



National Audit Office

How the Department for Culture, Media and Sport assessed the BBC's efficiency as part of the licence fee settlement

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15 January 2007

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SUMMARY

1 As part of the process of setting the level of the television licence fee from April 2007, the Department for Culture, Media and Sport (the Department) has to make an assumption about the level of efficiency savings the BBC can deliver. The BBC, as part of its licence fee bid, set out that its ongoing annual efficiency target should be £80 million of new savings each year from 2008 (approximately 2.5 per cent of the baseline expenditure in 2008-09). The savings to be generated through efficiencies at the BBC, coupled with the BBC's estimate of its funding requirements, will strongly influence the level of the new licence fee.

2 The Department's decision on the BBC's efficiency and the overall licence fee settlement will be based on its own assessment of the BBC's requirements and is not dependent on negotiations with the BBC. The Department has commissioned consultants to advise it on the BBC's efficiency and has welcomed submissions from interested parties, including the BBC. In July 2006 it sought the views of the National Audit Office on the adequacy of the evidence base available to it on the efficiencies the BBC might reasonably be expected to make. We agreed to report on whether we consider the Department has reasonable grounds on which to base its assessment of the BBC's scope for efficiency savings.

3 We have considered the extent to which the different approaches taken by the consultants are likely to provide the Department with sufficient, relevant and reliable evidence of the nature, scope, ambition and deliverability of the BBC's efficiency and value for money plans. As the basis for our work was to consider the evidence available to the Department, we have not re-performed any benchmarking work on the BBC or carried out any direct review of BBC activities. It has not been part of our work to identify a particular efficiency target for the BBC.

4 The Department now has available to it a considerable body of evidence:

- The BBC's own analysis of what is achievable, in the light of what the BBC will have achieved by 2008 under its three year value for money programme. This is based on internal BBC reviews of its costs across all business areas. The BBC's fundamental assumption is that by March 2008, when it is due to have completed its three year value for money programme, it will have matched best practice in current technology and work practices and therefore be at the efficiency frontier (where best practice in efficiency has been adopted across the organisation), at which point further efficiencies can only be achieved through adoption of technology or working practices yet to be developed. The BBC's analysis is supplemented by the work of **Oxera**, consultants initially commissioned by BBC management to establish whether its efficiency target beyond 2008 appeared appropriate. Oxera set out that because in 2000 PKF had stated that the BBC was at the efficiency frontier and that the BBC was on track to improve significantly on the targets set at that time by the Department (informed by PKF), there was evidence to suggest that the BBC would be at the efficiency frontier by the end of the value for money programme in 2008. Oxera considered that the BBC's target beyond 2008 was in line with external benchmarks and would be more challenging than many of them.
- The work of **PKF**, commissioned by the Department to consider the BBC's efficiency achievements against targets set in 2000 and efficiency assumptions underpinning the BBC's assessment of its future funding needs. PKF had previous experience of working at the BBC as part of the review leading to the previous licence fee settlement. Based on its review of the BBC's achievements and plans for further savings and its professional judgement and experience, PKF concluded that the BBC would not be at the efficiency frontier by 2008 by way of its value for money programme, and that it could therefore deliver a higher level of efficiency savings than set out in the BBC's bid.
- The response of the **BBC** to the PKF report. The BBC does not agree with some of the conclusions of the PKF report and, in particular, PKF's estimate of the efficiencies the BBC could deliver, which is higher than the BBC's estimate because the BBC believes it is based on judgement rather than evidence or analysis. The BBC's concern is that if its funding were based on unachievable efficiency targets it could face detrimental impacts on the quality and range of its programmes and services.
- The work of **PA Consulting**, commissioned by the BBC Governors to review the achievability and deliverability of the BBC's value for money plans, to review the BBC's licence fee bid and to comment on PKF's draft report. PA Consulting concluded that the BBC was beginning to deliver the value for money programme and that the target of £80 million in annual savings beyond 2008 was stretching but achievable. However it also noted that the changes proposed in the BBC's programme spending divisions and in some of the professional services divisions were not yet transformational (where the BBC would match best practice in current technology and work practices) and the absence of transformational change limited the efficiencies that the BBC could deliver.
- The work of **Magentum**, consultants commissioned by the BBC and some other UK broadcasters to compare the price per hour paid by the broadcasters for a range of UK commissioned television programmes. The data for the programme prices used for comparison pre-dated the BBC's value for money programme which aims to cut the cost of content programming by up to 15 per cent by March 2008. Magentum's work showed that, on average, the BBC paid more per hour for programmes than the other broadcaster comparator in nine out of the ten programme categories analysed. However, if prices are adjusted in those categories which Magentum considers are most likely to be affected by the longer programme length needed to fill a BBC 'hour', then the BBC pays more in eight out of the ten categories analysed. Based on this adjusted price, the price paid by the BBC is also more than five per cent greater than the other UK broadcaster comparator in six of the ten categories (representing 29 per cent of expenditure analysed).

An important part of the Magentum study was to analyse the impact of key production components and editorial decisions on prices paid across all categories. As the analysis was carried out at a programme level, there were no broad conclusions to be drawn about the different prices paid by the BBC in each programme category. However, the BBC asked Magentum to carry out further work on the factual programme categories to compare prices at a more detailed level in order to understand better the factors underlying the differences in price paid in these categories. Magentum considers the results for the categories in this further analysis indicate the BBC is commissioning programmes which have a more expensive set of production components and, that overall, these programmes may comprise a more complex set of production factors and higher level of editorial ambition than those commissioned by some other UK broadcasters. The BBC intends to conduct more work to assess whether the higher prices are justified or whether this represents a further opportunity to drive efficiency.

- Work completed for the Department by academics at Nottingham University Business School and Nottingham Trent University looking at productivity trends within the broadcasting sector. The work covered the BBC but did not identify the BBC's position relative to the rest of the broadcasting sector. Although the authors highlighted a number of caveats, all their estimates suggested that the broadcasting sector had experienced positive productivity growth in recent years.

5 In summary, the evidence available to the Department provides detailed analyses of the BBC's performance against targets set in 2000 and the range and deliverability of its current and future efficiency plans. However, determining how efficient an organisation is and can be, in absolute and relative terms, is fraught with difficulty. It is not a precise science, and ultimately is a matter of judgement.

6 In considering the evidence available to the Department we have been conscious of the added value brought by credible external assessments of organisations, particularly those by independently commissioned consultants such as PKF and PA Consulting, which have thoroughly considered, from the inside of the organisation, the BBC's current state of efficiency and efficiency plans. The credibility of such assessments is enhanced where they independently arrive at similar conclusions. Such work, combined with the external comparisons brought by Oxera and Magentum, gives the Department a good picture of the BBC.

7 While it is always possible to do more to inform the judgement, our principal conclusion is therefore that the Department now has adequate evidence from which to assess the broad level of efficiency the BBC could reasonably be expected to achieve during the period of the next licence fee settlement.

8 A successful efficiency programme must be able to demonstrate that the quality of service delivery has not been adversely affected. None of the consultants attempted to measure the quality of BBC outputs as it was outside their terms of reference. It will be for the Department, in its wider consideration of the licence fee settlement, to consider the quality of BBC output.

9 While the evidence now available to the Department is adequate for its purpose, some of this evidence was arrived at through work commissioned by the BBC. The Department considers it commissioned an adequate evaluation of the BBC's efficiency but welcomed all contributions to the subject from any source, including those commissioned by the BBC. While there is a proper tension between the Department's roles in knowing enough about the BBC to make a decision and not having an intrusive performance management framework in place, the Department's distance from the BBC may complicate its acting as an 'intelligent customer' when commissioning and evaluating work on the BBC's efficiency.

10 While the Department's decision on the BBC's efficiency will be informed by the evidence available to it from all sources, there are several ways in which the process of assessing the BBC's efficiency could be strengthened. These would include:

- consulting with the BBC and others on appropriate comparator organisations and performance indicators in advance of any assessments and building them in to the terms of reference for consultants to minimise subsequent disagreements; and
- the Department alone engaging any consultants thought necessary to take forward assessment or comparator work, although it cannot of course prevent others, including the BBC, from commissioning such assessments.

11 There may also be wider lessons for the Department and the BBC Trust to learn from economic regulators such as Ofgem and Ofwat, who have to consider similar issues when they determine outputs and set prices for the regulated utilities.

PART ONE

Introduction

1.1 The Government is considering the level of the licence fee for the BBC from 2007-08. In September 2005, the BBC submitted to the Department for Culture, Media and Sport (the Department) its licence fee bid for the next settlement, in which it outlined its service vision and funding requirements. This proposed an annual licence fee increase of Retail Price Index plus 2.3 per cent. In October 2006 the BBC submitted a revised bid which proposed an annual increase of Retail Price Index plus 1.8 per cent, a net increase in licence fee funding of £1.6 billion (**Figure 1**). The BBC's revised bid, if accepted, would imply a rise in the licence fee from the current £131.50 to £149 by 2013-14 in 2006-07, prices and approximately £180 at 2013-14 prices.¹ The level of the new licence fee will be influenced by the level of efficiency savings the BBC can deliver, coupled with an estimate of its funding requirements.

1.2 Efficiency savings can be cash-releasing (where inputs are reduced for the same level of output), or non cash-releasing (where outputs increase for the same level of input). The BBC's proposed net efficiency savings of £2.6 billion comprise three different elements, all of which the BBC has told us will need to be cash-releasing savings to fund the additional costs in Figure 1. The elements are: savings from the final year of its three year value for money programme (2007-08); savings from its continuous improvement programme (from 2008-09 onwards); and, savings required to fund super-inflation² (**Figure 2 overleaf**). The BBC believes it would be difficult to make further cost savings beyond those it has proposed without damaging the quality of output or shutting services.

1 The construction of the BBC's licence fee submission

Category	Detail	Cumulative totals 2007-08–2013-14 (£ billion, 2006-07 prices)
Increase in base costs		1.5
Total BBC new investment		3.9
Total BBC cost increase		5.4
Self-help	Efficiency savings	(2.6)
	Household growth	(0.8)
	Commercial dividends	(0.4)
	Improved licence fee collection	(0.2)
Total BBC self-help		(4.0)
Industry costs (Digital UK marketing, Spectrum charging)		0.2
Total projected increase in the licence fee		1.6

Source: National Audit Office analysis of BBC licence fee submission, October 2006

NOTE

Household growth is relevant because most new households will require a TV licence and this will increase licence fee income for the BBC.

¹ Source: BBC.

² Super-inflation is defined by the BBC as 'inflation above the Retail Price Index due to competition in the broadcast market or wider economy'. In its licence fee submission, the BBC presented the absorption of super-inflation as requiring non cash-releasing savings.

2 The BBC's efficiency proposals 2007-08 to 2013-14

	Cumulative total (£ million, (2006-07 prices)
Savings from the last year (2007-08) of the value for money programme (paragraphs 3.5 to 3.6)	861
Savings from the continuous improvement programme (paragraph 3.7)	945
Savings required to fund super-inflation (paragraphs 3.8 to 3.9)	980
Total gross savings	2,786
Implementation costs	(168)
Total net savings	2,618

Source: National Audit Office analysis of the BBC's licence fee submission, September 2005

1.3 There have been five principal assessments of the BBC's value for money and efficiency commissioned by either the Department or the BBC. They are:

- PA Consulting (commissioned by the BBC Governors) in February, March and August 2005;
- PKF (commissioned by the Department in July 2005 to review the BBC's bid);
- Oxera (commissioned by BBC management in September 2005 to assess the reasonableness of the BBC's efficiency proposals);
- PA Consulting (commissioned by the BBC Governors in March 2006 to provide an assessment of PKF's draft report); and
- Magentum, which carried out a programme price benchmarking study for the BBC and some other UK broadcasters between January and March 2006.

1.4 In July 2006, the Department asked the National Audit Office to provide its views on the adequacy of the evidence base available to it on the efficiencies the BBC might reasonably be expected to make. In particular, the Department asked the National Audit Office to examine:

- the differing assessments of the BBC's efficiency targets;
- the appropriateness of comparators; and
- any further advice on other relevant factors.

1.5 Our work has involved:

- a review of the documentation held by the Department on the BBC's efficiency, including that provided by the BBC, PA Consulting, PKF, Oxera and Magentum;
- a review of public submissions from interested parties to the Department on the licence fee;
- interviews with the Department, the BBC and consultants commissioned to provide expert advice to the Department and the BBC;
- interviews with ITV, Ofcom, Ofgem, the DTI Shareholder Executive and the Producers' Alliance for Cinema and Television; and
- a review of the literature on evaluating efficiency in regulated utilities.

1.6 The scope of our work has been to assess whether the Department is well placed, with the evidence available to it, to assess the level of ongoing efficiency the BBC can be expected to make under the new licence fee. As such, we considered the material available to the Department but did not re-perform any benchmarking work on the BBC or directly review BBC activities. It has not been part of our work to identify a particular efficiency target for the BBC.

PART TWO

The Department's approach to assessing the BBC's efficiency

2.1 The Department has confirmed that the licence fee remains the best way to fund the BBC and that this will hold true for the next ten years. Its objective was to examine the scope for delivery of efficiency savings by the BBC to relieve pressure on the licence fee. It sought to anticipate savings that could reasonably be expected and to incorporate those efficiencies in its calculation of the licence fee. This section sets out the approaches taken by the Department to meet its information needs.

2.2 The Department's decision on efficiency savings and the overall licence fee settlement is based on its own assessment of the BBC's requirements and is not reliant on submissions received from, or discussions with, the BBC. It sees a need for the exercise to be seen to be an independent assessment, rather than a joint process with the BBC. The Department realised from past experience that it would need to commission external advice to support its assessment of the BBC's efficiency. It identified a range of variables which would influence the level of the licence fee from April 2007 onwards. For the BBC's efficiency, these were:

- the prevailing cost environment for broadcasting and other BBC activities;
- the demonstrated value for money of the BBC's existing services;
- the BBC Governors' review of value for money;
- the coverage of the BBC's licence fee submission; and
- valid comparisons of service provision outside the BBC.

2.3 The Department used consultants to review the BBC's plans and assess the BBC's potential efficiency savings. In July 2005, the Department invited organisations to bid for the work and PKF, which had carried out a similar evaluation during the 2000 licence fee review, was appointed. The Department agreed with the BBC that, to avoid the duplication of work, PKF would in the first instance, review work already undertaken by the BBC on its value for money programme.

2.4 In assessing the BBC's efficiency, PKF set out to:

- examine the BBC's projections and, in light of past years' performance, seek a justification for the assumed level of costs and of income;
- examine the methods that the BBC applied historically to achieve efficiency targets and assess whether these have been comprehensive and sufficient;
- assess the BBC's past performance in different areas of delivering efficiency improvement in accordance with the forecasts set;
- undertake comparison in relation to services provided by other public service broadcasters such as ITV, Channel 4, S4C and Five; and
- make an independent assessment of future efficiency savings on what it considered to be achievable on the evidence obtained.³

3 Source: PKF proposal, August 2005.

2.5 The Department was clear in commissioning PKF that this was not necessarily a single source approach and that it expected PKF to identify whether there were issues for the Department to take forward through other routes. In addition to commissioning consultants, the Department's approach to assessing the BBC's efficiency has involved consideration of information and assessments from other sources (**Part 3**).

2.6 The Department also invited public debate on the Charter Review and, more specifically, on the level of the BBC's licence fee bid, at each stage of the Charter Review process. Following the publication of the White Paper, 'A public service for all: the BBC in the digital age', the Department invited industry experts, representatives, and members of the public to a seminar in May 2006 to discuss the key issues surrounding the future level of the licence fee.

2.7 In the summer of 2006 the Department commissioned further work from Nottingham University. The research aimed to assess productivity trends and break down productivity performance within the broadcasting sector.

2.8 In the light of the debate following PKF's report and assessments of the BBC's efficiency received from consultants commissioned by the BBC, the Department asked the National Audit Office in July 2006 for a view on the available evidence base.

PART THREE

Information available to the Department on the BBC's efficiency

3.1 The Department has two main sources of hard evidence on the BBC's efficiency: information contained in the BBC's licence fee submission; and consultancy reports on the BBC's efficiency from PKF (commissioned by the Department), PA Consulting (commissioned by the BBC Governors), Oxera (commissioned by the BBC management) and Magentum (commissioned by the BBC and some UK broadcasters).⁴ Drawing on these evidence sources, this Part of the report covers the evidence the Department has on:

- the BBC's achievements since 2000;
- the scope for further efficiencies; and
- the use of comparators to assess efficiency.

The BBC's achievements against the efficiency targets set in 2000

3.2 In February 2000, as part of the last licence fee settlement, the Department set a target for the BBC to deliver cumulative efficiency savings of nearly £2 billion

by 2006-07 (in 1999-2000 prices). This target was informed by a report which the Department commissioned from PKF, who found that the BBC had undertaken comprehensive and regular benchmarking studies against independent production companies and that these had demonstrated that the BBC had matched, and in many cases bettered, the competition on cost. PKF considered that there was, nonetheless, scope for additional efficiencies, particularly in overhead costs, and this was reflected in the target.

3.3 The BBC's latest forecast is that by March 2007 it will have delivered cumulative efficiency savings of £2.29 billion (in 1999-00 prices) over the period covered by the current licence fee settlement (2000-01 to 2006-07) (**Figure 3**). This is nearly £0.3 billion higher than the target set in 2000. PKF confirmed in April 2006 that the BBC is likely to meet or exceed the efficiency target set in 2000 for the period to March 2007. However, PKF has also advised the Department that, in its opinion, the cash-releasing efficiencies delivered by the BBC in the period 2000-01 to 2004-05, which equate to annual savings of less than 1.3 per cent of total expenditure, have been 'marginal'.

3 Annual income, expenditure and efficiencies in the current licence fee settlement period (£million in 1999-00 prices)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 forecast	2006-07 forecast	Total forecast
Licence fee income	2,295	2,396	2,475	2,579	2,649	2,737	2,812	17,943
New recurring efficiency savings each year	111	54	91	55	41	132	122	606
Cumulative efficiency savings	111	166	257	312	353	485	607	2,291

Source: BBC licence fee submission, May 2006 and PKF report, April 2006

NOTES

- 1 The higher savings forecast for 2005-06 and 2006-07 reflect the first two years of the BBC's three year value for money programme (paragraph 1.2).
- 2 Totals subject to rounding.

⁴ The Department also received a report from Indepen (commissioned by ITV) which included an assessment of the BBC's overall licence fee bid, and analysis of productivity growth in the communications sector. The report did not include an assessment of the BBC's efficiency.

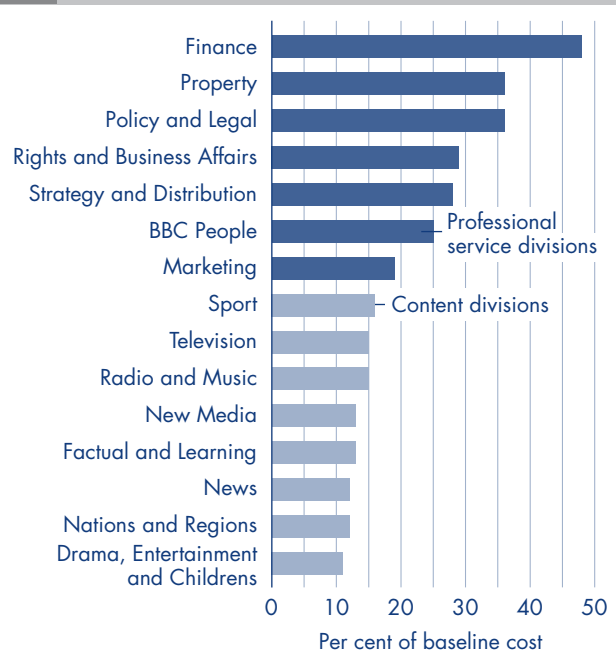
Consultants' views on the scope for further efficiency savings

3.4 As shown in Figure 1, the BBC's licence fee bid includes proposals to deliver cumulative efficiency savings of a net £2.6 billion (in 2006-07 prices) between April 2007 and March 2014. The BBC proposes to do so initially by completing its three year value for money programme (paragraphs 3.5 to 3.6) and then creating a culture of continuous improvement (paragraphs 3.7 to 3.9).

3.5 The BBC's three year **value for money programme** is intended to deliver cumulative cash-releasing efficiency savings of £355 million by March 2008 and take the BBC to what it regards as the efficiency frontier.⁵ The last year of the programme (2007-08) will count towards the savings target in the next licence fee period. The BBC aims to achieve these savings through reducing its staff numbers by 19 per cent (with overall staff reductions of 46 per cent in professional services areas, such as finance and human resources, and 13 per cent in programme producing (content) areas) and "transforming efficiency" in content areas, although its savings targets are lower in the latter, which account for 80 per cent of its 'non-excluded' expenditure (**Figures 4 and 5**). The BBC regarded the differential targets as important to ensure that quality of output is not affected during the value for money programme.

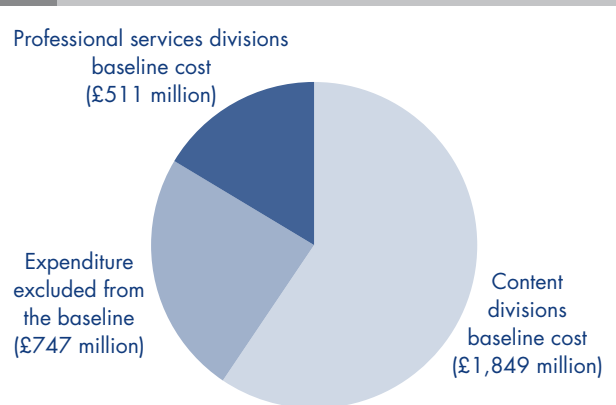
3.6 The BBC has excluded some expenditure, such as on sports rights and long term contracts, from its value for money programme on the grounds that these costs are not easily controlled. PKF concluded that the total cost of excluded expenditure is £1 billion, although the BBC believes it to be £747 million, after excluding some double counting. PKF considered some exclusions were justifiable but others were less so, and it therefore recommended that the Department review the BBC's excluded expenditure to assess whether the items omitted merit exclusion, or whether there was increased scope for extracting further value across the next licence fee period. The exclusions were temporary and related to the three year value for money programme only and will be included in the baseline for the continuous improvement programme (paragraph 3.7). On PKF's analysis, the BBC is planning to make gross savings of 14.4 per cent of the reduced cost base for the period of the value for money programme but 11.4 per cent of the total unadjusted cost base.

4 Divisional efficiency savings (as a percentage of the baseline cost in each division) over the three years to 2007-08



Source: National Audit Office using figures supplied to the Department for Culture, Media and Sport by the BBC

5 Programme content producing divisions' costs account for the largest component of the 2004-05 baseline cost of £3.1 billion



Source: BBC licence fee submission

⁵ The efficiency frontier is where best practice in efficiency has been adopted across the organisation. At this point, further cost reductions can only be achieved through 'frontier shift' which requires the adoption of technology or working practices yet to be developed (see Appendix).

3.7 From 2008-09, the BBC aims to deliver annual efficiency savings of £80 million (2.5 per cent of its predicted cost base in 2008-09) through its **continuous improvement programme**.⁶ The BBC stated in its bid that its overall savings target was based on the experience of Government, other public sector organisations, the media industry, utilities and listed companies. Within the £80 million target, the BBC categorises £45 million (1.5 per cent of the cost base) of new savings every year as cash-releasing, in line with the Gershon report on efficiency in central government.⁷

3.8 The BBC estimates that within its £80 million annual savings, £35 million a year (presented by the BBC as 1 per cent of its predicted cost base in 2008-09), or a cumulative £980 million over the period to 2013-14, will be needed to meet above-inflation increases in costs to the BBC which it refers to as 'super-inflation', although it recognises that super-inflation in areas such as wage cost is not unique to the BBC. The BBC considers it appropriate to classify the absorption of super-inflation as a non cash-releasing efficiency saving, in line with previous treatment. The BBC has confirmed to us that absorption of super-inflation is not an efficiency saving in itself but rather recognition of a cost pressure which requires cash-releasing efficiency savings to fund it. The BBC is therefore, in practice, proposing cash-releasing efficiency savings of £80 million a year.

3.9 PKF has challenged the BBC's approach to the amount of super-inflation, particularly with regard to £490 million of wage costs where it did not accept that that element was any different from the challenges faced by any other public or private sector organisation. PA Consulting has also advised the BBC Governors that the argument for wholesale incorporation of the absorption of super-inflation into efficiencies claimed has not been conclusively made by the BBC.

Assessments of the BBC's efficiency

3.10 The scope and approach of the four principal assessments of the BBC's efficiency are set out in **Figure 6 overleaf**. The first assessment was made by PA Consulting for the BBC Governors between February and August 2005, prior to the submission of the BBC's licence fee bid. The Department commissioned PKF in July 2005 to review the BBC's funding needs. The BBC, after submitting its funding bid to the Department in September 2005, commissioned Oxera to assess the

reasonableness of its efficiency proposals against external benchmarks. PA Consulting provided a further assessment in March 2006 in its review for the BBC Governors of PKF's draft report. Neither the BBC nor the Department consulted the other on the terms of reference when commissioning consultants.

3.11 The high-level conclusions from the various assessments are set out below. Each of these assessments relies on simplifying assumptions and approximations and no single one can provide a definitive picture.

- PKF's professional judgement arising from its assessment was that there was scope for the BBC to increase its annual cash-releasing continuous improvement target from 1.5 per cent to 3 per cent of the cost base other than in areas where transformational change (which is where the BBC matches best practice in current technology and work practices) was proven. This was in addition to the BBC's 1 per cent efficiency saving required to fund super-inflation. The BBC does not agree with PKF's conclusion as it considers it rested too heavily on judgement and not on evidence or analysis.
- PA Consulting also considered there was scope for further efficiencies above the BBC's target in the value for money programme, while noting that the overall continuous improvement target of 2.5 per cent was stretching yet achievable and in line with the Gershon report. PA Consulting believed that until the BBC reviewed its organisational design and processes, the scope for transformational change and further efficiencies would be limited. The BBC told us it is now taking this work forward.
- Oxera set out that because PKF stated in 2000 that the BBC was at the efficiency frontier in most areas, and that the BBC was on track to improve significantly on the targets set at that time by the Department (informed by PKF) and to catch-up in those areas identified as not previously being of frontier performance, there was evidence to suggest that the BBC would be at the efficiency frontier by the end of the value for money programme in March 2008. However, Oxera did not examine the BBC's current efficiency as that was outside the remit of its work. It did conclude that the cash-releasing efficiency target of 1.5 per cent from 2008 onwards was appropriate to an organisation at the efficiency frontier.

⁶ The BBC has asked the National Audit Office to report annually on the BBC's progress in delivering its continuous improvement efficiency programme.

⁷ Releasing resources to the front line, Sir Peter Gershon, CBE, July 2004.

6 Assessments of BBC efficiency by the Department and BBC

Author: report	Commissioned by	Date reported	Scope relating to efficiency	Methods and evidence used
PA Consulting: <i>Review of the BBC's professional services and content divisions</i>	The BBC Governors in February 2005	February and March 2005	Review the BBC's value for money proposals to confirm the BBC is on track to deliver efficiency savings committed to as part of the last licence fee settlement, confirm the viability of new savings target and identify whether further savings could be realistically achieved.	PA Consulting reviewed BBC value for money plans, conducted interviews with key BBC staff and undertook its own financial analysis.
PA Consulting: <i>Review of the BBC's licence fee bid</i>	The BBC Governors in June 2005	August 2005	Provide reassurance and a view on whether the BBC's assumptions concerning the contribution that self-help can make in meeting the additional investment required are stretching enough and achievable (including the assumptions for efficiency savings).	PA Consulting reviewed BBC documents, including the licence fee submission and updated value for money plans, conducted interviews with key BBC staff and undertook its own financial analysis.
PKF: <i>Review of the BBC's value for money and efficiency programmes</i>	The Department for Culture, Media and Sport in July 2005	April 2006	Assist the Department in considering the BBC's efficiency and value for money and the assumptions and arguments underpinning the BBC's assessment of its future funding needs.	PKF based its conclusions on its professional experience and judgement and a review of the BBC's recent performance in delivering efficiencies, the licence fee submission and the BBC's value for money plans.
Oxera: <i>What is a reasonable rate of cost reduction for the BBC?</i>	The BBC management in September 2005	July 2006	Establish how the BBC's long-term annual operating cost reduction compares with external benchmarks and identify possible work streams that the BBC could commission to demonstrate the reasonableness of its assumption.	Oxera reported on the BBC's historic performance, the future cost pressures on the BBC, the controllability of the BBC's cost base and compared the BBC's cash-releasing continuous improvement target of 1.5 per cent with efficiency benchmarks from other sectors (with a particular focus on regulated UK utilities) and the public sector and economy as a whole as well as other broadcasters.
PA Consulting: <i>Review of the PKF response to the BBC's licence fee proposals</i>	The BBC Governors in March 2006	March 2006	Provide a brief review of the draft report issued by PKF to the Department following its review of the BBC's licence fee proposals.	PA Consulting reviewed PKF's draft report in the light of its own review of the BBC's self-help and value for money proposals.

Source: National Audit Office summary of reports provided to the Department for Culture, Media and Sport

3.12 For the purpose of achieving clarity in terms of the evidence available to the Department, we have two comments about how the BBC has, in its licence fee submission, presented the numbers for its proposed efficiencies from 2008-09 onwards.

- The BBC presents the £35 million it estimates it needs to fund super-inflation as 1 per cent of its cost base (£3 billion from 2008-09). We note that this figure has been rounded down by the BBC and is actually 1.2 per cent, meaning the BBC is proposing total efficiency savings of 2.7 per cent rather than 2.5 per cent (paragraph 3.7). For the purposes of this review we use the language and numbers used by the BBC.
- The 2.7 per cent efficiency target (above) represents a figure averaged over six years against a cost base which has been fixed at a point in time (2008-09). Had the BBC instead set the target against its proposed expenditure over the period, the £80 million savings per year would equate to 2.3 per cent of the cumulative cost base. The BBC notes that the majority of the proposed additional expenditure is either fixed or is based on marginal cost and it therefore does not believe efficiency savings should be expected from all of this additional expenditure.

3.13 The report and our own review have highlighted a number of different figures for the BBC's efficiency targets, split between cash-releasing and non cash-releasing. For ease of comparison they are set out in **Figure 7**. The detailed findings of the different consultants on efficiency are in **Figure 8 on pages 16 and 17**.

The use of comparators in assessments of the BBC's efficiency

3.14 As well as direct evaluations of the BBC's efficiency, the Department was also able to draw on work which compares the BBC with other bodies. Both PKF and Oxera found that using published data on the costs of other broadcasters did not offer reliable efficiency benchmarks. Benchmarking the BBC against other organisations, even other public service broadcasters, at this high-level is difficult because each organisation faces different circumstances which will impact on its efficiencies. Oxera noted that in seeking to make comparisons with other broadcasters, a large consistent dataset would be essential but reported that it had not been able to obtain consistent data for other European broadcasters.

3.15 As Oxera and PKF stated, a more fruitful approach is to benchmark particular activities or business functions. For example, in recent years the BBC has benchmarked around 30 per cent of its total expenditure, including areas such as HR, Finance and IT. However, the majority of its expenditure is on programmes which has not been benchmarked since 2002. There are particular difficulties in comparing the quality of programme content as this requires agreement between comparators on the ambition, quality standards and editorial judgements involved in a programme. There is no readily available dataset with these characteristics so it would have to be specially commissioned.

7 Versions of the BBC's continuous improvement efficiency targets

	BBC presentation of its proposed targets %	National Audit Office understanding of BBC position %	PKF opinion of what BBC efficiency targets should be %
Cash-releasing	1.5 (para 3.7)	2.7 ¹ (para 3.12) 2.3 ² (para 3.12)	3.0 ³ (para 3.11)
Non cash-releasing	1.0 (para 3.8)	0 (para 1.2)	1.0 ⁴ (para 3.11)
Total	2.5	2.7	up to 4.0

Source: National Audit Office

NOTES

- 1 Based on updated BBC figures and roundings against a fixed cost base year of 2008-09.
- 2 Based on forecast BBC expenditure from 2008-09 to 2013-14.
- 3 The 3 per cent applies to areas which have not proven transformational change, although PKF did not quantify such areas.
- 4 PKF's analysis focuses on the BBC's proposed cash-releasing target and does not explicitly comment on the appropriateness of the BBC's proposed non cash-releasing target. PKF's report recognises that the BBC's proposals are split into cash and non cash-releasing and PKF has confirmed to us that the presentation above correctly represents its position.

8

Consultants' conclusions on the BBC's efficiency targets

PA Consulting: Review of the BBC's professional services and content divisions (February and March 2005)**Conclusion on the BBC's value for money programme (2005-06 to 2007-08)**

Savings in professional services appear reasonably testing and mainly relate to efficiency rather than merely withdrawing services.

Our overwhelming impression is that there are many different ways in which the content divisions have approached establishing the savings and the many different drivers for them. However, we do not think that this adds up to a BBC transformational change programme.

'Leading practitioners' would expect to deliver annual efficiency savings (as an accepted part of business as usual) of six to seven per cent, compared to a maximum of 4.6 per cent for the BBC's content divisions during the three year value for money programme, although we have not benchmarked these figures.

Conclusion on the BBC's continuous improvement programme (2008-09 to 2013-14)

Continuous improvement targets for 2008-09 onwards were not considered as part of these reviews.

PA Consulting: Review of the BBC's licence fee bid (August 2005)

The value for money programme appears to be on track to deliver the targeted savings.

The continuous improvement target of 2.5 per cent year-on-year net savings is stretching but achievable on the understanding that the savings of 2.5 per cent are net of implementation costs.

Source: PA Consulting, PKF, Oxera

Comparing the cost of programmes

3.16 As part of its review of the BBC's licence fee bid, PKF was supplied with data by Ofcom on the cost per hour of original programmes commissioned by the main terrestrial broadcasters. PKF concluded that this data did not show whether the BBC was any more or less efficient in producing original output than other broadcasters due to differences in, for example, the nature of programmes produced and scale economies in TV production.

3.17 In late 2005, in response to the lack of up-to-date benchmarking of programme spend, the BBC and some other UK broadcasters commissioned a programme price benchmarking study, conducted by Magentum in January to April 2006 (with more detailed analysis carried out over the summer) and released to the Department in September 2006. The data for the programme prices used for comparison pre-dated the BBC's value for money programme which aims to cut the cost of content

programming by up to 15 per cent by March 2008 (Figure 4 above). The BBC planned to use the benchmarking data to identify whether there was scope to make further efficiencies in particular areas of programme expenditure.

3.18 The study compared the prices of comparable categories of UK commissioned first-run television programmes (that is, not repeats) broadcast between 2003 and 2005, including drama series, comedy, entertainment formats and factual series. These programmes account for approximately 21 per cent of annual BBC expenditure on programming. The study did not cover the BBC's news, sport, children's programmes, regional or radio outputs. Due to commercial confidentiality, each participating broadcaster could identify only their own prices in reports to them as the price paid by the other participants was grouped together. This meant the BBC received only two data points, one point for the BBC and one point aggregating the other UK broadcasters. A further breakdown was available to the BBC for BBC1 and BBC2.

PA Consulting: Review of the draft PKF response to the BBC's licence fee proposals (March 2006)

There have been wide ranging and significant initiatives in divisions such as HR, IT, and Finance, delivering considerable changes and substantial savings.

The changes proposed in the content divisions and in some of the professional services divisions under the value for money programme are not transformational. This will limit the scale of potential efficiencies under the continuous improvement programme.

BBC management has made a good start in this area with the work commissioned from Oxera to establish external benchmarks and precedents for the BBC position.

Until the BBC has taken a top-down view of the business architecture it is hard to see how it can develop truly integrated and transformational change plans for the BBC as a whole, or indeed to confirm the magnitude of possible efficiencies that would result.

PKF: Review of the BBC's value for money and efficiency programmes (April 2006)

Some divisional proposals appear to represent fundamental or transformational change (particularly in support areas such as Finance, IT and HR) but many appear to represent marginal and not transformational change. There is scope for more fundamental change across BBC divisions.

The BBC has not exhausted the possibilities for catch-up efficiency through its value for money programme and could reasonably be expected to increase its cash-releasing efficiency target (other than in those areas where transformational change is proven) from 1.5 per cent to 3 per cent of the cost base.

Oxera: What is a reasonable rate of cost reduction for the BBC? (July 2006)

Because PKF stated in 2000 that the BBC was at the efficiency frontier and that the BBC was on track to improve significantly on the targets set at that time by the Department (informed by PKF), there is evidence to suggest that the BBC would be at the efficiency frontier by the end of the value for money programme in March 2008.

However, Oxera did not assess the BBC's value for money programme or its current efficiency.

The BBC's 1.5 per cent long-term operating cost reduction is, for an organisation at the efficiency frontier, in line with external sectoral and economy-wide benchmarks, and indeed, more challenging than many of them.

'Slot time' and 'running time' comparisons

3.19 All the broadcasters agreed the definition of categories and allocation of programmes into ten categories which were then analysed and compared. However, there was no resolution over a key factor affecting price – the unit of time for a programme 'slot'. A BBC 'hour' of programming contains 59 minutes of programme 'running time' whereas a commercial television 'hour' contains approximately 48 minutes of programme 'running time'. The price per hour comparison is dependent on which of the 'hour' definitions is used. Magentum recognised that in some programme categories it was valid to compare prices on the basis of both 'slot time' and 'running time' and that this was more appropriate in some categories than others. A comparison of prices was thus provided for each category on the basis of both 'slot time' and 'running time'.⁸ The findings were that:

- **using the unadjusted 'slot' price per hour**, the BBC appears to pay more than the other UK broadcaster comparator in nine out of the ten programme categories, representing 88 per cent (£775 million) of BBC expenditure analysed; while
- **using 'running time' price per hour**, the BBC pays more in three categories (covering 66 per cent of BBC expenditure analysed). The price paid is more than five per cent greater than the other UK broadcaster comparator in two of these categories (representing 17 per cent of BBC expenditure analysed).

⁸ For 'slot' price, one BBC hour = one commercial hour and for adjusted 'running time' price one BBC hour = 60/50 x one commercial hour. The 'running time' was adjusted by 60/50 rather than 59/48 as precise 'running times' were not used in the study.

Comparison using a combination of 'slot time' and 'running time'

3.20 While Magentum agreed with the BBC that it would take more resource to produce a scripted programme (for example a comedy or drama series) of 59 minutes than one of 48 minutes, it did not identify the additional price required to purchase a BBC 'hour' over and above a commercial 'hour' as the collection and analysis of the information required was outside the scope of the study. Magentum concluded that the true picture lies somewhere between 'slot' price and adjusted 'running time' price for all programmes.

3.21 Scripted programme categories are those where the longer programme length needed to fill a BBC 'hour' requires additional script material, longer location shoots or use of studio time and longer employment of cast and production teams. These categories include drama and comedy programmes. Magentum considered that there was less evidence to suggest that differences in prices were affected by the longer BBC 'running time' in the factual programme categories.

3.22 If the adjustments are made to the scripted categories where price is most likely to be affected by differences in 'running time' such as drama series and comedy, and the remaining programme categories are compared using 'slot time', then the BBC pays more in eight of the ten categories (covering 82 per cent of BBC expenditure analysed). The price paid is more than five per cent greater than the other UK broadcaster comparator in six of the ten categories (representing 29 per cent of BBC expenditure analysed).

Predicted and actual price comparisons

3.23 In the second part of its study, Magentum created a regression model to predict prices across all programme categories to ensure that the editorial ambitions of the programmes were factored into the analysis and that like was compared with like. Magentum identified over 30 different production components most likely to affect programme prices and, together with the industry average prices, constructed a model to predict programme prices which could then be compared with actual prices paid by the BBC and other broadcasters.⁹ As the analysis was carried out at a programme level, there were no broad conclusions to be drawn about the different prices paid by the BBC in each programme category. However, further work was carried out by Magentum, as requested

by the BBC, to compare factual programme prices at a more detailed level in order to understand better the factors underlying the difference in prices paid in these programme categories.¹⁰ The findings were that:

- **when the average predicted prices were compared to the actual prices paid for BBC programmes**, the BBC paid more than the predicted price in most of the factual programme categories (covering 16 per cent of total BBC expenditure analysed). The difference was less than five per cent for the bulk of such programming. The BBC intends to conduct more work in this area to assess whether the higher prices are justified or whether this represents a further opportunity to drive efficiency; and
- **when the average predicted prices of the BBC's factual programme categories were compared to the average actual prices paid by other broadcasters**, the BBC's predicted prices were higher in 19 per cent of total BBC expenditure analysed. The difference was greater than five per cent in 16 per cent of total BBC expenditure analysed. Magentum considers that this indicates the BBC is, in general, commissioning programmes in these categories which have a more expensive set of production components and that overall these programmes may comprise a more complex set of production factors and higher level of editorial ambition than those commissioned by some other UK broadcasters.

Productivity in the broadcasting sector

3.24 The work completed for the Department by academics at Nottingham University Business School and Nottingham Trent University (paragraph 2.7 above) looked at productivity trends within the broadcasting sector.¹¹ The work covered the BBC but did not identify the BBC's position relative to the rest of the broadcasting sector. Although the authors highlighted a number of caveats which suggest that the results should be treated with some caution, such as the relatively small sample size and the fact that it is difficult to define measurable units of output adjusted for quality and mix differences, all their estimates suggested that the broadcasting sector had experienced positive productivity growth in recent years. For example, they estimated 'Total Factor Productivity' growth for the broadcasting sector between 1998 and 2003 to be 5.4 per cent annually for 'Gross Value Added' and 11.88 per cent for 'Gross Output'¹² (or 3.4 per cent and

⁹ Magentum points out that this list of production factors is not exhaustive and there may be additional factors which affect the price paid.

¹⁰ The further work carried out on the factual programme categories covered 20 per cent of total BBC expenditure analysed.

¹¹ Broadcasting productivity growth in the UK: a report for the Department for Culture, Media and Sport, Paton, D., Nottingham University Business School and Vaughan Williams, L., Nottingham Trent University, October 2006.

¹² Total Factor Productivity is output growth not accounted for by the growth in inputs. Gross Value Added is defined as turnover, plus the change in work in progress at the start and end of the year, less total purchases. Gross Output is defined as turnover plus change in work in progress plus change in stocks bought for resale plus work of a capital nature by own staff.

8.2 per cent respectively for organisations in the size category which includes the BBC). The report noted that the findings of positive productivity growth over the period appeared to be generally robust to alternative estimation procedures. However, the authors noted that as the results are suggestive of general trends in broadcasting it is important to complement this analysis with detailed qualitative analyses of the sector.

Ways in which the Department's assessment process could be strengthened

3.25 The Department does not rely on submissions from, or negotiations with, the BBC to assess the BBC's funding requirements. Nevertheless, in considering the ways in which the Department approached the evaluation of the BBC's efficiency, we have identified a number of ways in which the process could be strengthened, drawing in part on the approaches of regulators of utilities. The points can all be grouped under a general theme of transparency:

- **consulting on terms of reference for the evaluation process.** The Department discussed the scope and content of the work to be commissioned from PKF with the BBC before it commissioned this work but it did not agree the terms of reference with the BBC. This was because, as it believed the decision was one for Government alone, the Department considered it was not appropriate to agree terms of reference or comparators with the BBC. This led to subsequent disagreements between the two organisations on the level of evidence and analysis provided by PKF to support its conclusions. The BBC told us that it was only after PKF approached the BBC to start work that the BBC appreciated the full extent of the information it would need for the review. Similarly, the BBC did not discuss the Oxera terms of reference with the Department;
- **specify information requirements, including comparators, in advance.** The Department did not give the BBC any guidance on the information its licence fee submission should contain and regarded the BBC's licence fee bid as unsolicited but helpful; and
- **where it is necessary to commission consultants to assess the BBC's efficiency for the licence fee, it should be for the Department to commission them.** Only after it had submitted its efficiency assessment in the licence fee bid and the Department had commissioned PKF (at an eventual cost of £300,000) did the BBC commission Oxera to establish whether its long run cash-releasing efficiency target was appropriate. If this work was required by the Department then the Department should have commissioned it and specified the question to be asked. However, the Department told us it did not believe such work was required. The BBC spent approximately £100,000 to support its case through this work.

3.26 There may also be wider lessons for the Department and the BBC Trust to learn from economic regulators such as Ofgem and Ofwat, who have to consider similar issues when they determine outputs and set prices for the regulated utilities. For example, Ofgem, the gas and electricity companies' regulator, commits significant resources to agreeing information requirements from the companies it regulates (see Appendix).

APPENDIX

How regulators approach efficiency and target setting

1 The Department is not alone in having to consider the efficiency of an organisation as part of an income setting exercise. Economic regulators have to consider similar issues when they determine outputs and set prices. Others with similar responsibility include Ofgem and Ofwat, the energy and water regulators respectively. Ofcom, the communications regulator, is also undertaking a major review of the Channel 4 Group.

2 There are four key components to utility regulators' assessment of the scope for efficiency savings:

- **outputs:** regulators begin by establishing the outputs that regulated companies must provide, such as the volume of water or the number of households receiving electricity;
- **information:** regulators then seek data on how much it costs to deliver these outputs, and seek to identify time series data from comparable sources;
- **the efficiency frontier:** on the basis of output and cost information, regulators assess whether each regulated company is at the efficiency frontier. If it is, regulators assume in the future that the company will only be able to improve efficiency at the rate of general productivity improvements in the regulated sector as a whole. Otherwise, the regulator assumes it can 'catch-up' and therefore sets a tougher efficiency target; and
- **incentives:** once the regulated company's efficiency target is set, the regulator creates incentives for it to increase its efficiency beyond the target. Under RPI-X (paragraph 3), this incentive consists of the ability to retain efficiency gains for a pre-agreed period of time, for example, five years. To ensure that incentives are not perverse, the regulator will also incorporate arrangements for 'cost shocks' and windfalls.

Utility regulators and the use of 'RPI-X'

3 Retail Price Index less X (RPI-X) is a means of controlling the extent to which companies with monopoly power raise their prices. It prevents regulated companies from increasing their prices or revenue by more than the general price inflation (RPI), less an 'X' value determined by the regulator. RPI-X provides companies with incentives to find efficiency savings, as any savings greater than the target can be retained by the company for a pre-agreed period of time.

4 In the case of water and energy, companies are incentivised to beat the regulator's efficiency target, because doing so can increase their profits. At the next price control the regulator resets prices on the basis of the new, more efficient company. In this way, the benefits of efficiency are shared between the companies and consumers. The incentives operate differently in the case of the BBC, as any out-performance is not captured in the form of profits or lower prices, but ploughed back into frontline programme making. The Department could consider how to formalise this incentive within the licence fee settlement, perhaps requiring the BBC to demonstrate how it has used efficiency gains to the benefit of licence fee payers.

5 Regulators require information from regulated companies so that they can assess relative efficiency and hence the level of 'X' during the price control period. **Figures 9 and 10** show that regulators such as Ofgem and Ofwat collect a range of information over an extended period and use various econometric techniques to analyse the relative performance of regulated companies.

Ofcom

6 Ofcom is undertaking a major review of the Channel 4 Group to ensure that it can maintain its public service remit – assessing the resilience of the Group’s business model. The review will try to answer a series of questions which include:

- How efficient is the Channel 4 Group now?
- What lies behind the Group’s financial performance over the last five years?
- What is the basis for the Group’s revenue forecasts and how challenging are they?
- What are the Group’s future efficiency plans and how challenging are they?
- What value and risks are there on the Group’s balance sheet?
- Are there any significant issues raised by the accounting treatment of the Group’s activities or its financial statements?
- How appropriate/challenging are the business plans of the Group’s new business ventures?
- What is the likely range of outcomes for the Group’s overall financial position?

7 These terms of reference were agreed by Ofcom and Channel 4. Ofcom is in the early stages of this work and has appointed consultants to help inform its thinking on areas such as: the use of comparators for relevant financial ratios and external benchmarks; Channel 4’s historic performance; and its existing levels of efficiency.

9 Ofgem’s Business Planning Questionnaire for Gas Distribution Networks

Ofgem collects historical and forecast data on many areas of regulated companies’ operating and capital expenditure and financial information. It also seeks to gain an understanding of how companies are adopting best practice in its activities. It asks for descriptions of: their processes, policies and procedures and forecasting assumptions; how management information is used to improve productivity and the measures used; the current structure and how this represents one that is efficient and appropriate; the efficiency benchmarks by which each operating unit measures its performance; examples of where companies have achieved exceptional performance or best practice and how this has been measured; and the measures used to monitor activities and the quality-quantity of outputs.

10 Ofwat’s approach to efficiency analysis – the use of judgement

Ofwat has developed an approach to price setting which recognises the need for pragmatism as well as theoretical considerations. While Ofwat has an extensive data holding, it still must make a substantial number of judgements. Such judgements are an important determinant of the extent to which unexplained differences in costs are assumed to reflect inefficiency. Ofwat makes forward-looking estimates of the scope for catch-up efficiency improvements by comparing actual performance with a benchmark set by a company identified by Ofwat as the most efficient in the industry.