



Channel 4 Group Financial Review

Terms of Reference

Publication date:

27 July 2006

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Market Context

- 1.1 The historic model of television broadcasting in the UK is one where Government and the Regulator have extracted significant commitments to public service programming from broadcasters in return for access to limited and highly valuable gifted analogue spectrum. However, this historic model of broadcasting in the UK is changing significantly, brought about by a number of significant market and regulatory developments:
- Deregulation, opening up the market to new entrants.
 - The growth of new technologies enabling new ways of distributing content to consumers
 - Greater competition and consolidation amongst media companies, at a national and international level
 - Convergence between media, removing the traditional barriers existing between different sectors.
- 1.2 All these factors will fundamentally change the traditional model of broadcasting, and public service broadcasting in particular. The BBC, ITV, Channel 4 and Five are all now pursuing strategies that recognise the opportunities and threats brought about by the migration to digital. They believe that if they wish to continue to engage with their viewers then they will have to extend their activities beyond network television, and into digital television, the internet, mobile and many other media platforms.
- 1.3 Both Ofcom and the Government remain committed to the model of plurality in public service broadcasting in a digital world, and to maintaining a strong Channel 4 as competition to the BBC.

Ofcom's first review of public service broadcasting

- 1.4 In the context of changes brought about by digital, the Government remains committed to public service broadcasting and the model of plurality and competition in its provision. In the recent White Paper the Government set out the following:
- “The Government believes that sustaining a plurality of PSB providers who both complement and compete with each other has been important in ensuring [that] quality and diversity are maintained.”
- 1.5 In performing its duties under the Communications Act (2003), Ofcom must have regard to the desirability of promoting the fulfilment of the purposes of public service television broadcasting in the UK. The Act specifically requires Ofcom to review the extent to which the public service broadcasters have provided television services which fulfil the purposes of public service broadcasting, and to report on how it can be maintained and strengthened, at least once every five years.

- 1.6 The first PSB Review completed in February 2005 reached the following overall conclusions:
- That there remained a strong role and demand for public service broadcasting.
 - The BBC should remain the “cornerstone” of public service broadcasting, but there was value in “competition for quality”, and plurality of provision of public service broadcasting would be vital to maintaining the overall quality, range and choice for viewers.
 - That the traditional model of PSB delivery was breaking down, and as the implicit funding to public service broadcasting began to fall away this would need to be replaced if public service quality and competition were to be maintained.
- 1.7 In its PSB Review, Ofcom stated that a not-for-profit, commercially funded Channel 4 would be an important part of the PSB landscape, and should remain so up to switchover and beyond. The Phase 2 Report anticipated a “*major role for Channel 4 as a broadcaster contributing to the continued success of the PSB system*”.
- 1.8 Phase 3 of the review looked specifically at Channel 4’s ability to deliver its remit in the face of increasing competition. It concluded that “*Channel 4, although facing different incentives as a not-for-profit broadcaster, faces similar competitive pressures to those affecting ITV1 and Five – its ability to deliver a wide range of PSB content will come under pressure*“. The review carried out initial financial modelling which found that projections of the future performance of the Channel 4 core channel were sensitive to small changes in key variables, including the rate of growth of the TV advertising market and Channel 4’s viewing share.
- 1.9 The Phase 3 Report welcomed the renewed focus of Channel 4 on its core PSB remit, and also welcomed in principle “*Channel 4’s ambition to extend its PSB role across new channels and media platforms.*” The report set out Ofcom’s belief that “*a multi-platform approach is the optimal strategy for achieving reach and impact for PSB in a digital age,*” although it noted that extending Channel 4’s PSB role to include new channels and activities would imply a significant change in the way the Group is viewed as a whole, which might require a clearer specification of Channel 4’s PSB remit and evaluation of how it should be monitored and assessed.
- 1.10 The Government’s White Paper on the future of the BBC also welcomed Channel 4’s commitment to maintaining the strength of the remit in the digital age and restated its support for Channel 4’s public service role:

“The Government is clear that Channel 4 has a vital role to play, alongside the BBC, in the provision of PSB for the future. We welcome recent moves to strengthen its commitment to providing high quality, diverse public service content across an increasing range of channels and platforms.”

Channel 4’s perspective on its future role and strategy

- 1.11 Channel 4 is a commercially-funded public service broadcaster with a statutory remit, reaffirmed in the 2003 Communications Act, to deliver innovative, culturally diverse, educational and distinctive programming. It is operated by Channel Four Television Corporation (“the Channel 4 Group,” or “the Group,” to distinguish it from the core channel), a statutory corporation without shareholders, established under the terms of the 1990 Broadcasting Act.

- 1.12 The 2003 Act set out a statutory remit for the core public service channel – Channel 4. The Group is also pursuing a strategy of developing its activities beyond terrestrial television into other media, including digital television and other new media platforms, which it believes is necessary for it to remain relevant in the digital age. The Group is seeking to ensure that the strength and relevance of its public service role is maintained in a more competitive and fragmented digital market and it is looking to secure new commercial revenues to support its public service remit. In addition to the core channel, the Channel 4 Group now operates a number of wholly owned digital channels (including More4, E4 and Film4) and a range of new media activities (such as FourDocs). It is also developing opportunities for commercial ventures (for example, activities based on exploitation of secondary rights).
- 1.13 The Channel 4 Group is an independent, publicly owned, not-for-profit Corporation whose primary purpose is fulfilling its public service remit. However, as a broadcaster whose activities are entirely funded by commercial revenue the Channel 4 Group faces all the broader market pressures outlined above, including
- The downward pressure on its audience share brought about by digital take-up.
 - The emergence of new routes to distributing content to viewers such as Video-on-demand, broadband and mobile TV which will change viewing patterns and threaten traditional TV advertising models.
 - Emerging new competitors as technologies converge across the global landscape which will increase competition for viewers, revenues, programme rights and key talent.
- 1.14 The Channel 4 Group argues that these challenges threaten its long-term ability to deliver its vision for a reshaped public service role, both on the main channel, and its digital channels and other new media services, and to fulfil the objective of sustaining plurality in the provision of PSB in a converged digital world. In the longer term, Channel 4 will face market, technological and competitive pressures which may reduce its capacity to deliver its public service role and vision in full. Without intervention, there may be a risk that Channel 4 will have to scale back its contribution to PSB in order to attract enough advertising to remain financially stable. This would leave the BBC as the only significant provider of PSB television in the UK.
- 1.15 The Government has committed to conducting a review of the case for public funding – including licence fee money – to be distributed beyond the BBC towards the end of switchover. However, the Channel 4 Group has argued that the financial pressures it faces may start to put its PSB contribution at risk prior to switchover. The PSB Review therefore committed to *“reviewing the Group’s financial and on-screen performance in 2006/07 . . . in order to be able to respond to any challenges the channel may face before our next PSB Review.”* Ofcom’s Annual Plan for 2006/07 reaffirmed this commitment, stating that we intended to *“review Channel 4’s financial position, taking into account the changing nature of broadcasting.”* The Government’s White Paper also welcomed *“Ofcom’s plan to undertake a full review of Channel 4’s financial prospects in 2006/07 and will take a close interest in its conclusions.”*

Objectives of the Financial Review of the Channel 4 Group

- 1.16 The common stated objectives of Ofcom, the Government and the Channel 4 Group are to ensure that Channel 4 can maintain its statutory public service remit up to switchover and beyond, to sustain the model of plurality in public service provision, and to understand the Group’s ability to reshape its public service role. The main

objectives of the Financial Review of the Channel 4 Group are therefore 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 financial challenges that the Group may face in fulfilling and reshaping its remit in the medium term, and in detail over the next 5 years, and if necessary to identify possible mechanisms to address any future pressures on its funding model.

- 1.17 The Financial Review will be carried out in two phases, although these may to some degree overlap. The first phase of the review will assess the Channel 4 Group's current financial performance, its financial projections, the impact of changes in the market on the Group's future financial performance and the likely risks to its long-term funding model. The second phase of the review will consider, if necessary, what forms of further regulatory intervention may be appropriate to address any future pressures on the Channel 4 funding model and their implications for the Group and for other affected parties. If required, potential options for intervention will be examined and evaluated in conjunction with the Group, where appropriate, and recommendations made for further action.
- 1.18 Phase I of the review will consist of a comprehensive, independent assessment of the Group's future plans and financial performance, with the objectives of:
- Evaluating the Group's recent financial performance;
 - Testing the assumptions underpinning the Group's future revenue and efficiency forecasts and assessing how challenging those forecasts are
 - Assessing the impact of changes in the market on the Group's future financial performance;
 - Establishing potential benchmarks against which the Group's current and future financial performance can be assessed;
 - Identifying the likely range of outcomes for the Group's medium-term financial position.
- 1.19 The financial assessment will provide a full evaluation of the Group's future financial performance and plans. It will operate at a high level of rigour and detail and be based on a thorough assessment of the Group's current operational model.
- 1.20 The assessment will consider the Group's historic financial performance, its current financial position, and its forward-looking expectations and medium-term plans. It is intended to encompass the full breadth of the Group's activities including the main channel, its digital channels, its new media activities and its other commercial ventures. It will answer questions such as:
1. How efficient is the Channel 4 Group now?
 2. What lies behind the Group's financial performance over the last five years?
 3. What is the basis for the Group's revenue forecasts and how challenging are they?
 4. What are the Group's future efficiency plans and how challenging are they?

5. What value and risks are there on the Group's balance sheet?
6. Are there any significant issues raised by the accounting treatment of the Group's activities or its financial statements?
7. How appropriate/challenging are the business plans of the Group's new business ventures?
8. What is the likely range of outcomes for the Group's overall financial position?

1.21 In addition, Ofcom will undertake work in parallel with Phase I of the financial review to assess Channel 4's delivery of its PSB remit. This will include:

- Understanding how the Group defines and implements Channel 4's PSB remit;
- Identifying relevant performance indicators and benchmarks for current and future performance.

1.22 Phase II will identify whether further regulatory intervention may be required to ensure continued delivery of Channel 4's PSB remit, and if so, the possible forms that intervention could take. It is likely that in practice the initial work on Phase II will run alongside Phase I, to ensure that the entire review can be complete by the end of March 2007. (If the final outcomes of Phase I suggest that there are no medium-term pressures that may make the funding model unsustainable, it will of course not be necessary to complete Phase II.)

1.23 Phases I and II of the review will be complete by the end of March 2007.

1.24 It is intended that these Terms of Reference, which largely cover Phase I of the work, will be reviewed and updated in due course to incorporate the work to be undertaken within Phase II.

Use of external advisors

1.25 Ofcom will appoint non-conflicted external financial advisors to assist in the financial assessment that forms Phase I of this review. The advisors are expected to undertake a full review of the Group's financial statements, business plans and management accounts for the past 5 years and of future performance projections with the objective of identifying both risks to performance and opportunities to realise value to fund PSB delivery, in order to establish the likely future financial performance of the Group. The review should identify the key business drivers of the Group's businesses, and assess both risks and opportunities associated with them.

1.26 Where possible, the advisors' view on the questions set out above should be informed by comparison with relevant financial ratios and external benchmarks, noting how these benchmarks may be influenced by differences between the Group's remit, status and operating model and those of other broadcasters.

1.27 Advisors will be selected through a competitive tender process.

Timing

1.28 Work on the financial review will commence in August with a view to substantial completion by the end of calendar year 2006. Once the conclusions of Phase I are

clear, and contingent on those conclusions, Ofcom will work with the Channel 4 Group to update these Terms of Reference, to ensure that Phase II is properly structured to identify regulatory options to meet any funding gap or risk identified and to evaluate those options. It is intended to complete Phase II of this review by the end of March 2007. Following full discussion with the Group, Ofcom will then publish its conclusions and make recommendations on the potential options to Government.

Agreement

1.29 These Terms of Reference were agreed by Ofcom and Channel 4 on 26/07/06.