

December 2008

Channel 4 and Public Money: The Accountability and Governance Challenges

Final report

PERSPECTIVE

Part of the Ingenious Consulting Network

Contents

1. Introduction	3
2. Background	4
3. The accountability challenge	5
4: Impact on Channel 4	7
5. Impact on the PSB system.....	10
6. Impact on Channel 4's competitors	12
7: Conclusions	14

1. Introduction

Perspective has been commissioned by Five to consider the accountability and governance implications of Channel 4 receiving public money to support some of its public service programming in future. This is in the context of the discussion in Ofcom's PSB Phase 2 Report: Preparing for the Digital Future, in which the regulator discusses how best to secure PSB in future, and how best to secure the viability of Channel 4, whose programme model is perceived to be vulnerable.

It is important at the outset to state what this report is **not** about. We have not addressed the justification for allocating public money to support specific public service goals. Nor have we looked at the merits of the different funding mechanisms that Ofcom has suggested in its recent report.

Instead, we have focused on the impact that a decision to support Channel 4 directly with public funding would have on the channel's own governance and accountability arrangements, as well as the wider impacts it would have on the way PSB is organised and held accountable.

We have also focused primarily on the cash benefits envisaged by the regulator, although it is possible that other forms of non-cash support would also require the oversight of a public agency other than Ofcom; and we have focused on the implications of receiving that public support on Channel 4, rather than looking in the same level of detail at the potential impact on other channels.

We have made no assumptions about whether such changes are necessary or desirable from a public policy point of view: and although the report which follows inevitably focuses on the challenges that any such decision would face, we do not assume that these challenges are insurmountable. But we do believe that they would be significant, and would need to be subject to considerable future debate – towards which we hope that this report will have made a helpful contribution.

2. Background

Under the Communications Act 2003, Ofcom is required, to report on the delivery of Public Service Broadcasting in the UK, and, if appropriate, to recommend ways in which the quality of such provision can be maintained and strengthened. Ofcom is required to conduct such a report not less than every five years.

In the first of its reviews, conducted during 2004, Ofcom concluded that the system faced significant challenges in future. Ofcom was concerned about the financial security of Channel 4 as switch-over neared and the value of analogue spectrum declined, but it was unsure of the strength of such impact on the channel.

During 2006, Ofcom commissioned a review by LEK Consulting into the channel's financial prospects. The review concluded that, if it maintained broadly the same schedule, Channel 4 was unlikely to generate profits after 2009, and would be dependent on its cash reserves thereafter – an unsustainable position in the long term. This assessment of Channel 4's prospects has been revisited by Ofcom in their *PSB Review phase 2: Preparing for the Digital Future*, which predicts a shortfall of between £60 - £100 million for the channel by the time digital switch-over is complete.

Ofcom's latest analysis specifically excludes additional costs that would be incurred if the channel were to implement all of the proposals outlined in its recent strategic document, *Next on 4*. It also excludes any additional costs it might incur as a result of broadcasting in HD in future.

In its research, Ofcom has also noted that the types of public service output that are most likely to be under-delivered in future include several that are core to Channel 4's delivery of its current remit: **challenging UK drama, UK comedy, current affairs and documentaries** (although it is also worth noting that two of the genres most likely to require support, regional news programmes and programmes for older children, do not at the moment form part of Channel 4's output).

Ofcom has further concluded that there are a number of possible ways to channel public support, both cash and other support, to public service providers, which fall under three broad headings:

Direct public funding - through direct taxation, or through other forms of tax relief

BBC related support - through use of the "switch-over surplus" – the element of the licence fee that is currently ear-marked for supporting DSO - or through taking whole or partial ownership of BBC Worldwide, or receiving a part of its dividend; it would also be possible to exploit cross promotion on the BBC of public service output carried on Channel 4 (although this latter proposal would not involve a cash transfer to Channel 4)

Direct industry support – through a levy on industry, or using the regulatory assets of ITV and Five

As set out in the introduction, we do not assess the relative merits of any of these forms of support in this report, but instead focus only on the accountability and governance implications for Channel 4 and others.

3. The accountability challenge

In its phase 2 report, Ofcom has recognised that any decision to offer public support to Channel 4 will inevitably require changes to the accountability framework for the channel. In particular, Ofcom has identified six criteria that will need to be satisfied:

- **Maintaining the channel's independence** – it is a fundamental principle of UK PSB that although the state may be involved in securing adequate funding, it has no role in determining the editorial agenda or treatment of individual subjects
- **Ensuring public funding is for programmes that meet audience needs** – within the context of a mixed schedule channel, it is imperative that the funding is directed towards programmes that have a specific public service goal, which itself has been thoroughly researched and identified
- **Ensuring public funding is efficiently used and does not overcompensate Channel 4** – funding for public service programmes must not have the indirect effect of subsidising other, non-PSB output
- **Avoiding complex bureaucracy or additional regulatory burden** – public funding schemes and distribution bodies are frequently criticised for inefficiency and over-bureaucratic processes (a recent example can be found in the recent Public Accounts Committee report into the grant-giving of the Arts Council)
- **Fit with Channel 4's organisational purpose and culture** – Channel 4 has positioned itself as an edgy and alternative voice among the PSB channels: public funding should not be at odds with this overall approach

Ofcom believes that Channel 4 will need to have a clearer public service remit if it is to receive public funding. The current remit, as set out in the Communications Act 2003, requires Channel 4 to “provide a broad range of high quality and diverse programming which, in particular:

- *demonstrates innovation, experiment and creativity in the form and content of programmes*
- *appeals to the tastes and interests of a culturally diverse society*
- *makes a significant contribution to meeting the need for the licensed public service broadcasters to include programmes of an educational nature and other programmes of educative value*
- *and exhibits a distinctive character.”*

Although Ofcom have not set out in detail how they would expect the remit to be altered, the analysis that underpins the PSB Review suggests that it is likely to involve a more prescriptive approach to the specific genres that Channel 4 would be required to broadcast.

To deliver this new approach, Ofcom has suggested the changes that may need to be made to the governance and accountability arrangements for Channel 4. To meet the requirement of overseeing the use of public money, of determining where that money should be spent (where Ofcom envisages a separate role for itself in assessing the impact on the wider market of any

such funding) and reporting adequately to Parliament on its use, Ofcom considers that there are three broad options:

- **The Channel 4 board could take these functions upon itself** – though Ofcom recognises the uncomfortable balance of responsibilities if Channel 4 retains its mixed funding, since the board would also be responsible for ensuring the continued financial viability of the business
- **A separate funding agency could be established for Channel 4** – though Ofcom recognises the potential problem of capture if Channel 4 is the sole recipient of funds from this agency, and the agency is therefore entirely dependent on Channel 4 for its analysis and assessment of options
- **Channel 4 could receive funding from a body with a wider remit** – such a body could ensure both competition for the available public funding, as well as independent assessment of Channel 4's performance against its public service remit

4: Impact on Channel 4

There are two main areas where we believe the use of public funding may impact on the Channel itself:

- In the flexibility it will have on its budget and commissioning – and the possible impact this could have on the output of the channel itself
- And the continuing independence of the channel

Budget and commissioning

If Channel 4 takes public funding, Ofcom has already recognised the need for mechanisms to ensure that the funding is used solely for the public purposes for which it has been ear-marked, and does not in any way serve to subsidise the commercial activity of the rest of the channel.

This is likely to require a significantly more intrusive approach to the way the Channel sets its budget and allocates funding across different parts of its schedule.

- **It will require Channel 4 to ring-fence budgets**

A key finding of the LEK report was that Channel 4's business model, described as the "cross-subsidy model" - in which high quality acquired and other "hit" programmes drive large audiences which in turn deliver the revenue to invest in less popular PSB output - is under significant pressure, not least from a significant loss of margin on acquisitions and "hit originations" which is unique to Channel 4.

If Channel 4 were permitted to replace its own funding for PSB genres with public money, it would be significantly advantaged in its ability to secure other, commercial programmes in direct competition with other broadcasters. This would be difficult to justify and would face serious challenge from Channel 4's competitors.

However, a key requirement of a public funding process will be that there is no cross-subsidy for non-PSB output. Channel 4 will presumably therefore have to commit to the funding it was already intending to spend in any genre or programme type for which it is receiving additional funds, in order to guarantee that the channel is definitely using the money to procure additional benefit. This will presumably include the existing element of Channel 4's funding base that is attributed to the value of its regulatory assets, which are estimated by Ofcom at around £80 million.

Assuming therefore that Channel 4 is unable to recycle all the money that is currently deployed on PSB programmes into other areas where the channel faces the most severe price inflation (eg acquisitions), but on which it is nevertheless dependent for driving its commercial viability, then the financial benefit to the channel overall will inevitably be reduced.

Channel 4 therefore faces the potential dilemma that it could lose flexibility in the way it sets its budgets, without gaining a commensurate relief where it needs it most.

- **It could reduce innovation and experimentation**

Since it was founded more than 26 years ago, Channel 4 has successfully been able to infuse public service ethos into popular programmes. However, if it is required in future to identify ahead of time the public benefit that specific commissions are intended to bring, then there is a risk that the programmes themselves could become more “functional” and less creative.

Specifically, there is a risk that it may become more difficult to commission “cross-over” programmes, which straddle two distinctive editorial approaches, because it could be harder to justify the use of public money for programmes that do not have a very obvious public service goal. Jamie’s School Dinners, an often quoted example of a programme which orchestrated a very significant debate about a key issue of social policy, might have found it difficult to secure public funding given that its format was much closer to a broader entertainment format, and its public policy goal therefore much harder to guarantee.

There is, as a result, a risk that two cultures could emerge within Channel 4: those insulated from the rest of the channel because of their use of public money versus those who are directly employed on the commercial side of the channel. The executives would face the prospect of separate reporting lines, with the potential for mixed, and possibly conflicting, objectives.

- **It could reduce the incentive to make public service content commercially attractive**

Channel 4’s premise has always been that the challenge of making public service content commercially successful is a key driving force behind its creativity. However, there could be less incentive to ensure that public service programmes are sufficiently broad to be likely to attract a large audience and thus fight their way into advantageous commercial slots. If such programmes are scheduled at a time when few viewers are likely to watch them, this would reduce their reach and impact.

However, if the funding body intervenes to secure schedule prominence, then the financial benefit to the channel from the public funding would again be reduced, since it would be unable to place commercially more successful programming in those slots.

Impact on Channel 4’s Independence

The BBC’s independence is derived from its size and scope, as well as its unique governance built up over most of the last century. Channel 4, however, will have neither of these advantages, which could put its independence more at risk.

- **Editorial focus**

The public funding is unlikely to amount to more than a small proportion of the channel’s programme spend. As discussed above, it is likely that, in order to justify public money, it will have to meet more prescriptive criteria about the public goals the programming has to meet. If it is competing with others to secure the funding, it will be even more incentivised to tailor its proposal to the requirements of the external funder.

- **Impact on the Channel 4 board**

Channel 4's board is currently responsible for all of the channel's output, both its public service and its more commercial programmes. It is required to ensure that the channel fulfils its primary purpose of satisfying the remit, but also that it is financially secure.

In future, while the Channel 4 board would remain responsible for the overall performance of the channel, the funding for a significant element could be separate, with the board having only limited say in how the public funding is to be spent or what is to be achieved by it. This could lead to tensions within the board, as Ofcom itself has recognised. The board's room for manoeuvre would be curtailed and its ability to operate effectively as a unified board potentially more difficult to achieve.

This separation of funding puts the independence of the channel potentially at risk. If the publicly funded programming comes under external criticism or pressure, the Channel 4 board may not feel the same degree of responsibility for it, or the same need to risk its own political capital in supporting it.

The existence of public funding would also affect the current arrangements both for the appointment of the Channel 4 board, and for the way in which delivery of the remit is assessed. At present, Ofcom appoints and government approves the board, reflecting the public ownership of the channel. Reporting on the delivery of the remit, however, is the responsibility of the Channel 4 board itself. Ofcom is responsible, through the arrangements set out in the Communications Act, for receiving an annual Statement of Programme Policy, and offering guidance on any significant changes Channel 4 wishes to make in the way it fulfils its PSB remit. The decisions on the strategy for fulfilling the remit, and assessing how it has been delivered, sit with the board alone.

If Channel 4 were to receive public funding, new arrangements, consistent with the way other public sector boards are appointed, would need to be put in place for future appointments not only to the Channel 4 board itself, but also to any new funding agency. The fact that Ofcom would be required to carry out Market Impact Assessments on the proposals made by the board of Channel 4, would make it inappropriate for the regulator still to be involved in the appointment of board members.

Whoever is providing the public money to Channel 4 would need to be the body that assessed whether the objectives set for the programming that results were being met. While Ofcom would retain responsibility for the oversight of other commercial PSBs, it would presumably lose any duties with regard to Channel 4's PSB remit.

5. Impact on the PSB system

While the decision to allocate public funding to Channel 4 would undoubtedly have important consequences for the governance of the channel itself, it would also have implications for the way in which the rest of the PSB system in the UK operates. The questions arise not only in relation to the relationship between any funding agency and other PSBs, most importantly the BBC, but also to the way that PSB might come to be defined, which in itself could have implications for the debate about how public funding is to be used in future.

Governance

As discussed above, Ofcom does not rule out the possibility that the Channel 4 board could take on responsibility for allocating public money and be held accountable for it. Nevertheless, Ofcom's analysis recognises that it would constitute a difficult conflict of interests, since the board is also charged with the overall commercial health of the organisation.

It is therefore most likely that the funding would be channelled through an independent body. Realistically, this could either be a brand new body – with or without responsibility for giving money to providers other than Channel 4 – or it could be a re-aligned version of the BBC Trust.

In addition to the potential weakening of the Channel 4 board, discussed in the previous section, this could have serious outcomes for the rest of the PSB system.

- **Impact of a new funding agency**

At present, although there are other public bodies charged with funding broadcast output, they fund services that are very distinctive from the BBC's services: Teachers TV and S4C are both examples of television channels which serve a specific audience that the BBC does not seek to reach independently. However, if a separate agency were established to distribute public money to Channel 4, it would be looking to serve the same audiences, and potentially the same audience needs, as those identified and focused on by the BBC Trust in fulfilling its functions under the BBC Charter.

There will therefore exist the possibility of two public bodies pursuing overlapping, or even identical, goals. At the very least, this will require significant collaboration or joint planning to avoid potentially unhelpful competition between the two bodies. It will almost certainly also require a third body to arbitrate which of the public goals should be met by which agency, in order to avoid the inefficient use of public money, or the undesirable outcome of both the BBC Trust and the new funding body both addressing the same audience need, while leaving others unmet.

It is possible that this role could be carried out by DCMS, but this carries the disadvantage of involving government directly in setting editorial objectives – something that public policy has successfully avoided thus far.

It is also possible that this role could be carried out by Ofcom: but that creates its own difficulty for the regulator in carrying out other of its duties, such as conducting Market Impact Assessments, or other investigations it might be called on to make resulting from its powers as a competition authority.

- **Impact of the BBC Trust funding Channel 4**

If the BBC Trust were to become the body responsible for allocating funding to Channel 4, its relationship to the BBC would need to change fundamentally. As it would no longer be solely responsible for the BBC, it would have to find effective ways to demonstrate even-handedness in the way it chose to allocate the licence fee.

Definition of PSB – and implications for the use of the BBC licence fee

Ofcom recognises that, if Channel 4 is to receive public funding, its remit will need to be altered. As discussed above, it is highly likely that this will involve a more targeted approach to the programme genres that Channel 4 will be required to deliver.

Such an approach would be at odds with the prevailing philosophy of how best to secure PSB output from the core PSB providers. The Communications Act of 2003 represented a deliberate move away from an approach to the regulation of PSB based around tight definitions of genres with commitments measured in numbers of hours of each genre to be delivered. Instead, broadcasters were encouraged to define for themselves the way in which they could best meet the purposes of public service broadcasting as defined in the Act. Ofcom built on this approach in its first PSB Review, by moving beyond genres and putting forward a set of purposes and characteristics of PSB programming.

A change to Channel 4's remit to make it more genre specific may make it harder to sustain an overall approach for other PSB broadcasters, especially the BBC: the fragile public consensus that it is legitimate for public funding to support a very wide range of programmes, some of which may not meet particularly obvious public service goals other than maintaining the audience to the channel, may be weakened if public support is so clearly linked to specific programme types.

This in turn could dovetail with arguments for a smaller and much more tightly defined licence fee, the consequences of which will be either a much smaller BBC or a BBC that is able to secure alternative commercial funds. While it is beyond the scope of this paper to express any view on whether or not this is a desirable policy goal, it is our view that it is a potential consequence of deciding to allocate public funding for Channel 4, and would benefit from being more widely debated.

6. Impact on Channel 4's competitors

If Channel 4 receives public funding, it will inevitably affect its potential competitive impact and therefore increase the degree of oversight required, not simply from the funding body, but also from third parties tasked with ensuring that the impact of the public funding is justifiable and proportionate.

Impact on the advertising market

The principle of universal availability means that Channel 4 will continue to be a free-to-air channel, substantially funded by advertising and sponsorship revenue but additionally supported by its own commercial activity and, potentially, public money.

Channel 4 already competes vigorously for advertising income, and schedules its programmes in such a way as to balance both public service and commercial goals. However, the existence of public funding for some programmes could have significant impact:

- the channel will be incentivised to play publicly funded programmes in less commercially attractive airtime, to maximise commercial impacts
- competitors will be incentivised to ensure that Channel 4 cannot take commercial advantage by maximising its commercial impacts – and may have a relevant cause on which to bring complaints to the regulator

Even if the funding agency does not itself impose scheduling requirements (which, as discussed above, would weaken the financial benefit that the intervention is designed to achieve) it is likely that the way Channel 4 operates in the advertising market would come under much closer scrutiny from its competitors.

Existing PSBs will have less incentive to invest in public service content unless they receive public funding

Ofcom has identified the difficulty faced by commercial PSBs in continuing to deliver non-commercial public service content. However, if public funding is to be made available to Channel 4 for specific public goals, there will be a strong case for other commercial providers to be able to bid for public money if they judge that it would enhance their ability to continue to deliver public service output, and that it is consistent with their overall commercial goals.

In this context, it will be harder to justify the existence of public support reserved only for Channel 4, if other channels can demonstrate that they would have an equal, or better, chance to deliver the public benefit that the public funding is designed to achieve.

Channel 4 will be subjected to much higher levels of external regulatory scrutiny

Ofcom has already accepted in the PSB report that it will be required to carry out Market Impact Assessment in relation to public funding. At present, Ofcom is required to conduct an MIA in very limited circumstances, related to either the extension of an existing BBC service (beyond its service licence) or the creation of a new BBC service. Ofcom does not look at the market impact of the way in which the licence fee is spent within existing BBC services.

However, if Channel 4 becomes a service with mixed funding, this distinction may become much harder to sustain. It is possible that the regulator will be called upon to investigate the way in which public money is being used to support essentially an existing schedule, especially if there are concerns that it is being used to cross-subsidise other commercial programmes.

7: Conclusions

The rapid development of digital media has undoubtedly forced a necessary reappraisal of how public service content can best be secured and delivered in future. Changes to the way in which content is both distributed and consumed may require radically different structures and organisations to support high quality programming.

Alongside the growing awareness of this challenge among broadcasters and policy makers, the last five years have seen already significant changes in the governance and accountability arrangements for Public Service Broadcasters:

- the creation of Ofcom
- the creation of the BBC Trust
- the development of ex-ante tests of both public value and market impact

If Channel 4 is accorded public funding as a result of the PSB Review, it is inevitable that there will need to be further changes to an already complex PSB system. Regardless of the merits of the argument for delivering that support to Channel 4, or indeed to other broadcasters, it is clear to us that there are significant challenges and risks that such a radical change would have to meet, and answer.