1, Channel4/S4C and five.

(c) programme audience size; and

(d) the ITV premium.

Change in share of commercial impacts

6.27 ITV1's SOCI for adults[49] fell from 43 per cent in 2003 to 30 per cent in 2008.[50] ITV1 still remains by far the single largest commercial channel. ITV1's SOCI has declined across all demographics. It has lost share to a range of other channels, the channels that have gained most being ITV's other channels and Channel 4. However, the increasing number of small channels, considered in aggregate, have taken a substantial proportion of ITV1's share, even though individually these channels have relatively few viewers.

6.28 The adult SOCI of the whole of ITV (ie ITV1 and ITV's digital channels) fell by a smaller amount—from 46 per cent in 2003 to 39 per cent in 2008, reflecting the growth in ITV's digital channels and that some of the impacts lost by ITV1 have been gained by its own digital channels.

Change in share of net advertising revenue

6.29 ITV1's share of NAR fell from 48 per cent in 2004 to 36 per cent in 2008.[51] We agree with the OFT's observation that market indicators based on revenue measures will be affected by the existence of the CRR remedy. As with SOCI, ITV1's share of NAR has been lost to a range of other channels, but the main beneficiaries have been ITV's other channels, Channel 4 and ids. Whilst small channels, collectively, have taken a significant proportion of viewers they account for a much smaller proportion of NAR than of SOCI.

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[49]Individuals aged 16 and over.
[50]OFT advice, paragraph 5.10. Estimated figures.
[51]OFT advice, paragraph 5.10. Note there are no reliable figures for 2003, so 2004 was used as the comparator date. Overall ITV's NAR (excluding GMTV) fell from 50 per cent in 2004 to 41 per cent in 2008.

Change in share of mass audience programmes

6.30 Given the CC's concern in 2003 regarding ITV1's unique ability to attract large audiences, the OFT examined changes in the share of such 'mass audience' programming. The OFT found that, although the number of mass audience programmes declined by around 30 to 35 per cent between 2003 and 2008, ITV1 maintained its share of these programmes at greater than 90 per cent. In 2003, ITV1 accounted for 995 of the top 1,000 most watched programmes on commercial television for all adults, and in 2008 this figure was 993.[52] We note that viewing levels have changed significantly over the period, so the viewing figures of these programmes are significantly less than comparable figures for 2003, and that what is considered a mass audience now might not have been regarded as such in 2003.

6.31 We discuss the importance of the reach and frequency provided by ITV1's mass audience programmes in allowing advertisers to achieve their campaign objectives in more detail in paragraphs 6.53 to 6.58.

Change in the ITV premium

6.32 The OFT considered how prices for advertising on ITV1 have changed since 2003, although again noting that prices will have been heavily influenced by the existence of CRR. The 'premium' of a channel is the share of NAR divided by SOCI for a particular demographic. A premium greater than 1 indicates that the price of advertising (ie the price of an impact) on a channel is above average. ITV1 has a premium of around [✂] and this has changed very little since 2003.

6.33 This result is not altogether surprising as CRR allows a reduction in advertisers' SOB commitment (which drives NAR) that is directly proportionate to SOCI. However, the CRR remedy was designed such that advertisers only need to rely upon their CRR

[52]Source: Ofcom.

protected contracts as a fall-back position. They could choose to negotiate new arrangements with greater or lesser SOB commitments. The lack of a reduction in the ITV1 premium suggests that there has not been significant freely negotiated net switching away from ITV1.

Changes in market indicators—assessment

6.34 The market indicators presented by the OFT show a fall in ITV1's SOCI and share of NAR between 2003 and 2008. This pattern holds across all demographics. However, the market for television advertising has become increasingly fragmented since 2003 and ITV1 shares of SOCI and NAR remain much larger than those of other channels. The market share that ITV1 has lost has been spread among many other channels, including ITV's own digital channels. Over this period ITV1 has maintained its very high share of mass audience programmes.

6.35 Against this background of market changes since 2003 we now turn to the degree of substitutability of ITV1.

Changes in substitutability of ITV1

6.36 In this section, we consider the extent of substitutability of ITV1:

(a) *Substitutability of individual advertising campaigns:* We consider first whether individual campaigns could be run without ITV1 and whether there are limitations to substitutability of individual campaigns (see paragraphs 6.37 to 6.65).

(b) *Scale of switching required to constrain price rises:* We go on to consider what scale of movement of campaigns would be necessary to make unprofitable an attempt by ITV to raise prices of ITV1 airtime (see paragraphs 6.66 to 6.80) and whether this would be viable. We consider the scope for price discrimination as this affects the analysis.

(c) *Ability of media agencies to switch from ITV1:* We then consider whether a media agency would be able to reduce or threaten credibly to reduce its SOB commitment during the deal season.

Substitutability of individual advertising campaigns

6.37 In this section we consider whether and to what extent individual advertising campaigns could be run without ITV1. We start with some introductory observations, after which we consider:

(a) detailed analyses:

(i) provided by ITV;

(ii) provided by third parties; and

(iii) summary of the results;

(b) some possible limitations of the analyses;

(c) relevance of audience size (or mass audiences);

(d) evidence of past switching; and

(e) the relationship with market definition.

We conclude with an assessment.

6.38 ITV submitted that media buyers could now achieve their campaign objectives without ITV1. To support this, it provided evidence that for a given level of expenditure, a media buyer could expect to achieve a very similar degree of coverage for a given campaign length by using either a mix of commercial channels which included ITV1, or one from which ITV1 was excluded.

6.39 In 2003, the CC examined analysis by Carlton and Granada that sought to demonstrate that equivalent levels of 1+ and 4+ coverage could be achieved with and without ITV1 in relation to some, but not all, demographics.[53] These measures attempt to address coverage (1+ coverage) as ideally an advertiser wants to reach as high a proportion as possible of its target audience and frequency (4+ coverage) to give an indication on the level of repeat viewings. The CC report noted that, although this analysis appeared to be technically correct, there were barriers to switching and other ‘must have’ features of ITV1 that limited this substitutability (see paragraph 3.3*(b)* above).[54]

ITV’s analyses

6.40 ITV argued that the situation had changed substantially since 2003. Its new evidence was based on two different approaches:

(a) First, ITV looked at the substitutability of ITV1 using media planning software. In each scenario, ITV took a hypothetical campaign and distributed television ratings (TVRs, a way of measuring the supply of impacts[55]) in proportion to each channel’s existing share of commercial impacts. It then calculated the total cost of this campaign. To assess the effect of removing ITV1 from the schedule, ITV reallocated TVRs away from ITV1 in proportion to the other channels’ existing shares of commercial impacts based on the same budget and same price of impacts. In relation to these scenarios with and without ITV1 it compared the resulting changes in coverage and frequency. This approach was the same as that used for submissions by Carlton and Granada to the CC in 2003 and allowed direct comparisons to be drawn between substitutability in 2003 and in 2008/09.

(b) Second, ITV looked at substitutability of ITV1 using manual reallocation of advertising spots, incorporating expert judgement rather than following a software algorithm. ITV requested the media auditor, [✂], to examine a number of actual

[53] The exceptions were ABC1 Adults, Adults and Housewives, where excluding ITV1 led to a decline in 1+ coverage of between one and three percentage points.
[54] CC 2003 report, paragraphs 2.128, 2.129 and 5.111.
[55] Television ratings (TVRs) are the number of impacts achieved (by an individual spot, or by a group of slots aggregated over a specified time period or an entire advertising campaign) expressed as a percentage of a target audience.

campaigns and to reallocate the spots from ITV1 to other channels, using the same budget. The media auditor used media planning best practice to reallocate the spots from ITV1 to other commercial channels.[56] As with the software-based substitutability methodology, the media auditor examined the resulting changes in coverage and frequency for scenarios with and without ITV1. This manual type of substitutability analysis was not conducted in 2003 so it does not facilitate comparison of the degree of substitutability in 2003 and 2008.

6.41 Using both methodologies, ITV tested campaigns with differing campaign objectives (in terms of required ratings), durations and seasonal timings.[57] ITV also undertook these analyses assuming that a large number of campaigns had already been switched away from ITV1. ITV then examined the switching of an individual campaign after taking into account the effect on the price of impacts on ITV1 and other commercial channels of switching *(a)* £30 million and *(b)* £205 million away from ITV1.[58]

Third party analyses

6.42 A number of third parties also undertook both software-based and manual analyses of substitutability (including software-based analyses of actual campaigns).

6.43 In Appendix C, we have set out in more detail the findings and assumptions of the various different analyses of substitutability that were conducted by ITV and third parties.

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[56]ITV stated that this was to avoid too many advertisements on the same channel, avoid using rarely-used channels and be consistent with channels' sales policies. We discuss limitations to this approach in Appendix C.
[57]For example, ITV examined the substitutability of a four-week 400 TVR campaign, a one-week 100 TVR campaign, a one week 150 TVR campaign and also provided the breakdown by week of a four-week campaign on a week-by-week basis (ie showing 200 TVRs after 2 weeks and 300 TVRs after 3 weeks).
[58]ITV used £30 million based on its critical loss type analysis (see paragraph 6.70) and £205 million based on the [✂] implied by ITV's customer survey. We consider this survey in Appendix E and paragraphs 6.69 & 6.71.

Summary of the results of the substitutability analyses

6.44 We reviewed these analyses and although the approaches vary, in our view, the evidence can be taken together to assess the substitutability of campaigns that use ITV1.

6.45 ITV's software-based substitutability analysis showed that campaigns in 2008/09 seemed to be capable of getting closer to their campaign objectives without ITV1 than they had in 2003. In addition, a higher proportion of campaigns were able to achieve their original coverage and frequency when ITV1 was not used.

6.46 Based on ITV and third party evidence, we found that, using both the software and manual methodologies for 2008/09:

(a) There are a number of demographics for which removing the use of ITV1 will generally lead to deterioration in 1+ coverage, a key objective for media buyers. The demographics that showed least substitutability in relation to 1+ coverage comprise the main demographics that ITV1 sells—Housewives, Adults and ABC1 Adults—and, to a lesser extent and to varying degrees, the next three most important demographics—ABC1 Men, 16–34 Adults and Housewives with Children.[59] These six demographics comprise [✂] per cent of ITV1's net revenue.[60]

(b) If ITV1 is not used for a campaign this tends to increase frequency, with 4+ coverage increased in nearly all scenarios.

(c) There are some demographics for which ITV1 seems substitutable for most campaigns. These include Children and Men.

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[59]More detail is provided in Appendix C.
[60]Revenue net of agency commission.

Limitations of the substitutability analyses

6.47 These analyses assume that each impact for a given demographic is of the same value to the advertiser, regardless of the programme it is associated with, the channel it is shown on or the time at which it is shown. Media buyers challenged this assumption, arguing that ITV1's impacts generated above average increases to advertisers' sales and greater levels of engagement.

6.48 In 2003, the CC found that ITV1 had an advantage in terms of the quality of its impacts, particularly in terms of better programme engagement and levels of attention.

6.49 We examined a range of evidence from ITV and third parties in relation to the quality of impacts provided by ITV1. This evidence is summarized in Appendix D and includes our assessment of some ITV1 marketing materials and third party analysis of the quality of impacts.

6.50 We found that the belief that there is some qualitative point of difference between ITV1 impacts and those on other channels, as propounded by ITV over many years, is widespread among media buyers. We accept that ITV's marketing materials cannot be expected to put forward a wholly objective evaluation of its offerings. Although argument and evidence has been advanced linking high levels of viewing engagement with a programme and increased effectiveness of associated advertising, we have not found it necessary to form a view on the matter.

6.51 The research we have seen from media buyers does not generally address issues such as audience engagement but rather the effectiveness of ITV1 as a sales and marketing channel. This research suggests that ITV1 does indeed generate incremental sales and this is reflected in the premium ITV1 charges. It is not clear to what extent ITV1's extra effectiveness should be attributed to its ability to generate large audiences and thus reach (as discussed in paragraphs 6.53 to 6.58) or to the quality of its impacts.

6.52 We note that ITV1's customers pay higher prices for some impacts (notably at peak times) than others. This suggests that not all impacts are of equal effectiveness and thus that the analyses of substitutability of individual campaigns do not take account of all relevant factors, although it is not clear to what extent these factors would affect the outcomes.

Audience size and ability to achieve coverage

6.53 Media buyers argued that ITV1's ability to provide large audiences was very important in enabling them to achieve coverage (especially 1+ coverage) and that this was especially important for fast-build and time-critical campaigns.

6.54 ITV submitted that its ability to provide large audiences was not a relevant consideration as it did not sell spots in programmes. ITV argued that sales houses sold impacts, subject to broad quality parameters on the part of the media buyers and optimization parameters on the part of the sales house.

6.55 In the 2003 report, the 'must have' features of ITV1 identified included its unique ability to attract large audiences, a consistently high audience share in the evening peak and a very high proportion of prestigious programmes. ITV1's ability to deliver large audiences appears to be a key reason for its strength in delivering 1+ coverage, as identified by the substitutability analyses. When ITV1 is not used, higher levels of frequency are reached in most cases because other commercial channels are not able to deliver large numbers of impacts at one time, but instead must do so through more frequent broadcasting of the advertisement. ITV1's ability to deliver large audiences appears to give it an advantage in ensuring 1+ coverage and speed of build for certain demographics.

6.56 ITV submitted that ITV1's ability to deliver large audiences does not necessarily assist it in delivering coverage since the programmes with large audiences (such as *Coronation Street*, *Emmerdale* and *The X Factor*) tend to deliver the same viewers again and again. These programmes, it asserted, can therefore be detrimental to delivering a media buyer's campaign objectives, especially in relation to 1+ coverage.

6.57 However, evidence from media buyers suggests that this problem is, at least to some extent, addressed in the review of schedules. Placement of an advertisement will be part of the discussion that takes place between a media buyer and a sales house once the initial schedules have been released. A media buyer would generally not want to have its advertisement in the same programme spot over and over again. It may, however, want one or two spots in these large audience programmes in order to increase the prospect of delivery of the campaign objectives. The existence of one or two of these large audience programmes in a campaign schedule will allow speed of build to be achieved more quickly and more efficiently.

6.58 In our view, ITV1's ability to reach large audiences is important because it allows ITV1 to deliver a campaign's coverage objectives more effectively (and with greater certainty) than on other commercial channels. This is particularly the case for those campaigns that require coverage to be built in a relatively short period of time. Although the way that airtime is traded means that ITV1 does not generally sell spots in mass audience programmes, in our view these remain particularly important to advertisers.

Evidence of past switching of individual campaigns

6.59 If ITV1 can be substituted by other commercial channels, we might expect to see some examples of past switching of expenditure away from ITV1.

6.60 ITV presented some evidence to suggest that media buyers have successfully switched away from ITV1.[61] However, we did not find the evidence on past switching to be convincing. The two most significant examples—[✄] and [✄]—had reduced advertising expenditure on ITV1 for certain campaigns in the past but both continued to advertise on ITV1.[62]

6.61 ITV argued that the extent of historic switching was not relevant to considering whether the CRR undertakings should be relaxed or removed. It said that the relevant issue would be switching behaviour in the event that ITV1 was to demand that media buyers pay more than they would have had to pay absent the merger (ie rates higher than those allowed by CRR). ITV also said that it would not be possible to link historic switching to changes in prices for advertising on ITV1 holding all other prices constant given annual changes in the SOB commitment on the other commercial channels and fundamental changes in the supply of impacts over the period that CRR had been in place.

6.62 We agree with ITV that the expected level of switching would depend on the prices for ITV1 airtime but note that ITV has suggested that ITV1 is substitutable at current prices. If there had been a significant amount of switching, this would support ITV's contention that ITV1 is substitutable. Our view is that it is significant that there has

[61]ITV identified the following as companies which had switched all spend away from ITV1 to other channels since 2003: [✄]. ITV said that for [✄] the cost of advertising on ITV1 was a reason for switching. Other reasons given are related to the ability to target a particular audience. ITV also provided figures on the reduction in spend with ITV1 by the [✄] sectors as evidence that ITV1 is no longer necessary to the particular issue of achieving quick coverage. That [✄] had not used ITV1 in its most recent campaign was said to be evidence that advertising on ITV1 is not essential for new product launches.

[62][✄] told the OFT that it had not switched away from ITV1, but that its focus in 2007 on promoting its [✄] product, aimed at young men, meant that for this period more of its spend was with other channels that were more effective in reaching this target audience. [✄] told the OFT that it continued to advertise with ITV1—particularly during event programming—and that ITV1 remained essential to achieving the reach it wanted.

been little switching although that in itself does not necessarily mean that ITV1 is not substitutable.

Relationship with market definition

6.63 ITV argued that identical levels of reach and frequency were not necessary for a particular demographic to be fully substitutable because there was a single broad market for television advertising in which all demographics were fully substitutable at the margin. Therefore despite the reductions in reach for some demographics, it considered that these demographics were still fully substitutable.

6.64 However, as we note in paragraph 6.23*(d)*, the competitive constraints on ITV1 may differ between different demographics to some extent. For example, the availability of impacts on other channels varies between demographics. In addition, whilst campaigns may be able to capture their target audience by amending the demographic purchased, this may have a cost implication. In our view it is not correct to infer from the market definition that each demographic is fully substitutable.

Substitutability of individual campaigns—assessment

6.65 In our view there has been some increase in substitutability of individual campaigns since 2003. Campaigns for which the main objective is delivering frequency can now substitute away from ITV1. However, for many demographics 1+ coverage is reduced if ITV1 is not used. This most severely affects those campaigns that require more impacts to be delivered in a shorter period of time. ITV1's advantage in delivering coverage quickly arises out of its ability to deliver large audiences compared with other commercial channels.

Scale of switching required to constrain price rises

6.66 We considered what level of reduction in expenditure on ITV1 by media buyers would be required to offset an attempt by ITV to reduce discounts or request a greater SOB commitment. We begin our consideration of this issue on the basis that worse terms are imposed across all media buyers. We then discuss the issue in the context of price discrimination.

6.67 We first consider the evidence ITV provided on critical-loss-type analysis, including its survey of media buyers. We then consider capacity constraints.

6.68 It is usual to consider what amount of ‘marginal’ switching is required in order to constrain a firm from being able profitably to increase its prices (the ‘critical loss’) and whether this amount of switching would actually occur in response to the price rise. In this case, the relevant amount of switching is the amount of budget media buyers would need to be willing and able to switch away from ITV1 in order to render unprofitable an attempt by ITV to extract a higher SOB commitment or reduce discounts.

ITV’s survey of media buyers and critical-loss-type analysis

6.69 ITV engaged an independent research firm to conduct a survey of media buyers so as to understand how they would behave in the event that ITV was to attempt to extract a 5 to 10 per cent higher expenditure commitment to ITV1 (this would be equivalent to a 5 to 10 per cent price rise).

6.70 ITV used its survey to derive a critical loss. Based on the survey sample, if ITV1 was to demand a 5 per cent increase in expenditure from its customers, then £[✂] million of expenditure switching away from ITV1 would be sufficient to offset the revenue gains to ITV1 from buyers paying increased prices. Of this £[✂] million, £[✂] million would switch to other media and £[✂] million would switch to other television channels.[63]

6.71 We have some concerns about the survey and this critical loss analysis. Our assessment of the survey is set out in Appendix E. In particular, we are concerned that most of the respondents to the survey were not responsible for making advertising buying decisions and that the sample size was small. We therefore consider that the results of the survey are not determinative as to the expected extent of switching in response to a price increase across all media buyers. In relation to critical loss, ITV's critical loss calculation only related to the respondents of the survey[64] and not all media buyers purchasing ITV1 airtime. It is therefore an underestimate of the critical loss across all media buyers purchasing ITV1 airtime. Nevertheless, based on ITV's assumption that there are high fixed costs and low marginal costs in television advertising, we would not expect the critical loss across all media buyers purchasing ITV1 airtime to be significantly higher than the figure of £[✂] million ITV submitted.

Capacity constraints on other channels

6.72 ITV stated that, if demand increased across the whole market or for a particular channel, this would simply lead to an increase in the price per impact across the whole market or for that particular channel, ie media buyers would receive fewer impacts for the same amount of revenue committed. ITV argued that the key constraint on switching was therefore the relative change in prices that would occur post-switching. ITV submitted analysis that showed that due to the annual growth of impacts, £182 million ([✂] per cent of ITV1's revenues) could move away from ITV1 in 2008 without causing any year-on-year increase in the cost per thousand for other

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[63]The survey question did not differentiate between non-ITV and non-ITV1 channels. The extent to which spending switched to ITV's other channels would affect ITV's incentives.
[64]ITV told us that the results obtained buying points accounting for 75 per cent of ITV1's revenues.

broadcasters.[65] ITV stated that the findings from its substitutability analysis would remain accurate up to this amount of switching away from ITV1.

6.73 We do not agree that there are no limitations to the number of impacts that can be absorbed by other commercial channels. ITV's argument does not reflect the capacity constraints which exist on other commercial channels. These constraints include:

(a) *Inventory constraints imposed by other commercial channels.* Although ids and VBS stated that there would not be any operational constraints in accepting a proportion of ITV1's business, Channel 4, Five and Sky noted some practical constraints to accepting advertising switched from ITV1. In addition, broadcasters also try to ensure that products of the same type are not advertised in the same break (for example, avoiding two car advertisements in the same break) and to avoid over-exposure on any one channel. Volume limits, in-break clashes and advertisement overload were not considered in the software-based substitutability analysis but attempts were made to consider them in the manual substitutability analysis, where the reviewing media auditor [✂][66] noted that on several occasions the revised schedules exceeded 50 TVRs on Channel 4 in a single week.[67] ITV stated that this was, however, only in relation to the scenarios with exceptionally high levels of TVRs (ie all campaigns greater than 200 TVRs and some over 150 TVRs).

(b) *Capacity constraints at a particular point in time on another channel, especially at certain times of year (eg Christmas).* Neither the software-based nor the manual substitutability analysis sufficiently took into account that there were a relatively fixed number of impacts in the short term because even with optimization other commercial channels only have limited ability to offer more impacts to media

[65]This analysis assumes that expenditure is redistributed consistent with any different rates of growth of impacts across each channel.
[66]See paragraph 6.40*(b)*.
[67]OFT advice, paragraph 5.76.

buyers that wish to switch away from ITV1. For example, spots in peak-time programmes with larger audiences on other commercial channels would already have been allocated to reflect the demands of other media buyers. In particular, peak-time impacts are less likely to be available on other commercial channels given optimization override clauses in contracts. In the event that the media buyer did try to get into these specific spots on other channels in order to overcome capacity constraints, these would be likely to come at a significant premium.

6.74 Capacity constraints were a concern in 2003 and in our view they remain one, despite the change in ITV1's market position.[68] It is not clear to us whether the capacity constraints would prevent campaigns from being switched from ITV1 to other channels to such an extent that switching could not constrain price increases by ITV.

Price discrimination

6.75 The discussion above is on the basis that ITV would worsen terms to *all* media buyers. If ITV is able to price discriminate between media buyers, price rises would be targeted on those customers that were relatively price insensitive and the critical loss analysis becomes less relevant.

6.76 In 2003, the CC was concerned about price discrimination. With regard to pre-existing price discrimination, it said 'we are unsure whether … this indicates the existence of systemic price discrimination'.[69] However, it also stated: 'there is at least some ability to discriminate between media buyers, based on their negotiating skills'[70] and in its conclusions it stated that 'the enhanced market position of a

[68] CC 2003 report, paragraph 2.128.
[69] 2003 report, paragraph 2.181.
[70] 2003 report, paragraph 5.76.

merged Carlton/Granada … might manifest itself in a number of ways, including in particular the parties' ability, post merger, to … enhance the degree of price discrimination'.

6.77 ITV told us that it would not be able to price discriminate successfully because:

(a) Media buyers had no need to use ITV1 based on the substitutability analysis described in paragraphs 6.40 and 6.41.

(b) ITV could not identify media buyers that were 'reliant' on ITV1 because they were easily able to mask their true requirements on a campaign by campaign basis. ITV submitted that during the deal season it had no knowledge of how a media buyer's SOB commitment would translate into absolute expenditure and no visibility of what demographics would be purchased or how this would translate into individual advertisers' requirements as these could shift substantially year on year. Moreover, ITV submitted that individual campaigns could be 'disguised' by buying more than one traded demographic.

(c) Given *(a)* and *(b)*, ITV cannot introduce a new trading mechanism to extract 'reliant' expenditure successfully.

6.78 We do not agree with ITV's view that price discrimination is not possible. The CC considered that price discrimination was possible in 2003. In our view, the factors that led to this decision have not changed since then and that conclusion remains valid. We note that SOB commitments and discounts are negotiated with each individual media buyer and that there are many individually negotiated terms. This facilitates price discrimination.

6.79 With regard to ITV's specific arguments:

(a) The results of the substitutability analysis for individual campaigns (see paragraph 6.65) do not support ITV's contention that media buyers have no need to use ITV1.

(b) Although we agree that it is not possible to predict precisely expenditure during a year, experience of a media buyer's behaviour in the past is crucial in allowing ITV to consider how media buyers are likely to react to changes in price.

Scale of switching required to constrain price rises—assessment

6.80 ITV's critical loss type analysis suggested that £[✄] million of expenditure switching away from ITV1 would be sufficient to offset the revenue gains to ITV1 from media buyers paying increased prices. We have a number of concerns about the derivation of this figure. We consider that capacity constraints that this analysis has omitted are likely to be relevant. We believe that ITV is able to price discriminate and that as a result it would be able to impose price increases selectively, even if it were not possible to apply price increases to all customers.

Ability of media buyers to switch from ITV1

6.81 Having considered the potential for media buyers to substitute ITV1 on an individual campaign basis, we now consider whether this could actually be realized in practice. We consider how media buyers would try to incorporate any potential substitutability of ITV1 into their annual deal negotiations with ITV1 and whether these negotiations would place a practical constraint on switching. Whilst some advertisers do not use media agencies, the vast majority of ITV1's advertising is bought through agencies and so we focus on media agencies in our discussion.

6.82 We first consider whether the increase in concentration of media agencies has affected the balance of bargaining power. We then consider whether it is likely that, if

ITV attempted to impose worse terms for ITV1 advertising, media agencies would shift SOB commitment away from ITV1.

Countervailing buyer power

6.83 ITV claimed that ITV1 had become a much less important part of the media agencies' business as the share of the top three media agencies' budget going to ITV1 had fallen significantly since 2003, while the same media agencies were responsible for almost twice as much of ITV1's revenue compared with 2003. As a result, ITV submitted that there had been a material shift in the relative dependency of the media agencies versus ITV.

6.84 In the 2003 report, the CC concluded that the media buyers had a lack of countervailing buyer power.

6.85 ITV argued that the degree of dependence that media buyers had on ITV1 today was less than the degree of dependence that media buyers had on either Carlton or Granada pre-merger. It said that as a result the increase in the level of competition between ITV1 and other sales houses since 2003 far exceeded the limited loss of competition that resulted from the merger of Carlton and Granada.

6.86 Since the merger there has been consolidation of media agencies and some media agencies now trade together without having formally merged their businesses. Our analysis of the concentration of media agencies is set out in Appendix G. Appendix G shows that in 2003 the top three media agencies' share of ITV1's total revenue was [✄] per cent but by 2008 this had risen to [✄] per cent of ITV1 revenues.

6.87 In our view, even though ITV1 has lost some share of audience and there are more rival channels, this does not necessarily mean that media buyers are less dependent on ITV1 than they were in 2003. Whilst media agency concentration has increased since 2003, this does not necessarily imply that there is any countervailing buyer power.

Can media agencies threaten credibly to switch a proportion of SOB away from ITV1?

6.88 ITV submitted that the threat of media buyers reducing their expenditure on ITV1 was sufficient to prevent it from imposing less attractive terms on media buyers.[71]

6.89 The substitutability analysis showed that not all campaigns can be substituted away from ITV1 because some campaign objectives can only be met effectively with ITV1. In the light of this analysis, it is not a credible threat for a media buyer to move *all* expenditure out of ITV1 given that at least some campaigns will require ITV1. This removes the threat of complete switching from ITV1 from the negotiations between ITV1 and the media buyers.

6.90 However, our concern is whether a media buyer could move enough SOB commitment away from ITV1 to make enforcing worse terms unprofitable. This depends on what terms the media buyer would be left with for its remaining SOB commitment.

6.91 Media agencies have said that it is extremely difficult to negotiate any reduction in SOB commitment. Any reduction in the SOB a media agency is willing to commit to ITV1 will lead to a renegotiation regarding the discounts and other contractual terms that apply to the remaining SOB commitment. A media buyer would not expect simply to reduce its SOB commitment to ITV1 and to retain the same terms. Indeed, media buyers will tend to offer a 'buyout' rate if they wish to reduce SOB commitment —ie how much the media buyer is prepared to reduce its discount on the remaining

[71] OFT advice, paragraph 5.132.

expenditure in return for a lower SOB commitment.[72] As media buyers tend to need at least some of ITV1's airtime, this means that ITV is in a strong negotiating position when determining terms for the remaining SOB commitment.

6.92 We found that there has been limited negotiation by media buyers beyond the reduction in SOB commitments allowed by the CRR remedy.

6.93 ITV said that, as the CRR remedy ensured that media buyers never had to pay more for ITV1 airtime than they would have paid absent the merger, no market data existed to assess properly whether ITV1 could successfully demand a higher expenditure commitment if the CRR remedy was removed.

6.94 We note that ITV has a wide range of levers that it can use outside of annual negotiations within the terms of contracts if it holds sufficient market power to exercise them. These include less access to peak times, fewer centre breaks, worse positions in breaks, reduced programme access and decreased amount of 'pick your own spots'. In addition, ITV1 can use its optimization override clause or just refuse to amend schedules, implement late fees that have been previously waived, remove or deny airtime and demand premiums where they have not previously existed. These terms may be particularly important at certain times of the year, for example if any clients are trying to promote their products for the Christmas period.

Evidence of disputes before the adjudicator

6.95 We have considered two cases, which went before the Adjudicator, where advertising agencies wished to reduce the SOB committed by more than that required by the ARM. These, are summarized in Appendix F. In each case, ITV's and the media agency's notions of what constituted a fair and reasonable 'buyout' price were very

[72] Similarly there are 'buy-in' rates when media buyers wish to increase their SOB commitment and ITV is expected to give them higher discounts in return.

different. In one case, the Adjudicator was unable to rule for procedural reasons. In the other, he considered that the buyout terms offered by ITV were not fair and reasonable.

6.96 In the other case, ITV required a significant reduction in discount in response to the proposed reduction in SOB commitment. The effect of this reduction would be to increase the cost of the advertising that remained with ITV1. As a result, the amount of money that would have had to be paid to ITV (in respect of advertising on ITV1) would reduce by a proportion that was much lower than the reduction in the amount of advertising. This would release a relatively small sum that could be spent with other channels and, as a result, the agency would be likely to be significantly dis-advantaged by switching, unless the advertising that had been switched could be placed on other channels at exceptionally favourable prices.

Ability of media buyers to switch from ITV1—assessment

6.97 It is clear that media buyers are not able to switch all expenditure away from ITV1 as at least some campaigns require ITV1. Marginal switching is normally critical, but in this case can be deterred—as a result of the prevalence of SOB deals, any reduction in expenditure can be expected to affect the price a media buyer pays for all other airtime on ITV1. In addition, there are a wide range of other contractual terms that ITV can alter. The increased media buyer concentration since 2003 has not resulted in countervailing buyer power.

6.98 Our view is that the evidence from the case decided by the adjudicator is consistent with our analysis that ITV has the incentive and, through the SOB contract terms, the means to discourage media agencies from reducing their SOB commitments.

6.99 In our view, the evidence does not suggest that ITV's advantage in media negotiations has been eroded materially since the merger.

Changes in substitutability of ITV1—assessment

6.100 The analysis of the substitutability of individual campaigns suggests that there remains a significant issue for many demographics in that 1+ coverage is reduced if ITV1 is not used.

6.101 We do not think that media agencies are able to threaten credibly to switch advertising away from ITV1, because:

(a) complete switching is not practical because some (or many) of their clients will insist on access to ITV1; and

(b) an attempt to negotiate a reduced SOB commitment is not likely to lead to an acceptable outcome, due to the strength of ITV's negotiating position.

Changes in other aspects

Entry and expansion

6.102 An attempt by ITV to worsen terms to media buyers may be ineffective if this led to expansion or entry by competing sales houses. In its advice, the OFT concluded that it was possible that the growth of multi-channel digital homes had made it easier for broadcasters to expand by launching new channels. However, it added that it seemed unlikely that other broadcasters would be able to extend quickly the amount of mass audience programming shown in order to be able to constrain the prices of advertising on ITV1.[73] We agree with the OFT's advice on entry and expansion. In particular, we consider that expansion into the sort of mass audience programmes that could compete with ITV1 would require significant investment in programming with considerable uncertainty as to whether this investment would be recovered.

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[73] OFT advice, section 5.

Although ITV noted that the television market included large group companies with access to significant resources (for example, RTL and BSkyB), in our view, due to the time it would take to compete with ITV1's mass audience programmes and the uncertainty of success, the possibilities of entry and expansion do not constrain ITV significantly.

Other 'must have' features of ITV1

6.103 It has been suggested that other 'must have' features of ITV1 prevent effective substitution. These were:

(a) *Light viewers.* In 2003, the CC identified 'light viewers' as one of the 'must have' features of ITV1. ITV1's share of all 'light viewers', those individuals whose weekly viewing hours fall into the lightest percentile of all viewing and are the most difficult to reach via a television advertising campaign, has declined from 19 per cent in 2003 to 14 per cent in 2007 for the last sixth of the television audience.[74] In response to questions from the OFT, media buyers did not seem to attach particularly strong weight to ITV1's advantage in light viewers. We therefore agree with the OFT that access to light viewers no longer seems to be a particularly significant unique feature of ITV1.

(b) *Spillover effects.* There was limited evidence that 'spillover' effects, which arise when an advertisement bought under a particular demographic is viewed by a wider audience (particularly if shown in a mass audience programme), are a significant consideration for media buyers when planning campaigns. In our view, these effects are likely to be secondary in nature.[75]

(c) *Wastage.* Some parties argued that there were 'wasted' impacts where frequency was higher than a campaign's objectives. Excluding ITV1 from a campaign results in higher levels of frequency. However, we agree with the OFT that these

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[74] OFT advice, paragraph 5.88. ITV defines the sixth of the total television audience that watch the least amount of television as light viewers.
[75] OFT advice, paragraph 5.57.

additional impacts are only detrimental once the value of the extra impacts is outweighed by the cost.[76] This does not appear to be a major factor affecting substitutability.

(d) *Regional advertising benefits.* Some parties suggested that ITV1 offered a unique benefit of regional advertising and an ability to use these regions for test campaigns. Loss of these benefits was not identified specifically as an adverse effect of the merger by the CC in 2003 and we have not received evidence that suggests that this is a substantial issue.

Possible market developments

6.104 During the review, we heard of a number of changes in the industry that might have an effect on the CRR remedy. These included digital switchover to be completed by 2012, a prolonged recession shrinking the market for television advertising, possible mergers between sales houses and future reviews of the way in which public service broadcasting is financed. We consider that the effect of each of these on the CRR remedy is too uncertain for us to form a view.

Change in competition—assessment

6.105 Since 2003 there have been significant changes in the marketplace and ITV1's shares of NAR and SOCI have declined.

6.106 The results of the analyses submitted to us suggest that significantly more campaigns could be run effectively without ITV1 than in 2003 and that excluding ITV1 would compromise the effectiveness of the other campaigns to a lesser extent now than in 2003. However, in key demographics accounting for about [✄] per cent of ITV1's revenue most campaigns would suffer from the exclusion of ITV1, especially

[76] OFT advice, paragraph 5.62.

with regard to 1+ coverage. This appears to be due in large part to ITV1's ability to deliver large audiences.

6.107 In our view, the increased media buyer concentration since 2003 has not resulted in countervailing buyer power.

6.108 Most advertising is bought through media agencies and in our view these agencies need to be able to purchase ITV1 airtime at competitive prices (relative to other media agencies) in order to attract and retain clients. As a result, we do not consider that an agency can threaten credibly to withdraw all its business from ITV1. Moreover, in our view, media buyers who seek to reduce their SOB commitment are likely to be offered significantly less favourable terms. As a result, whether or not individual campaigns could be switched away from ITV1, the likelihood of such switching has no significant constraining effect on ITV.

7. Unintended effects of the CRR Undertakings

7.1 We recognize that in certain circumstances behavioural remedies, and price controls in particular, can have unintended effects on markets. If the CRR Undertakings have resulted in significant unintended effects, this could suggest that there has been a change of circumstance sufficient to justify their release.

7.2 ITV raised a number of unintended effects, which can be broadly categorized as: [77]

(a) unintended incentives for ITV1, primarily caused by the ARM;

(b) unintended incentives for other broadcasters; and

(c) a lack of incentive for media agencies to renegotiate contracts, resulting in an inability for ITV1 to react to changing demand due to CRR's 'protected' contracts.

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[77] ITV also noted that the direct costs of operating CRR (in terms of the Adjudicator's Office, compliance teams within ITV and ITV's reporting obligations to Ofcom and the OFT) are around £1 million a year.

7.3 We consider each of these areas in turn, addressing first whether these unintended effects have been caused by, or exacerbated by, the CRR remedy and secondly whether these effects are sufficient to justify a variation of the Undertakings.

7.4 Third parties did not raise any significant unintended effects of the CRR Undertakings. Indeed, the OFT advice noted that most third parties believed it was most appropriate for CRR to stay in place with only minor adjustments to the definition of ITV1 (see paragraph 3.7).

Unintended incentives for ITV1

ITV's views

7.5 ITV submitted that there were two main ways in which CRR was formulated that had distorted its incentives to deliver what advertisers and audiences wanted:

(a) The ARM was based on SOCI, which meant that ITV was incentivized to maximize ITV1's SOCI. ITV submitted that this led to outcomes that were inconsistent with the demands of advertisers and audiences.

(b) CRR was defined in terms of the ITV1 licence only and so ITV's incentives to innovate through new or time-shifted channels such as ITV1+1 (which would show ITV1 programmes but one hour later than ITV1) or ITV1 HD (which would show ITV1 programmes in HD) were reduced.

7.6 ITV submitted that prior to CRR being introduced, Carlton and Granada negotiated with media agencies across a range of factors: reach and frequency, quality of programming, ability to deliver viewers in key demographics, average programme viewings and other qualitative terms (for example, position in break).

7.7 The ARM focuses solely on changes in ITV1's SOCI, weighted by demographic. Under the ARM, for each percentage point fall in SOCI there is a proportionate fall in

SOB commitment. CRR therefore rewards ITV for maximizing volumes of commercial impacts on ITV1 so as to maintain SOCI and prevent decreases in the SOB commitment of individual media agencies. ITV argued that the consequence of the ARM not capturing reach and other quality parameters was that, to prevent reductions in SOB commitment, ITV was indifferent between reach and frequency on ITV1, focusing only on maintaining SOCI.

7.8 ITV submitted that there were four main consequences of the incentive to maximize SOCI.

- *Investing in daytime programmes*

7.9 ITV stated that the ARM created an incentive to invest in daytime rather than peak because SOCI treated all impacts at all times and on all channels as equal. Consequently ITV submitted that it was incentivized to maximize impacts on ITV1 wherever it could gain incremental viewers for least cost and irrespective of daypart. ITV argued that, because peak-time programmes were more expensive to produce and faced greater competition than daytime TV, it was more expensive and harder to attract incremental viewers during peak time. ITV had therefore focused on increasing ITV1 impacts in the daytime rather than peak. ITV told us that, although increasing impacts, this was inconsistent with what advertisers wanted because they wanted strong peak impacts to match their target audiences, not daytime impacts.

7.10 ITV submitted that between 2003 and 2007, ITV1's share of budget spent on daytime programming increased from [✂] to [✂] per cent, an increase of [✂] per cent. In contrast, investment in non-daytime programmes fell by [✂] per cent. However, despite the incentive to maximize ITV1's SOCI, ITV nevertheless adopted a '2100 strategy' for ITV1 (investing in its 2100 hours peak-time programming) from September 2007. ITV submitted that this was a recognition that the long-term success of ITV1 was dependent on delivering a diverse range of quality programming in peak time but noted that, as this strategy did not seek to maximize SOCI, it might lead to a reduction in revenue under CRR.

- *Sub-optimal allocation of advertising time*

7.11 ITV stated that the ARM created an incentive to place its allowed advertising time (minutage) in a suboptimal way. In considering where to place advertising minutage, ITV will seek to optimize the number of impacts. This optimization acts within the constraints of the Code on scheduling of TV advertising (COSTA), which sets the maximum amount of advertising minutage during particular dayparts, and the TV Airtime Sales Rules, which require ITV to offer to sell all its TV airtime (and prevent withholding supply). Under the ARM, which is weighted by demographic, ITV is incentivized to maximize its minutage in programmes that deliver the largest audiences rather than in such a way as to reach different demographics and light viewers. ITV provided evidence that it reduced advertising minutage in *Parkinson* using its peak-time advertising quota up in earlier, more popular programmes such as *Ant & Dec* and *The X Factor*. ITV attributed this change to CRR.

- *Risk aversion in programming*

7.12 ITV stated that the ARM created an incentive for it to be risk averse in its programming choices. ITV told us that, because SOB commitment fell in line with SOCI, it had become more risk averse in its programming decisions. In addition, ITV told us that, as the ARM was weighted by revenue for each demographic, it focused attention on the largest demographics. ITV is therefore less incentivized to reach the less popular demographics. ITV submitted that, because of these two factors, it had focused on ITV1 programmes that guaranteed a high volume of impacts in the required demographics.

7.13 ITV submitted that, absent CRR, it might commission or schedule a programme even if it did not maximize SOCI. Examples include programming to attract new viewers and extend reach (eg new movies); high-quality or 'event' status programming, which had a 'halo effect' (positive association) on brands in advertisements (eg *The Brits*); and programming targeted at a demographic valued by certain advertisers but potentially not delivered effectively elsewhere in ITV1's schedule.

7.14 ITV cited the following evidence to illustrate this unintended effect:

(a) *Increasing the number of weekly episodes of soaps. Emmerdale* had an extra episode introduced in January 2004 (although we noted that an additional episode of *Coronation Street* was introduced pre-CRR in 2002). ITV submitted that occasional additional episodes of *Coronation Street* and *The Bill* had also been screened since 2004 to give a timely uplift to ITV1's SOCI. ITV added that these additional episodes, although increasing SOCI, were damaging the programme brands because they increased frequency rather than reach.

(b) *Recommissioning series that have performed well rather than taking a risk on a new series.* In a marketing presentation entitled *Event Entertainment programming*, ITV submitted that there were three times as many series in 2006 and 2007 as in 2003. ITV calculated that 41 per cent of its impacts on ITV1 now came from only eight series.

(c) *Giving recommissioned series extended runs rather than taking a risk on a new series.* For example, *Ant & Dec's Saturday Night Takeaway* was 66 per cent longer in 2005 compared with 2004 and *Bad Girls* was 80 per cent longer in 2005 compared with 2004.

Views of third parties

7.15 The OFT's advice noted that third parties responded that the choice of ITV1's programme schedule had been driven by factors other than CRR, such as a general aversion to risk that applied pre-merger as well as in recent years. A few third parties agreed that, while the CRR remedy encouraged ITV to produce programmes and schedules that would deliver high audience levels for ITV1, it might also discourage innovation and experimentation.[78]

Unintended incentive effects on ITV—assessment

7.16 In our view, the ARM provides some incentive to act in the ways described by ITV, although the examples cited by ITV appear unlikely to be due solely to CRR. First, we were told that peak-time television was more competitive than daytime television, and this may have contributed to decisions to invest in daytime programmes. Second, although there is evidence that since 2003 there are more event entertainment programmes recommissioned and more episodes of soaps, it is difficult to tell how pronounced this trend would have been absent CRR. A risk-averse programming strategy may have been driven by factors other than CRR and, indeed, ITV has recently moved towards a different strategy despite the existence of CRR.

7.17 It is difficult to attribute these unintended effects solely to CRR and we do not consider, in any event, that these effects are sufficient to justify the release of ITV from the CRR undertakings. However, we believe that it is worth examining whether there are ways in which the ARM could be adjusted to minimize these effects.

Incentives of other broadcasters

7.18 ITV argued that other channels had been incentivized to launch +1 and HD channels because they could reduce ITV1's SOCI and derive additional income from the market as a result. Absent CRR, the broadcaster's business case for +1 and HD channels would not consider the resulting loss of SOB commitment to ITV1 from a

[78] OFT advice, paragraph 6.30.

reduction in ITV1's SOCI so in some cases this might have altered the decision to invest in such channels.

7.19 A number of third parties also made the same observation as ITV in relation to the incentives for other broadcasters to launch new free-to-air channels, particularly +1 channels, that assist in reducing ITV1's SOCI.[79]

Unintended incentives of other broadcasters—assessment

7.20 We have not seen any evidence on the business cases for launching other new commercial channels to support a contention that the CRR remedy would have had other than a marginal effect.

Incentives to invest in new digital channels

7.21 The current definition of ITV1 in the undertakings relates to the 'Regional Channel 3 Services' licence and not to the ITV1's programme schedule. It does not therefore include all methods of delivering the ITV1 programme schedule—an ITV1 HD[80] or potential ITV1+1 or other delivery.[81]

7.22 This definition has reduced the incentive for ITV to invest in other methods of delivery of ITV1: impacts delivered through other methods would not count as part of the ARM and so could potentially mean ITV1 would lose impacts to any new ITV digital channels (especially as programmes are likely to be the same and advertisements identical) and hence would lose SOB commitment in line with the reduction in SOCI. The existence of CRR might therefore mean that ITV makes less revenue than it otherwise would do by introducing these channels. ITV submitted that other commer-

[79] OFT advice, paragraph.6.33.
[80] ITV has already launched a partial HD channel on Freesat and has been awarded capacity to carry a peak-hours HD channel on digital terrestrial television.
[81] Also impacts on ITV1 broadcast on satellite and cable platforms are not counted in CRR but have been considered in this way to date.

cial channels introducing HD or +1 channels did not suffer from an overall reduction in SOCI (even if some Channel 4 impacts were taken by Channel 4+1), whereas ITV1 SOCI would fall if it lost impacts to ITV1+1 or ITV1 HD and, under CRR, this would entitle ITV1's customers to an automatic reduction in the level of their SOB commitments in their next year's contracts for ITV1 airtime.[82]

7.23 The OFT proposed that, if CRR was retained, it should be changed to refer to the ITV1 programme schedule, not the licence. The OFT's advice stated that the vast majority of third parties agreed with the OFT's proposal. The OFT noted that there was some opposition from broadcasters, including concern that this would further increase ITV's revenues and decrease the revenue available to other broadcasters. There was also concern that the impacts which were not delivered on the standard ITV1 channel, particularly the +1 channel, were of lower quality, in which case they may not need to be rewarded at the same level. This was because the channels would not deliver mass coverage.[83]

7.24 We agree with the OFT that the current definition of ITV1 in the CRR Undertakings not including ITV1+1 or ITV1 HD is an unintended consequence and is sufficient to consider a variation to the CRR Undertakings.

Inability of ITV to react to changing demand

Views of ITV

7.25 ITV submitted that, absent CRR, it would negotiate new contracts during the deal season so as to match the expected supply of television airtime (based on expected schedule performance) to advertisers' demand. The negotiation would ensure an annual recalibration of the supply of impacts with the demand for impacts.

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[82] ITV submitted that a similar argument applied to its other digital channels but not to the same extent because these channels were targeted at different audiences and so there was less cannibalization of ITV1 impacts.
[83] OFT advice, paragraphs 6.9 & 6.10.

7.26 Under CRR, media agencies are entitled to fall back on their 2002/03 contracts in all negotiations. These historic ‘protected’ contracts remain in place even when agencies negotiate new contracts (unless an agency nominates the new contract as a ‘protected’ contract[84]). This means that ITV1 has to be in a position to meet these historic contractual commitments, even though they may not actually be required to do so. ITV submitted that, even if all contracts were renegotiated, this meant that it could not optimize its inventory in response to changes in demand.

7.27 ITV submitted that demand for demographics had changed year on year since CRR was introduced with shifts towards upmarket and younger target audiences. ITV submitted evidence of significant changes in impacts since 2002 across its six major demographics. Despite these changes in demand, ITV told us that it had been unable to renegotiate contracts with media buyers because umbrella contracts had allowed them to manage demand changes from advertising clients without needing to renegotiate with ITV. ITV said that it had not foreseen this when it proposed the CRR remedy in 2003. ITV also told us that media buyers had tended to favour not negotiating their contracts and retaining their historic protected contracts because they were concerned that renegotiation will become a protracted and costly process.

7.28 ITV told us that, although the big agencies typically entered into some form of annual negotiation and generally reprotected their new contract, this tended to [✂].[85]

7.29 ITV told us that this inability to negotiate led to significant deal debt problems (see paragraph 6.21 and associated footnote) of about £[✂] million in 2006. This deal debt disappeared the following year. ITV submitted that this was largely due to *(a)* improved performance in impacts in 2006 and 2007, especially Formula 1

[84]See undertakings, Clause 10e.
[85]At present, historic protected contracts account for £[✂] of revenues ([✂] per cent).

coverage with the arrival of Lewis Hamilton, Liverpool in the Champions League final and England in the Rugby World Cup final, and *(b)* some major customers [✂].

Views of other parties

7.30 In relation to incentives for media buyers to negotiate, the OFT's advice noted that a number of third parties suggested that CRR may be inhibiting dynamism in the media buyer market. These third parties argued that to depart from their existing protected contract—for example, to change their channel profile, target audiences, trading parameters and so on—necessitated renegotiation which was a potentially protracted process. They also argued that if a media buyer involved the Adjudicator to decide on fair and reasonable terms, it risked reprisals from ITV. They said that the status quo therefore represented a safe option and was the path of least resistance.[86]

7.31 The OFT also noted the mixed views on the extent of contract negotiations. Some media buyers considered that the CRR remedy had increased the complexity of contract negotiations, with agreements becoming increasingly legalistic where every aspect of the deal is covered. However, one third party said that it was easy to negotiate minor changes to contracts, and another believed that there were similar levels of changes to ITV's contracts as for other channels.[87]

7.32 In relation to the impact of any lack of contract negotiations, the OFT's advice noted that third parties did not believe that CRR was preventing ITV from honouring its contracts. Many third parties pointed out that deal debt had been eroded even with CRR in place. One suggested that the deal debt was caused by giving away more discount to dissuade media buyers from reducing their expenditure commitments to the full extent provided by the ARM. Another suggested that it was due to lack of

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[86] OFT advice, paragraph 6.21.
[87] OFT advice, paragraphs 6.23 & 6.24.

audience supply. Some suggested that ITV had made use of its digital channels to deliver on deals and that this was mutually acceptable.[88]

ITV1's ability to react to changing demand—assessment

7.33 Many of the largest contracts are renegotiated each year albeit often only in relation to relatively minor contractual terms. However, if negotiation were not possible, we might expect to have seen persistent deal debt in ITV1 given the continual decline in its SOCI since 2003. This has not been the case. Indeed, deal debt might well have arisen absent CRR given the way the advertising is sold. Moreover, absent CRR we would not expect significant negotiation as media agencies will only really need to change their contracts in the event that there is *(a)* a change in their client base or *(b)* their existing clients changes their demands.

7.34 We do not therefore consider that this issue warrants releasing ITV from the CRR Undertakings. We nevertheless believe that it is worth examining whether there are ways in which the CRR Undertakings could be varied to introduce more flexibility into the negotiation process.

Unintended effects of the CRR Undertakings—assessment

7.35 It is likely that the CRR undertakings are leading to some unintended distortions in ITV's and other broadcasters' incentives, although we have not seen evidence to suggest that the effects are large. Even so, we consider that it would be appropriate to consider variations of the CRR Undertakings, and of the ARM in particular, that might mitigate these unintended effects.

7.36 Our assessment of the evidence as to ITV's inability to respond to changes in demand for ITV1 is that this is not likely to be a persistent effect caused by CRR.

[88] OFT advice, paragraph 6.37.

Even if the CRR has a negative effect in this area we doubt that this would merit ITV's release from the CRR Undertakings. However, we would consider mechanisms whereby the CRR Undertakings are varied, or superseded, to address the problem identified provided these do not undermine the effectiveness of the remedy.

8. Provisional decision

8.1 We have considered whether the changes of circumstance identified by the OFT have led to sufficient change in the competitive environment identified in the 2003 report or the operation and effect of the CRR Undertakings such that they should be released, varied or superseded.

8.2 Taking into account all the evidence we have seen, we have provisionally decided that the changes of circumstance have not sufficiently changed the competitive environment identified in the 2003 report or the operation and effect of the CRR Undertakings to warrant ITV's release from the CRR Undertakings. However, we consider that there may be a case for some variation in the CRR Undertakings. We will examine whether there are appropriate ways to address the following changes of circumstance:

(a) the decline in the market position of ITV1;

(b) the unintended incentives for ITV created by the ARM to focus primarily on maximizing ITV1's SOCI;

(c) the unintended incentives for ITV created by the definition of ITV1 in the Undertakings; and

(d) the difficulties for ITV in reacting to changing demand.

9. Next steps

9.1 This document is issued to provide an opportunity for representations to be made in relation to our provisional decision on the CRR Undertakings.

9.2 We have separately issued a Notice of possible variations exploring possible ways in which the CRR undertakings might be varied.

9.3 Comments are therefore invited and should be received by the CC no later than 17.00 on 6 October 2009 and should be addressed to:

Marjorie Davies
Competition Commission
Victoria House
Southampton Row
London
WC1B 4AD

or emailed to: marjorie.davies@cc.gsi.gov.uk.

9.4 Before issuing its final decision in relation to the CRR Undertakings, the CC will have regard to any representations made and may modify its decision as a result of such representations.