



# Licensing of Channel 3 and Channel 5

A report from Ofcom to the Secretary of State for  
Culture, Olympics, Media and Sport

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## Section 1

# Introduction

- 1.1 Ofcom has a duty to prepare a report for the Secretary of State for Culture, Olympics, Media and Sport explaining whether we consider the Channel 3 and Channel 5 broadcast licences should be renewed after 2014.
- 1.2 We are not required to submit that report to the Secretary of State until June 2012. However, as a step towards preparing a final document and as part of our annual work plan, in April we announced our plan to publish a paper in the latter half of the year outlining our approach to this work.
- 1.3 On 1 July 2011, the Department for Culture, Media and Sport asked Ofcom to provide the Secretary of State with advice about the options for relicensing Channel 3 and Channel 5.
- 1.4 In that request, a copy of which may be found at Annex 1, we were asked to include some specific points within the scope of our paper:
  - 1.4.1 to set out all the options open to the Secretary of State in relation to the relicensing of Channel 3 and Channel 5;
  - 1.4.2 to assess the benefits and implications of each of those options, including any decision by the Secretary of State to extend the current licences; and
  - 1.4.3 to highlight any timing or process requirements associated with the options.
- 1.5 This paper, which replaces our planned document, is our response to the Secretary of State's request.

## Background to the current review

- 1.6 The UK has two commercially owned national public service television networks – known as Channel 3 and Channel 5. As public service channels, and in return for specific benefits, the holders of the Channel 3 and Channel 5 licences are subject to a number of licence conditions not placed on other commercial broadcasters. These additional obligations are designed to ensure that, in return for their special status, the Channel 3 and Channel 5 licence holders contribute to the purposes of public service broadcasting ('PSB') defined in section 264 of the Communications Act 2003 (the 'Act').
- 1.7 Among other things, the purposes of PSB set out in the Act are designed to secure the delivery of high quality programmes which meet the needs and interests of differing audiences, provide comprehensive and authoritative news coverage and reflect the lives of and concerns of different communities in the UK. In return for fulfilling obligations designed to secure these aims,<sup>1</sup> the Channel 3 and Channel 5 licence holders receive a range of benefits including prominence on electronic programme guides and reserved capacity on multiplexes that enable them to broadcast to over 98.5% of the UK population.

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<sup>1</sup> The obligations imposed on the commercial PSBs are set out in Figure 8 on page 18 of this document and at annex 2.

- 1.8 Each of the fifteen regional Channel 3 licences,<sup>2</sup> the national Channel 3 breakfast licence<sup>3</sup> and the Channel 5 licence<sup>4</sup> are due to expire on 31 December 2014.
- 1.9 Although the Act permits those licence holders to apply to renew their licences for a new ten year period, before any decisions about renewal are made by Ofcom, we must submit a report to the Secretary of State on the basis specified in section 229 of the Act. This requires us to assess the capacity of the existing Channel 3 and Channel 5 licence holders to:
- “contribute, in the next licensing period, to the fulfilment of the purposes of public service television broadcasting in the United Kingdom at a cost to the licence holders that is commercially sustainable.”
- 1.10 In our second review of PSB,<sup>5</sup> completed in 2009, we acknowledged significant changes to the broadcasting environment brought about by the growth of multi-channel television and the increasing pressures this had placed on the public service broadcasters. In particular, we recognised a growing tension between the incentives on commercial PSB licence holders to sustain profitable business models while continuing to invest in a wide range of public service content. Given this, and in light of the support from most respondents to a continuing role for commercial networks within the public service framework, we advocated a new approach that would see Channel 3 and Channel 5 maintaining modest but important public service commitments.
- 1.11 However, since 2009, there have been a number of developments that could affect the ability of the Channel 3 and Channel 5 licensees to deliver meaningful public service commitments over the next licence period. Among other things:
- 1.11.1 the structural changes we identified in our PSB review – including the fragmentation of TV audiences, growth in on-demand and online viewing – have continued, concurrent with a rise in advertising expenditure on the internet;
  - 1.11.2 the increased likelihood that IPTV and over the top providers of audiovisual content including Google and Facebook will seek to compete with broadcast services;
  - 1.11.3 the focus of government broadcasting policy on the creation of a strong local media sector which has the potential to play a significant role in the delivery of public service purposes;
  - 1.11.4 the government has announced its intention to examine the core focus of public service broadcasting in the next Communications Bill; and

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<sup>2</sup> The 11 regional English and Welsh licenses are currently held by ITV Broadcasting Limited (a wholly owned subsidiary of ITV plc). The two Scottish licenses are held by STV Central Ltd and STV North Ltd, both subsidiaries of STV Group plc ('STV'). The licences in Northern Ireland and the Channel Islands are held by UTV Ltd ('UTV') and Channel Television Ltd ('Channel') respectively.

<sup>3</sup> The national Channel 3 breakfast licence is currently held by ITV Breakfast Ltd (a wholly owned subsidiary of ITV plc).

<sup>4</sup> The national Channel 5 licence is held by Channel 5 Broadcasting Ltd (a wholly owned subsidiary of Northern & Shell plc).

<sup>5</sup> See Ofcom's Second Review of Public Service Broadcasting at: [http://stakeholders.ofcom.org.uk/consultations/psb2\\_phase2/statement/](http://stakeholders.ofcom.org.uk/consultations/psb2_phase2/statement/)

- 1.11.5 in our detailed review of the financial arrangements between the Channel 3 licensees we noted it was unclear that the structural arrangements of the Channel 3 service as currently configured will be sustainable in the next licence period.
- 1.12 This report focuses on the options open to the Secretary of State which relate to Channel 3 and Channel 5. Of course, the Government will need to consider its approach to these services in the wider context of public service delivery. In particular, the role of commercial broadcasting will need to be set in the context of the wider market delivery of public service content, the role of the BBC and the role of the Channel 4 Corporation.

## Structure of this paper

- 1.13 In this document, we seek to inform the Secretary of State about the options currently available to him in relation to the licensing of Channel 3 and Channel 5.
- 1.14 In section 2 we set out the specific nature and purpose of our duties under section 229 of the Act. We explain that at the end of the section 229 process we will look to provide the Secretary of State with information about the ability of the existing licensees to continue as commercial PSBs and, in light of that, advise him if we believe he should intervene in the relicensing process. We also summarise the Secretary of State's powers under the Act, explaining each of the options open to him:
- To allow us to proceed with the renewal process (following receipt of a final report from us on the subject of relicensing), which may result in ten year licences being granted to the existing licensees from 1 January 2015;
  - To block licence renewal, leaving us to award vacant licences (following receipt of a final report from us on the subject of relicensing), resulting in ten year licences to new licensees from 1 January 2015; or
  - To extend the existing licences for a period of his choosing (at any time).
- 1.15 In section 3, we provide a summary of some relevant developments in UK content delivery. We note that demand for linear television – including public service content – has remained resilient despite the pace of technological change and growth in viewer choice. Nevertheless, it is possible that the commercial networks' reliance on advertising revenue could threaten the sustainability of the public service licences in the years to come. Finally, we look briefly at some of the approaches taken by Channel 3 and Channel 5 in response to these developments.
- 1.16 In section 4 we examine both the benefits of PSB status and the obligations currently placed on the Channel 3 and Channel 5 licence holders in return. We look at the range of duties placed on the PSBs and briefly consider factors which may affect the sustainability of those obligations in the next licence period.
- 1.17 Finally, in section 5, we look at the implications of each of the options open to the Secretary of State. In particular, we examine the likely consequences of any decision by the Secretary of State to postpone decisions about the future of commercial public service television until after the implementation of a new Communications Act.

## **Next steps**

- 1.18 As noted above, this document is Ofcom's response to the request made by the DCMS on 1 July 2011. It does not seek to fulfil our duty to submit a formal report to the Secretary of State within the terms set out in section 229 of the Act.
- 1.19 We anticipate further discussions with stakeholders over the coming months as we develop our views about the commercial sustainability of Channel 3 and Channel 5 licences in the next licence period and their ability to fulfil their public service purposes.
- 1.20 We will submit our statutory report to Government before the end of June 2012.

## Section 2

# Legal framework and options for the Secretary of State

## Introduction

2.1 In this section we set out the specific nature and purpose of our duties under section 229 of the Act. We explain that at the end of the section 229 process we will look to provide the Secretary of State with information about the ability of the existing licensees to continue as commercial PSBs and, in light of that, advise him whether he should intervene in the relicensing process. We also summarise the Secretary of State's powers under the Act, explaining each of the options open to him.

## Channel 3 and Channel 5 licences

2.2 The Communications Act 2003 (the 'Act' – as amended by the Digital Economy Act 2010) separates the commercial PSB licences into three distinct types:

2.2.1 Licences to provide Channel 3 services. These include all 15 regional Channel 3 licences and the national Channel 3 breakfast licence;<sup>6</sup>

2.2.2 The licence to provide the Channel 5 service; and

2.2.3 The licence to provide a public teletext service.<sup>7</sup>

2.3 Section 224 of the Act specifies 31 December 2014 as the expiry date for each of these three types of licence.

## Ofcom's duties under section 229 of the Act

2.4 Under section 229 of the Act, Ofcom is required to prepare a report for the Secretary of State on the effect of licence conditions and the renewal process on the capacity of the existing Channel 3 and Channel 5 licence holders to:

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<sup>6</sup> The 11 regional English and Welsh licenses are currently held by ITV Broadcasting Limited (a wholly owned subsidiary of ITV plc). The two Scottish licenses are held by STV Central Ltd and STV North Ltd, both subsidiaries of STV Group plc ('STV'). The licences in Northern Ireland and the Channel Islands are held by UTV Ltd ('UTV') and Channel Television Ltd ('Channel') respectively. It is worth noting that decisions relating to the renewal of Channel 3 licences cannot differentiate between individual licences; any decision must apply to all licences included in that type of licence, i.e. each of the 15 regional Channel 3 licensees and the national breakfast licence.

<sup>7</sup> The public teletext licence was held by Teletext Ltd, a wholly owned subsidiary of Daily Mail and General Trust plc, until its revocation on 29 January 2010, since which time no licence has been issued. Further to our duty under section 218A of the Act, we submitted a report to the Secretary of State in December 2010 concluding that it was unlikely that a public teletext licence would be commercially sustainable. In light of that assessment, and pending any decision by the Secretary of State following our report, we do not intend to re-examine the matter at the current time. See *Report to the Secretary of State on the public teletext service* at <http://stakeholders.ofcom.org.uk/binaries/broadcast/tv-ops/public-teletext-report.pdf>.

“contribute, in the next licensing period, to the fulfilment of the purposes of public service television broadcasting in the United Kingdom at a cost to the licence holders that is commercially sustainable”.

- 2.5 The Act stipulates that our report must be submitted to the Secretary of State no later than 30 months from the end of the current licensing period. As the expiry date specified in the Act is 31 December 2014, the deadline for our report is 30 June 2012.
- 2.6 There are two elements which our report is required to cover:
- 2.6.1 The first relates to the fulfilment of PSB purposes<sup>8</sup> by Channel 3 and Channel 5 during the next licensing period. This in effect requires us to assess how worthwhile the specific public service obligations which Ofcom is able to impose on licence holders are likely to be in meeting the needs of viewers over the next decade; and
- 2.6.2 The second is about deliverability, and specifically whether it will be commercially sustainable for licence holders to deliver services containing a worthwhile level of public service obligations.
- 2.7 The Act also states that we should include a recommendation in our report if our work leads us to a clear view as to whether the Secretary of State should exercise the following powers:
- 2.7.1 To make an order preventing renewal of one or more of the types of licence specified in paragraph 2.2 above; or
- 2.7.2 To make an order to remove from the relevant licences any of the public service obligations specified in the Act.<sup>9</sup>

## **Powers of the Secretary of State in relation to the licensing of Channel 3 and Channel 5**

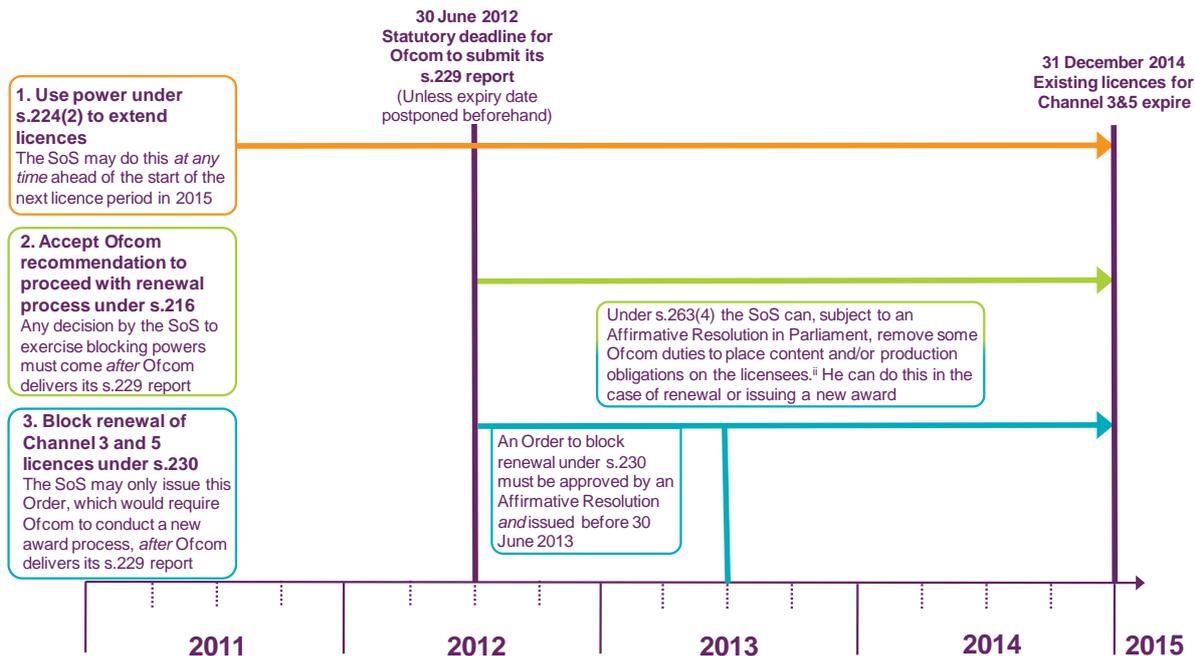
- 2.8 The Secretary of State has three alternative options in relation to the licensing of Channel 3 and Channel 5. He can:
- 2.8.1 allow us to proceed with the renewal process (following receipt of a final report from us on the subject of relicensing), which may result in ten year licences being granted to the existing licensees from 2015;
- 2.8.2 block licence renewal, leaving us to award vacant licences (following receipt of a final report from us on the subject of relicensing), resulting in ten year licences to new licensees from 2015; or
- 2.8.3 extend the existing licences for a period of his choosing (at any time).
- 2.9 These options are summarised in figure 1 and considered in detail below.

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<sup>8</sup> The PSB purposes are defined in section 264 (4) of the Act and are in essence designed to ensure the provision of a balanced and diverse set of high-quality programming, which meets the needs and interests of different audiences. See *Explanatory Notes to the Communications Act 2003*, para. 572.

<sup>9</sup> See section 263 (4) of the Act.

**Figure 1: Summary of options open to the Secretary of State in relation to the licensing of Channel 3 and Channel 5**



*i) Licensees may apply for renewal of their licences under s.216 (2) at any time up to 3 months before a date determined by Ofcom as the day on which we would need to issue a tender notice for applications to an award process. If the Secretary of State decides to issue an order to block renewal it must be in force by this date.*

*ii) The Secretary of State may remove any of the duties on Ofcom to secure licence obligations specified in Chapter 4 of the Act. However, with the exception of the Independent Productions quota, he cannot make amendments to the type or level of any of the obligations specified in the Act.*

### Allowing Ofcom to proceed with the renewal process as set out in the Act

- 2.10 Once the Secretary of State has received our section 229 report, he may decide to allow Ofcom to proceed with the renewal process set out in the Act. Accordingly, it would then be left to us to make a technical assessment of any renewal applications submitted by existing licence holders.
- 2.11 Once a licensee has formally submitted an application to Ofcom, we must then decide whether or not to grant a licence for a new ten year term, although we may not make a decision until June 2013.<sup>10</sup>
- 2.12 At the same time as making any decision to renew, we would also need to decide on an annual fee for the new licences and, in the case of Channel 3, the area which the renewed regional licences should cover.<sup>11</sup>

<sup>10</sup> See section 216 of the Act. Although Channel 3 and Channel 5 licence holders have been able to submit an application for a renewed licence since the beginning of 2011, none have so far done so.

<sup>11</sup> In our second PSB review we recommended that if the Channel 3 service were to continue beyond 2014 it should be based either on the existing regional map or on separate licences for each of the five nations (England, Scotland, Wales, Northern Ireland and the Channel Islands) - See *Putting Viewers First*, paragraph 8.64. It is worth noting that although this would be feasible under the existing legislative framework, a renewed regional licence may include all or part of an additional area only with the consent of the existing licence holder. A proposal to redraw the Channel 3 map on a national basis would, for example, require the consent of ITV plc (as the holder of the Wales & West and Border region licences) to create separate Scottish and Welsh licences.

## **Suspending rights of renewal under section 230 of the Act**

- 2.13 Following receipt of Ofcom's report, the Secretary of State may make an order that the relevant types of licence are not to be renewed.<sup>12</sup> Although he may only do so after he has received the report, he does not have to follow any recommendation contained in it, but may instead make an order where "he considers... that it would be appropriate to do so". The Act does, nevertheless, apply a number of conditions to such an order:
- 2.13.1 Unless licences have been extended, he must make the order before June 2013;
  - 2.13.2 In the case of the regional Channel 3 licences, such an order could not apply selectively – it would have to apply to all of the Channel 3 licences collectively; and
  - 2.13.3 Any order made by the Secretary of State is subject to the affirmative resolution procedure.
- 2.14 If the Secretary of State chose to exercise this power Ofcom would not be able to renew the existing licences. However, we would still be bound to ensure the provision of Channel 3 and Channel 5 services. Accordingly, we would need to invite applications for new licences.<sup>13</sup> That invitation to tender would set out the obligations that we expected potential licensees to deliver and invite applicants for a new ten year licence to submit programming proposals along with a cash bid.
- 2.15 The award process would require careful design. It is important to emphasise that, although the level of most obligations is at Ofcom's discretion, the number of obligations – which include requirements for specific kinds of programming as well as methods of production – are not. These are considered in greater detail at section 4 below.

## **Power to extend the expiry date of Channel 3 and Channel 5 licences**

- 2.16 The Secretary of State may (on one or more occasions) make an order to postpone the expiry date of each specified type of licence thus extending the term of those licences.<sup>14</sup>
- 2.17 The Act does not specify any conditions on the Secretary of State's discretion to extend the existing licence period. In particular, it is worth noting that:
- 2.17.1 The Secretary of State may make an extension order at any time, regardless of whether Ofcom has submitted its report under section 229 of the Act; and
  - 2.17.2 Any extension order is subject to the negative resolution procedure only.<sup>15</sup>
- 2.18 In the event that the Secretary of State made an order to extend either or both the Channel 3 and Channel 5 licences, the issue of licence renewal would not then arise until 30 months before the end of the extended licence period. Accordingly, we would

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<sup>12</sup> See section 230 of the Act.

<sup>13</sup> This process is set out in the Broadcasting Act 1990.

<sup>14</sup> See section 224 of the Act as amended by section 25 of the Digital Economy Act.

<sup>15</sup> The provisions of section 402 of the Act would apply to such an order.

not proceed with consideration of licence renewal or a fresh award process until that time.

## Related matters

- 2.19 The licence for the Channel 4 service is, as with those of the Commercial PSBs, due to expire at the end of 2014. Unlike the Channel 3 and Channel 5 licences, however, under current legislation the Secretary of State has no role in determining whether or not the existing Channel 4 licence should be renewed or extended. Instead, section 231 provides that:
- 2.19.1 it is for Ofcom alone to decide whether the Channel 4 licence should be renewed; and
  - 2.19.2 a renewed licence may last “for such period as Ofcom may think fit”. Consequently, unlike the Channel 3 and Channel 5 licences which may only be renewed for ten year periods, a Channel 4 licence could be renewed for a shorter or longer period if we considered that it was appropriate to do so.
- 2.20 There are also differences in the process of, and considerations to be applied to, Channel 4 licence renewal. Unlike the Channel 3 and Channel 5 licence holders, which are commercial companies, Channel 4 is a publicly owned broadcaster. Beyond this, the detail of the renewal process is not prescribed by legislation and does not involve a test of, for example, the commercial sustainability of the licence. At this stage, we anticipate that the Channel 4 licence renewal process would be essentially an administrative and relatively concise exercise.

## Section 3

# The market context

3.1 In this section, we provide a summary of some relevant developments in UK content delivery. We note that demand for linear television – including public service content – has remained resilient despite the pace of technological change and growth in viewer choice. Nevertheless, it is possible that the commercial networks' reliance on advertising revenue could threaten the sustainability of the public service licences in the years to come. Finally, we look briefly at some of the approaches taken by Channel 3 and Channel 5 in response to these developments.<sup>16</sup>

## The UK viewing experience

- 3.2 Prior to the launch of multichannel television, the viewing options available to UK consumers were controlled by the PSBs. However, the launch first of analogue and then digital cable and satellite services, coupled with further technological innovations and the growth of the DTT platform, have increased viewer choice and competition between providers for viewers' time and attention. Today over 50% of households pay for additional TV services. Digital video recorders which enable viewers both to record and store television programmes could be found in 46% of households by the start of 2011, while 22% have watched programmes made available on demand by their television service provider.
- 3.3 Despite increasing choice in the forms of content distribution available for consumers to select, scheduled linear viewing on television sets has remained resilient: live TV broadcasts continue to account for more than 80% of the audiovisual content which UK viewers consume. Further, there is no indication that TV viewing appetites are declining. Throughout the past decade daily average viewing remained at between 3.5-3.8 hours, before a slight increase to four hours in 2010.
- 3.4 The PSBs remain the providers of the most popular television services, accounting for 2.5 hours (or 63%) of average daily viewing. The online catch-up services run by the PSBs, including the BBC iPlayer and ITV Player, account for the large majority of online viewing. They also continue as a group to fund the vast majority of UK content – around 90% of total investment in UK originated programming<sup>17</sup> – even as their absolute levels of spend have declined. Investment in first run original programming on the main PSB channels, for example, has fallen from a peak of £2.7bn in 2004, to £2.3bn as a result of lower advertising revenues and tougher licence fee settlements.

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<sup>16</sup> This section contains viewing data based on BARB figures. In 2010 a new BARB panel was introduced. The effect of this is data pre- and post 2010 are based on different viewer panels and should therefore be compared with caution.

<sup>17</sup> This figure excludes spend on sport, where costs are largely attributable to the acquisition of rights rather than programme production, and film which is primarily intended for cinema.

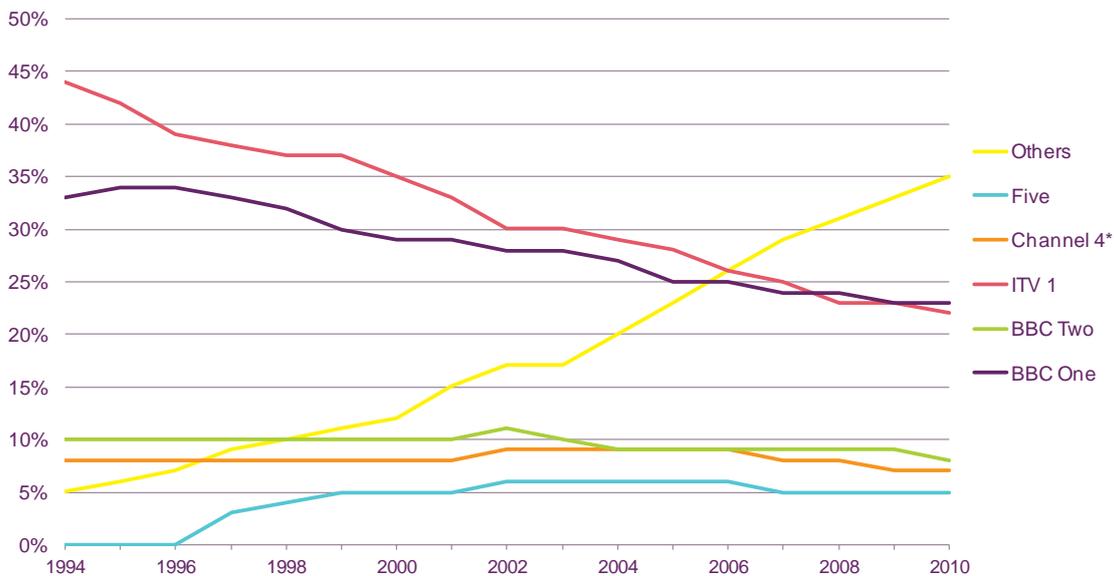
Figure 2: Spend on first run originations by the five main PSB channels



Source: Ofcom/broadcasters. Note: figures are expressed in 2010 prices and the analysis does not include S4C or BBC HD. Figures exclude nations/regions programming.

3.5 Yet, despite this and even with a significant increase in new channels, a number of which in any case re-broadcast old PSB content, the five main PSB channels' share of viewing has broadly stabilised in recent years.

Figure 3: Share of peak-time viewing across all homes since 1994



Source: BARB, All homes. Peak time = 18:00-22:30

\* C4 2006-09 data includes S4C; in 2010 it is excluded as S4C became a separate channel following DSO in Wales. S4C 2010 peak share = 0.1%

3.6 In addition, the PSBs responded to increased competition for viewers by seeking to diversify their own offerings through portfolio channels<sup>18</sup> which has actually enabled them to increase their share of viewing overall:<sup>19</sup>

**Figure 4: Share of viewing in multichannel homes**



Source: BARB. Portfolio channels are services operated by the PSBs excluding the main 5 PSB channels. Portfolio channels operated by ITV plc, Channel 4 and Channel 5 are not PSB services. The actual number of portfolio channels has increased over the years, and the proportion of people with multichannel television has also grown substantially year on year.

\*Channel 4 2006-09 data includes S4C; in 2010 it is excluded as S4C became a separate channel following DSO in Wales.

3.7 Nevertheless, the share of viewing figures for the portfolio channels serve to obscure large differences between the overall size of audience reached by the different PSBs. BARB data shows that the BBC's, ITV plc's and Channel 4's portfolio channels as an aggregate each reach over 40% of viewers each week, whereas Channel 5's subsidiary services are watched by on average 15% of the television audience.<sup>20</sup>

## Developing trends in UK television investment

3.8 Today the UK has a strong mixed broadcasting ecology based on a range of different business models and ownership structures. Taken as a whole the sector has delivered several positive outcomes:

- 3.8.1 Plurality across a range of key public service genres, including news provision at a UK, National and regional level;
- 3.8.2 High levels of investment in a range of content that appeals to audiences;
- 3.8.3 Innovation in technology and distribution which has served to enhance consumer choice; and

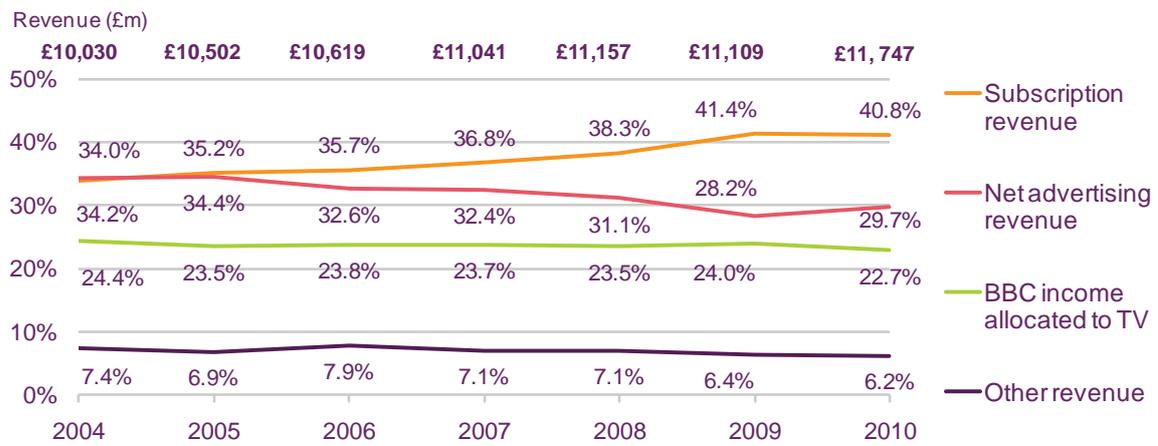
<sup>18</sup> The portfolio channels operated by ITV plc, Channel 4 and Channel 5 are not PSB services.

<sup>19</sup> Share of viewing is not an absolute proxy for value. The larger audiences gathered by Channel 3, Channel 4 and Channel 5 generate proportionately more advertising revenue than the smaller audiences obtained by the portfolio channels.

<sup>20</sup> Reach is defined as viewing of at least 15 consecutive minutes in the average week during 2010.

- 3.8.4 Creation of intellectual property that continues to create value for the UK economy from international markets.
- 3.9 Despite this broadly positive picture, however, continuing evolution in the market for audiovisual content has created challenges to the traditional PSB model to which the networks have had to respond.
- 3.10 Whilst the steady growth in pay-TV has shown it to be comparatively unaffected by macroeconomic conditions, TV advertising revenue has suffered from the cyclical nature of both public and private sector advertising budgets. As a source of funding for the UK television industry, subscription revenue overtook advertising revenue in 2005:

**Figure 5: TV industry revenues, by percentage share**

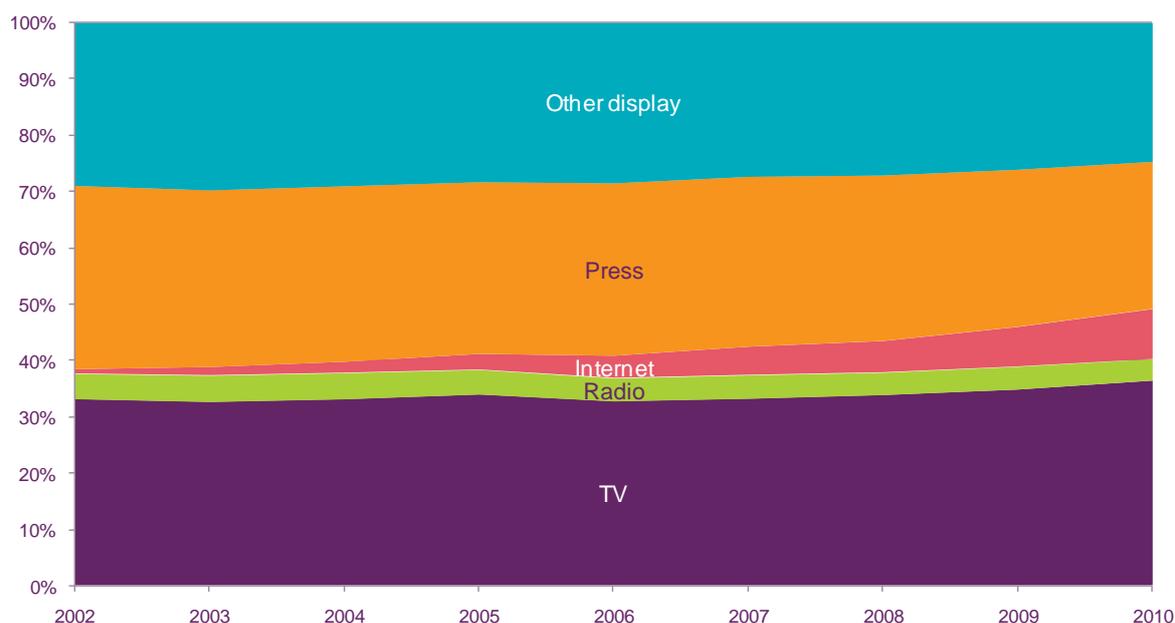


Source: Ofcom/broadcasters

Note: Figures expressed in nominal terms and replace previous Ofcom revenue data for TV industry, owing to restatements and improvements in methodologies. 'Subscription revenue' includes Ofcom's estimates of BSkyB, Virgin Media, BT Vision, TalkTalkTV, Setanta Sports (until its closure), ESPN and Top Up TV television subscriber revenue in the UK (Republic of Ireland revenue is excluded). It also excludes revenue generated by broadband and telephony. 'Other' includes TV shopping, sponsorship, interactive (including premium-rate telephony services), programme sales and S4C's grant from the DCMS. The BBC restated licence fee revenue in 2008. Totals may not equal the sum of the components due to rounding.

- 3.11 At the same time the internet's share of total UK advertising is scheduled to overtake that of television this year. Although the majority of internet advertising spend is related to search (57%) rather than display (24%), the benefits of online display advertising – including low price entry points and the ability to target specific audiences – have become increasingly valued by advertisers. The proportion of UK display advertising spend online has grown from 0.8% in 2002 to 9% in 2010, as shown in Figure 6 below. Nevertheless, even major online advertising players such as Google have found it difficult thus far to replicate their online success in products focussed on television markets.

**Figure 6: UK display advertising expenditure by type**

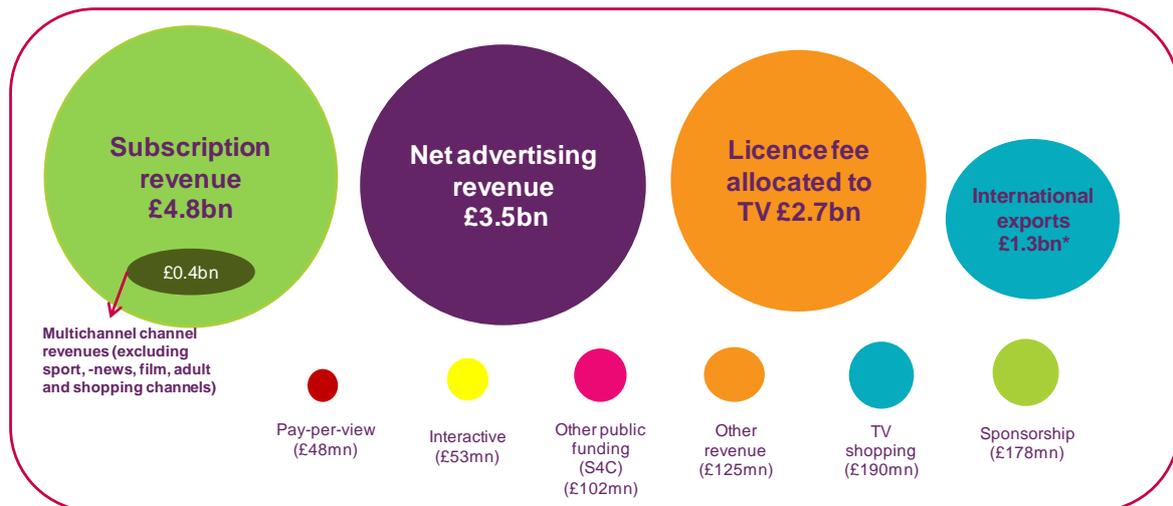


Source: AA/Warc expenditure report ([www.warc.com/expenditurereport](http://www.warc.com/expenditurereport))  
 Note: TV figure excludes sponsorship income and radio figure excludes branded content. Press includes supplements.

- 3.12 Whilst the PSBs have as a group continued to fund the vast majority of UK content, with the growing maturity of the digital television market there are signs of increasing investment in original content by cable and satellite operators. A recent report by the Cable and Satellite Broadcasters' Group ('COBA') highlighted a 7% year on year increase in content investment by its members, with £432m spent on "UK commissions".<sup>21</sup> BSkyB, meanwhile, has announced its intention to increase its "UK commissioning and production" budget to £600m by 2014.<sup>22</sup>
- 3.13 Broadcasters reliant on advertising revenue have increasingly looked for opportunities to diversify their revenue streams. Changes in technology and methods of distribution have led to a range of new models through which broadcasters are able to generate income, including video on demand services, sponsorship and teleshopping. However, these remain small relative to the main sources of industry revenue. Pay-per-view revenue among Ofcom licensees generated £48m in 2010 compared to net advertising revenues of £3.5bn:

<sup>21</sup> COBA expenditure data was provided by COBA members for a Deloitte report and may not be strictly comparable to PSB originations data.

<sup>22</sup> Speech by Jeremy Darroch, (CEO, BSkyB), 8 June 2011 at: <http://corporate.sky.com/media/Speeches/2011.htm>. The £600m figure may include investment in sports production and may not be strictly comparable to PSB originations data.

**Figure 7: Sources of TV industry revenue**

Source: Ofcom, PACT/UKTI, Oliver & Ohlbaum. Size represents relative revenues (figures are indicative). International export figures based on 2009 figures, all other figures 2010.

- 3.14 As figure 7 shows, relative to sources like sponsorship, teleshopping and pay-per-view, international programme exports have become a major source of revenue for the UK television industry. In 2009 the total value of global programme exports stood at £1.3bn – a rise of 9% over the 2008 figure despite the economic downturn.
- 3.15 Although historically the value of most UK television content was realised at the point of its first British transmission, the potential for additional exploitation of content via digital channels and the emergence of new markets such as sales of DVD box sets has had a significant impact on the value of secondary rights. Research commissioned by PACT and UK Trade & Investment suggests that the total revenue generated from international sale of UK television programming and associated activities grew by 127% between 2006 and 2009 to £1.34bn, of which licensing accounted for £386m.
- 3.16 The UK is of course well placed to take advantage of this growth, in part because of the strength of English-speaking markets. However, this desire to access global markets can in turn influence the nature of programme content produced. Content owners will inevitably look to maximise returns and reduce risk by seeking global audiences to militate against the relatively small size of the UK market.
- 3.17 The consequence of this is that broadcasters are increasingly focussing on programming that will sell globally. This requires commercial content to be attractive and accessible to as wide a range of audiences as possible. Whilst some public service content is globally exploitable, some types of programming designed to meet public service purposes, including current affairs and arts programming, are likely to have limited appeal to audiences outside the UK. As a consequence, these potentially unprofitable genres have become less commercially attractive to broadcasters including the commercial PSBs.

## The effect of these developments on Channel 3 and Channel 5

- 3.18 The market trends outlined above suggest that whatever decision is made about licence renewal, that there will be a continuing need for the PSB system to adapt to changes in content consumption and technology, particularly as broadcasters develop strategies to compensate for declining advertising revenue.

- 3.19 Over the past few years, both of the commercial networks have responded to tough market conditions by cutting budgets for content. Between 2006 and 2010 spend on Channel 3 output declined by 13%, from £971m to £847m and by 24% on Channel 5 from £214m to £162m. This compares with a 17% reduction by Channel 4 and 9% reduction across all of the BBC's services over the same period. Similarly, given the need of both broadcasters to maintain audience levels to secure revenue, both Channel 3 and Channel 5 have sought to concentrate spend in peak periods, with [X] and [X] respectively of their original programming budgets 'on screen' during the main evening viewing hours.
- 3.20 However the need of both networks to reduce costs hides different strategies. Whereas the proportion of Channel 3's budget spent on original first run programming has remained consistently at around 90%, highlighting the importance to ITV plc of maintaining its production business, Channel 5's declined significantly from 57% in 2006 to 38% in 2010. This, combined with the fact that new acquired programming now makes up nearly a quarter of Channel 5's schedule, suggests a shift in the broadcaster's approach away from original commissioned content towards popular and established shows which can be obtained for a substantially lower cost.
- 3.21 Some of the implications of these trends on public service delivery by Channel 3 and Channel 5 are discussed in the next section.

## Section 4

# PSB delivery by Channel 3 and Channel 5

4.1 In this section we examine both the benefits of PSB status and the obligations currently placed on the Channel 3 and Channel 5 licence holders in return. We look at the range of duties placed on the PSBs and briefly consider factors which may affect the sustainability of those obligations in the next licence period.

## The purposes of PSB delivery by Channel 3 and Channel 5

4.2 Traditionally the contribution of the commercial PSBs to the delivery of the purposes of public service broadcasting has been through a set of specific licence obligations. These obligations have been set by Ofcom and its predecessor regulators to reflect specific statutory objectives, ensuring that television programmes on the main networks display a range of characteristics: high quality, originality, innovation, challenge, engagement and wide availability.

4.3 When we last examined the purposes of PSB delivery in the second PSB review, we concluded that the commercial networks played an important role in delivering popular and entertaining programming that was culturally relevant to British audiences as well as provision of national and international news.

4.4 We accepted however, that there was an inevitable tension between the networks' willingness to invest in public service programming given the decreasing value of quantifiable assets associated with public service licences and the requirement to maintain commercially sustainable businesses. Traditionally much of the value to the commercial networks of PSB status derived from their licences to use scarce analogue spectrum, enabling them to take a significant share of UK television advertising revenue. The transition to digital broadcasting has eroded some of their competitive advantage.

4.5 Accordingly we sought to identify a sustainable set of regulatory obligations on the commercial public service networks that met the key requirements for news and culturally relevant programming. By seeking to align obligations with the commercial incentives of these providers, it remained our view that Channel 3 and Channel 5 would continue to be able to make a real contribution to the delivery of aspects of public service content particularly valued by audiences and informing their understanding of the world.

4.6 In order to maximise public service delivery by Channel 3 and Channel 5 we looked again at the detailed regulatory obligations placed on the broadcasters. Following consultation, including extensive deliberative and quantitative research carried across the Nations and regions of the United Kingdom, we decided to reduce the level of regulatory intervention for both services to enable them to focus on the core obligations specified by Parliament in the Communications Act. These obligations were therefore limited to:

4.6.1 a core focussed on a few specific genres, namely news and current affairs, where plurality is particularly valued as critical to a well-functioning democracy;

4.6.2 explicit legislative requirements designed to stimulate production across the country (Out of London obligations) and ensure the continuation of a vibrant

independent production sector (commissioning quotas and code of practice requirements); and

- 4.6.3 structural obligations which applied specifically to the Channel 3 licensees, known as the networking arrangements,<sup>23</sup> as well as the terms included in all PSB licences designed to secure the widest possible level of coverage for the UK’s main public service channels:

**Figure 8: Summary table of PSB obligations by type and rationale**

Type of obligation	Obligation	Commercial PSBs affected	Rationale
Core genre obligations	To show an appropriate amount of national and international news (overall and in peak)	All commercial PSBs	Ensure a range of impartial news programming is available which appeals to different audiences
	To show an appropriate amount of regional news and non-news programmes (overall and in peak)	Channel 3 licensees only	Ensure plurality of news provision in Nations/ English regions to reflect distinct cultural identities across the UK
	To show an appropriate amount of current affairs programmes (overall and in peak)	All commercial PSBs	Ensure a range of programmes are available providing analysis of current events and ideas
Content production and investment obligations	To show an appropriate amount of original programming (overall and in peak)	All commercial PSBs	To stabilise investment in UK creative economy and encourage production of content which reflects and strengthens our cultural identity at a UK level
	To ensure a suitable proportion & range of programmes by spend & volume are made outside the M25	All commercial PSBs	To secure investment in production businesses across the UK and encourage production of content which reflects the lives of people across the UK.
	To ensure a minimum of 25% of programming is allocated to independent productions	All commercial PSBs	To secure investment in a range of diverse UK businesses
	To draw up, revise & comply with a code for commissioning from independent producers	All commercial PSBs	To ensure that PSBs are not able to use purchasing power in a manner which will stifle innovation in the UK independent sector
Structural obligations	To ensure approved networking arrangements are in force	Channel 3 licensees only	To ensure the regional Channel 3 services are (as a whole) able to compete effectively with other UK television services
	To achieve the greatest possible level of coverage for PSB channels	All commercial PSBs	To ensure that public service channels are accessible on a near universal basis.

- 4.7 We consider the role and delivery of each of these types of obligations below. A list of the current quotas for output and investment can be found at Annex 2.

### The role of core programme genre obligations

- 4.8 Alongside our general duty to secure a wide range of programming that meets the purposes of public service programming, we are also required by statute to impose quotas in two core programme areas:

- 4.8.1 News and current affairs; and
- 4.8.2 Programming for the Nations and regions of the UK.

<sup>23</sup> The networking arrangements are a set of arrangements between the holders of the 15 regional Channel 3 licences designed to enable the regional Channel 3 services, when taken as a whole, to compete effectively with other television services in the UK. The impact of the networking arrangements on the individual Channel 3 licensees is discussed below.

## News and current affairs

- 4.9 The Act requires Ofcom to set licence conditions to ensure the delivery of high quality news and current affairs programming, tackling both national and international matters. In addition, news bulletins must be scheduled appropriately between peak and other viewing times.
- 4.10 Ofcom research has consistently identified news programming as the most valued of all public service genres. Over 80% of viewers asked in our most recent PSB tracker survey said it was important that such programming was “trustworthy”, would “help me understand what’s going on in the world today” and cover major news stories well.
- 4.11 Viewers have also emphasised the importance of plurality in both news and current affairs genres. Research conducted during our last PSB review showed that 86% of those questioned thought plurality of news provision among the main television channels was important, with 77% assigning a similar value to current affairs programming.
- 4.12 Nevertheless, whereas viewing of current affairs programming increased between 2006 and 2010, viewing of news programming has despite its perceived importance declined modestly, from 91 hours per individual in 2006 to 88 hours in 2010. This decline has been particularly marked in Channel 3 news viewing, which fell by 8 hours to 18 hours a year in 2010, although the evidence suggests that this may be due to a drop in viewing of daytime rather than the main evening bulletins. This compared with a decline of one hour on Channel 5, two hours on Channel 4 and an increase on BBC One from 53 hours to 62 hours over the same period:

**Figure 9: Average total hours of national/ international news watched per year**



Source: BARB. New BARB panel introduced 1st Jan 2010. As a result pre and post panel change data must be treated with caution.\* C4 2006 data includes S4C viewing. Following DSO in Wales, S4C became a standalone channel and so is excluded from C4's 2010 data.

- 4.13 Given the central role played by news in the delivery of public service purposes, we concluded in the PSB review that Channel 3 and Channel 5 licence holders should retain obligations to provide news content beyond 2014. The burden placed by continuing obligations in this area is, however, uncertain. In light of the importance

attached by viewers to news programming and an expectation that established broadcasters will provide it, it is certainly possible that the provision of news provides an intangible value for public service broadcasting networks in building brand confidence and reputation. Nevertheless it is clear that the existing obligations provide a strongly regulatory support for plurality in news provision.

- 4.14 Finally, in addition to traditional forms of investigative journalism, much of the peak time programming classified as current affairs by Channel 3 and Channel 5 has had a narrower focus, including crime (*Real Crime with Mark Austin*) and the role of the emergency services (*Emergency Bikers*), with a potentially lower impact. Whether such programming, which has a lower cost than investigative current affairs, represents a specific burden on licence holders is unclear.

### **Programming for the Nations and regions of the UK**

- 4.15 The Act requires Ofcom to set conditions to ensure the delivery by the regional Channel 3 licensees of a suitable range of high quality programming of particular interest to persons living within the area covered by the service, including regional news programming.
- 4.16 As with national news, our research has shown that plurality in the provision of news programmes designed for the Nations and regions of the UK is of particular importance to viewers, with 79% rating it as important. However, unlike national news provision, there is a notable difference between the perceived importance of such programming and viewer satisfaction: only 52% of viewers think that news programming for the Nations and English regions is delivered well by the PSBs as a whole.
- 4.17 Research conducted by Ofcom has shown that the strength of opinion on this matter is not uniform across the UK. Between 2007 and 2010 opinions among regular viewers of Channel 3 on the delivery of nations and regions news have become less positive in each devolved Nation, while remaining static in England. Satisfaction with Nation news on Channel 3 declined from 66% to 57% in Scotland, from 64% to 52% in Wales and from 77% to 69% in Northern Ireland over this period, during which regional programming quotas were cut.
- 4.18 Similarly, although viewing levels vary significantly across the UK, the evidence suggests this type of programming is of particular importance in the devolved nations. Viewing of Scottish, Welsh and Northern Ireland focussed news programming consistently exceeds the UK average of 28 hours per annum. As shown below, share of viewing in Scotland and Northern Ireland where the Channel 3 licences are held by 'single Nation' broadcasters, is consistently higher than in the English regions or the UK as a whole:

**Figure 10: Early evening news bulletin – shares of viewing in all homes (2010)**

Source: BARB

Note: Based on Regional News prog, start time 17:55-18:35, 10mins+ duration, BBC1 & ITV1, weekdays

- 4.19 In the second PSB review, we recognised the heightened role of public service content in the devolved nations as well as the need to sustain choice to enable citizens to engage fully with new democratic institutions. However, we were also clear that although National and regional programming had been a leading part of Channel 3's contribution to the purposes of PSB, it was an unavoidable fact that these obligations represented the single biggest cost of public service status.
- 4.20 Accordingly, and given the ever increasing importance of devolved institutions, we now consider that securing a workable solution to plurality of news in the Nations represents an additional key consideration in determining the capability of existing licensees to contribute to the purposes of PSB.

## The role of content production and investment obligations

- 4.21 Ofcom is required by statute to impose obligations on the public service broadcasters designed to provide support for the UK production sector. These are:
- 4.21.1 The quota for original productions;
  - 4.21.2 The quota for commissions from qualifying independent producers and duty to set and comply with a code of practice for commissioning; and
  - 4.21.3 The quota for programmes made outside the M25 area, known as the Out of London obligation.

### Original productions

- 4.22 Section 278 of the Act requires Ofcom to set obligations on the commercial PSBs to show a suitable proportion of programming commissioned by or for them "with a view to [the programme's] first showing on television in the United Kingdom."<sup>24</sup> Obligations apply in peak periods as well as overall.

<sup>24</sup> 'Original productions' are defined by the Broadcasting (Original Productions) Order 2004

- 4.23 Unlike the genre quotas discussed above, the aims of the originations quota are broader. It aims both to promote investment in the UK creative economy and implicitly encourage (though not mandate) production of specific types of content which have traditionally been regarded as ‘public service’, such as UK drama, comedy and specialist factual programming including arts and documentaries. The quotas are also intended to ensure that the channels deliver programming across the schedule designed to appeal to a broad range of interests.
- 4.24 In keeping with ITV plc’s aim to achieve growth by securing global sales of content, spend by Channel 3 on high-risk or UK-centric genres including drama, comedy and current affairs have all declined over the four year period examined in Ofcom’s PSB annual report. The only significant increases in spend between 2006 and 2010 have been in the more lucrative entertainment and factual entertainment genres, which have grown by [X] and [X] respectively.
- 4.25 As discussed in section 3, Channel 3 chooses to invest [X] of its spending on the peak aspects of its schedule to secure a higher proportion of commercial impacts. This is in contrast to the publicly owned BBC and Channel 4, which spread their resources more broadly across the day, spending [X] and [X] of their budget on ‘off-peak’ original programming.<sup>25</sup>
- 4.26 The definition of original programming includes repeat showings of commissioned programmes. Therefore, although Channel 5 has consistently met or exceeded its original production quotas – reduced in 2009 to 50% overall with 40% in peak – it has increasingly done so with repeats. These accounted for 59% of Channel 5’s scheduled programming in 2010, compared to 42% in 2005. In comparison, repeats account for a quarter of Channel 3’s total schedule, although Channel 4’s is also just over 50%.
- 4.27 Spend by Channel 5 on first-run originated programming has declined by 49% in four years, from £122m in 2007 to £62m in 2010. It should be noted, however, that since Channel 5 changed hands in 2010, the new owners have both acquired the rights to the *Big Brother* franchise, which is likely to boost the broadcaster’s spend on original programming, and announced their intention to invest more broadly in new in-house content.

### Qualifying independent productions

- 4.28 Section 277 of the Act requires Ofcom to set obligations on the licensed PSBs to ensure that not less than 25% of the total amount of qualifying programming is allocated to broadcasting a range and diversity of independent productions. In addition, they are obliged to draw up, maintain and comply with Codes of Practice governing the terms under which they commission programming from independent producers.
- 4.29 The restriction of the quota to ‘qualifying’ programming is an important one because the absolute level of the obligation decreases as more non-qualifying acquired programming is shown. Channel 5, like Channel 4, is predominantly a publisher broadcaster with a small in-house production unit responsible for [X] of first-run original programming in 2010 compared to [X] sourced from external producers. Accordingly [X] of its programming meets the terms of the obligation.

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<sup>25</sup> The peak viewing period is defined as the period between 6pm and 10.30pm.

- 4.30 In contrast, the Channel 3 licensees have traditionally contributed a large proportion of the network schedule. The repeated success in recent years of programming commissioned by Channel 3 from the independent sector including *Who Wants To Be A Millionaire* and *The X Factor* has seen the proportion of qualifying programming increase to [38], broadly in line with the BBC. However ITV plc's strategic goal to develop its international production and distribution business<sup>26</sup> may place increasing strain both on this obligation and the code of practice stipulation.

### **Out of London productions**

- 4.31 Under section 286 of the Act, Ofcom is required to set licence conditions to ensure that a suitable proportion of programmes made in the UK for viewing on a PSB channel, both in terms of volume and expenditure, are produced outside the M25 area. These obligations have become known as the out of London quotas.
- 4.32 The quotas for Channel 3 licensees increased in 2005 from 33% by volume and 40% by expenditure to 50% by both volume and spend. This was in response to a concern that output on the PSB channels could not adequately reflect the full cultural diversity of the UK when (at the time) less than 40% of programming was produced outside London.
- 4.33 However, it subsequently became clear that meeting the revised quota had imposed a significant cost on the Channel 3 network and in 2009 the quota was cut to 35% by spend and volume. In addition, we concluded that the requirement, which had been met by long-running shows including quiz and other studio-based programming, had not delivered the additional diversity on screen which it had been in part intended to achieve.
- 4.34 Both Channel 3 and Channel 5 – which has much lower quotas set at 10% of qualifying programming by spend and volume – have since met their quota obligations. However, viewers remain concerned that programmes on PSB channels fail to portray their Nation or region well to the rest of the UK. In 2010, whilst 62% considered it was important that PSB services achieved this aim, only a third believed they did so.

## **The role of structural obligations**

### **Channel 3 networking arrangements**

- 4.35 By statute all of the Channel 3 licensees must participate in networking arrangements which allow them jointly to commission or acquire content for the Channel 3 schedule and to share the costs of doing so.
- 4.36 In our last full review of the arrangements, completed in December 2010, we recognised that the eroding value of PSB status had, combined with licence consolidation, placed considerable tensions on a federal system designed for 15 separate licence owners of broadly equal size. In particular, we concluded that despite the fact that ITV plc paid proportionately more towards the common costs of providing the network service than the other Channel 3 licensees, if the smaller licensees were required to contribute more towards common costs it could prejudice their ability to meet their public service obligations.

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<sup>26</sup> See ITV plc Annual Report and Accounts (2010), p 20ff.

- 4.37 We had already noted in our second PSB review our concern that networking arrangements, which relied on the willing participation of all of the regional licensees, may not be sustainable in the next licensing period. We therefore encouraged licensees to begin a dialogue to develop new arrangements. Whilst we understand that discussions on these matters are ongoing, it remains our view that new arrangements designed to underpin a competitive set of PSB services are likely to be necessary if a regional Channel 3 service is to be sustainable.

### **Coverage obligations**

- 4.38 The licences contain a series of obligations to ensure that PSB services are made available to the widest possible audience. These include obligations to ensure DTT transmissions can be received by 98.5% of the population and to make licensed PSB services available to users of cable and satellite services.
- 4.39 In the second PSB review we noted that if content was publicly funded (either directly or through the use of public assets), a large majority of citizens needed to be given the chance to watch it. Although stakeholders have previously noted the higher costs of transmission on the PSB multiplex as compared to commercial multiplexes, we also note that broadcasters are able to derive additional advertising revenue from the extended coverage. Nevertheless, the PSBs may face challenges from other content providers, including IPTV and over the top services, using lower cost distribution methods.

### **Benefits associated with PSB status**

- 4.40 In return for the obligations outlined above, the licensees retain the use of specific regulatory assets. Below, we briefly summarise the two main assets: DTT capacity and EPG prominence.

### **Reserved DTT capacity**

- 4.41 The digital terrestrial television platform in the UK is streamed to viewers via a network of land-based transmitters using a part of the radio spectrum known as a frequency channel. With developments in compression technology, a number of different services can be combined on a single frequency channel, known as a multiplex. Currently the DTT platform comprises six multiplexes which each carry between four and ten simultaneous television services.<sup>27</sup>
- 4.42 Just under half of the capacity of the commercial PSB multiplex is reserved for the Channel 3 licence holders, with the majority of the remainder reserved for Channel 4. From their share of this multiplex, the Channel 3 licence holders must in turn provide capacity at a commercial rate to Channel 5 to ensure that service can be received by viewers across the UK. Capacity is also reserved for the Channel 3 licensees on a separate multiplex to enable them to broadcast a high definition version of their regional service.

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<sup>27</sup> Of the six multiplexes currently operating on DTT, two (multiplex 1 and multiplex B) are operated by the BBC, two by Arqiva Services Ltd (multiplex C and multiplex D), one by SDN Ltd (multiplex A) and the commercial PSB multiplex (multiplex 2) by D3&4 Ltd, a joint venture between the ITV Network and Channel 4.

## EPG Prominence

- 4.43 Electronic Programme Guides, or EPGs, are defined as systems for the listing and promotion of content and its selection by intended audiences in the UK. Section 310 of the Act requires us to draw up a code of practice for providers of EPG services including an obligation to give “appropriate prominence” to public service channels.
- 4.44 The obligation to provide appropriate prominence applies to the core Channel 3 and Channel 5 services, but not to other digital services operated by the licence holders including HD services. The application by Ofcom of the Code and then the decisions made by EPG operators in applying “appropriate prominence” to the design of their particular guide have balanced the requirements of regulation to ensure appropriate prominence against commercial factors including consumer expectation as well as the practical management of the EPG.

## The future value of PSB benefits

- 4.45 The likely value of these specific assets in the next licence period (along with other benefits such as the brand value derived by licence holders from PSB status), is a matter which we will consider carefully in preparing our section 229 report. Nevertheless, our initial view is that PSB status, for both the Channel 3 licensees and the Channel 5 licensee, will continue to be worth in the order of tens of millions of Pounds each year.
- 4.46 However, it is important to be clear that decisions by Government and the regulator could have a material impact on the value of these benefits over the next licence period. Some changes could have a positive impact: a decision to strengthen EPG regulation (as the Government has indicated it may do in the context of Local TV) would be likely to add to the value of PSB status. Conversely, changes including the potential application of Administered Incentive Pricing (‘AIP’) on multiplex operators or a decision to remove EPG prominence obligations from legislation would have a significant negative impact on the value of benefits attached to PSB status.
- 4.47 Accordingly, it is clear that, depending on the changes to be made and how those are applied, the value of PSB status could be altered significantly in the next licence period.

## Section 5

# Assessment of possible options for the Secretary of State

5.1 In this final section we look at the implications of each of the options open to the Secretary of State. In particular, we examine the likely consequences of any decision by the Secretary of State to postpone decisions about the future of commercial public service television until after the implementation of a new Communications Act.

## Possible options for the Secretary of State

5.2 In section 2 above, we identified three options for the Secretary of State in relation to licence renewal. He can:

5.2.1 allow us to proceed with the renewal process (following receipt of a final report from us on the subject of relicensing), which may result in ten year licences being granted to the existing licensees from 2015;

5.2.2 block licence renewal, leaving us to award vacant licences (following receipt of a final report from us on the subject of relicensing), resulting in ten year licences to new licensees from 2015; or

5.2.3 extend the existing licences for a period of his choosing (at any time).

5.3 We summarise the key benefits and implications of each option in the diagram on the next page before considering them in more detail.

Figure 11: Benefits and Implications of the options open to the Secretary of State

Option	Benefits	Implications
Allow licence renewal following s.229 report	<b>Ensures continuity:</b> secures medium term provision of key public service objectives – plurality of news (national, nations & regional) and UK originations quotas	<b>No long term guarantees:</b> need to re-balance PSB benefits and obligations over the last licence period suggests new commitments may not be sustained until 2024 without adjustments
	<b>Secures existing structures whilst providing scope for change:</b> retains current services but allows for a new Communications Bill to alter benefits	<b>Ignores developing patterns of viewing:</b> renewal may not take account of new forms of content delivery, such as video on demand, developed over the current licence period
	<b>Allows for a Nations-based structure:</b> subject to the consent of licence holders, the creation of separate Nations based licences would be possible following licence renewal	<b>Pre-empts new communications legislation:</b> means decision whether to retain commercial PSBs is taken ahead of Government review of the UK communications sector
Block licence renewal following s.229 report	<b>Creates competition for the franchise:</b> a new award would provide an opportunity to assess innovative approaches to PSB delivery proposed by potential licensees	<b>Repeats failings in existing system:</b> obligation on Ofcom to make an award of vacant licences requires licences to be granted before Parliament has reassessed approach to commercial PSB
	<b>Scope for a new regulatory approach:</b> enables redrawing of the C3 map and provides a fresh start from which to set appropriate obligation levels, while retaining C3 and C5	<b>New entrants may not come forward:</b> No certainty that bidders will come forward to take on incumbent broadcasters, particularly if current level of regional obligations remain
	<b>Ensures accurate asset valuation:</b> represents the best way of finding out the true value for broadcasters of PSB status	<b>May affect UK content spend:</b> Long term uncertainty may lead to reduced investment in UK originated content by the existing PSB licence holders
Extend existing licences at any point	<b>Potential to reassess the aims of commercial PSB:</b> enables PSB to be remodelled on the basis of developments in viewer choice including the success of the proposed local TV model	<b>Uncertainty and disruption:</b> uncertainty may lead existing licensees to re-evaluate commitment to PSB status before the end of extended licences, increasing the threat to Nations programming
	<b>Enables a holistic review of PSB:</b> allows Parliament to assess the delivery of PSB as well as aligning the future of commercial networks with BBC Charter Renewal	<b>Threatens existing levels of PSB delivery:</b> It may be difficult to maintain existing level of PSB obligations until the end of any extended licence period
	<b>Allows PSB duties to be aligned with value:</b> PSB provision could change in light of more accurate valuation of DTT spectrum and/or additional PSB benefits determined by Parliament	<b>May impact long term spectrum planning:</b> Licences lasting to late 2020s could complicate plans to harmonise use of the 700 Mhz spectrum band

## Benefits and implications of a decision to allow the licence renewal process to continue

- 5.4 Following our final report under section 229 of the Act, the Secretary of State may decide to allow Ofcom to proceed with the renewal process. Subject to a formal application for renewal from licensees meeting the terms specified in statute, we would renew the relevant Channel 3 and/or Channel 5 licences for a period of ten years until the end of 2024.
- 5.5 Licence renewal in those circumstances should ensure the continued provision of the most important aspects of public service provision including national and Nations' news and a continued commitment to UK original production.
- 5.6 Although licence renewal would be completed prior to the enactment of a new Communications Bill, licence obligations could then be reassessed in light of new objectives for public service broadcasting set by Parliament. Renewal may also provide scope to incorporate amendments to the current licence structure, such as the creation of a separate licence for Channel 3 in Wales or a single Scottish licence, although this would rely on the consent of ITV plc.<sup>28</sup>
- 5.7 The Government may also wish to take account of the possible interaction between the relicensing of Channels 3 and 5 and EU discussions on future uses of the 700

<sup>28</sup> See footnote 11 on page 7 above.

Mhz spectrum band (which is currently used for DTT in the UK). Licences which are renewed for ten years from 2014, ending in 2024, are unlikely to complicate plans for future use of the 700 Mhz spectrum band unduly. However, as these licences confer rights in relation to access to spectrum, the Government may need to consider whether ten year licences granted from a later date complicated longer term spectrum planning options.<sup>29</sup>

- 5.8 We are also conscious that any assessment of commercial sustainability over a ten year period is inevitably subject to a high degree of uncertainty. Levels of public service commitments on Channels 3 and 5 have declined steadily since the existing licences were issued to take account of the ever more challenging commercial climate faced by the incumbent commercial PSBs. As we noted in the second PSB review when restructuring public service obligations on Channel 3:

“a system which is reliant on a continuing balance being struck between the value of the regulatory assets awarded to Channel 3 and the costs imposed on a commercial company by regulatory obligations is vulnerable to continuing requests for regulatory relaxation by ITV plc, particularly if economic conditions remain difficult.”<sup>30</sup>

- 5.9 A simple analysis of the costs and benefits is unlikely to capture the full value of PSB status to the broadcasters. Further reductions in quota obligations based on such an analysis could in any case call into question the value provided by the commercial networks to our PSB system. In particular, unless some form of agreement can be reached with the licensees, licence renewal without additional enforcement mechanisms may not provide an appropriate level of certainty about the ability of the broadcasters to maintain PSB commitments until the mid-2020s.
- 5.10 In addition, we are mindful that renewal under these conditions would be based on a statutory framework developed a decade ago, when fewer than 50% of households had access to multi-channel television and before video-on-demand services became widely available.

## **Benefits and implications of a decision to block licence renewal**

- 5.11 Following our report under section 229 of the Act which is due by June 2012, the Secretary of State could, subject to affirmative resolution by Parliament, issue an order blocking licence renewal. Ofcom would then seek to award the vacant licences. The process is summarised in figure 12 below:

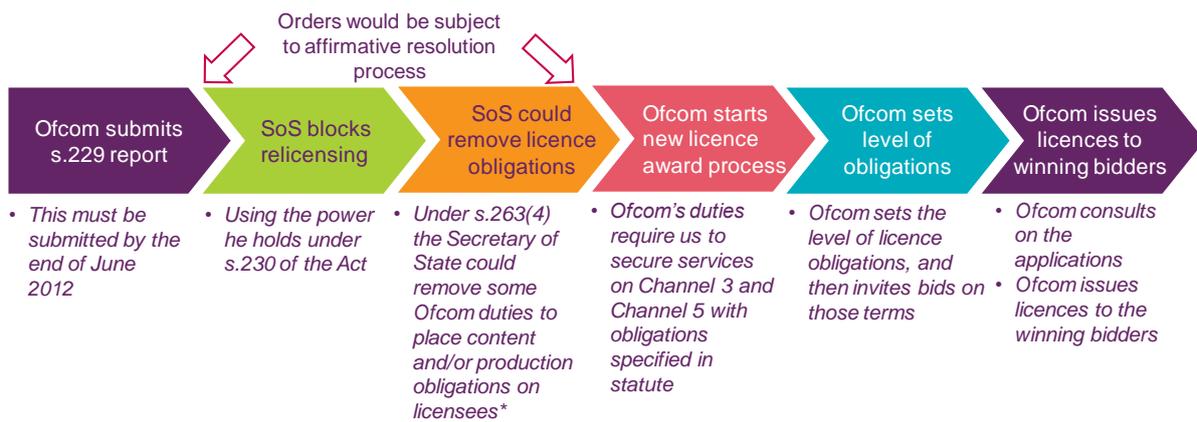
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<sup>29</sup> We are currently working on a framework to ensure that future uses of ultra high frequency spectrum (including the 700 Mhz band) deliver citizen and consumer benefits in the long term. A copy of our recent call for input can be found at:

<http://stakeholders.ofcom.org.uk/binaries/consultations/uhf-spectrum-band/summary2/condoc.pdf>

<sup>30</sup> See Ofcom, *Putting Viewers First*, paragraph 8.18.

Figure 12: Flow chart summarising new licence award process



\* The Secretary of State may remove any of the duties on Ofcom to secure licence obligations specified in Chapter 4 of the Act. However, with the exception of the independent productions quota, he cannot make amendments to the type or level of any of the obligations.

- 5.12 Following a decision to block renewal, Ofcom would look to award the Channel 3 licences on the basis outlined in the Broadcasting Act 1990, potentially based on a system of five Nations licences. However, the exact requirements we would attach to licences and specify in any invitation to apply would depend on the obligations in force at that time. Although the level of most obligations is at Ofcom's discretion, the obligations themselves are not. Subject to any changes prior to an award, the list of obligations which we are required to apply to Channel 3 and Channel 5 services is currently (as discussed in section 4 above and illustrated in annex 2 below) a reasonably long one.
- 5.13 A significant factor in determining the scale of obligations to be placed on the PSBs post 2014 will be whether a charge known as Administered Incentive Pricing or 'AIP' is levied on one of the key regulatory assets associated with PSB status, access to a reserved DTT multiplex. Alongside EPG prominence, the value of the DTT spectrum will represent the majority of the value of PSB status post 2014, particularly for Channel 3. We will need to consider the potential effects on PSB output before making fee proposals.
- 5.14 It is open to the Secretary of State (subject to positive resolution by Parliament) to remove some obligations to place content and/or production obligations on licensees. However, with the exception of the independent productions quota, he may not make modifications to current quota levels, which are determined by Ofcom, or the breadth of the obligations specified in the Act. For example, he could not remove obligations on Channel 3 licensees to produce programming for the English regions without removing similar obligations in the Nations. The willingness of new bidders to bid for licences containing the existing range of obligations, including the provision of news for the Nations and English regions, is unclear.
- 5.15 It is equally possible, however, that a new award process may serve to reinvigorate the existing commercial PSB model, by encouraging potential licensees to develop innovative approaches to the delivery of public service objectives. The bidding process for independently funded news consortia in 2010 and, more recently, responses to the consultation on the local media action plan, have both produced a range of creative proposals for content to meet the needs of regional and local communities. The Secretary of State may not, however, add completely new obligations within the current legislative framework.
- 5.16 Beyond the possibility of creative renewal it is also likely that an award would bring into the open the true value of PSB status for potential licence holders. This would

include the brand benefits which licensees offering portfolio channels derive from their long-standing association with public service status.

5.17 Accordingly, we consider that a licence award remains a credible possibility.

## **Benefits and implications of a decision to extend the existing licences**

5.18 The final option open to the Secretary of State would be to extend the current licences to allow for a full consideration of the public service broadcasting regime in the next Communications Bill.

5.19 The extension of commercial PSB licences would enable Government to assess the role played by Channel 3 and Channel 5 in the provision of public service content overall, taking account of the different remits of both the BBC and Channel 4. Such a review could also take account of the relative importance of existing public service obligations, including changes to supply and demand for public service content since the current Act came into force in 2003. For instance, developments in the provision of local TV services in the next few years may lead Parliament to reassess the continuing need for English regional programming on Channel 3, although it is clear that local services focussed on UK's larger conurbations would not offer a whole solution to Nations and/or regions provision.

5.20 New legislation could also create an opportunity for increasing PSB provision by bringing additional benefits clearly within the PSB framework. For example, it would be possible to clarify and tighten the regulation of EPG prominence in order to create additional public service value. Equally it may be possible to place a more accurate valuation on the DTT capacity currently allocated to the commercial public service networks following the planned award of the 800 Mhz spectrum band in 2012.

5.21 There are, however, a number of potential issues generated by a licence extension. First, it would be difficult to maintain the existing level of public service obligations on the Channel 3 licensees until the end of an extended licence period. Our findings in the PSB Review made clear that, for ITV plc, the costs of PSB status would outweigh its tangible benefits before the initial licence expiry date in 2014. This coupled with uncertainty about the possible benefits of PSB status in the future may again lead ITV plc and/or Channel 5 to consider becoming a fully commercial UK-wide broadcaster. In those circumstances, it may not be possible to secure a replacement licensee given both the high fixed costs of providing a fully regional service with the existing range of obligations and the short term nature of any licence that Ofcom would be able to offer.

## **Summary**

5.22 Our report under section 229 of the Act will seek to assess the commercial sustainability in the next licence period of a historically strong and successful commercial public service broadcasting model. It is already clear that, as outlined above, the options open to the Secretary of State regarding licence renewal will essentially offer a choice between stability and disruption to the current forms of public service broadcasting.

5.23 If the existing Channel 3 and Channel 5 licence holders are able to maintain a commercially sustainable model for PSB, in the medium term licence renewal is the approach most likely to ensure the continuing delivery of the key public service

objectives of supporting investment in original programming and news provision. Regulatory certainty may help to provide the stability that would enable the broadcasters to take creative risks to support PSB delivery. However, in advance of our work under section 229 of the Act, it is unclear to us whether the existing regulatory settlement with the commercial PSBs will be sustainable throughout the next licence period. In particular, it is uncertain whether the regulatory enforcement mechanisms currently in place would be sufficient to prevent licensees from seeking to pare back delivery of public service content in the future in response to unfavourable market conditions.

- 5.24 Alternatively, regardless of the commercial sustainability of the existing licences, a decision by the Secretary of State to block licence renewal would lead to an award process that could lead to the development of new and innovative forms of public service content and drive efficiency. Such an approach is not, of course, without risk and, as noted above, would require affirmative resolution by Parliament.
- 5.25 Finally, a decision by the Secretary of State to extend the existing licences would also carry the risk that licensees may reconsider their long term commitment to public service broadcasting. However, in the absence of such a step, it is at least highly likely that some decisions about the future of commercial public service broadcasting will be taken in advance of the next Communications Bill debate.

## Annex 1

# Letter from DCMS to Ofcom, 1 July 2011

Department for Culture, Media and Sport  
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1<sup>st</sup> July 2011



Dear Chris,

I am writing to ask Ofcom to provide written advice to the Secretary of State about the options for the relicensing of Channels 3 and 5. The advice should include consideration of all the options open to the Secretary of State including renewing, extending and auctioning the licences. It should set out the benefits and implications of each of the options, and also highlight any associated timing or process requirements. I would be grateful if you could provide the advice by Friday 21 July.

I know Ofcom has already started the process of preparing its interim report on the relicensing of 3 and 5, but the work I am requesting here goes beyond that as it is intended to advise the Secretary of State on all possible options open to him.

I understand the Broadcasters will be very eager to see this and I would fully expect it to be made public in due course. However, given that this is outside Ofcom's existing duties under the Communications Act and that it is specifically for the purpose of advising the Secretary of State on a decision for which he is responsible, I would ask that you delay publication until he has had a chance to consider it, at which point DCMS and Ofcom can jointly agree a plan for publication.

Either I or [REDACTED] are very happy to discuss this. I look forward to hearing from you.

Rita Patel  
Deputy Director, Media



## Annex 2

# Current PSB Obligations on Channel 3 and Channel 5

Table A: Obligations placed on Channel 3 and Channel 5 licensees (per annum)

Requirement	Channel 3	Channel 5
<b>Original Production</b> (Total)	65%	50%
<b>Original Production</b> (Peak)	85%	40%
<b>Independent Production</b> (% of broadcast time)	25%	25%
<b>Regional Production</b> (% spend and volume outside the M25 Area)	35%	10%
<b>National and International News</b> (Total)	365 hours/year	260 hours/year
<b>News</b> (Peak)	125 hours/year	100 hours/year
<b>Current Affairs</b> (Total)	43 hours/year	130 hours/year
<b>Current Affairs</b> (Peak)	35 hours/year	10 hours/year

Table B: Channel 3 obligations by region (weekly average)

Requirement	ITV English Licences	STV	UTV	ITV Wales	Channel TV
<b>Regional News</b> (Total)	3hrs 45mins	4hrs	4hrs	4hrs	3hrs 09mins
<b>Regional News</b> (Peak)	2hrs 15mins	2hrs 30mins	2hrs 30mins	2hrs 30mins	1hrs 40mins
<b>Regional Non-news</b> (Total)	15 minutes	1hrs 30mins	2hrs	1hrs 30mins (of which 47 must be current affairs)	51 minutes (of which 22 must be current affairs)
<b>Regional Non-news</b> (Peak)	14 minutes	45 minutes	45 minutes	45 minutes	49 minutes