

Foreword

Channel 4's role in the future of public service broadcasting

In July 2006 we announced plans for a Financial Review of the Channel 4 Group – the first time such an external review of Channel 4 has been carried out. We proposed this project in our first review of public service broadcasting (PSB), in 2004-05, in response to Channel 4's analysis suggesting that by 2009 it would face a financial shortfall that would limit its ability to deliver its public service remit. Although we found no evidence of an immediate problem in 2004, we concluded that a subsequent review would be needed before the next PSB review. Channel 4 supported this review, which was also welcomed by Government in its White Paper on the future of the BBC.

To inform our review, we commissioned LEK to carry out a comprehensive, independent assessment of Channel 4's financial and operating performance. Channel 4 prepared a submission to the review including a medium term financial forecast, and an analysis of its public service contribution, which we supplemented with our own analysis of Channel 4's delivery of its statutory remit.

We are pleased to publish LEK's report, along with Channel 4's submission on its public service delivery and our own analysis. Publication of these reports represents the completion of the initial phase of the financial review. This foreword describes the context for the work, details the main conclusions as we see them and sets out a number of issues we believe are raised by the findings.

Our first PSB review concluded that there remained a strong role and demand for public service broadcasting. We argued that a not-for-profit, commercially-funded Channel 4 would be an important part of the future of PSB, up to switchover and beyond. We said that Channel 4 had a critical role in the provision of plurality in PSB and as a source of innovation in the television market.

However, our review also found that historic models of PSB would break down as a result of the transition to digital TV, and that there would be steadily growing pressure on commercial public service broadcasting in the period through digital switchover and beyond. We observed that Channel 4 faced many of the same pressures on its funding model as the other commercially-funded public service broadcasters, and that this could constrain its ability to fund a wide range of high quality public service programming in future.

Channel 4 has argued that there are indeed risks to its funding model that could hinder its ability to deliver the remit of its public service channel. Its analysis suggests that increasing digital penetration and fragmentation of viewing will limit future growth in advertising revenue at the same time as programme prices rise faster than inflation. As a result, it concludes that Channel 4 will face a 'funding gap' in seeking to deliver its remit and that it will need new public support of some kind to help substitute for its historic form of indirect support – its gifted analogue and digital spectrum – in order to enable it to serve its statutory purposes as we approach digital switchover.

This risk has been illustrated by Channel 4 in a medium term forecast for its businesses over the five years to 2012. The details of this forecast have not been published, as Channel 4 considers them commercially confidential, but LEK has closely reviewed the entire forecast as a key input into its work.

LEK's report provides important evidence to inform thinking about the Group's financial future, while Channel 4's submission on its PSB contribution together with our own analysis

provide a benchmark against which recent and future changes in Channel 4's delivery of its remit can be assessed. Together, we believe that the reports provide a clear account of the circumstances facing Channel 4 as it completes the transition to a digital era, and raise a number of important questions for Channel 4, Ofcom and the Government.

The purpose of the financial review

The Terms of Reference for the financial review (first published in July 2006 and appended to this document) set out the purpose of this work. Our objectives are to assess the resilience of the Group's business model in the face of changing competitive pressures, to understand the scale and timing of the funding challenges that the Group may face in fulfilling its remit, and if necessary to identify possible mechanisms to address any future pressures on its funding model.

We commissioned LEK to provide an independent evaluation of the Channel 4 Group's recent financial performance, its future revenue and efficiency forecasts, the impact of market change on the Group, potential benchmarks for assessing future financial performance and the likely range of outcomes for the Group's medium-term financial position. We believe that LEK's report meets these objectives.

Our analysis of Channel 4's delivery of its remit is intended to supplement Channel 4's own submission on its public service contribution. It uses data available to Ofcom to help understand how Channel 4 defines and implements its remit in practice and identify relevant indicators of current and future performance. Together these reports describe Channel 4's current level of public service delivery, both as a basis for modelling Channel 4's financial performance in the medium term and to provide a benchmark against which its future public service delivery could be assessed. One of the findings of our report is that looking at Channel 4's output only with respect to the mix of genres it broadcasts does not give a complete picture of its public service contribution. We believe that it would be beneficial to develop a wider basket of measures to assess Channel 4's public service contribution more effectively, including measures of the reach and impact of Channel 4 programmes and the more qualitative aspects of its remit such as innovation, in addition to the mix of genres it broadcasts.

Summary of conclusions

LEK's central forecast suggests that Channel 4's recent strong commercial performance will deteriorate in the near- and medium-term. This is a result of what it describes as a short-term correction in the margins Channel 4 has recently earned in its most profitable programme categories, and some – albeit low – ongoing inflation in production costs for other Channel 4 programming at a time of flat or declining television advertising revenues. The Group's digital channels and other commercial ventures will make a positive contribution, and it is possible that additional cost cutting could be implemented. Based on these assumptions, and a significant reduction in planned investment in new services, in LEK's central case, current cash reserves would be sufficient to cover losses at least through to 2012. However the Group would not be generating operating surpluses after 2010 and would begin to face pressures on its working capital requirements, thereby rapidly calling into question the longer-term health of its underlying business model. LEK concludes that in pursuing such a strategy, Channel 4 will face "difficult trade-offs" between investments and other measures to support the long-term commercial health of the Corporation, versus ongoing investment in public service delivery.

In LEK's view, the central scenario represents only one of a number of realistic outcomes. Relatively modest changes in the assumptions can lead to wide variations in the Group's performance; in LEK's high case, the Group continues to be profitable and to add to cash

reserves throughout the forecast period, but in its low case the Group is loss-making from 2009 and exhausts its cash reserves in 2011. Given the degree of unpredictability in several of the key variables, particularly future growth of the TV advertising market, there is significant uncertainty around these forecasts, but LEK's view, based on its analysis, is that the downside scenarios for Channel 4 are more likely than the upside scenarios.

Channel 4's submission on its remit and our own analysis set out the public service context for this financial analysis, and shed light on the possible implications of any future financial pressures. They make clear that Channel 4 is delivering the quantifiable elements of its remit, consistently meets and in some cases significantly exceeds its licence obligations, and has a significant role in delivering some core PSB genres that are highly valued by viewers.

The analysis also identifies some ways in which Channel 4's delivery of its remit has developed in recent years. Although this is not the focus of the review, it provides important context for the financial analysis, and illustrates that Channel 4 believes it has already had to adapt its public service delivery to maintain its impact in a more competitive landscape. Over the last five years, hours of original programming on Channel 4 have declined, and whilst there has been an increase in the volume of output in a number of traditional PSB genres, spending on several PSB genres has also declined in real terms despite Channel 4's strong commercial performance. At the same time, spend on US acquired programmes has increased, partly as a result of programme inflation. There has also been a shift from serious factual programming to more accessible and commercial educational output, which seeks to engage audiences through a more entertaining style and approach.

Questions arising

Understanding the full implications of these findings for Channel 4's ability to maintain its statutory public service remit up to the end of switchover and beyond will take time, careful consideration and further debate. We hope stakeholders will be able to provide additional evidence for us to consider in deciding how to move forward from here.

However, it seems clear to us that the assessments provided by LEK, Channel 4 and our own analysis suggest that Channel 4 will face some challenging strategic issues over the next few years. Some of these – growing competition for content, uncertainty in the TV advertising market and the increasing significance of new platforms – are common to all commercial broadcasters. Others are specific to Channel 4, and arise from its remit, its particular model of funding for public service content and its competitive position.

The strategic issues are for Channel 4 to address in the first instance. However it is impossible to separate these issues from the policy questions Ofcom and Government are currently considering with respect to the future of public service broadcasting, since the strategic direction chosen by Channel 4 will have a direct impact on whether and how our common goals are achieved.

As the market develops, and Channel 4's role within it, our ambition is clear: to ensure that Channel 4 is able to continue to meet its remit and by doing so continues to make a substantial contribution to public service purposes and characteristics, providing plurality and effective competition to the BBC and the commercial public service broadcasters, and delivering innovative, distinctive, high quality programmes.

From our perspective, it is highly desirable that throughout this period of strategic evolution, Channel 4 remains focused on delivery of its public service remit. Given the public ownership of Channel 4, that is, and should remain, its core purpose, while its commercial activities should be designed to continue to support this purpose, not become ends in themselves. Channel 4 has always lived with the challenge of combining a public service

purpose with a commercial funding model, and this challenge is likely to become tougher over the next few years.

Channel 4's statutory remit currently pertains only to its public service channel. We have argued in the PSB review and our subsequent work that, in a digital age, delivering public service content with reach and impact requires use of the full range of media, platforms and technologies. In this context, it may be appropriate to consider in due course whether in future Channel 4 should seek to strengthen its public service impact across its digital channels and interactive media services, as well as its core channel, and whether this would require any extension to its remit.

The Channel 4 Board is charged with the dual remit of the commercial management of the Channel 4 Group and oversight of the fulfilment of Channel 4's public service remit, as set out in the Communications Act. It has a number of processes in place to enable it to oversee Channel 4's creative and commercial activities. Any future changes to C4's remit or status – should they be necessary – would of course be likely to require also a review of the existing arrangements for accountability.

In this context, we welcome the work underway by Channel 4 to develop a framework that articulates the public value delivered by the different components of its remit delivery. We anticipate that this will, amongst other things, include a basket of measures that can be used to assess Channel 4's public service contribution as fully as possible, both in terms of the output of the channel and its reach and impact. It will be important that such an assessment is public and accountable, without compromising Channel 4's independence and editorial freedom. We encourage the Board to continue to develop its thinking by building on the work already completed by Channel 4 and Ofcom, and published with this Foreword.

What happens next

We will consider the implications of LEK's report, Channel 4's submission and our own analysis of remit delivery more fully over the next few weeks, along with any new evidence in response to LEK's report from stakeholders. We will then issue a statement on what we believe should happen next, in early summer.

The immediate question for Ofcom is whether to carry out further work at this stage, to assess whether any forms of further regulatory intervention may be appropriate to address potential future pressures on its funding model. There are four main options:

- If we conclude that there is no case for intervention of any kind, we should recommend that further public support for Channel 4 should be ruled out for the foreseeable future;
- If we conclude that the problems are not immediate, and may not emerge at all, we should monitor Channel 4's financial performance and remit delivery closely, and review the case for future intervention again as and when there is more evidence available;
- If we conclude that major problems are unlikely to be immediate, but that there is some short-term risk to Channel 4's ability to deliver its remit, we should consider what limited 'safety net' measures could be put in place to mitigate this and any medium term risk, and review potential options for more significant intervention at a later date; or
- If we conclude that there is a compelling case for immediate structural intervention, we should move directly to make a detailed assessment of the options for intervention.

As these options suggest, the work carried out to date raises important questions about timing. LEK's central case suggests that with cost cutting measures and reductions to

Channel 4's planned investment in new services, Channel 4's cash reserves would likely be sufficient to cover its losses, at least until 2012, although it would move into losses from 2010.

It might therefore be possible to monitor Channel 4's performance for another year or two before considering further intervention, to establish whether in fact support would be needed before taking any specific action. However, if it were appropriate to implement any further measures during that period, some would take longer to put in place than others, particularly if they require primary legislation or raise issues of state aid. A 'wait and see' approach also holds the risk that Channel 4 may make choices in response to uncertainty that could have unintended and undesirable consequences for our longer-term policy objectives. We will weigh these factors along with any further evidence submitted in making our proposals about the timing of any future work.

Questions for stakeholders

We invited stakeholders to provide evidence to the review as LEK started work in late 2006. LEK found the submissions we received very helpful and we are grateful to stakeholders for their input. Although this is not a formal consultation, we would welcome any further evidence that could help inform our assessment as we consider LEK's report and our own remit analysis. In particular, we would welcome responses to the following questions:

- Do you have any evidence to support or modify LEK's forecasts of growth in the TV advertising market?
- Do you have any evidence to support or modify LEK's forecasts of Channel 4's price premia and share of commercial impacts?
- Do you have any evidence to support or modify LEK's analysis of trends in costs of acquired programmes?
- Do you have any evidence to support or modify LEK's analysis of trends in costs of commissioned programmes, or to suggest whether the trends are different for different kinds of commissions?
- Do you have any evidence to support or modify LEK's projections for Channel 4's non-core commercial activities?
- Are there any other issues reflecting on LEK's analysis that you believe we should consider in deciding what should happen next?
- Are there any aspects of Channel 4's public service delivery that are not adequately captured by its submission and by our own analysis, and if so how could they be measured?

We would welcome responses to these questions by **Friday 4 May**, to mark.bunting@ofcom.org.uk.