



Licensing of Channel 3 and Channel 5

A report to the Secretary of State under section 229 of the
Communications Act 2003

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Section 1

Executive summary

Ofcom's duty to advise the Secretary of State on renewal of Channel 3 and 5 licences

- 1.1 The Channel 3 and Channel 5 broadcast licences are due to expire on 31 December 2014. Ofcom has a duty under the Communications Act 2003 ('the Act') to report to the Secretary of State about matters which are relevant to the question of renewal.
- 1.2 In this report, we are required to give our opinion as to whether the existing licence holders will be able to contribute, at a commercially sustainable cost, to the fulfilment of the public service broadcasting purposes in the 10 years from 2015.
- 1.3 The Secretary of State's powers in relation to relicensing provide for three options:
 - intervention to block licence renewal, requiring Ofcom to **auction** the vacant licences;
 - no intervention, so that Ofcom proceeds with the **renewal** process; and
 - **extending** the existing licences, potentially until after the Communications Bill is completed.
- 1.4 Under each of these options, the Secretary of State also has the choice of exercising his powers to remove (or in some cases amend) the statutory obligations that must be included in public service broadcasting licences.
- 1.5 This document is intended to meet the reporting duty placed on Ofcom. In carrying out our duty we have looked at two separate, but overlapping, issues that we consider are central to any decision by the Secretary of State to exercise his powers under the Act, namely:
 - whether the licensees could continue to make a **sufficient** contribution to the fulfilment of public service purposes; and
 - whether those contributions would be **commercially sustainable** in the next licence period.

Ofcom's view is the Channel 3 and 5 licensees could continue to make a sufficient contribution to the fulfilment of public service purposes

- 1.6 In preparation for this report, Ofcom published an open letter in September 2011 inviting views from licensees and other interested parties. We asked whether it would remain possible for the Channel 3 and Channel 5 licence holders to make a continuing commitment to public service broadcasting over the next licence period and, if so, what the appropriate level of obligation would be.
- 1.7 Licence commitments are currently focused on meeting public service purposes in a small number of core programming genres regarded by audiences as the most

important (in particular news and current affairs). In return, the licensees receive specific benefits. These include the right to appropriate prominence on Electronic Programme Guides ('EPGs') as well as access to spectrum that enables them to make their services available to 98.5% of the UK population on the digital terrestrial platform.

- 1.8 Despite significant changes in technology and evolving consumer consumption patterns, the commercial public service broadcasters ('PSBs') have continued to play a key role in delivering public service programming and providing opportunities for the UK content production industry. Both Channel 3 and Channel 5 exceeded their respective production and programming obligations between 2007 and 2010, the last year for which full data is available.
- 1.9 For the Channel 3 licensees, this contribution is also reflected by:
- collective spending on original content second only to the BBC, of which around 40% has been sourced from independent producers in recent years;
 - the provision of competition for the BBC in relation to universally accessible UK television news; and
 - plurality in Nations and regions news coverage.
- 1.10 In comparison, delivery by Channel 5 is more modest, in part a reflection of the more limited range of PSB benefits it receives. Furthermore, between 2007 and 2010 spend by Channel 5 declined by 49% from £122m to £62m. Within this context, however, we note that Channel 5's own provisional figures indicate that its investment in new programming increased to £[<]m in 2011. We also note that its most popular news bulletin receives an audience broadly comparable in size with *Channel 4 News*.

Although the potential value of PSB licences have declined, we believe commercial PSB services could make a sustainable public service contribution over the next licensing period, creating a case for renewal

- 1.11 The background to our present assessment of licence renewal is very different from the analogue environment in which the Channel 3 licences were first awarded in 1991. At that time, new businesses were created effectively to serve licences which offered privileged access to mass audiences across the UK. Companies competed vigorously to secure this advantage.
- 1.12 Within the current digital framework, the licences represent a set of assets among others to companies that, in most cases, have media interests far beyond the public service broadcasting licences which they operate. The pressures that changes in digital technology have placed on this long-standing broadcasting model are likely to continue over the next licence period.
- 1.13 Set against this environment, the Channel 3 and Channel 5 licensees have argued to us that the benefits they receive in return for PSB status have declined significantly as digital switchover has progressed and choice for viewers has grown. Nevertheless, the licensees maintain that, in broad terms and with some

amendments, their existing public service obligations could continue to be sustainable during the next licence period.

- 1.14 Given uncertainty around future changes in technology and viewer consumption patterns, some of the Channel 3 and Channel 5 licensees have made it clear to us that they cannot be sure that their commercial imperatives and obligations to fulfil public service remits will remain aligned throughout the next licence period. Channel 5, in particular, has argued that amendments to certain PSB obligations may be necessary. Equally, all licensees have stated that they consider a contribution beyond existing levels is not possible.
- 1.15 The lack of clarity faced by the licensees about market developments and their impact up to 2024 is a matter that we have noted within this report. We also note that the existing licensees do not acknowledge any value in intangible factors linked to PSB status. We consider that there are benefits to the licence holders arising from certain elements – including the additional media coverage PSB programme schedules receive and viewer awareness of channel brands. Although they are difficult to quantify, we consider the potential loss of these benefits could represent a risk to an incumbent broadcaster. Nevertheless, taken as a whole, it is our assessment that the licensees have sought to present proposals for public service delivery that are realistic, sustainable and commensurate with current levels of delivery.

However, the options open to the Secretary of State – to ask Ofcom to auction the licences or extend them pending new communications legislation – remain credible and could offer benefits to citizens and consumers

- 1.16 As we set out in our interim paper last summer,¹ there are a number of reasons why the Secretary of State could decide that the public interest is best served by either re-auctioning or extending the existing licences.
- 1.17 Re-auctioning would open up the licensing process to competitive examination and could establish a more accurate value for the licences.
- 1.18 In the case of Channel 3, it offers the potential to reinvigorate the existing Channel 3 model. Re-auctioning could test whether potential bidders – including the current licensees – would be able to bring forward alternative models of PSB delivery. An auction would also offer an opportunity to restructure the licensing map to reflect more accurately national and regional identities within the UK.
- 1.19 In the case of Channel 5, it would clarify whether a new bidder could offer a more significant commitment to original content production or important areas of public service content than the current licence holder.
- 1.20 Alternatively, a decision to extend commercial PSB licences would allow, as a new Communications Bill is developed, a full consideration by Parliament of the institutional structures required for delivering public service content in a world changed by the growth of digital media.

¹ See *Licensing of Channel 3 and Channel 5: A report from Ofcom to the Secretary of State for Culture, Olympics, Media and Sport* at: <http://stakeholders.ofcom.org.uk/binaries/broadcast/tv-ops/licensing-c3-c5.pdf>.

- 1.21 In this event, the role played by Channel 3 and/or Channel 5 could also be assessed alongside the different remits of both the BBC (in the context of Charter renewal) and Channel 4. Such a review could also take account of the relative importance of existing public service obligations, acknowledging changes to supply and demand for public service content including the impact of local television services over the next few years. Equally, it would create an opportunity to increase PSB provision by bringing possible additional benefits, such as retransmission fees or advertising minutage rules, clearly within the PSB framework.
- 1.22 In choosing between the options open to him, we believe the Secretary of State should be mindful of certain specific concerns. We consider the most notable of these to be the potential impact his decision could have on the future of ITN and news plurality more generally, particularly if he were to require an auction for the licences.² However, it is ultimately a matter of judgment for the Secretary of State whether the benefits that might be secured through the exercise of his powers to re-auction or to extend the existing licences are sufficient to outweigh either the risks of doing so, or the contributions the licensees are currently willing to offer towards public service purposes in the future.

Ofcom believes the Secretary of State should take into consideration a number of potential changes suggested by the licensees as well as a range of other issues

- 1.23 Some amendments to the existing licences may be required in preparation for renewal. In the event that the Secretary of State decides not to exercise his powers to intervene in the renewal process, we would propose to examine through a consultation the specific proposals made by ITV plc, STV and UTV in relation to content for the Nations and the English regions. At the same time we would also propose to consider whether it may now be appropriate to amend the definition of peak-time programming in order to bring it into line with the definition currently in use for advertising.
- 1.24 Further, we also set out a number of additional matters relating to PSB delivery that we believe the Secretary of State may wish to consider when weighing up the alternative options open to him. In particular, we note the possibilities which exist in certain circumstances to:
- establish a separate, stand-alone licence for Channel 3 in Wales;
 - ensure provision of Scottish news in the south of Scotland; and/or
 - require a continuing commitment from Channel 5 to make children's programming.

² ITN is currently one of three wholesale broadcast news providers in the UK, alongside Sky and the BBC. See section 5 below.

Depending on the Secretary of State's decision, Ofcom may need to undertake a formal licensing process that should serve to secure the delivery of public service broadcasting purposes

- 1.25 Finally, we note that for the last few years, Ofcom's relationships with the Channel 3 and Channel 5 licensees have been characterised by an ongoing dialogue about alignment in the costs and benefits of PSB status, with licensees seeking to establish equilibrium through reductions in the obligations imposed on them. An ongoing process like this is not in the public interest. In the event of renewal, the benefits of stability enjoyed by the existing licensees must also serve the interests of citizens and consumers across the UK.
- 1.26 Therefore, if the Secretary of State elects not to intervene to prevent renewal, we would seek both to establish that commitments proposed by the licensees represented minimum licence requirements during the next period and expect the future regulatory and legislative framework to discourage further reductions in PSB delivery.

Section 2

Legal framework and approach to this report

2.1 In this section, we explain:

- our specific duties as they are set out in section 229 of the Communications Act 2003 ('The Act');
- the approach we have taken in this report to fulfil those duties; and
- the process following our submission, including the options open to the Secretary of State.

The key points covered in this section are:

The Act places a duty on Ofcom to provide its opinion to the Secretary of State as to whether the existing Channel 3 and Channel 5 licence holders will be able to contribute, at a commercially sustainable cost, to the fulfilment of the public service purposes set out in the Act in the ten years from 2015.

Therefore Ofcom's role is to assess two separate, but overlapping issues: whether the licensees could continue to make a sufficient contribution to the fulfilment of public service purposes, and whether those contributions would be commercially sustainable in the next licence period.

Once he has received our report, the Secretary of State is then able to use powers to intervene in the relicensing process. In addition to blocking licence renewal or extending the current licences, he may also seek to amend the public service remits of the relevant service and remove, suspend or amend some of the obligations placed on the licensees.

Ofcom's duties under s.229 of the Act

2.2 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 other arrangements on 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”.

2.3 The Act states that we should also include in our report any recommendations that we have as to whether the Secretary of State should exercise the following powers:

- To make an order preventing renewal of the regional or national Channel 3 licences or the Channel 5 licence or two or more of the licence categories;³ or
 - To make statutory instruments under Chapter 4, Part 3 of the Act,⁴ notably to remove or, in some cases, amend certain licence obligations which are required under the Act.
- 2.4 With the exception of his powers under section 310 relating to the EPG Code, orders made in exercise of his Chapter 4 powers are subject to the affirmative resolution procedure.
- 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.

The purpose of this report

- 2.6 As public service broadcasters, 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 television licensees. 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 set out in section 264 of the Act.⁵
- 2.7 The purposes of PSB are designed to secure the delivery of a wide and balanced range of high quality programmes which meet the needs and satisfy the interests of as many different audiences as practicable. The Act states that those purposes, which are intended to be achieved by the PSBs collectively rather than by any individual licensee, can be fulfilled by, among other things, the provision of comprehensive and authoritative news coverage, high quality and original programmes for children, and programming which reflects the lives and concerns of different communities in the UK.
- 2.8 In return for fulfilling obligations designed to secure these aims, the Channel 3 and Channel 5 licence holders receive a range of benefits including prominence on electronic programme guides and reserved universal multiplex capacity.
- 2.9 In light of the wording specified in the Act, we consider that there are two issues which this report is required to address:
- The first relates to the contribution that the Channel 3 and Channel 5 licensees could make to the fulfilment of PSB purposes during the next licensing period. In

³ The Act separates the commercial PSB licences into three distinct licence types – the licences to provide Channel 3 services (including all 15 regional Channel 3 licences and the national Channel 3 breakfast licence); the licence to provide the Channel 5 service; and the licence to provide the public teletext service. As we noted in our interim paper, 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 licences and the national breakfast licence.

⁴ See sections 263 (4), 271, 277 (4) and (8), 278 (6), 282, 283, 306 and 310 (5) of the Act.

⁵ References throughout this document to ‘public service purposes’ relate to the broadcasting purposes specified in section 264 (4) of the Act.

effect, this requires us to consider what programming Ofcom is able to require the licence holders to provide and the extent to which that programming represents an adequate contribution to meeting the needs and satisfying the interests of viewers over the next decade.

- The second is about deliverability, and specifically whether, in light of the benefits which they receive, it will be commercially sustainable for the existing licence holders to deliver services containing public service broadcasting obligations which would make such a contribution.
- 2.10 To help us come to a view on these matters, we published an open letter inviting submissions from licensees and other interested parties.⁶ In particular, we invited views as to whether, as we had anticipated in 2009, it would remain possible for the Channel 3 and Channel 5 licence holders to make a continuing commitment to public service broadcasting over the next licence period, and if so, what the appropriate level of the associated obligations would be.
- 2.11 We received twelve responses to our request, from the affected licensees as well as other broadcasters and a range of other stakeholders.
- 2.12 In light of those responses and the further analysis which we have undertaken, we explain in this document the basis for our view that, although the existing licensees could continue to deliver public service commitments beyond 2014, all of the options open to the Secretary of State following this report remain viable.

Options open to the Secretary of State following this report

- 2.13 The Secretary of State has three alternative options in relation to the licensing of Channel 3 and Channel 5.
- 2.14 Upon receipt of this report, but not before, the Secretary of State may make an order that the licences, or specific types of licence, are not to be renewed. Even in the absence of a recommendation from Ofcom in the report to make such an order, the Secretary of State may still make the order where “he considers... that it would be appropriate to do so”. However, the order must be made no later than 30 June 2013 and would be subject to the affirmative resolution procedure.
- 2.15 Alternatively, he may decide not to intervene so as to allow Ofcom to proceed with the renewal process set out in the Act. Accordingly, it would then be left to us to decide whether to grant any renewal applications submitted by existing licence holders.⁷
- 2.16 Finally, the Secretary of State may at any point make an order to postpone the expiry date of each specified type of licence thus extending the term of those licences. The Act does not specify any conditions on the Secretary of State’s discretion to extend the existing licence period – which is subject to Parliament’s negative resolution procedure only.
- 2.17 In addition, the Secretary of State is able to exercise his order-making powers under Chapter 4, Part 3 of the Act in conjunction with any of these options. Among other things, these powers enable him to amend the public service remit of the Channel 3

⁶ See <http://stakeholders.ofcom.org.uk/binaries/broadcast/tv-ops/Open-letter.pdf>.

⁷ The grounds on which we may decide not to renew a licence are set out in s.216 (5) to (7) of the Act.

and Channel 5 licences, to remove or suspend the inclusion of any licence condition required by the Act, to amend the independent production quotas included in the licences and to amend the specification of original productions for the purposes of the original productions quota in the licences.

2.18 More detail on these options is set out in section 7 below.

Section 3

Current levels of PSB delivery by Channel 3 and Channel 5

3.1 In this section, we:

- summarise the consequences of developments in UK content delivery over the past decade;
- examine the specific role played by the commercial PSBs in meeting viewer needs; and
- look at the current contributions by the Channel 3 and Channel 5 licence holders to fulfilment of public service purposes.

The key points covered in this section are:

Over the past decade, and despite changes in technology and evolving patterns of consumer consumption, the commercial PSBs have continued to play a key role in providing opportunities for the UK content production industry and delivering public service programming.

Specifically, the commercial PSBs have fulfilled public service purposes through a defined set of licence obligations designed both to ensure plurality in a few core programming genres and to stimulate a wide variety of content production for UK audiences.

To meet these obligations, and in return for the benefits they receive, the Channel 3 licensees:

- *collectively spent £760m in 2010 on original content across a wide range of genres, second only in terms of investment to the BBC, of which approximately 40% is sourced from independent producers;*
- *provide competition for the BBC in the provision of universally accessible UK television news (with 18.8m viewers each week watching Channel 3's UK bulletins, compared to 33.5m on the BBC); and*
- *deliver plurality in news coverage for the Nations and regions of the UK, rated by nearly four-fifths of viewers (79%) as an important aspect of public service provision.*

In comparison, and as a reflection of the limited range of PSB benefits it receives, delivery by Channel 5 is more modest. Our analysis suggests that in 2010, when the company changed hands:

- *Channel 5 spent £62m on original first-run content, accounting for 38% of its total programme spend. This is approximately one fifth of the programme budget of either BBC Two or Channel 4 in the same year. It is also around 15% of the £432m spent by all UK cable and satellite broadcasters, including BSkyB, the previous year, although Channel 5's owners new owners argue that programme investment has grown since;*
- *Nearly three fifths (59%) of the original content shown by Channel 5 in 2010 consisted of repeats. This compares to a quarter of Channel 3's and just over half (51%) of Channel 4's commissioned output;*

- *Channel 5's news programming received a higher proportion of viewers from DE socio-economic groups than news on the other main PSB networks. Although the impact of its programming among this group may be limited by audience size, its main bulletin's viewing figures – a nightly average of 700,000 viewers in 2010 – are broadly in line with those obtained by Channel 4 News (c.800,000); and*
- *The levels of satisfaction reported by Channel 5 news viewers were lower than for other PSB services – 46% of its viewers considered Channel 5 news programming to be trustworthy, compared to 68% for PSB services overall.*

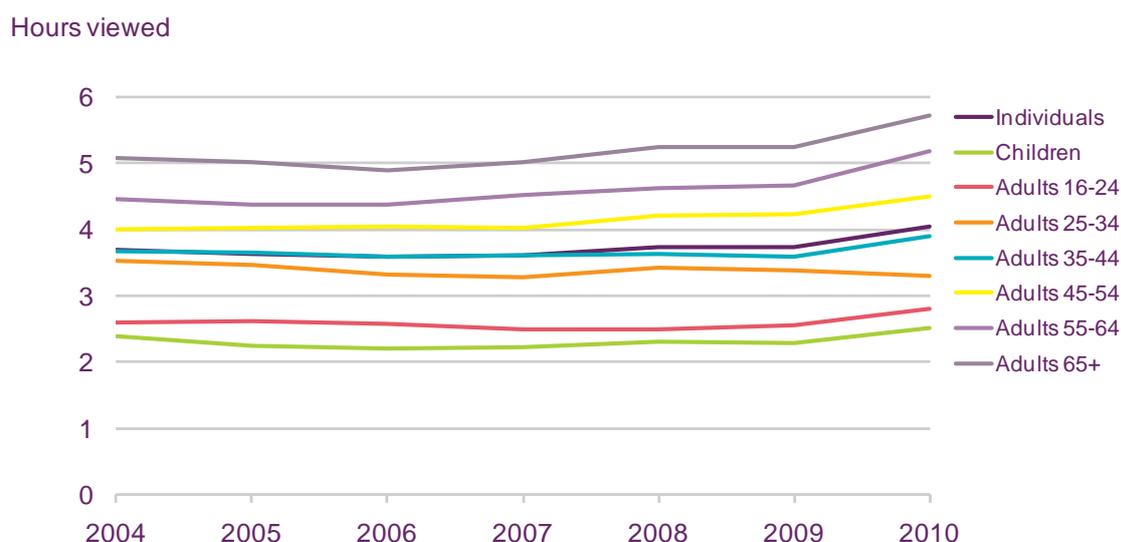
The context for our assessment of commercial PSB delivery

- 3.2 The Communications Act 2003, which set out the regulatory framework in which the commercial PSBs operate, was designed within a predominantly analogue environment, before the impact of technological change on the media landscape had become clear. Since the Act came into force, we have seen among other things:
- the proliferation of high capability digital networks leading to a step-change in consumer demand for flexible forms of content delivery;
 - huge innovation in software and hardware enabling over-the-top providers of audiovisual content to bypass traditional linear broadcast services and reach viewers watching on connected TVs, smart phones and tablets; and
 - the growth of mass social media platforms with an ability to enrich, distract from or promote long-standing means of content consumption.
- 3.3 As we approach a new Communications Bill, the structure of our current public service broadcasting system, designed in an analogue world of spectrum scarcity, requires careful consideration.
- 3.4 We start from a position of strength. The UK has a successful content sector, delivering a mixed ecology of public service and commercial output. We have a proportionate regulatory regime which continues to provide important interventions to secure desirable public service content and there are increasing global opportunities for UK companies to exploit UK content, building on the strength of UK brands and a healthy and thriving production sector.
- 3.5 Encouraging investment in the UK's creative sectors to support growth and innovation must be a primary economic aim, making maximum use of the UK's creative strength.
- 3.6 There remain a number of uncertainties about how technology, consumer consumption and business models will evolve over the next decade, including:
- the potential of universal take-up of broadband and rollout of next generation broadband (fixed and mobile), will continue to facilitate new models of content delivery over IP networks;
 - economic uncertainty and new models of targeted advertising have the potential to threaten the long-term stability of businesses which are predominantly reliant on display advertising;

- a variable pace of digital adoption by consumers. Although it is likely that linear TV will remain very popular for many years to come, the speed of growth of on demand, catch-up and other models of content consumption remain a risk to linear, advertising-based business models; and
- the continuing threat from piracy to content businesses.

3.7 Set against this uncertainty, linear TV viewing is remarkably resilient and continues to be an incredibly popular medium. As Figure 1 below shows, the average hours of television viewing per day is continuing to increase year on year.

Figure 1: Average hours of television viewing per day, by age, all homes



Source: BARB. Note: due to a new BARB measurement panel from 2010 onwards, 2010 data are not directly comparable with previous years.

3.8 It is possible that social media will actually reinforce, not dissipate, live viewing as people increasingly use social media to interact around live TV events and as broadcasters offer more and more services on smart phones and tablets to complement the live viewing experience. Research conducted by ICM in January 2012 suggests that 26% of internet users have commented on a programme they were currently watching via a social media platform such as Twitter or Facebook, rising to 46% of those aged 18-25.⁸

3.9 Further, a rising number of consumers are acquiring internet enabled TV sets. Whereas 9% of television sets sold in 2010 were capable of being connected to a broadband connection, by 2011, the figure had risen to 16%.⁹ Already we are seeing that home broadband is being increasingly used for TV catch-up services, with the 23% of UK households using services such as the BBC iPlayer in the first quarter of 2009 rising to 35% during the same period in 2011. This includes particularly significant increases in older age groups (an increase from 14% to 29% among those aged 55-64 and from 10% to 24% among those aged over 65) which have

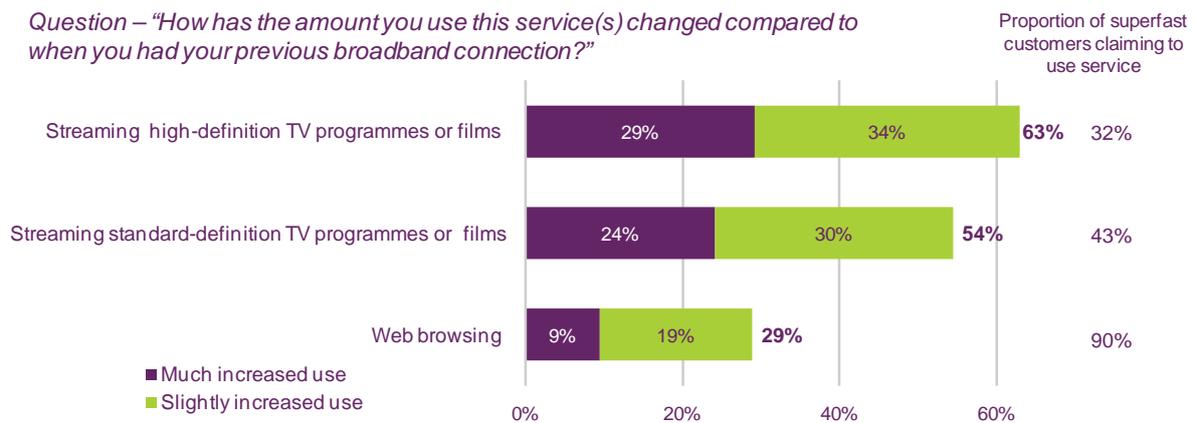
⁸ TV Licensing/ICM research – survey of 2,611 adults conducted online in January 2012. See: http://www.tvlicensing.co.uk/resources/library/BBC/MEDIA_CENTRE/TV_Licensing_Telescope_Report_2012.pdf

⁹ Source: TV Licensing/GFK sales data. We note the fact that these sets are capable of being connected to a broadband connection does not mean that they have been.

traditionally been later-adopters of internet services but higher consumers of TV services.

- 3.10 In addition, although fewer than 4% of households had access to super-fast broadband¹⁰ by June 2011, 82% of users surveyed by Ofcom in April 2011 described the experience of streaming TV programmes or films to be either slightly better or much better than before, leading to an increase in the amount of content that they consumed. This trend is particularly marked when set against changes in behaviour around web browsing, by far the most common use of an internet connection (see Figure 2).

Figure 2: Changes in behaviour relating to streaming of television programming by super-fast broadband users - compared with web browsing



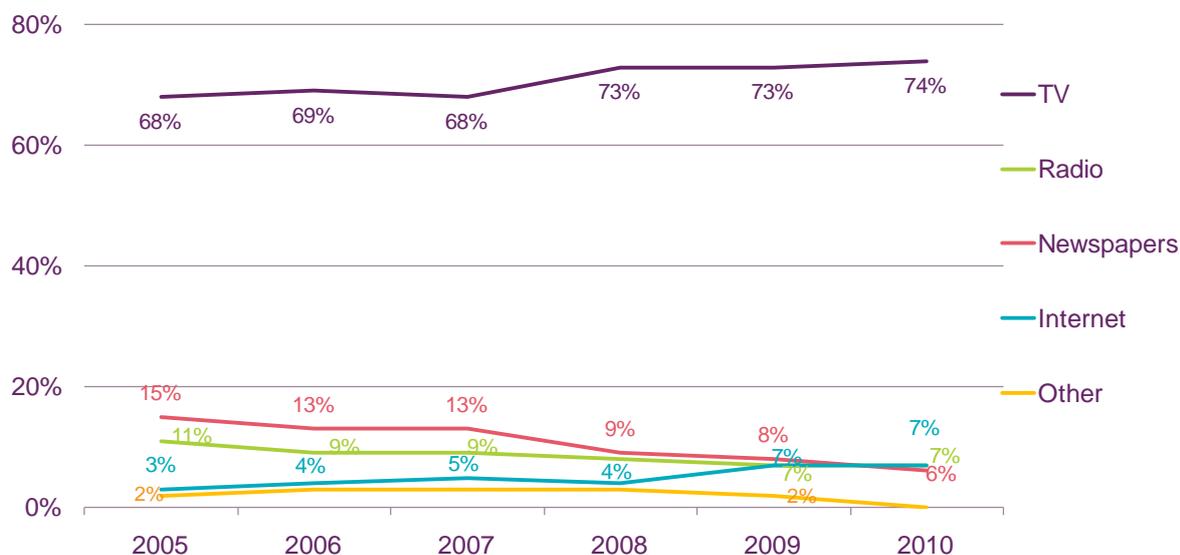
Source: Ofcom research, fieldwork carried out by YouGov in April 2011

- 3.11 These trends provide opportunities as well as threats to both commercial and public service broadcasters. Despite increasing competition for audience attention, television remains the key medium through which people find out about the world. Our research shows that television is the most significant source of UK news for nearly three-quarters of those surveyed (see Figure 3).

¹⁰ Defined as a connection with speeds above 24 Mbit/s.

Figure 3: Average hours of television viewing per day, by age, all homes

Q - Can you tell me what, if anything, is your main source of news about what is going on in the UK



Source: Ofcom Media tracker. Base: All respondents.

3.12 The UK's audiovisual creative sector has traditionally been underpinned by the UK's public service broadcasters. Increasingly, as digital distribution has facilitated greater access to limited spectrum assets, provision by public service broadcasters has been complemented by an increasing number of commercial providers, leading to a successful mixed ecology of public and commercial services. Today we have:

- The BBC, entirely publicly funded and set a series of defined tasks to carry out in return for the public money it receives.
- Channel 4 Corporation, in public ownership with a defined set of statutory tasks which it meets without direct public funding.
- The commercial public service broadcasters, Channel 3 and Channel 5, which are required to provide more limited public service obligations in return for certain indirect benefits (predominantly prominence on electronic programme guides and access to DTT spectrum).
- A large number of purely commercial providers, some of whom provide content of a kind likely to meet public purposes but who are not obliged to do so.

3.13 The PSB services remain the most watched channels in the UK with over 50% of viewing to PSB channels in multichannel homes (see Figure 4).

Figure 4: PSB and portfolio channel shares in multichannel homes

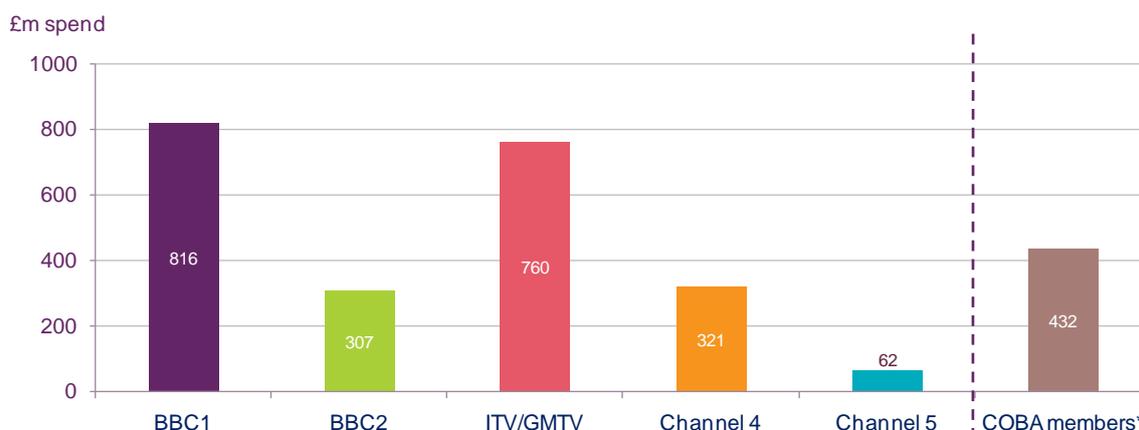
Source: BARB. Note: due to a new BARB measurement panel from 2010 onwards, 2010 data are not directly comparable with previous years.

- 3.14 Although market provision of public service content is increasing, it remains the case today that the PSBs account for around 90% of funding of production by UK producers and all broadcast news for the Nations and regions.
- 3.15 However, it is important to recognise that commercial operators may be increasing their contribution to public purposes:
- A report issued by the Commercial Broadcasters' Association ('COBA') in 2011 highlighted a 7% year-on-year increase in content investment by its members, with £432m spent on "UK commissions";¹¹
 - BSkyB, meanwhile, has announced its intention to increase its "UK commissioning and production" budget to £600m by 2014.¹²
- 3.16 Figure 5 below sets out the relative levels of investment by UK broadcasters in original programming.

¹¹ COBA represents commercial broadcasters which are not public service licence holders. Its members include Discovery, Sky, Viacom, UKTV and Disney. The expenditure data cited above was provided by COBA members for a Deloitte report and may not be strictly comparable to Ofcom's PSB originations data.

¹² 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 Ofcom's PSB originations data.

Figure 5: Spend on first run originations by PSB channels and “UK Commissions” by COBA members – 2010 figures*



Source: Ofcom/PSBs/COBA/Deloitte.

*COBA expenditure figures are based on 2009 figures and may not be strictly comparable to PSB originations data

The existing framework for PSB delivery on Channel 3 & Channel 5

- 3.17 As we noted in our interim paper to the Secretary of State, the traditional contribution made by the commercial PSBs to the delivery of public service purposes has been through a set of specific licence obligations. These obligations have been designed to ensure that television programmes on the main networks display a range of characteristics including high quality, originality and innovation.
- 3.18 With the decline in analogue revenues over the past decade, and in recognition of the inevitable tension between the networks' willingness to invest in public service programming and the requirement for commercial organisations to maintain sustainable businesses, Ofcom has sought to identify and prioritise those aspects of public service content particularly valued by audiences.
- 3.19 Ofcom last examined the sustainability of commercial public service broadcasting during our second PSB review, completed in 2009.¹³ At that time, 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.
- 3.20 As part of that review, therefore, following extensive consultation and research, 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 after 2014.
- 3.21 In addition, we decided to limit the level of regulatory intervention for Channel 3 and Channel 5 to:

¹³ See Ofcom's Second Review of Public Service Broadcasting at: http://stakeholders.ofcom.org.uk/consultations/psb2_phase2/statement/

- a core focused on a few specific genres, namely news (at a UK, Nations and regions level) and current affairs, where plurality is particularly valued as critical to a well-functioning democracy;
- explicit legislative requirements designed to stimulate production across the country (out of London obligations) and to ensure the continuation of a vibrant independent production sector (commissioning quotas and code of practice requirements); and
- structural obligations, including the specific obligations on the Channel 3 regional licence holders to sustain networking arrangements,¹⁴ as well as the terms included in all PSB licences which are designed to secure the widest possible level of coverage for the UK's main public service channels (see Figure 6).

Figure 6: 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.

The current scope of PSB delivery by Channel 3

3.22 Channel 3 has the second largest audience share of any channel in the UK with 17% of viewing in 2010. Only BBC1 was higher (21%) while Channel 4 was considerably lower with 6% and Channel 5 at 5%.

3.23 In terms of reach, ITV is again second only to BBC1. In 2010, 68% of the UK population watched ITV1 for at least 15 consecutive minutes in a week, compared to 79% for BBC1, 54% for Channel 4 and 40% for Channel 5.¹⁵

¹⁴ The networking arrangements are discussed in more detail in section 5 below.

¹⁵ Average weekly reach is defined as the proportion of the population that watched at least 15 consecutive minutes of a channel in an average week.

News and current affairs

- 3.24 The News obligations on the Channel 3 licensees have remained at the same levels since 2003. Each regional licensee must deliver 365 hours of national and international news per year, of which 125 must be in peak-time.
- 3.25 In 2010 Channel 3 exceeded both quotas, delivering a total of 394 hours of news and 247 hours of peak-time news. Since the Channel 3 network reintroduced the *News at Ten* in 2008 peak-time news delivery has broadly doubled, albeit without the provision of additional news content overall,¹⁶ with the result that news and weather content accounted for nearly 18% of the channel’s peak time output:

Figure 7: Channel 3 performance against national and international news quotas, peak-time



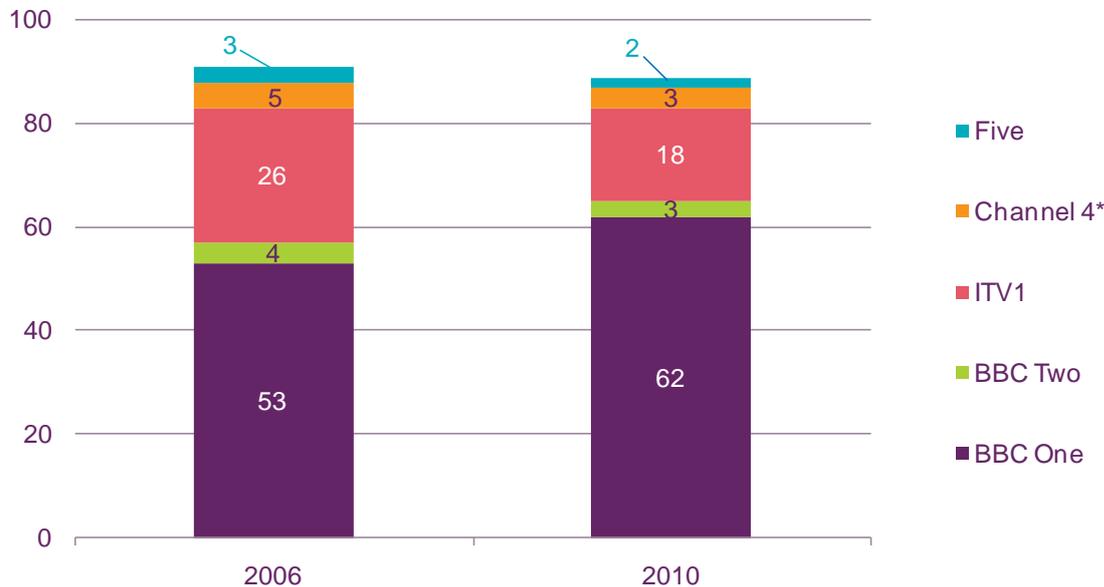
Source: Ofcom/Channel 3. *Note that Channel 3 reintroduced the *News at Ten* in January 2008, replacing its late evening bulletin which had been shown out of peak viewing time. Figures from 2008 onwards reflect this change, which was achieved without the provision of additional overall news content.

- 3.26 Channel 3 news is the second most watched national news service, playing an important role in securing plurality as the main competitor to the services offered by the BBC. Channel 3 receives an average audience of 3.4m for its *Early Evening News*, and 2.4m for its *News at Ten*. Despite the difference in audience size, in an average week both programmes reach about the same number of people (15.4% and 15.8% respectively). This is almost twice the reach of the next largest PSB news service *Channel 4 News* (8%) although significantly lower than the BBC, which reaches 20.7% with its *6 O’Clock News* and 26.7% of people with the *10 O’Clock News*.
- 3.27 Further, as Figure 8 shows below, the amount of news programming which UK viewers as a whole watch on Channel 3 during the course of a year has declined,

¹⁶ Between February 2004 and December 2007 the main evening Channel 3 news bulletin was shown between 2230 and 2300 every weeknight. In January 2008, the *News at Ten* was reintroduced between Monday and Thursday with a later bulletin on Friday evenings. Since February 2009, *News at Ten* has been shown on every weekday.

from 26 hours in 2006 to 18 hours in 2010, while the amount of time UK viewers spent watching BBC news content has increased by a broadly similar amount:¹⁷

Figure 8: Total hours of UK/ international news watched by average viewer per year across PSB services



Source: BARB.

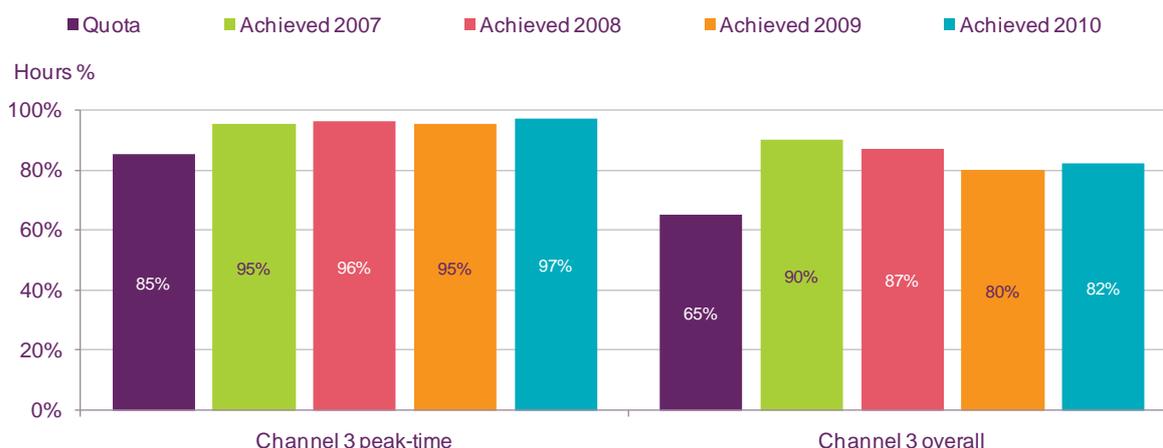
* C4 2006 data includes S4C viewing. Following DSO in Wales, S4C became a standalone channel and so is excluded from C4's 2010 data

- 3.28 Ofcom's research suggests that 70% of Channel 3 news viewers consider that its news programmes are 'trustworthy', in line with viewer perceptions of the PSBs as a whole, although the number who consider that its programmes "*help me understand what is going on in the world*" declined by 6% to 63% between 2009 and 2010.
- 3.29 In relation to current affairs, the Channel 3 licensees must show 43 hours of current affairs per calendar year, of which at least 35 hours must be shown in peak-time. In 2010, Channel 3 over-delivered significantly on this requirement – broadcasting 66 hours of current affairs programming including its *Tonight* and *Exposure* strands, although this represented a significant decrease from the 86 hours broadcast on average in each of the previous five years.

Original programming

- 3.30 The quota for original programming is one of the most significant requirements on the Channel 3 licensees and is at the core of their PSB obligations: 65% of Channel 3's overall schedule must meet the criteria for original programming, with a higher 85% requirement for programming in peak. Programmes of all genres contribute to the originations quota, including sport and factual programming alongside drama and arts programming.
- 3.31 As shown in Figure 9 below, the Channel 3 licensees have consistently exceeded their obligations, with original programming accounting for 97% of content in peak time and 82% of the network's overall schedule.

¹⁷ The evidence suggests that the decline in news viewing on Channel 3 is predominantly focussed on daytime news programming, rather than the main evening bulletins.

Figure 9: Channel 3 compliance with original production quotas

Source: Ofcom/broadcasters. Includes repeats.

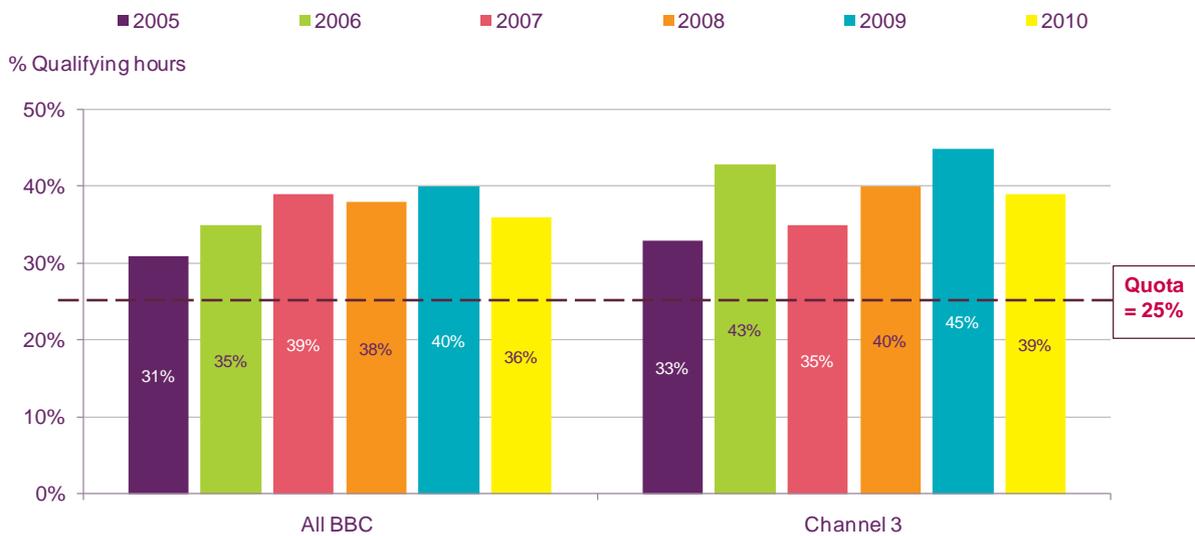
- 3.32 The definition of original programming does not exclude repeat showings of commissioned programmes.¹⁸ Channel 3 shows far more first run programming than either Channel 4 or Channel 5, with repeats accounting for 25% of programming contributing towards the quota, compared to more than 50% on both Channel 4 and Channel 5.
- 3.33 These differences can be explained to a large extent by the scale of the investment made by the regional Channel 3 licensees in original programming. Although their investment in network content has fallen from its peak of £906m in 2003, when fewer than 50% of UK households had access to multi-channel television, the network still invested over £760m in original programming in 2010 – the largest commissioner of content for UK audiences after the BBC. Of this, first-run content accounted for 88% of its total spend on output.
- 3.34 However, the breadth of Channel 3 programming has shifted in recent years as the network has looked to increase the proportion of its schedule based on factual output, particularly during daytime. Between 2006 and 2010, factual programming – which predominantly consists of talk based formats such as *The Jeremy Kyle Show*, *Loose Women* and *The Alan Titchmarsh Show* – grew by 53% from 1,729 hours in 2006 to 2,653 hours in 2010.
- 3.35 Conversely, despite maintaining investment in event programming like *Downton Abbey* with significant resale value, the amount of drama (including soap operas) aired by the network declined from 649 hours in 2006 to 464 hours in 2010 [8].
- 3.36 This shift has, however, broadly been positively received by viewers. The proportion of viewers surveyed by Ofcom who considered that Channel 3 showed “well made, high quality programmes” increased by 4% to 67% between 2007 and 2010.

¹⁸ Original productions are defined in the Broadcasting (Original Productions) Order 2004 as programmes which “are commissioned by or for a licensed public service channel with a view to their first showing on television in the United Kingdom on that channel, or in the case of a Channel 3 service, on that service or on another Channel 3 service.”

Qualifying Independent Productions

- 3.37 All of the commercial PSB licences contain an obligation to ensure that not less than 25% of the total amount of qualifying original programming is allocated to broadcasting a range and diversity of independent productions.
- 3.38 Traditionally the Channel 3 licensees contributed a large proportion of the network schedule (initially through the large production businesses run by Granada, Yorkshire and Carlton and more recently via ITV plc). In the past few years, however, with the continuing success of programming such as *Britain's Got Talent* and *The X Factor*, the proportion of qualifying programming commissioned by the network from the independent sector has increased to around 40%, broadly in line with external commissioning by the BBC (see Figure 10).

Figure 10: Qualifying hours commissioned from independent producers by BBC and Channel 3 licensees

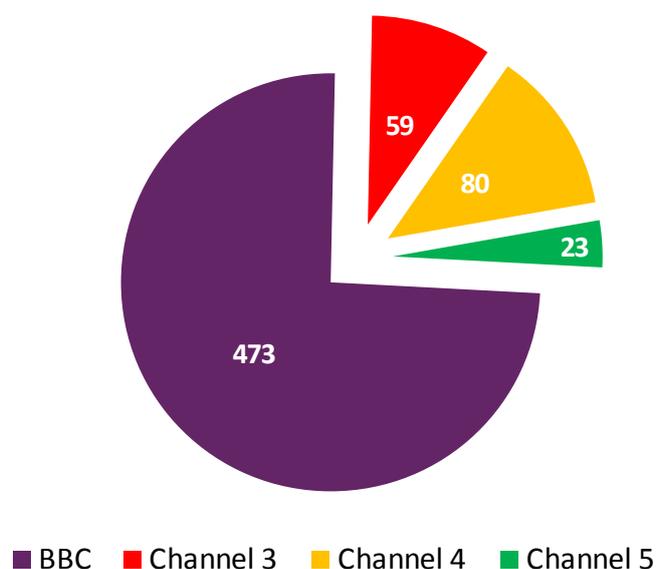


Out of London productions

- 3.39 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.
- 3.40 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.
- 3.41 However, it subsequently became clear that meeting the revised quota had imposed a significant cost on the Channel 3 network. We also 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, in part, it had been intended to achieve. Accordingly, in 2009 Ofcom cut the quota to 35% by spend and volume.

- 3.42 The percentage of qualifying Channel 3 programmes made outside London consequently fell from 50% to 39% by value and 50% to 44% by volume between 2008 and 2010. Despite this, the percentage of viewers surveyed by Ofcom who considered that the channel’s entertainment and factual programming featured “people from different parts of the UK” increased by 5% between 2007 and 2010 to 57%.
- 3.43 In 2010, only 59 different Channel 3 programmes (or 13% of the total across the five main PSBs) were produced outside of London, compared to 473 separate titles shown by the BBC (see Figure 11).

Figure 11: Out of London production: broadcaster contributions by title (2010)



Source: Ofcom/broadcasters

- 3.44 Channel 3’s *Nightscreen*, an animated sequence containing programming information aired during late night slots, alone accounted for approximately 40% of the Channel 3 out of London programming by volume in 2010. It is also the case that a lot of the high value content used by Channel 3 to meet its obligations is limited to a small number of long running series including *Coronation Street*, *Emmerdale* and *Midsomer Murders*.

Regional programming

- 3.45 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.
- 3.46 As with UK 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 significance 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 as a whole the PSBs deliver news programming for the Nations and English regions effectively.

3.47 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. Whereas consistently around 60% of viewers in England consider that their regional Channel 3 service “provides a wide range of good quality news about my area,” satisfaction with Nations 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.

3.48 Further, 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 focused news programming consistently exceeds the UK average of 28 hours per annum. As shown in Figure 12 below, viewing of Channel 3 regional content in Scotland and Northern Ireland – where the Channel 3 licences are held by ‘single Nation’ broadcasters – is consistently higher than in most English regions or the UK as a whole.

Figure 12: Early evening regional news bulletin – shares of viewing in all homes (2010)



Source: BARB. Based on regional news programme start time 1755-1835, 10mins + duration, Channel 3 weekdays

3.49 Although viewing in the Nations has held up over time, the evidence in England suggests there is no clear upward or downward trend in viewing, with relative changes in audience seemingly based on regional factors (see Figure 13).

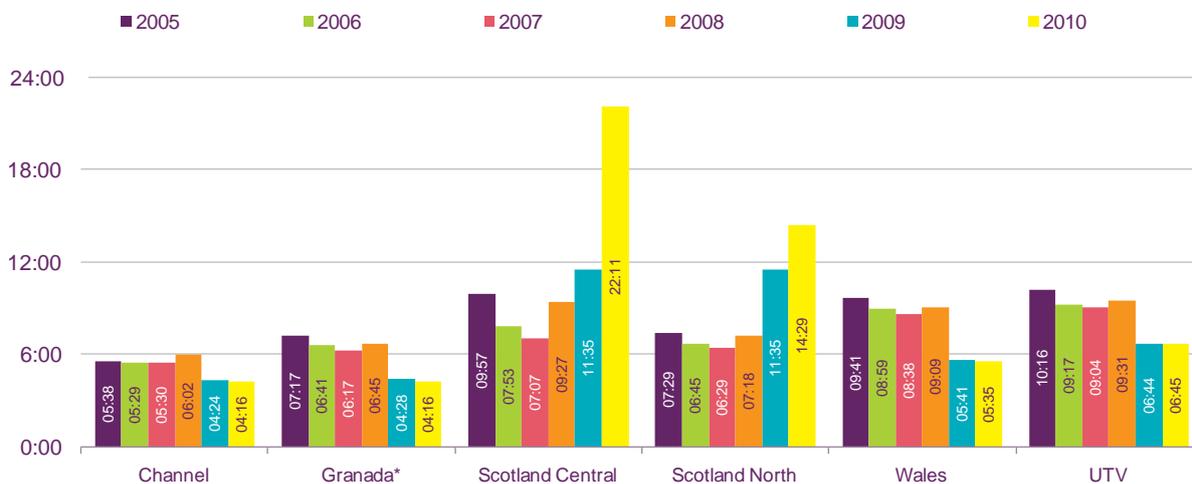
Figure 13: Channel 3 regional news viewing share (2006 and 2010)



Source: BARB. Note as part of a change in the BARB panel, there was a re-defining of geographic boundaries which may contribute to any viewing data changes 2006 v 2010. Data should be viewed with caution

3.50 It is worth noting, however, that the amount of specific content received by viewers varies significantly depending on their location and the individual strategies adopted by the regional licensees as shown in Figure 14, below.

Figure 14: Average hours of regional programming per week



Source: Ofcom/broadcasters *Granada figures are used as a proxy for the Channel 3 English regions

3.51 STV in particular, has sought to transmit higher amounts of programming than it is required to do under the terms of its licence. In contrast, particularly in English regions, ITV plc has shown a much lower level of regional content. In England, ITV plc produced an average of 4 hours 16 minutes regional output each week, including approximately 40 minutes of weather.

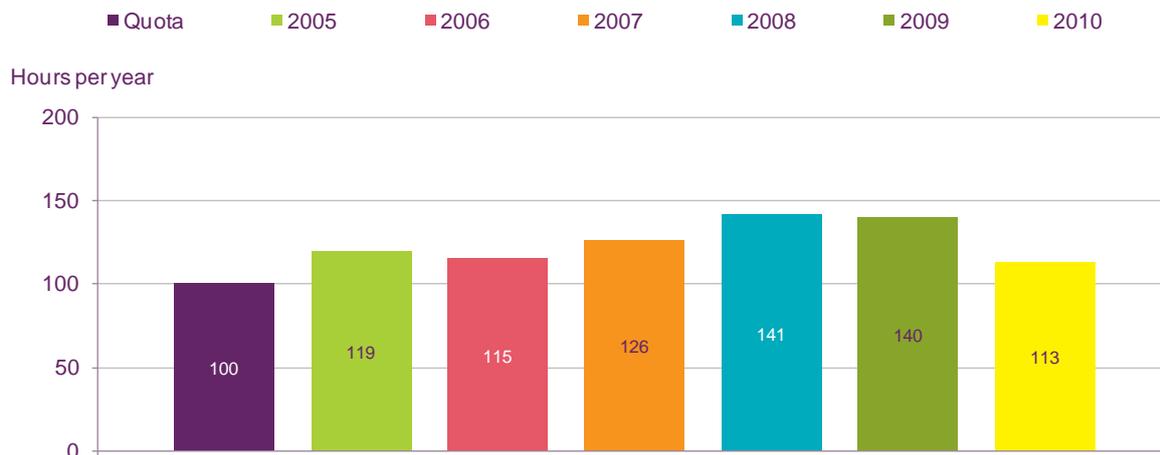
The current scope of PSB delivery by Channel 5

3.52 Channel 5, like the Channel 3 services, has a public service remit to provide “a range of high quality and diverse programming”. Spectrum limitations at the time of its launch in 1997 meant that it was only available to 70% of UK households, although this differential has largely disappeared through digital switchover. However, Channel 5 still receives fewer benefits than the Channel 3 and Channel 4 licensees, such as their licence to operate Multiplex 2, and Channel 5 has operated with a more limited set of programme obligations to reflect this.

News and current affairs

3.53 Channel 5 is required, following amendments to its licence obligations in 2010, to broadcast a total of 260 hours of news in each calendar year, of which 100 hours must be in peak time. In 2010, Channel 5 delivered 331 hours of news across the schedule, and also exceeded the peak time requirement by 13%:

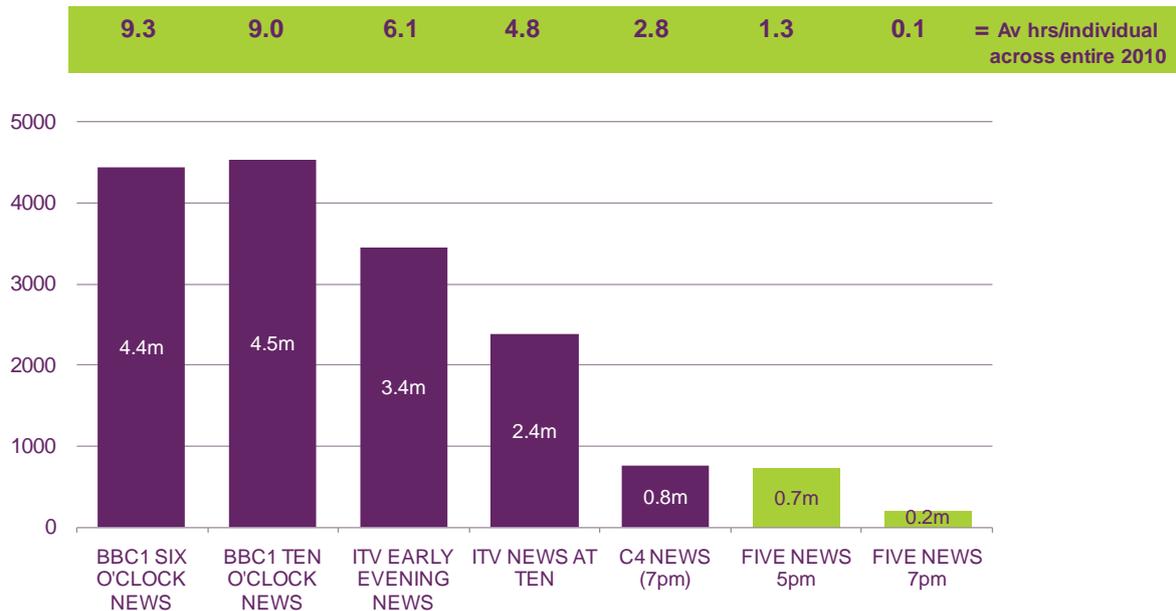
Figure 15: Channel 5 performance against national and international news quotas, peak-time



Source: Ofcom/Channel 5

3.54 In 2010 Channel 5’s peak time news programme had the lowest audiences of any of the PSBs main evening news bulletin. As the chart below shows, this may in part be the consequence of its earlier and more popular 5pm bulletin which draws an audience that is broadly comparable with those achieved by Channel 4’s 7pm news programme (see Figure 16).

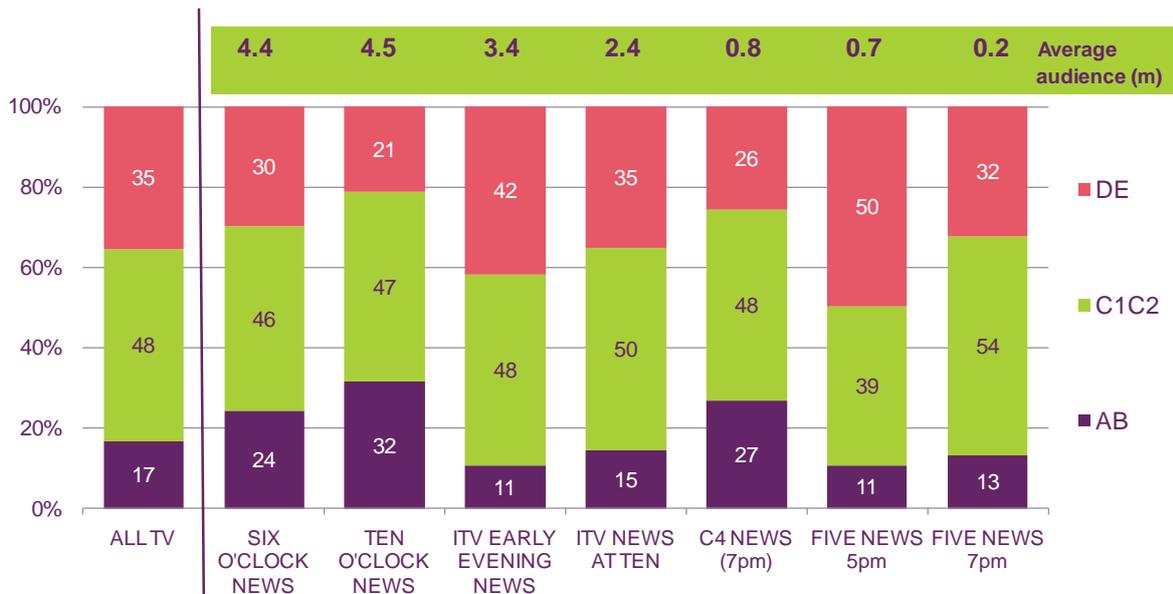
Figure 16: Average audiences for peak-time news bulletins on main PSB channels, 2010



Source: BARB, all individuals (4+), all homes, 2010. Based on network news, Mon-Fri broadcasts of a minimum 15 minutes duration only.

3.55 The socio-economic profile of Channel 5's viewers shows that half of the viewers it gets for its main 5pm bulletin are from DE socio-economic groups, compared with 35% of TV viewers as a whole. However, the relatively small size of Channel 5's news audience when compared to that obtained by Channel 3 and BBC1 for its main bulletins means that, in absolute terms, its programmes serve a far smaller number of DE viewers (350,000 as opposed to 1.4m on Channel 3 and 1.3m on BBC1).

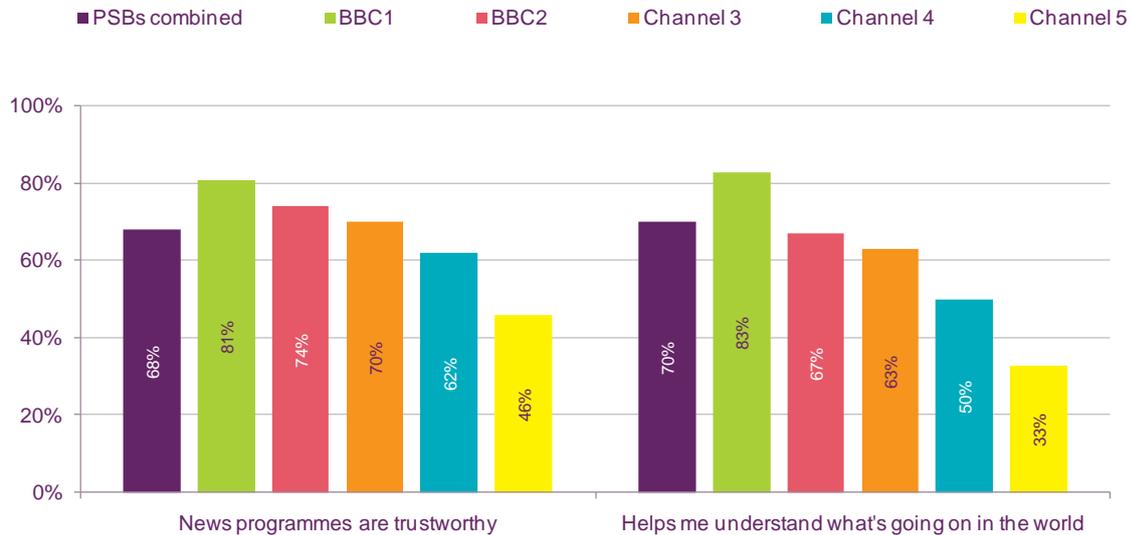
Figure 17: Socio-economic profiles for television news viewers on PSB channels, 2010



Source: BARB, all individuals (4+), all homes, 2010. Based on network news, Mon-Fri broadcasts of a minimum 15 minutes duration only.

- 3.56 Satisfaction with Channel 5 news content is lower than for other PSB news services. In 2010, 46% of its viewers considered its news programmes to be trustworthy, compared to 68% for PSB services overall – although Channel 5’s figure had increased by 5% over the previous year. In contrast, 33% of its viewers said that Channel 5 “helps me understand what’s going on in the world” – an 11% decline since 2007.

Figure 18: Self reported satisfaction with news programmes (2010)



Source: Ofcom

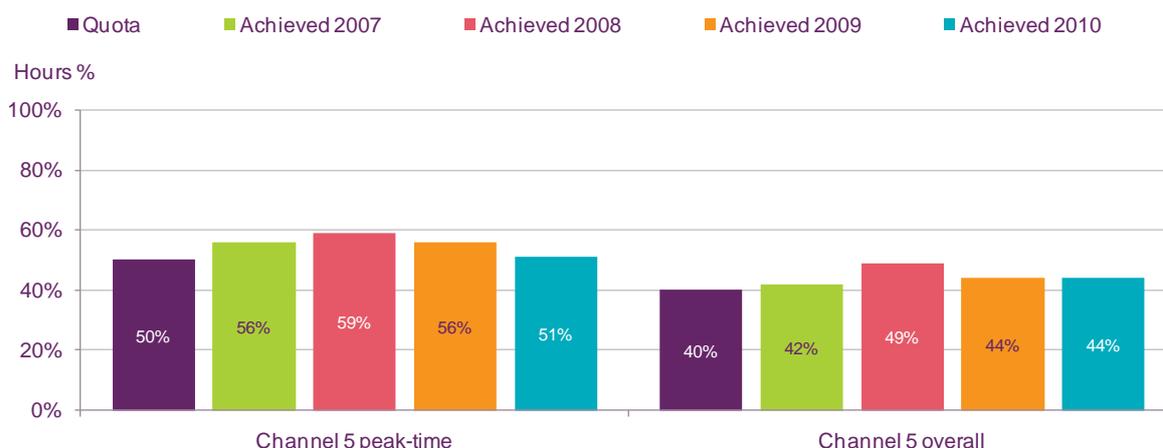
Base = self-reported regular viewers – BBC1 (4998), BBC2 (2586), Channel 3 (3518), Channel 4 (2305), Channel 5 (1331). Amalgamated data (Jan, Apr, July, Oct, 2010)

- 3.57 In relation to current affairs, Channel 5 must show 130 hours of current affairs per calendar year, of which 10 hours must be in peak time. In practice, Channel 5 significantly overdelivers on its overall current affairs obligations, showing 374 hours of programming, primarily as a result of its morning phone-in show, *The Wright Stuff*.

Original programming

- 3.58 From 2003, Channel 5 was required to ensure that at least 50% of its programming content qualified as original programming, and to increase this to 60% by 2009. In our first PSB review in 2005 we concluded that this obligation would be unsustainable given the limited benefits of PSB status which the channel received, and set the quota at 55%. In 2009, the quota was reduced to 50%, in line with the minimum EU wide requirements for European content. Channel 5’s peak-time obligations were reduced at the same time to 40% from the 42% set in 2003. Channel 5 has consistently met these obligations (see Figure 19).

Figure 19: Channel 5 performance against original production quotas

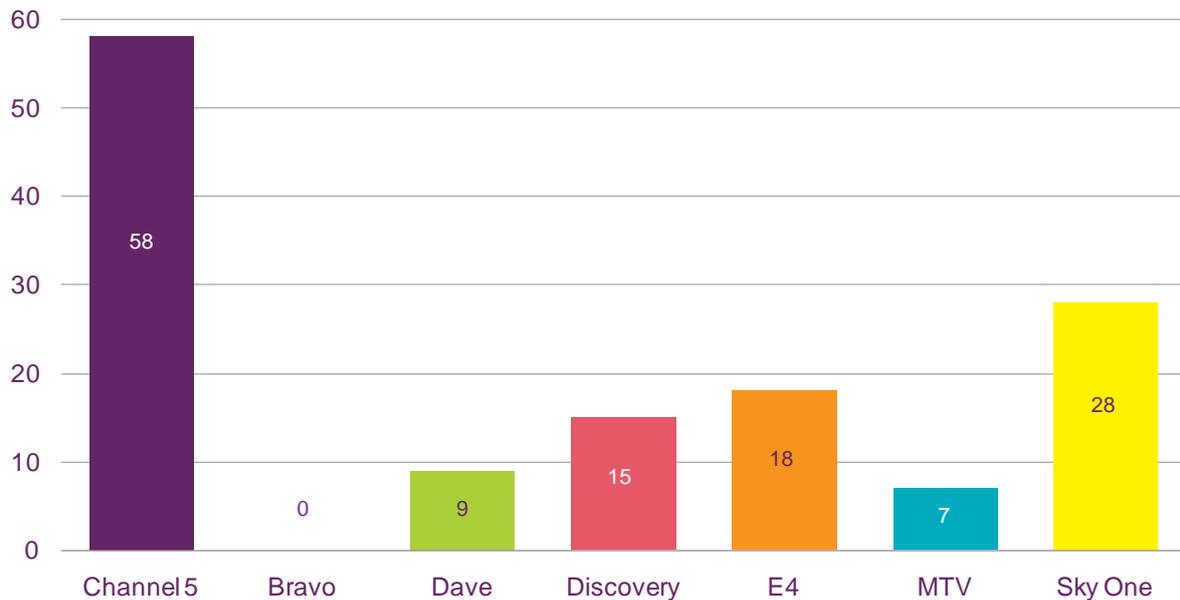


Source: Ofcom/Channel 5. Includes repeats.

- 3.59 Channel 5’s investment in original programming is significantly lower than that of the other commercial PSBs. Between 2006 and 2010, its spend on first-run originations fell by 49% to £62m, compared to £321m at Channel 4 (a 25% reduction since 2006) and £760m for Channel 3 (down 12% over the same period).
- 3.60 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 and set up a new in-house content operation. Channel 5’s own provisional figures for 2011 suggest that its spend on original programming increased by [X]% to £[X]m in the first full year under new ownership. Further, although the number of programmes it commissions is low compared to the other main PSB services, evidence suggests that both in terms of numbers of hours and range of programmes, Channel 5 commissions notably more than other UK ‘digital’ entertainment channels (see Figure 20).¹⁹

¹⁹ Based on an Ofcom analysis of programmes commissioned during 2011 recorded by *Broadcast Greenlight*.

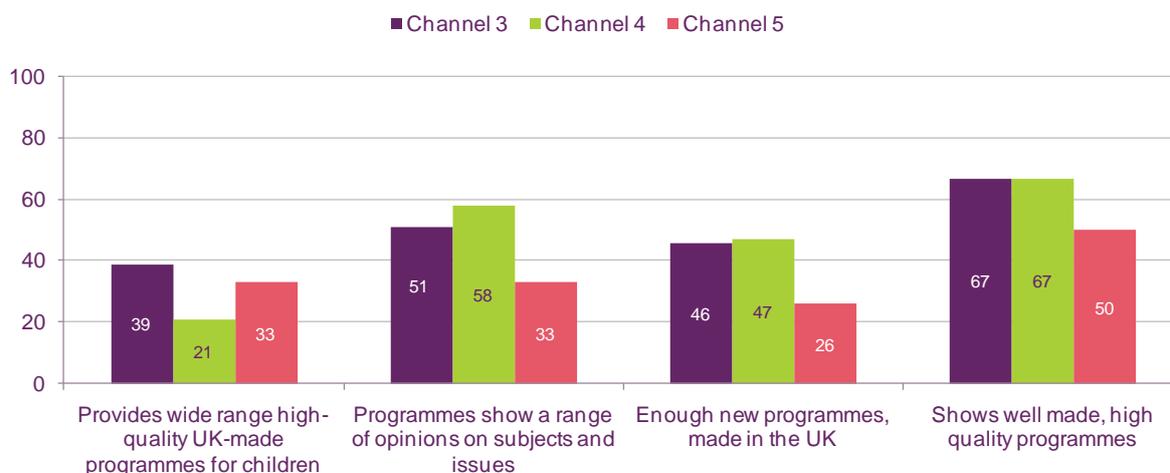
Figure 20: Number of programmes commissioned by title in 2011 by Channel 5 and a range of UK non-PSB channels*



Source: Ofcom estimate based on Broadcast Greenlight Commissioning Index (<http://greenlight.broadcastnow.co.uk>). Figures refer to number of programmes reported as 'greenlighted' during 2011 rather than shown.

- 3.61 The breadth of Channel 5's programming has, as with Channel 3, shifted in recent years. Most notably, factual programming such as *Soho Blues* and *Police Interceptors* has increased by 70% from 883 hours to 1,502 hours between 2006 and 2010 while other genres, such as comedy programming (in which output fell from 100 to 12 hours), have declined over the same period.
- 3.62 Unlike Channel 3, which has broadly withdrawn from significant levels of children's programming on its main service, Channel 5 showed an average of 29 hours of children's output each week in 2010, comprising 17.5% of the schedule. To a large extent this output consisted of pre-school and animated content (comprising 489 and 619 hours respectively out of a total of 1534 hours of children's programming).
- 3.63 Viewer responses to Channel 5's output, are less positive than for public service broadcasting as a whole. Half of Channel 5 viewers (50%) consider that it shows well made programming while just over a quarter (26%) believe that the service provides "enough new programmes made in the UK". This compares to higher scores among television viewers – of 64% and 45% respectively – when asked for their view of delivery by the PSBs collectively. Excluding the BBC, viewer satisfaction with Channel 5's delivery of PSB purposes and characteristics is, with the exception of children's programming, below that of the other advertising-funded PSB channels (see Figure 21 below).

Figure 21: Viewer opinions of the delivery by the commercial PSBs of specific PSB purposes and characteristics



Source: Ofcom Base = self-reported regular viewers of Channel 3 (3518), Channel 4 (2305) and Channel 5 (1331). Amalgamated data (Jan, Apr, July, Oct 2010).

3.64 Finally, as noted above, the statutory definition of original programming covers repeats. In 2010, 59% of Channel 5's original programming was made up of repeats, compared to 25% for ITV plc and 51% of Channel 4's content.²⁰ In particular, repeats accounted for 92% of the children's programming shown by Channel 5 in 2010, compared with 73% in 2005.

Qualifying Independent productions

3.65 The licence for Channel 5, like those for Channel 3, contain an obligation to ensure that not less than 25% of the total amount of qualifying original programming is allocated to broadcasting a range and diversity of independent productions.²¹

3.66 Because Channel 5 has to date been, like Channel 4, predominantly a publisher broadcaster with only a small in-house production unit, it has consistently and significantly exceeded its obligations. In 2010, the proportion of its qualifying content from independent producers was above 80%. Channel 5 has, however, announced its intention to increase its in-house production capacity over the coming year.

Out of London productions

3.67 'Out of London' programming must account for at least 10% of Channel 5's programme expenditure and 10% of its commissioned programming – a significantly

²⁰ In discussions with Channel 5 while preparing this report, the broadcaster has indicated that its initial figures for 2011 indicate that repeats as a proportion of original content have declined since 2010. Channel 5 also emphasised its view that its repeat strategy enabled it to secure maximum value from programming and to avoid spreading its budget too thinly to the overall detriment of its schedule.

²¹ See the *Broadcasting (Independent Productions) Order 1991* as amended in 1995 and 2003. The restriction of the obligation to 'qualifying' programming is an important one. Certain types of programming – such as news and repeats – are excluded from any calculation of qualifying content. Accordingly, a high number of repeats will reduce the hours of original programming required to satisfy the quota.

lower obligation than that faced by Channel 3 in recognition of the differences in the regulatory assets each receives.²²

- 3.68 As with the other production obligations, the scope of the quota is more narrowly drawn than total transmission time, limiting the amount of programming which PSBs need to show to meet their obligations. In 2010, for example, Channel 5 was able to meet its obligations on the basis of 128 hours of programming, representing 1.5% of its schedule.
- 3.69 However, as Channel 5 has noted, much of the programming which contributes to the quota includes its higher value shows such as *Fifth Gear* and *The Gadget Show*. Accordingly, although out of London programming accounted for 12% of Channel 5's qualifying programmes by volume in 2010, it represented 26% by value.

Summary

- 3.70 **The Commercial PSBs invest almost £1bn per annum in UK originated content across a range of genres, including core obligations to provide news programming, designed to fulfil both their commercial needs and the interests of viewers. On the basis of the evidence set out above, we consider the contribution made by Channel 3 and to a lesser extent Channel 5 towards public service purposes remains a sufficient contribution to the fulfilment of those public service purposes when set against the scale of regulatory intervention (and in particular the regulatory assets) which they receive.**
- 3.71 **Specifically, we note that the Channel 3 licensees:**
- **collectively spent £760m in 2010 on original content across a wide range of genres, second only in terms of investment to the BBC, of which approximately 40% is sourced from independent producers;**
 - **provide competition for the BBC in the provision of universally accessible UK television news (with 18.8m viewers each week watching Channel 3's UK bulletins, compared to 33.5m on the BBC); and**
 - **deliver plurality in news coverage for the Nations and regions of the UK, rated by nearly four-fifths of viewers (79%) as an important aspect of public service provision.**
- 3.72 **In comparison, and as a reflection of the limited range of PSB benefits it receives, delivery by Channel 5 is more modest. Our analysis suggests that in 2010, when the company changed hands:**
- **Channel 5 spent £62m on original first-run content, accounting for 38% of its total programme spend. This is approximately one-fifth of the programme budget of either BBC Two or Channel 4 in the same year, although the company's new owners argue that programme investment has since grown;**

²² See section 6 below.

- **Nearly three fifths (59%) of the original content shown by Channel 5 in 2010 consisted of repeats. This compares to a quarter of Channel 3's and just over half (51%) of Channel 4's commissioned output;**
- **Channel 5's news programming received a higher proportion of viewers from DE socio-economic groups than news on the other main PSB networks. Although the impact of its programming among this group may be limited by audience size, its main bulletin's viewing figures – a nightly average of 700,000 viewers in 2010 – are broadly in line with those obtained by Channel 4 News (c.800,000); and**
- **The levels of satisfaction reported by Channel 5 news viewers were substantially lower than for other PSB services – 46% of its viewers considered Channel 5 news programming to be trustworthy compared to 68% for PSB services overall.**

3.73 Each of the licensees have proposed amendments to their public service obligations which they consider will help to secure their commercial sustainability in the next licence period. We examine their proposed amendments, along with additional factors which we consider to be relevant in determining sustainable public service delivery going forward, in sections 4 and 5 of this report.

Section 4

Amendments to PSB obligations proposed by Channel 3 and Channel 5

4.1 In this section we set out the specific proposals made by the licensees and other stakeholders in relation to:

- News provision in the Nations and regions by the Channel 3 licensees;
- The range of PSB obligations imposed on Channel 5; and
- The definition of peak programming used by Ofcom.

The key points covered in this section are:

ITV plc has proposed a more localised regional news service in England. We will not undertake a full examination of these proposals until we are clear whether and if so how the Secretary of State intends to use his powers to intervene in the renewal process. It is our initial view, however, that the proposed changes may be valued by viewers.

The proposals by the Channel 3 licensees to maintain existing levels of content provision in the Nations will help secure plurality in coverage of devolved institutions and represent a key contribution to the fulfilment of public service purposes.

We consider the burden of the public service obligations imposed on Channel 5 is modest. We do not consider that its obligations could be lessened in any significant way without calling into question the channel's contribution to PSB purposes.

Simplification of regulation in relation to definitions of peak viewing times, to ensure consistency between programming and advertising, may also be appropriate.

4.2 In response to our open letter inviting views on licence renewal, we received a number of proposals from the licensees for amendments to their existing obligations. The proposals made by the licensees would, they argued, serve both to maintain sustainability and their contribution to public service purposes. A summary of those proposals and our initial views is set out below.

Proposals to amend the Channel 3 licensees' regional programming commitments

4.3 The Channel 3 licensees submitted a range of proposals in relation to regional news provision.

4.4 ITV plc noted that prior to the second PSB review it had offered 17 separate main regional news programmes across the 11 regional licences it then held, with additional short sub-regional variations in the Border and Westcountry regions. Following changes made by Ofcom in 2009 in recognition of the decreasing value of those licences, ITV plc had since that time offered nine programmes covering these regions, with short 'sub-regional' sequences within a number of these services.

- 4.5 ITV plc proposed a range of changes to the structure of its regional news programming which it sought to implement ahead of the next licence period. It stated that the regional programmes merged in 2009 would again become separate services. In total, ITV plc believed that 17 services in its licence areas would be sustainable. In order to fund these changes, it proposed:
- replacing the current 30 minute early evening bulletin in the English and Border regions with 20 minute regional or sub-regional news segments “*likely to be included within a longer programme that presents other news, current affairs and factual material [but] that would not be governed by... any other specific quota*”;²³ and
 - broadly halving the length of the existing lunchtime, late-evening and weekend regional bulletins.
- 4.6 ITV plc argued that its proposals would enable it to increase the local focus of programmes in the majority of licence areas with fewer features and more hard news. It considered that this would enable its services to “*complement the soon to be launched Local TV services on DTT...[which] are likely to be concentrated on serving large urban areas rather than being economically sustainable in areas of lower and/or more dispersed population*”.
- 4.7 ITV plc also submitted deliberative research conducted in six of the affected regions in support of its proposals. This research suggested that the viewers questioned believed that ITV plc’s proposals would offer a potentially improved programme and service.
- 4.8 ITV plc did not, however, propose to amend the structure of the existing 30-minute early evening programme in Wales or the Channel Islands. It also believed that its current obligation in Wales to provide an average of 90 minutes a week of non-news content would be sustainable.
- 4.9 Both STV and UTV stated that they believed their current regional news obligations would continue to be sustainable throughout the next licence period. In relation to non-news programming, UTV asked for “*Ofcom’s early consideration of bringing [its] licence into line with the other devolved nations*” by reducing its weekly obligations from two hours to 90 minutes.
- 4.10 Following discussions between Ofcom and the Channel 3 licensees, the licensees stated their intention to maintain four hours of regional news content in the licences covering Scotland, Wales and Northern Ireland. UTV also made clear its willingness to reconsider the extent of its current non-news programming content as part of a broader package around renewal.
- 4.11 Ofcom also received a range of submissions from other stakeholders in relation to regional content:

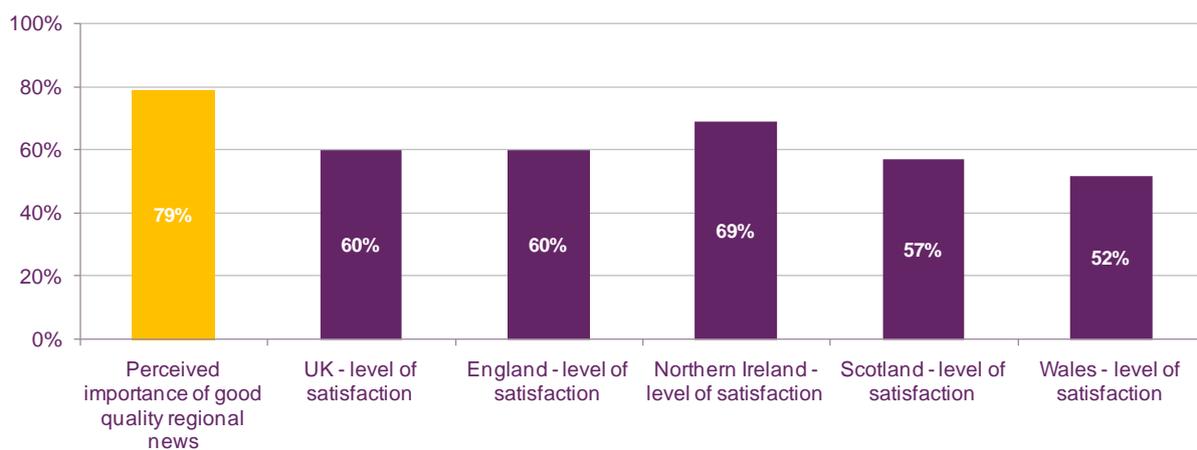
²³ For example, under ITV plc’s proposal, the current 30 minute Anglia early evening bulletin, which contains a six-minute segment shown only to viewers in the East and West of the region, would be replaced by separate twenty-minute slots for Anglia West and Anglia East programming “*predominantly about events and issues in that part of the region... [although] some big stories... that apply throughout the whole region would still be included*”.

- The BBC said that the regional news requirements for Channel 3 provided significant consumer and citizen value, providing an important source of competition to the BBC's own regional services.
- BECTU said it was explicitly opposed to any watering down of current PSB obligations. It argued that a collapse in Channel 3's regional capacity was a specific market failure that needed to be addressed within the licensing process.
- The Campaign for Press and Broadcasting Freedom said that it was deeply concerned that the increasing commercial focus of the Channel 3 licensees had impoverished its output, especially in the English regions. The CPBF argued that the current regulatory requirements represent a minimum acceptable level, noting that any reduction in the current requirements would serve to hasten the reduction in quality and diversity already taking place.

Ofcom's view

- 4.12 As Ofcom recognised during the second PSB review, the high fixed cost of regional news remains the biggest opportunity cost of PSB status for the Channel 3 licensees.
- 4.13 Nevertheless, regional programming is and remains a leading aspect of Channel 3's contribution to PSB purposes. Ofcom's own research has emphasised that viewers place a high priority on regional news which is relevant (i.e. sufficiently local) to them. Our findings indicate that nearly four out of five viewers (79%) rate the provision of "a wide range of quality news about my area" as important.
- 4.14 However, programming for the Nations and regions is also the area where our research indicates there is the biggest gap between perceived importance and actual delivery of public service purposes and characteristics. As Figure 22 below shows, only 60% of viewers in the UK as a whole believe that the regional news programmes provided on Channel 3 are of good quality.

Figure 22: viewer satisfaction with Nations and regional news versus perceived importance (2010)



Source: Ofcom

- 4.15 Further, as we noted in section 3 above, the strength of opinion on this matter has shifted across the UK in recent years. Between 2007 and 2010, opinions among regular viewers of Channel 3 on the delivery of news for the Nations and regions have become less positive in each devolved Nation, while remaining static in England. Satisfaction with Nations 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 the same period, when regional programming quotas were cut.

- 4.16 We are mindful also that proposals to amend regional news content can provoke significant concerns from viewers and other stakeholders. In particular, we note that the large majority of respondents to our consultation in 2008/9 on changes to programming in the Nations and regions expressed opposition to the amendments then brought forward.
- 4.17 Taking account of these concerns, we consider that:
- ITV plc's proposals for regional news in England and the Channel Islands have the potential to deliver more localised and news-driven content, potentially addressing viewer needs within the scope of existing costs; and
 - obligation levels for the devolved Nations (including the Scottish Border region) in particular, must take account of the specific need for plurality in news and current affairs content which enable viewers to engage fully in democratic processes. As a principle, we consider that equivalent obligations should apply in Scotland, Wales and Northern Ireland.
- 4.18 However, ahead of the Secretary of State's consideration of licence renewal, we do not consider it would be appropriate to make amendments to such obligations, either with or without public consultation. We propose to look again at licensees' regional obligations after the Secretary of State has decided whether or not to exercise his powers.

Requests for regulatory amendments by Channel 5

- 4.19 In its response to our open letter, Channel 5 argued that certain obligations represented a burden which should fall away if the established 'glide path' for public service delivery by the commercial networks is to continue in the next licence period.
- 4.20 In particular, Channel 5 suggested that obligations should be *"more commercially focused, with clear and robust obligations in respect of news, original content, and free and universal availability."* Channel 5 highlighted two duties which it believed had a negative impact on the sustainability of its service:
- Channel 5 maintained that the out of London production obligation was no longer necessary, because of the number of well established production hubs across the UK and the scale of investment made in recent years by publicly-owned PSBs. In particular, it suggested that the existing obligation for 10% of its qualifying programming by volume to come from outside London *"could have a detrimental, if not perverse, impact on our commissioning policy,"* in certain circumstances requiring the channel to invest in programmes that it might not want.
 - Channel 5 suggested that extensive consolidation among independent production companies had altered the economic balance between producers and broadcasters. It believed that the impact of this sector should be taken into account by Ofcom in setting the guidance to be applied to programme commissioning.
- 4.21 In preparing this report, we have looked closely at the current performance of the licensees against their specific production obligations. On the basis of our analysis,

including that set out in section 3 above, we do not consider the burden which licence obligations represent for Channel 5 should be overestimated. Specifically, we note that:

- Quotas are not calculated as a percentage of total transmission time. In 2010 the 25% quota on independent productions represented approximately only 4% of Channel 5's total output.²⁴
- Repeats can count towards a channel's original programming obligations. Our analysis suggests that in 2010 nearly three in five (59%) Channel 5 programmes which met the criteria for original programming were repeats.²⁵
- The out of London production quota by definition excludes acquired programming. Accordingly, the amounts which channels are required to deliver are significantly lower than the headline figure. In 2010 only 128 hours of content or 1.5% of Channel 5's transmission time enabled Channel 5 to meet its out of London obligations.²⁶

- 4.22 As discussed above, the vision for commercial public service broadcasting set out in the second PSB review anticipated that Channel 3 and Channel 5 would retain modest but important public service commitments that were consistent with shareholder objectives.
- 4.23 Ofcom considers that production obligations could continue to play a valuable role in encouraging innovation and growth, complementing the contributions to public service made by the BBC and Channel 4. Set in this context, we believe the modest burdens placed on Channel 5 from its existing obligations would continue to represent an appropriate contribution by the channel to the fulfilment of public service purposes in the next licence period.
- 4.24 In any case, we consider that the evidence examined above does not suggest the investment obligations placed on Channel 5 are so great that they are unlikely to be sustainable. Although Channel 5 may argue that certain amendments will be necessary *"if the new licences are to be sustainable for a full ten year term,"* it is our view that its obligations are already set at a core level which could not be significantly amended without calling into question the public value generated for UK viewers.

Proposals for amendments to definitions of peak-time programming

- 4.25 The Act requires Ofcom to set peak viewing periods for the public service channels which we regulate. Public service obligations, including those for original programming and news and current affairs, are then determined for those periods.

²⁴ In the case of the independent productions quota, certain programmes – such as news and repeats – are excluded from total to which the quota is applied. As a result, Channel 5's quotas are based on a smaller subset of its schedule than Channel 3 because the latter shows fewer repeats.

²⁵ In a follow-up submission to Ofcom, dated 3 February 2012, Channel 5 stated that (on the basis of its own provisional figures for 2011) the proportion of its peak-time original programming comprising repeats declined from [x%] in 2010 ([x] hours) to [x%] in 2011 ([x] hours).

²⁶ Out of London production obligations are designed 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. Channel 5's licence requires that Out of London' programming must account for at least 10% of its programme expenditure and 10% of its commissioned programming.

- 4.26 In their responses to the open letter, both UTV and STV queried the current definition of peak viewing time. Both parties asked for extensions from the existing 1800-2230 period in order to increase flexibility in programme scheduling and bring programming obligations in line with the peak advertising period which runs from 1800 to 2300.
- 4.27 We have analysed viewing patterns for the advertising funded PSBs throughout the peak evening periods. This indicates that, although television viewing begins to drop sharply after 2200, the combined viewing total for Channel 3, Channel 4 and Channel 5 between 2230 and 2300 is comparable to that at the beginning of the peak period.
- 4.28 In light of viewing patterns, and in order to align peak viewing definitions for programme and advertising content, we are minded to accept the proposal to extend the peak viewing period to 2300. This would not affect the separate definitions which apply to the BBC's digital channels or to party political and referendum broadcasts.
- 4.29 We will write to each of the licensed PSBs and the Welsh Authority to seek their views on this matter over the coming months.

Summary

- 4.30 **Ofcom believes that there is little scope for amendments to the obligations on:**
- **Channel 3 licensees in the Nations, given the important role these services play in helping to secure plurality in coverage of devolved institutions; and**
 - **Channel 5, without calling into question its contribution to public service purposes.**
- 4.31 **Nevertheless, Ofcom accepts that licence renewal may require some amendments to be made to existing licences. In particular, we consider the proposals advanced by ITV plc in relation to English regional news could deliver a more localised regional news service of the kind particularly valued by viewers.**
- 4.32 **However, any such changes would need to be examined more closely in light of the decision taken by the Secretary of State. Accordingly, we propose to consult on specific proposals made by the Channel 3 licensees about content for the Nations and the English regions after the Secretary of State has made his assessment. We will also consider how to take forward licensee proposals in relation to peak programming hours.**
- 4.33 **In section 5 we go on to discuss other possible considerations in relation to licence renewal not raised directly by the licensees.**

Section 5

Additional considerations for PSB delivery by Channel 3 and Channel 5 in the next licence period

5.1 In this section we examine the case for amendments to:

- the map for Channel 3 services including licensing arrangements in Wales and the regional content received by viewers in the south of Scotland;
- the structure of the Channel 3 networking arrangements;
- provision of children’s programming by Channel 5; and
- the possible consequences for ITN of the Secretary of State’s decision.

The key points covered in this section are:

We consider that a separate stand-alone licence for Wales, formally separated from the service in the West of England, may be appropriate.

Changes to the Channel 3 service broadcast in the south of Scotland may also be appropriate to ensure viewers receive coverage of both regional and National matters. This could take the form of separate regional news arrangements, additional coverage of Scottish affairs or a new licence potentially as part of all-Scotland service. We will conduct further research on this issue if requested by the Secretary of State.

Proposals by the Channel 3 licensees to alter the structure of the network were received in March 2012. We are currently considering and consulting interested parties as to whether these arrangements – which would give ITV plc sole responsibility for the funding, acquisition and scheduling of network programming with STV and UTV becoming affiliates – meet statutory criteria.

In recognition of the need identified in our second PSB review to strengthen provision of children’s programming, the Secretary of State may wish to consider whether it would be appropriate to issue an order, subject to approval by Parliament, to amend Channel 5’s public service remit to include an obligation to provide “high quality and original programming for children”.

Finally, in making his assessment whether to intervene in licence renewal, we believe that the Secretary of State will also need to be mindful of the potential impact his decision could have on the future of ITN and news plurality more generally.

PSB delivery by Channel 3 in Wales and the South of Scotland

5.2 In our second PSB review, we examined the potential to restructure the Channel 3 licences by moving from the existing fifteen licence regional structure to one based on five licences, i.e. one for each of England, Northern Ireland, Scotland, Wales and the Channel Islands.

- 5.3 As part of that review, we acknowledged both the heightened role of public service content in the Nations and the need to sustain plurality to enable civic engagement with devolved institutions. However, we also recognised that there was unlikely to be a one-size-fits-all solution to the needs of each nation given the differences in the existing licence structure:
- In Scotland, the north and central Scotland licences are held by STV with a separate 'Border' licence held by ITV plc combining the south of Scotland and Cumbria in England.
 - The existing licence covering Wales held by ITV plc also includes the west of England, although the two constituent areas receive separate regional programming content and are subject to separate licence obligations.
- 5.4 At the time of the second PSB review we noted the view held by many respondents that a separate licence for each nation could bring greater accountability with regard to the service provided. Ofcom's Advisory Committees for Scotland and Wales also emphasised their support for the Channel 3 map to be redrawn on a national basis.
- 5.5 Given the evolving nature of devolution, in our interim paper we argued that a workable solution to plurality of news in the Nations represented a key consideration in determining the capability of existing licensees to contribute to the purposes of PSB. We subsequently asked the affected licensees to comment on various options that would serve to secure this aim.

Submissions received by Ofcom

- 5.6 In its response to our open letter, STV called for the creation of *"a single Scotland-wide Channel 3 licence to end the anomaly whereby viewers in the south of the country have no access to Scottish programming, particularly news and current affairs."* It noted that amendments to the 1990 Broadcasting Act introduced under the Digital Economy Act 2010 permitted the creation of single Scottish licence and envisaged extending its existing model within Central and Northern Scotland *"to provide tailored output for the east and west Scottish Borders with dedicated newsgathering and production."* Although STV considered that such an approach should be considered for implementation under the renewal process set out in section 216 of the 2003 Act, in the short-term it stated it was *"ready to make available its news and/or non news material for relay in the Border Scotland region."*
- 5.7 In contrast, ITV plc did not *"accept the need... for a separate Scottish Channel 3 licence"*. It maintained that it *"recognise[d] very clearly the issues associated with serving a region which falls partly into England, and partly into Scotland"* and was particularly conscious to ensure that its Border service offered appropriate coverage of major events affecting Scottish viewers, including retransmission of STV content related to the Scottish Parliamentary elections. It argued the predominantly rural population in the Scottish Borders would be better served under its proposed regional service than as *"a subordinate part of a large nation dominated by the news agenda of two very large cities"*.
- 5.8 ITV plc also stated that it spent more on a per capita basis in Border than in any other region of the UK and believed that audiences were particularly well-served as a result. It believed the level of its investment was reflected in the viewing figures for the regional content it produced.

- 5.9 ITV plc noted that the audience for the early evening regional news programme in Border, *Lookaround*, was split broadly in line with the population in the Scottish and English areas and achieved the highest audience share of any Channel 3 regional news programme, including those offered by STV and UTV. It also argued that an additional effect of splitting the Border licence area would be to leave an English region that would be “*impossibly super-served by a dedicated news service*” which did not make either “*economic or editorial sense*”.
- 5.10 In relation to Wales, ITV plc asserted that there was not, to its knowledge, “*significant viewer demand... for a separate licence for the Welsh service.*” ITV plc argued that it already had a clear set of licence obligations for its service in Wales and did not see how a specific licence, excluding the West of England, would “*impact on viewers either positively or negatively.*”

Ofcom’s view

- 5.11 Ofcom has previously noted that the Channel 3 regions in the Nations reflected cultural identities more closely than those in English regions which were largely designed to reflect “*the practicalities of the 1950s television transmission map.*”²⁷ In our assessments of public service broadcasting, we have sought to acknowledge and respond to the importance attached by audiences in the UK’s devolved Nations to programming designed to reflect the distinct cultures, histories and interests of Scotland, Wales and Northern Ireland. Within this context, we are clear that the Channel 3 services received by viewers in Scotland and Wales are the subject of strongly held views across all stakeholder groups.
- 5.12 In relation to Wales, although we note ITV plc’s arguments, we see no reason to alter our earlier assessment that it would now be correct to separate Wales formally from the regional Channel 3 licence for the west of England.
- 5.13 We consider, however, that different factors apply in Scotland. We note that STV, a dedicated national broadcaster, already offers a service covering most of Scotland that provides coverage of Scottish news and current affairs in addition to regional material.²⁸ In the south of Scotland, however, the amount of content which the licensee – ITV plc – is required to provide, is more limited.²⁹
- 5.14 Ofcom last looked in detail at the service received by viewers in the south of Scotland in 2008 as part of our second PSB review. At that time, independent research conducted for Ofcom suggested that viewers in the region placed a greater importance than those in other areas on regional news delivery while also being less satisfied than others with the breadth of the content which they received. A summary of this research is set out in Figure 23 below:

²⁷ First PSB review, phase 3, 3.49.

²⁸ Currently, in northern and central Scotland, STV is required to broadcast four hours of regional news (including two and a half hours in peak viewing times) and 90 minutes of non-news content each week. As shown in figure 14 above, STV has sought to transmit higher amounts of programming than it is required to do under the terms of its licence.

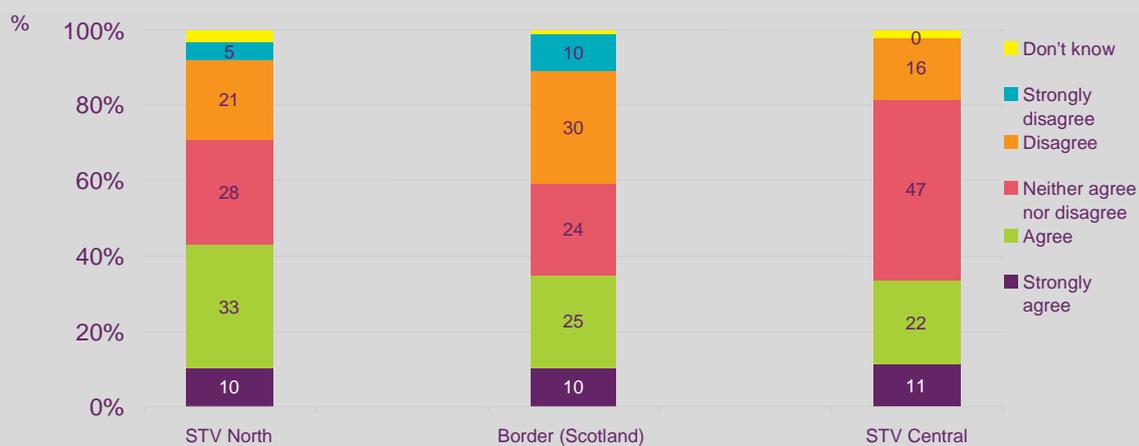
²⁹ Currently, in the Border region, ITV plc is required to broadcast three and three-quarter hours of regional content (including two and a quarter hours in peak viewing times) and 15 minutes of non-news content each week.

Figure 23: Audience research on regional news in the south of Scotland (2008 data)

Research conducted by Ofcom during the second PSB review suggested that, prior to the merging of the Border and Tyne Tees news services in 2009, viewers in the Scottish Borders were significantly less satisfied with coverage of news across the region (42%)³⁰ than viewers in the English Border region (62%) or in any other of the regions surveyed.³¹ Viewers in the south of Scotland were at that time significantly less satisfied with the coverage of Scottish news that they received from their Channel 3 licensee than those further north, with only 49% responding positively compared to 64% and 74% in central and northern Scotland respectively.

However, the same viewers placed considerably more importance than other Scottish viewers on “focus on my local area” whilst expressing more concern than any other group across the UK that they “would easily find alternative sources for regional news and information”. Respondents in the south of Scotland were the least likely to agree (35%) and most likely to disagree (43%) with this statement, making it the only region with a negative balance of opinion on this point. Although viewers in the south of Scotland were, like their counterparts in STV regions, split as to whether their regional news coverage should form part of a whole-Scotland programme, in contrast to other Scottish viewers, they were on balance marginally against this option:

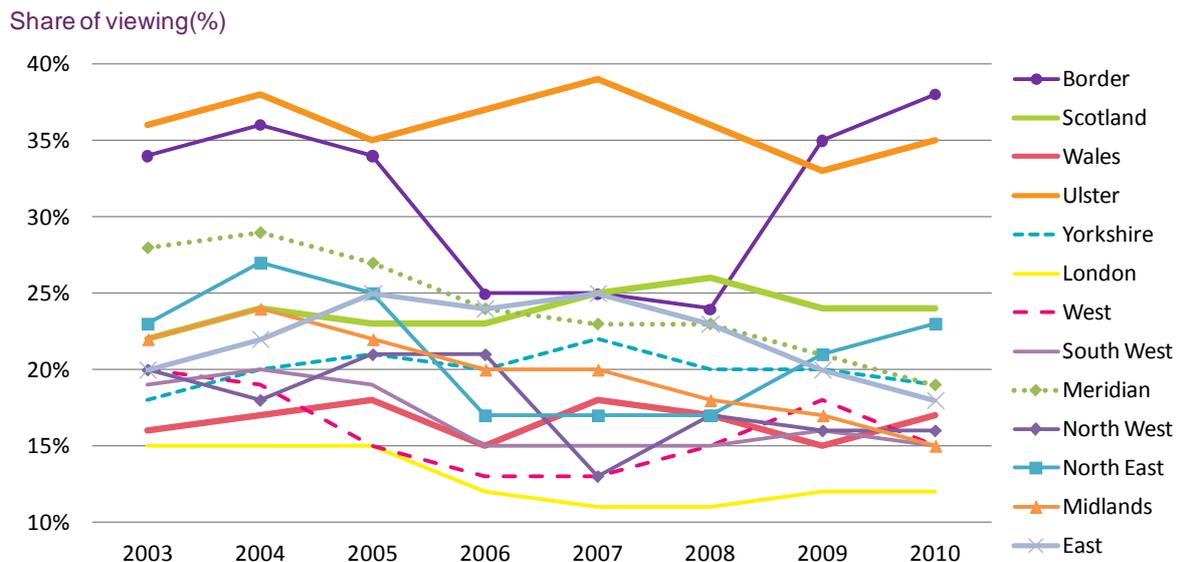
Figure 23a: Agreement with “I would prefer news about my region to be reported within a programme that covers news across the whole of Scotland” (2008 data)



Source: Holden Pearmain, June 2008
 Base: Scotland only n=624, minimum sample in any region n=200

5.15 Ahead of the Secretary of State’s decision whether to exercise the powers open to him to block licence renewal or extend the existing licences to allow for a fuller consideration of public service broadcasting in the Communications Bill, we have not sought to revisit our earlier research to assess whether opinions in the south of Scotland have changed. We note that the popularity of the regional *Lookaround* programme – shown in figure 24 below – remains very high relative to the services provided in other UK regions.

³⁰ Percentage of viewers surveyed answering “satisfied” or “very satisfied”.
³¹ This question was not asked in Northern Ireland or Wales.

Figure 24: Viewing share of Channel 3 early evening regional news bulletin

Source: BARB Note: due to a new BARB measurement panel from 2010 onwards, 2010 data are not directly comparable with previous years.

- 5.16 The Channel 3 service which viewers in Border were asked about in 2008 is different from the service they now receive or which ITV plc proposes for the next licence period. Nevertheless, it is certainly possible that there could be deficiencies in the coverage that viewers in the south of Scotland may receive of particular Scottish issues and which it would therefore be appropriate to examine more closely in the lead up to the next licensing period.
- 5.17 As noted above, we have discussed with ITV plc the possibilities for restructuring the Border licence under licence renewal.³² In response, ITV plc has made it clear that it does not accept the need to do so at this time. However, it seems to us that three possible options could meet the aspirations of viewers in the south of Scotland for coverage of both regional and national matters:
- A dedicated regional service for viewers in the south of Scotland, supplemented with coverage of national Scottish issues. Under this scenario, we would anticipate that viewers in the English Border region would continue to receive the existing Border/Tyne Tees service; or
 - An amendment to regional obligations in the Border region (either as a whole or only for viewers in the south of Scotland) to ensure Border's Scottish viewers received a level of news content consistent with obligations in northern and central Scotland; or
 - Auctioning a new all-Scotland licence in place of the existing licences held by STV and the area of southern Scotland currently covered by the Border licence.
- 5.18 Ofcom is conscious that the current report is intended to provide the Secretary of State with a basis on which to decide whether to exercise the powers open to him to block licence renewal or extend the existing licences. In particular, we are not at this

³² Any amendment to the existing Channel 3 map as part of renewal would require the consent of ITV plc.

stage seeking to assess the appropriate basis for licence renewal or choose between the possible options.

- 5.19 Nevertheless, we consider it is important to make the Secretary of State aware of matters which may be relevant in deciding whether or not he should use his powers under the Act, given the opportunity the Government currently has to make amendments to licensing arrangements during the Communications Bill process. Accordingly, we will conduct further consumer research on this issue if requested by the Secretary of State to do so. We anticipate we could produce a supplementary research report on this issue within three months of receiving such a request.
- 5.20 Beyond this, if following his assessment the Secretary of State does not intervene in the renewal process, Ofcom will need to decide whether or not to renew the existing Channel 3 licences and the area which regional licences should cover.

The sustainability of the Channel 3 networking arrangements

Background to the networking arrangements

- 5.21 The regional Channel 3 licensees are required to operate a set of regulated contractual agreements known as the networking arrangements (the 'NWA'). These documents set out the basis on which the regional licence holders co-operate in order to broadcast the Channel 3 network service.
- 5.22 The obligation for the regional licensees to participate in NWA dates back to the Broadcasting Act 1990 (the '1990 Act'). The 1990 Act required the holders of the Channel 3 licences to conclude a set of arrangements, approved by the Independent Television Commission (the 'ITC'), that would enable them to work together to deliver a network television service capable of competing with services such as those offered by the BBC.
- 5.23 Although the form which the NWA were to take was a matter for the licence holders, the ITC's guidance to applicants for the regional Channel 3 licences set out a series of issues which it expected the NWA to address. Among other things, the ITC proposed that contributions to the network's programme budget should be shared between licensees according to a formula which took account of the different earning potential of each area. This formula meant that the licence holders for regions with smaller populations made lower contributions to the programme budget than their relative size would otherwise warrant, with the large licensees making proportionately higher contributions. The purpose of this proposal – which, with minor amendments, was accepted by the licence holders – was to ensure that the holders of the small licences could afford to meet regional programming costs that were relatively inflexible regardless of licence size as well as contributing to the overall cost of the network schedule.
- 5.24 Although the provisions of the 1990 Act have been superseded and the companies holding Channel 3 licences have consolidated, the structure of the NWA, including the network cost-sharing arrangements, have remained broadly unchanged.

Recent assessments by Ofcom

- 5.25 During our second PSB review, both ITV plc and the remaining licensees³³ (referred to collectively as the non-consolidated licensees or 'NCLs') submitted evidence to demonstrate that the approach set out in the NWA to used to allocate shares of network costs to the regional licensees was inequitable. Both sides argued that the existing structures provided a significant net benefit to the other group of licensees.
- 5.26 At that time ITV plc called for substantial amendments to the NWA. It argued that the difference between the existing arrangements and what it considered to be a more equitable sharing of network costs amounted to a transfer of over £25m per year from the ITV plc owned licensees to the NCLs.
- 5.27 For their part, the NCLs argued that ITV plc's calculations had failed to take account of the broader benefits which they argued ITV plc derived from membership of the network, and that – in their opinion – there was in fact a transfer of value from the NCLs to ITV plc of between £28m and £31m per year.
- 5.28 In *Putting Viewers First*, the statement with which we concluded our second PSB review, we noted that the NWA had since their inception provided different degrees of benefit to the different licensees. We also recognised that the value of the regional licences was in decline and acknowledged that unless all of the regional licensees were willing participants in the network, the existing arrangements would become unsustainable.
- 5.29 Ofcom returned to the issues identified by the licensees in a further consultation published in July 2010.³⁴ In that document we said that ITV plc's contribution to common costs could have been up to £[<] more than under an appropriate alternative cost sharing mechanism. However, given other factors including the sustainability of the smaller services and because the relative burden placed on ITV plc was the result not of regulatory intervention but of commercial consolidation entered into by ITV plc's predecessors in full knowledge of the system of cost allocation in place, we considered that only the preservation of the status quo would be compliant with the statutory framework for NWA at that time.
- 5.30 Ofcom's analysis in the consultation was, with reservations, accepted by all of the licensees. However, ITV plc made clear its view that the cost sharing arrangements, which it considered "*mandated cross subsidy within the network to smaller licensees*", led to an unjustifiable and unsustainable distribution of profit between the licensees. Arguing that Ofcom's approach in effect amounted to an acceptance that spending on network programming should be sacrificed to protect regional output, ITV plc maintained that "*de-investment*" on this basis would adversely affect the continued provision of a competitive Channel 3 service. Nevertheless, it was willing to retain the existing model "*in the interests of focussing on trying to fashion a new and more sustainable set of arrangements.*"

³³ In addition to the eleven regional licences held by ITV plc in 2009, the four other regional licences were held by STV (northern and central Scotland), UTV (Northern Ireland) and Channel (the Channel Islands) known collectively as the non-consolidated licensees or 'NCLs'. In November 2011, Channel Holdings Ltd was acquired by ITV plc. A change of control review was published by Ofcom on 20 March 2012. See: http://licensing.ofcom.org.uk/binaries/tv/ccrs/Channel_TV_CCR.pdf.

³⁴ See <http://stakeholders.ofcom.org.uk/binaries/consultations/itv-networking/summary/itv-networking.pdf>.

- 5.31 In our conclusion to that review,³⁵ we acknowledged the considerable tensions between the licensees in relation to the operation of networking arrangements that had been devised in and for the broadcasting landscape of the early 1990s. We also reminded licensees of our duty to consider within the scope of the present report:

“...whether the licensees as a group are able to sustain cost-sharing arrangements under the NWA which will enable them to contribute to the public service broadcasting remit of a competitive Channel 3 service in the future.”

- 5.32 Accordingly, and given the differences between the parties, we concluded our review by strongly encouraging the licensees to examine how they would develop robust arrangements between themselves that would be sufficient to underpin a competitive set of PSB services at a commercially sustainable cost in the next licensing period.

Proposals by the licensees

- 5.33 In its response to our open letter, ITV plc noted that it was *“in the final stages of negotiation”* with the other licensees over a new and, in its view, *“far more workable intra Channel 3 arrangement than currently exists.”* ITV plc considered that the new arrangements *“will give ITV more freedom but will also involve ITV continuing to subsidise UTV and STV via substantial discounts to what would otherwise be their appropriate share of the costs.”*
- 5.34 In March 2012, following further dialogue between them, the Channel 3 licensees submitted new networking arrangements. These agreements provide for ITV plc to take on sole responsibility for network programming – in terms of funding, acquisition and scheduling of content – which it would make available to STV and UTV as affiliate members of the network in return for a fixed cost.

Ofcom’s assessment

- 5.35 Ofcom has a duty under the Act to assess whether the arrangements agreed by licensees will enable them collectively to provide a competitive, regionalised Channel 3 network service. Specifically, the criteria set out in s.290 of the Act state that arrangements may only be approved by Ofcom if:
- they apply to all the Channel 3 licensees;
 - they provide for programmes made, commissioned or acquired by or on behalf of the regional licensees to be available for broadcast across the Channel 3 network; and
 - they are made for *“the purpose of enabling regional Channel 3 services (taken as a whole) to be a nationwide system of services which able to compete effectively with other television programme services provided in the United Kingdom.”*
- 5.36 We are currently considering and consulting interested parties as to whether the arrangements, provided to Ofcom in March 2012, meet statutory criteria. Our initial assessment is that, taken collectively, the affiliate arrangements may do so.

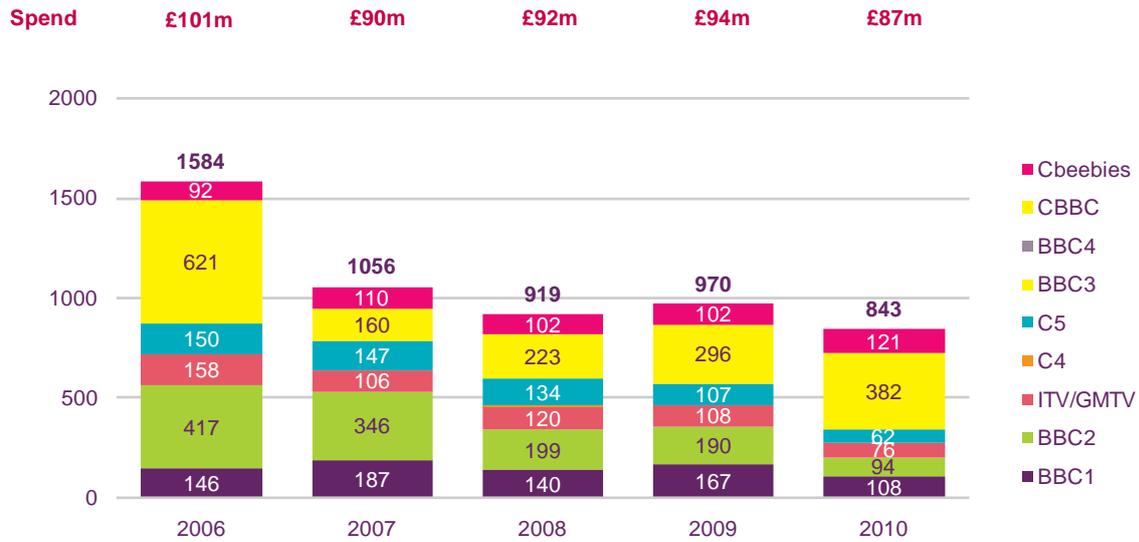
³⁵ See our *Statement* at <http://stakeholders.ofcom.org.uk/binaries/consultations/itv-networking/statement/nwa-statement.pdf>.

- 5.37 The new affiliate model simplifies the Channel 3 structure in recognition of the progressive consolidation of the network over the past two decades. However, given the previous disagreements between the Channel 3 licensees – particularly STV and ITV plc – it remains to be seen whether the new arrangements will enable them to network together effectively over the period of the next licence, as the digital environment in which they operate continues to evolve.
- 5.38 As we noted in section 1, the background to our present assessment of licence renewal is very different from the analogue environment in which the Channel 3 licences were first awarded in 1991. The regulatory framework at that time included restrictions which prevented companies from holding regional licences in more than two areas. Few companies chose to bid for multiple licences during the auction process and ultimately the licences were won by 15 separate bidders which essentially created new businesses which received privileged access to mass audiences across the UK.
- 5.39 Although the current licensees have proposed new agreements to form the basis of networking arrangements in the next licence period, we consider that, in the context of a network where the ITV plc licensee now accounts for over 90% of the qualifying revenue of the network, there is an issue as to whether a networking structure developed in the early 1990s continues to be an appropriate and effective means of delivering the Channel 3 services. In addition, the statutory definition of networking arrangements is concerned with the delivery of broadcasting services. In the next licence period, it may be that this focus will be too narrow as the importance of exploiting broadcast programming on other audio-visual platforms grows, and where the licensees' business interests are increasingly cross-media. These are matters that may need further consideration in the Communications Bill.

Provision of children's programming by Channel 5

- 5.40 In the second PSB review, Ofcom noted that there was a clear public interest in addressing needs for the provision of a range of high quality original programming for children, particularly among older children (primary school age and above), and young teens.
- 5.41 This concern has to some extent been addressed by the amendments to Channel 4's functions contained in the Digital Economy Act 2010, which required Channel 4 to make content that appeals to the tastes and interests of older children and young adults.
- 5.42 Nevertheless, our research has shown the provision of children's programming has remained an issue for parents. Although 85% of parents and carers of children under 15 years old continue to rate the delivery of PSB children's programming as important, only 60% believe that the public service channels provide *"a wide range of high quality, UK-made programmes for children."* One respondent to our open letter in particular, Save Kids TV, argued that change was needed to *"address market failure and [ensure] content for UK kids which is relevant, appropriate and locally produced could be stimulated once more."*
- 5.43 The evidence collected by Ofcom about delivery of children's programming indicates that, although the amount of output has remained broadly constant – with the main broadcasters offering over 12,000 hours of content over their main and portfolio channels in 2010 – both the amount spent on children's programming and the absolute levels of new commissioned content have declined (see Figure 25).

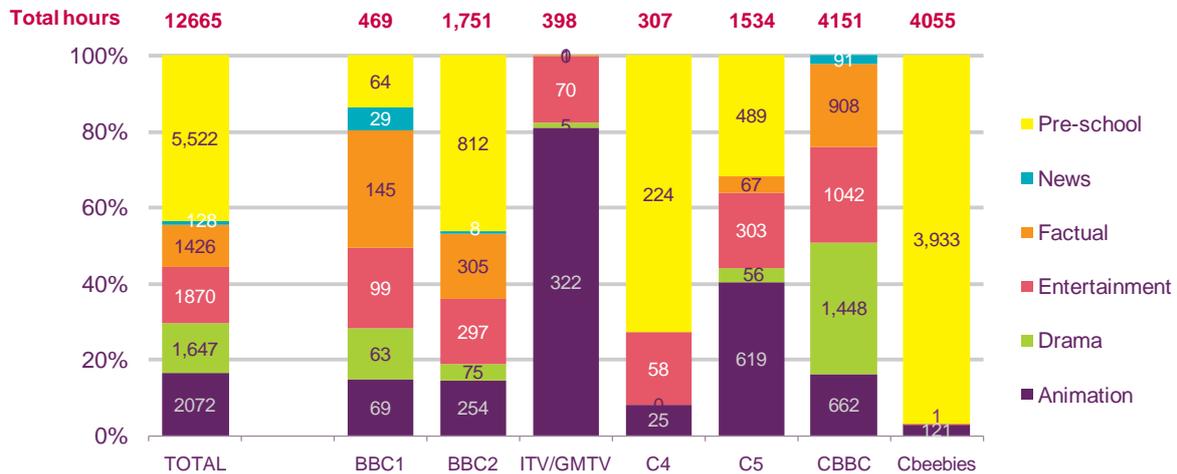
Figure 25: Children’s PSB output first run UK originated hours per year



Source: Ofcom/broadcasters
 Note: Spend is given in 2010 prices. Output and spend on the CITV channel is excluded.

5.44 In particular, as we noted in the second PSB review, the limited opportunities which exist to supplement programme investment by selling children’s drama and factual programming overseas have affected the viability of such programming beyond the BBC. As shown in Figure 26 below, Channel 5 is the only one of the commercially funded PSBs offering a significant level of children’s output, albeit primarily focused on younger age groups, on its main service.

Figure 26: Children’s output by sub-genre 2010



Source: Ofcom/broadcasters
 *PSB Channels included: BBC One, BBC Two, ITV1, Channel 4, Five, CBBC, Cbeebies Excluded: CITV and S4C.

5.45 In assessing the potential contributions by licensees to public service purposes, we have been mindful both of the issues identified above and of the submission made by Channel 5 in 2008 that “it would be prepared to enter into a commitment... in respect of its children’s programming, thereby safeguarding plurality of provision for younger children.” However, in discussions with Channel 5 as part of this review, the current owners have made clear that, although they envisage maintaining their investment in

children’s programming as part of the delivery of their public service remit, they would be reluctant to enter into a more specific obligation.

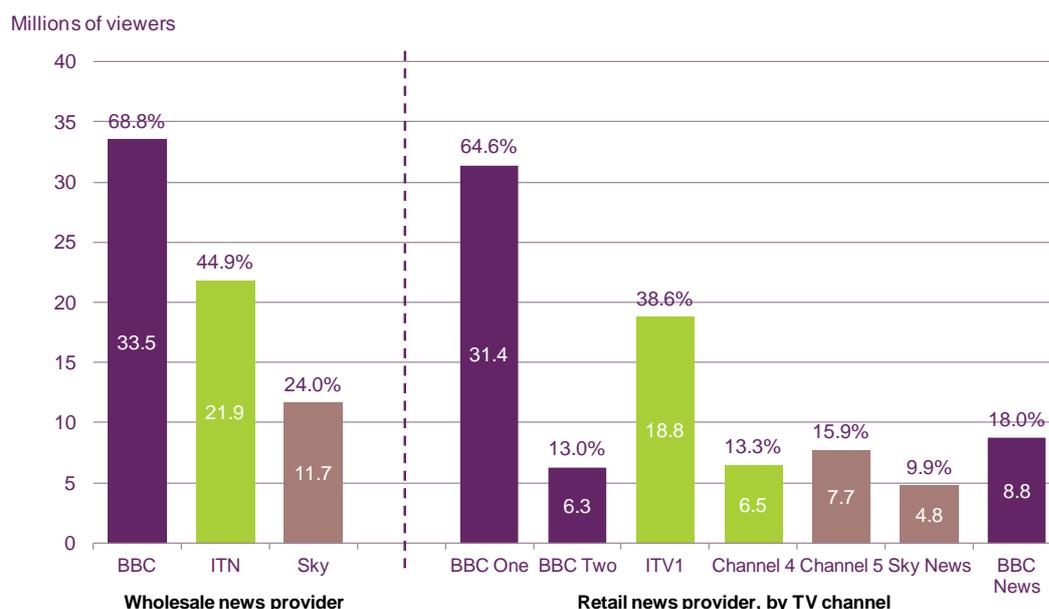
- 5.46 Nevertheless, we note that under s.271 of the Act, the Secretary of State may make amendments to the public service remits of the commercial PSBs following his consideration of this report. Therefore, the Secretary of State could achieve more certainty about the continued provision of children’s programming by Channel 5 by exercising his power to amend the channel’s public service remit to include an obligation to provide “*high quality and original programming for children.*”
- 5.47 In the time available for this report we have not been able to form a view as to whether there is a sufficient case for securing such certainty of provision; therefore, we make no recommendation to the Secretary of State about the exercise of his powers under s.271 of the Act.
- 5.48 If requested to do so, Ofcom could carry out further work to assess the impact of such a measure, although we are conscious that the Act requires any order amending the public service remits of the commercial PSBs to be made under the affirmative resolution procedure within twelve months of the date of this report. Accordingly, it may be difficult to examine this issue further within the scope of a licence renewal process.
- 5.49 However, particularly if the Secretary of State were to exercise the powers open to him under the Act to extend any of the types of licences, he may wish to consider within the Communications Bill process whether a need remains to strengthen this important area of public provision.

Consequences for ITN of the Secretary of State’s decision

- 5.50 A further consideration for the Secretary of State is the potential impact of any decision on the future of ITN.
- 5.51 As we set out in our *Report on Public Interest Test*,³⁶ in relation to broadcast news, ITN is one of three significant suppliers of wholesale broadcast news in the UK, alongside the BBC and Sky. ITN currently provides national news on a wholesale basis to three main television news outlets – Channel 3, Channel 4 and Channel 5. In addition, ITN supplies the Channel 3 regional news bulletins for London to ITV plc.
- 5.52 Figure 27 below illustrates ITN’s position in the UK market for wholesale news as it stood at the end of 2010, before it gained the contract to provide UK news for Channel 5. The reach that each retail outlet commands among UK consumers is also illustrated.

³⁶ See *Report on public interest test on the proposed acquisition of British Sky Broadcasting Group plc by News Corporation* at: <http://stakeholders.ofcom.org.uk/binaries/consultations/public-interest-test-nov2010/statement/public-interest-test-report.pdf>

Figure 27: Average weekly reach for UK News (October 2010)



Source: BARB, All Adults (16+), All homes, Oct 2010. 'National News genre'. Reach criteria = 3 consecutive minutes at least once in the week. Full weeks used. BBC = BBC One, BBC Two, BBC News. ITN = ITV1, C4. Sky = Sky News, Channel 5. Note – C5 news from Q1 2012 is to be provided by ITN.

5.53 We consider the potential impact on ITN is a significant factor in considering the impact of each of the options open to the Secretary of State and have accordingly discussed the matter with the company. ITN has emphasised to us that:

- it considers that comprehensive newsgathering cannot be achieved without the significant funding required to enable the company to make long-term commitments in terms of staffing and infrastructure;
- the certainty offered to ITN by the long-term contracts it has struck with its customers enables it to retain staff and make significant investments in capital equipment with five- to six-year replacement cycles; and
- the company’s long-term financial viability is underpinned by its major news contracts. It considers the Channel 3 and Channel 5 contracts vital to its business.

5.54 It is important to emphasise that there is no protection in legislation for ITN in relation to the Channel 3 news contract. The current licensees may choose who they use to provide news services, subject to the restrictions specified in the Broadcasting Act 1990 and the Communications Act 2003. Accordingly, renewal would not of itself secure ITN’s status as the nominated news provider.³⁷

³⁷ Ofcom has a duty under s.280 of the Act to ensure that the financial resources available to the appointed news provider for Channel 3 “are adequate, throughout the period of its appointment, to ensure that the Channel 3 news obligations are capable of being met”. Those obligations require Channel 3 news to be “able to compete effectively with other television news programmes broadcast nationwide.” Provided this test is met, and the company appointed as the news provider is not disqualified from that position under the terms set out in s.281 of the Act, the choice of news provider is a matter for licensees and not for Ofcom. Section 281 makes clear that the same restrictions which apply to holders of Channel 3 licences apply to the appointed news provider for Channel 3.

- 5.55 However, a decision by the Secretary of State to block licence renewal could have a significant impact on ITN, calling into question its position within the wholesale news market. The corollary of course is that, as with the licences themselves, an auction process could ultimately offer an opportunity for other companies to seek to enter the market for wholesale news provision.
- 5.56 If, alternatively, the Secretary of State chooses not to intervene in the renewal process, the impact on ITN would be more likely to be a positive one if a new agreement between the Channel 3 licensees and ITN were then agreed. Past contracts have generally lasted around six years. An agreement now on a similar basis would help to maintain ITN's ability to invest in newsgathering.
- 5.57 A decision by the Secretary of State to extend the existing licences would introduce a level of uncertainty in relation to the future arrangements between the commercial PSBs and ITN. We would expect that uncertainty to be reflected in any contracts agreed between the licensees and ITN and in the levels of investment those contracts would be made into the company's production facilities.

Summary

- 5.58 **Ofcom considers that the renewal process offers an important opportunity to assess whether the obligations and structures which are specific to commercial public service broadcasting are likely to remain appropriate in the next licence period.**
- 5.59 **We consider that the Channel 3 network can continue to provide high quality and well resourced content meeting the needs of people in the Nations and regions of the UK offering competition to the BBC and complementing the planned roll-out of local television services. However, if those services are to remain effective their structure, particularly in the devolved Nations, must represent and serve modern cultural identities and evolving political structures.**
- 5.60 **Accordingly, we consider that there is a strong argument for a separate Channel 3 licence to recognise the specific needs, interests and priorities of Welsh viewers. We believe that changes to the Channel 3 service received by viewers in the south of Scotland may also be appropriate and propose to conduct further research on this issue if requested by the Secretary of State.**
- 5.61 **We also note that questions about safeguards for the provision of children's programming on public service networks beyond the BBC and Channel 4 remain. Accordingly the Secretary of State may wish to consider whether additional measures, including possible amendments to Channel 5's public service remit, may now be appropriate. Finally, in making his assessment whether to intervene in licence renewal, we believe that the Secretary of State will also need to be mindful of the potential impact his decision could have on the future of ITN and news plurality more generally.**

Accordingly, if a party is prevented from holding a Channel 3 licence, they are unable to become an appointed news provider for Channel 3.

Section 6

Assessment of the commercial sustainability of Channel 3 and Channel 5 in the next licence period

6.1 In this section:

- we examine the submissions we have received from the licensees on their ability to contribute to the PSB purposes “at a cost to the licence holders that is commercially sustainable”; and
- we set out our analysis on the commercial sustainability of the Channel 3 and Channel 5 licences over the next licence period.

The key points covered in this section are:

The Channel 3 and Channel 5 licence holders consider that the value of PSB status has declined significantly over the current licence period. Nevertheless, each of the licensees has indicated that renewed licences containing terms broadly similar to those currently in place could be sustainable over the next licence period. In the case of Channel 5, that view was expressed with caution and was said to be dependent on favourable economic and market conditions.

Part of Ofcom’s role in this report is to assess the deliverability of public service purposes in the next licence period. In particular, we have sought to determine whether, in light of the benefits which they receive, it will continue to be commercially sustainable for the existing licence holders to deliver services which will make an adequate contribution to meeting the needs and satisfying the interests of viewers over the next decade.

To make our assessment, we have looked at a range of key benefits and costs that could make an impact on the overall value of Channel 3 and Channel 5 licences. These include guaranteed access to DTT spectrum, the value of appropriate prominence on EPGs, the application of AIP and the Channel 3 networking arrangements.

An estimate of the commercial sustainability of licences in the future will inevitably be subject to a significant margin of error resulting from possible changes to the market, technology and consumer behaviour. It is also possible that a new Communications Bill could radically alter the value of the benefits associated with PSB licences in a manner which it is difficult to take into account.

Based on licensee submissions and our own analysis, it is our view that there is likely to be sufficient value associated with the Channel 3 and Channel 5 licences to enable the commercial PSBs to sustain a meaningful contribution to public service purposes over the next licence period.

Nevertheless, we consider that a significant proportion of the benefits the licensees enjoy result from their right to appropriate EPG prominence, the value of which is less easy to predict at the tail end of the next licence period. In the longer term, therefore, and in the absence of other regulatory changes, the sustainability of these licences may be dependent

on the right to appropriate EPG prominence continuing to deliver a significant commercial benefit.

Basis for assessing commercial sustainability

Ofcom's duties

6.2 The Act requires Ofcom 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.*” [emphasis added]

6.3 To determine whether the licences are commercially sustainable, we need to assess two things:

- the costs associated with holding a PSB licence over and above the costs that would be incurred without the PSB obligations; and
- the benefits that licensees enjoy by virtue of holding their PSB licences.

6.4 In order for the licences to remain commercially sustainable in the future, the benefits need to match or exceed the costs faced by licence holders, including any costs resulting from PSB programming and production obligations such as the regional news obligations faced by Channel 3 licensees or the quotas imposed on all providers which govern where or by whom their programming is produced.

6.5 The principal benefits associated with the licences in the next licence period will be the right to gifted or reserved DTT capacity and the right to appropriate EPG prominence.³⁸ Although there are other intangible benefits associated with holding a PSB licence, including the additional media coverage PSB programme schedules receive and viewer awareness of channel brands, we do not consider that it is possible practically to quantify these for the purposes of this report. Nevertheless, we consider the potential loss of these benefits could represent a risk to an incumbent broadcaster.

6.6 For this and other reasons – including the possibility of changes to the market, technology and consumer behaviour – there is likely to be a significant margin for error in assessing the commercial sustainability of relevant PSB services in the next licence period. Additional changes brought about by a new Communications Bill could also alter the costs and benefits associated with holding those licences. The licensees have told us they acknowledge that there are inevitable uncertainties and judgments associated with estimating the future balance of costs and benefits associated with operating PSB licences. Our own assessment can therefore only be an indicative one. We believe it represents an appropriate and proportionate approach to establishing whether the benefits and the costs of PSB licences are

³⁸ Historically the main benefit has been the right to broadcast on analogue spectrum. The benefit of this right has reduced as digital viewing has increased alongside digital switchover ('DSO'). DSO has already occurred in many regions and will be complete by the end of 2012.

within a range which means we can be satisfied that the delivery of the obligations should be commercially sustainable in the future.

The views of the licensees and other parties

- 6.7 We used our open letter in autumn 2011 to ask licensees and other interested parties two relevant questions:
- what level of public service obligations the licensees would be able to provide in the next licence period on a commercially sustainable basis; and
 - what effect, if any, other factors could have on the value of regulatory assets associated with Channel 3 and Channel 5 licences.
- 6.8 All of the licensees have maintained that the benefits of PSB status have declined significantly as digital switchover has progressed and the market has shifted to a multi-channel environment.
- 6.9 However, each of the licensees has indicated that renewed licences containing terms which are broadly similar to those currently in place could be sustainable over the next licence period. In the case of Channel 5, that view was expressed with caution and was said to be dependent on favourable economic and market conditions.

ITV plc

- 6.10 [X].
- 6.11 [X]. ITV plc argues that a renewed regional Channel 3 PSB licence on the basis outlined in its submission '*would be likely to be sustainable for the next licence period*'.
- 6.12 A summary of ITV plc's estimates of the costs and benefits associated with operating its PSB licences are set out in Figure 28 below.

Figure 28: ITV plc estimate of costs and benefits of PSB status

	2011	2012	2013	2014
<i>Opportunity costs to ITV plc of PSB status - £m</i>				
Regional news	[X]	[X]	[X]	[X]
Regional non-news	[X]	[X]	[X]	[X]
Current affairs	[X]	[X]	[X]	[X]
National news	[X]	[X]	[X]	[X]
Combined 'subsidy' to NCLs	[X]	[X]	[X]	[X]
Original production	[X]	[X]	[X]	[X]
Independent production	[X]	[X]	[X]	[X]
Miscellaneous	[X]	[X]	[X]	[X]
Total costs	[X]	[X]	[X]	[X]
<i>Benefits to ITV plc of PSB status - £m</i>				
Access to analogue homes	[X]	[X]	[X]	[X]
Reserved universal DTT capacity	[X]	[X]	[X]	[X]
Potential additional universal DTT capacity	[X]	[X]	[X]	[X]
Total benefits	[X]	[X]	[X]	[X]
Value (benefits-costs)	[X]	[X]	[X]	[X]

Source: ITV plc.

- 6.13 ITV's original submission did not include a value of the right to appropriate EPG prominence. However, since making its submission ITV plc has revised its position and stated that it considers there is some benefit associated with the right to appropriate EPG prominence, although it considers that *'any benefit associated with EPG prominence would be unlikely to exceed [X]*'.

STV

- 6.14 STV acknowledges that valuing the costs and benefits of PSB licences *'against a commercial environment that is unpredictable and highly volatile is extremely difficult*'.

- 6.15 However, STV concludes that the current level of delivery should continue during the next licensing period. We have confirmed in discussions with STV that this proposal is based on their belief that the licence obligations will remain commercially sustainable during the next licence period.

UTV

- 6.16 UTV supports ITV plc's submission in relation to commercial sustainability. In relation to its own obligations, UTV states that its current regional news provision *'is and must be sustainable until 2024'*.

- 6.17 UTV also proposes that most of its PSB obligations should remain at their current levels with the exception of its regional non-news commitments (see section 4). However, we have clarified with UTV that the principal purpose for its request relates to parity with other licensees rather than commercial sustainability.

Channel 5

- 6.18 Channel 5's submission presented an analysis of the current opportunity costs of being a PSB as well as the factors likely to impact on the viability of its PSB service through to the end of 2024.
- 6.19 Channel 5's submission argues that '*further changes will need to be made to the position of all the public service broadcasters in order to ensure the PSB system can be properly sustainable for the whole decade of a new licence term*'. These further changes include the introduction of retransmission fees, changes in the advertising minutage rules, waiving any future spectrum charges and abolishing 'minor' PSB obligations.

Other respondents

- 6.20 The BBC responded to our open letter by stating that it considered the Channel 3 and Channel 5 licences were likely retain a value in the order of tens of millions of pounds per annum and that they will therefore be able to sustain an important public service contribution over the next decade.
- 6.21 The BBC also believes that EPG prominence '*has the potential to become more, not less important, in an age of ever greater choice of programming and navigation*.' It also considers that EPG prominence has played an important role in offsetting the decline in PSB audience share as a result of digital migration.
- 6.22 COBA stated in its response that that the costs of the commercial PSB licences for channels 3 and 5 – i.e. the duties that are imposed on the licence holders and any accompanying opportunity costs – should equate to the benefits that come with that licence. In particular, COBA outlined its view that the quotas for independent production, original production, and out of London programmes were less costly to deliver than in previous years, due to the effects of the Code of Practice.
- 6.23 Both COBA and the BBC believe that the 'brand value' of being a PSB should be explicitly counted as a regulatory asset, although in their initial responses to our open letter neither provided estimates for the value that should be attached to this or a basis for calculation.

Our assessment of the commercial sustainability of the Channel 3 / Channel 5 licences

- 6.24 We set out below our assessment of:
- the opportunity costs associated with holding the Channel 3 and Channel 5 licences; and
 - the benefits associated with holding those licences.

Opportunity costs associated with holding the licences

6.25 The main cost associated with the Channel 3 and Channel 5 licences is the requirement to meet public service programming commitments. In the case of ITV plc we consider that there is an additional opportunity cost associated with the ability to broadcast into Scotland and Northern Ireland as a non-PSB, which it foregoes by remaining a regional Channel 3 licence holder.

Opportunity costs of PSB programming and production (e.g. regional news, national news, current affairs, original production, etc)

6.26 Channel 3 and Channel 5 licence holders are required to provide PSB programming such as regional or national news. The costs associated with PSB programming may be higher than the costs associated with replacement programming, and similarly the revenues generated by PSB programming may be lower than more popular programming. The difference between the profitability of these PSB programmes and other replacement programmes represents the opportunity cost.

Channel 5

6.27 [X]

6.28 [X]

ITV plc

6.29 In its submission, ITV plc provided detailed estimates for the opportunity cost of all of its PSB programming and production.

6.30 We have undertaken a broad review of ITV plc's assessment of the costs of PSB status. A summary of this is set out in the table below.

Figure 29: Ofcom’s assessment of ITV plc’s estimate of PSB opportunity costs

PSB opportunity costs	ITV plc	Ofcom’s view
Regional news	[REDACTED]	This is a reasonable estimate of the opportunity cost to ITV plc of regional news, and consistent with previous submissions and detailed models on the matter.
Regional non-news	[REDACTED]	This is a reasonable estimate of the opportunity cost to ITV plc of regional non-news.
National news	[REDACTED]	ITV plc would be likely to continue to show national news, even if there was no obligation to do so. [REDACTED]
Current affairs	[REDACTED]	This is a reasonable estimate of the opportunity cost to ITV plc of current affairs.
Original production	[REDACTED]	ITV plc would be likely to continue to deliver originations at the current level, even if there was no obligation to do so.
Independent production	[REDACTED]	ITV plc has over-delivered on independent production for several years and would be likely to continue at a similar level.
Miscellaneous	[REDACTED]	ITV plc’s costs cover aspects such as subtitling, Ofcom tariffs, TV archive costs and switchover costs. These appear reasonable.
Total		[REDACTED]

6.31 ITV plc has used the same methodology to estimate the opportunity costs as it has used in previous submissions and we consider that its estimates are reasonable. [REDACTED].

STV and UTV

6.32 Neither STV nor UTV provided detailed estimates of the opportunity costs associated with their PSB programming and production. However as noted, both licensees have stated that they believe their current obligations in these areas to be sustainable.

Summary

6.33 We consider that Channel 3 and Channel 5’s estimates of the opportunity cost associated with PSB programming and production are reasonable. We further consider that these estimates are likely to be representative of the opportunity costs over the next licence period, as the difference between the cost of licensees’ PSB programming commitments and value of replacement programming is unlikely to change significantly, although significant amendments in a new Communications Act could affect this calculation.

Other opportunity costs

- 6.34 ITV plc claims in its submission that, via the networking arrangements, it “*subsidises*” the non-consolidated licensees (‘NCL’s) STV and UTV. ITV plc maintains that the contributions made by licensees to the cost of network programming and other common costs should be determined strictly according to the share of the network’s qualifying revenue which each licensee receives, with the result that it would pay less and the other Channel 3 licensees would pay more. ITV plc estimates that it would contribute £[<] less to the programme budget in 2014 if the costs of the networking arrangements were shared on this basis, which it considers represents an opportunity cost to the company of PSB status.
- 6.35 Although there are valid alternative cost allocation mechanisms, some of which would benefit ITV plc, we do not accept that the existing formula represents an opportunity cost to the company. As noted in section 5 above, the consolidated Channel 3 ownership structure was not the result of regulatory intervention but of commercial decisions taken by ITV plc’s predecessors in full knowledge of the system of cost allocation in place.³⁹
- 6.36 However, we do consider that there is a potential opportunity cost to ITV plc of being a PSB operator in that, as a result, it is not able to broadcast to the NCL regions and generate incremental revenue.
- 6.37 In a counterfactual situation where ITV operated as a non-PSB, it would be likely to broadcast into the STV and UTV regions and therefore benefit from at least some of the operating profits that STV and UTV currently generate themselves.⁴⁰ The profit potentially available to ITV plc in this scenario – and hence an opportunity cost of holding the PSB licence – could be worth around £20m per year. [<]. However, we consider that it is reasonable to include an annual opportunity cost of around £20m over the course of the next licence period.⁴¹

Benefits associated with holding PSB licences

- 6.38 The principal benefits associated with the licences are the right to gifted or reserved DTT capacity and the right to appropriate EPG prominence. We consider the benefits associated with DTT capacity are likely to be broadly maintained over the course of the next licence period. On the other hand, while we consider that there is a benefit associated with the right to appropriate EPG prominence in the short to medium term, the size of the benefit is difficult to quantify and there is greater potential for it to be impacted by changes in technology or consumer behaviour over the longer term.

³⁹ Since ITV plc provided its initial response, we note that the Channel 3 licensees have negotiated new networking arrangements based on an affiliate model – discussed in section 5 above. Nevertheless, ITV plc has maintained that “*within the realities of regulatory regime for Channel 3 and against the backdrop of the need to obtain Ofcom approval, is that we had little choice but to broadly maintain the current subsidy economics of the Network*”.

⁴⁰ This assumes that if ITV plc were to leave the C3 network, STV and UTV would no longer operate in the manner that they currently do (without, for example, access to network programming).

⁴¹ In theory this reasoning could also apply to UTV and STV – they could, as non-PSB operators, become UK broadcasters, invest in their own programming and compete with ITV plc in England and Wales. However, we consider it unlikely that in such a scenario either operator would benefit from significant additional revenues as they could potentially lose access to much of the Channel 3 network schedule.

Reserved DTT capacity

- 6.39 Channel 3 licence holders have the right to reserved capacity on Multiplex 2 as well as joint ownership alongside Channel 4. This means that Channel 3 licence holders only need to pay their share of the multiplex costs to secure carriage rather than the market rate on a commercial multiplex. An additional benefit associated with reserved capacity on a PSB multiplex is that PSB multiplexes cover 98.5% of the UK population, rather than the 90% achieved by commercial multiplexes.
- 6.40 Capacity is reserved for Channel 5 on Multiplex 2 and on Multiplex A. Unlike the Channel 3 licence holders, however, Channel 5 is required to agree commercial carriage fees with the multiplex operators.
- 6.41 The benefits of reserved DTT capacity are therefore much higher for Channel 3 licensees than Channel 5 – approximately £[X] per annum compared to £[X] per annum.

Channel 5

- 6.42 Channel 5 states that the direct financial advantages it enjoys as a result of reserved capacity are limited, as the licence does not grant it the right to own and operate part of a multiplex. However, the licence does deliver long term security of carriage to Channel 5, removing the need to compete periodically in a limited market to secure capacity. Channel 5 estimates that this is currently worth around £[X] a year in terms of reduced contracting costs.

ITV plc

- 6.43 The Channel 3 licensees are joint owners (along with Channel 4) of Digital 3 & 4, which operates Multiplex 2.
- 6.44 ITV plc estimates the benefit of its reserved DTT capacity by taking the revenue uplift it derives from those channels which are broadcast via Multiplex 2 alongside the benefit of not having to acquire commercial DTT capacity for these channels, and netting this off from its share of the costs involved in operating Digital 3 & 4. This calculation gives a benefit in 2014 of £[X] per year.
- 6.45 [X]
- 6.46 Beyond this ITV plc argues that the capacity reserved for its high definition ('HD') services does not represent a benefit to its business [X].

Summary

- 6.47 We consider that Channel 5's valuation of this regulatory asset appears reasonable. We would also note that Channel 5 is afforded the opportunity to apply to launch an HD channel on DTT by virtue of holding a PSB licence (non-PSB operators are not eligible to apply for these services). There is an argument that if Channel 5 was successful in such an application, this would enable it to derive further incremental revenues, as well as prevent audience share from being lost to other channels which do provide an HD offering. However, it is difficult to quantify the size of that benefit and we have not placed a value on it.

- 6.48 In relation to ITV plc, we note that the approach adopted by the company to calculating the benefit it derives from DTT capacity is similar to that used in its submissions to Ofcom during the second PSB review. We consider that it represents a reasonable approach to estimating the value of this regulatory asset. [X].
- 6.49 [X]
- 6.50 Consequently, we do not agree with ITV plc that it derives no benefit from its reserved HD capacity, although we do accept that it is difficult to quantify the size of this benefit. Accordingly, we have not sought to place a value on it.
- 6.51 In conclusion, we consider that, assuming the DTT platform continues to represent a significant share of viewing over the next licence period, the benefits associated with reserved DTT capacity are likely in broad terms to be maintained.

The value of appropriate EPG prominence

- 6.52 The Channel 3 and Channel 5 licences afford the holders the right to ‘appropriate prominence’ on Electronic Programme Guides (‘EPGs’). Being placed on the first page of the EPG means that the licensees’ PSB channels are easily accessible to viewers. As such, there may be a significant benefit associated with this right since without EPG prominence fewer viewers may watch the programmes on prominent channels.
- 6.53 In order to assess whether EPG prominence will contribute to the commercial sustainability of licensees over the next licence period, we have considered:
- whether the EPG will continue to play an important role in consumer behaviour during that period; and
 - whether the right to appropriate EPG prominence is a benefit that the licensees would cease to enjoy as non-PSB operators, and if so, what additional costs they would incur if they no longer enjoyed this benefit.
- 6.54 In relation to the first point, we have assessed the argument that the value of EPG prominence will decline over the next licence period as digital technology changes viewing consumption habits.⁴²
- 6.55 We believe that actual consumer use will define the potential benefit of EPG prominence over the period of the next licences. However, we consider that there are strong reasons to believe that the value of EPG prominence will endure for a significant part of the next licence period:
- in the medium term, existing platform operators are likely to remain popular with consumers – and these operators will continue to structure their EPGs to suit consumer tastes;
 - similarly, watching mainstream TV content (in particular linear channels) is likely to remain the main activity on TV sets; and

⁴² In this context we note the Government has indicated that the Communications Bill may seek to reform EPG regulation and that changes to the regulatory regime could have a material impact on the benefit associated with EPG prominence in the next licence period – for example, by extending the right to appropriate prominence beyond the levels afforded by current legislation.

- users will continue to favour easy, familiar and intuitive ways to access content, and reject any application that requires complicated inputs or significant change from existing behaviour.

6.56 Therefore, it is our view that channel listings/positions will remain a key entry point for viewers in the medium term, even if they search for individual programmes. Although TV sets will increasingly present other services alongside AV content, the relative value of prominence within the linear content genre will remain.

6.57 In relation to the second point, existing licence holders held different views on the value which they derived from appropriate EPG prominence.

Channel 5

6.58 [REDACTED]

6.59 Channel 5's submission states that it is difficult to place a precise value on this benefit, [REDACTED]. We note this is consistent with previous work commissioned by Ofcom, which suggested that significant movements up or down the EPG can have a material impact on audience share.⁴³

6.60 [REDACTED]

UTV and STV

6.61 Neither STV nor UTV gave details as to the counterfactuals they considered in assessing whether delivery of their PSB obligations were commercially sustainable. However, both acknowledged the existence of a benefit for PSBs of EPG prominence. Their assessment of the commercial sustainability of their licences therefore appears to take into account the risk of losing EPG prominence and the subsequent impact of this on their businesses.

ITV plc

6.62 Consistent with previous submissions, ITV plc did not include a benefit associated with appropriate EPG prominence in its response to our open letter. It argued that:

- platform operators would continue to place ITV1 at the same position even if it was no longer a PSB; and/or
- that its programming and brand strength would mean that viewers would seek out ITV1, leading to no impact on audience viewing even if it was put on a lower EPG slot.

6.63 [REDACTED]

Summary

6.64 [REDACTED]. Accordingly, we have examined the value of the right to appropriate EPG prominence to ITV plc in three ways:

⁴³ See report for Ofcom by Attentional at:

http://stakeholders.ofcom.org.uk/consultations/review_c3_c5_licences/attentional

- the revenue impact of a demotion down the EPG;
 - the market value of securing a prominent EPG position; and
 - the impact of a well-funded new entrant at position three following a Channel 3 licence auction.
- 6.65 In relation to the first point, there is no guarantee that ITV1 would be placed at position 3 on the EPG if ITV plc no longer held a PSB licence. The regulatory framework means that were the Channel 3 licence awarded to a new entrant via a re-auction, there would be a reasonable expectation on EPG providers to place that channel at position 3. As a consequence, ITV1 would have to move to a lower EPG position – possibly that currently occupied by ITV2.⁴⁴
- 6.66 Even taking account of ITV plc's arguments on programming and brand strength by assuming that any popular output would not be affected by a move at all, on the basis of work previously commissioned by Ofcom from Attentional, the impact on ITV plc of a lower EPG position for its main service could be between 0.3% and 2.4%.⁴⁵
- 6.67 Assuming that any audience impact would translate directly into a revenue impact, even this modest decline in viewing figures could result in a material reduction in ITV plc's revenue of between £5m and £40m per annum. We therefore consider that the *potential* value of EPG prominence to ITV plc is significant.
- 6.68 In relation to the market value of prominence, there are two circumstances where ITV plc could need to pay to secure a prominent EPG position as a non-PSB operator. First, if no new Channel 3 licensee entered the market, there is still the possibility that EPG operators would look to charge ITV plc for its continued use of the position 3 slot. Second, if ITV plc's main service was demoted down the EPG (due to a new entrant or because the right to appropriate prominence no longer afforded it any protection), it could look to pay an existing operator for a more prominent slot. In both scenarios ITV plc could need to pay a market rate to secure prominence.
- 6.69 Because front page EPG slots have not been traded to date, it is difficult to determine a benchmark for the market rate. [X].
- 6.70 Finally, the possibility that a well-funded new entrant could win the Channel 3 licences currently held by ITV plc in an auction, and thereby force ITV plc's services down the EPG, represents potentially the most significant risk to the company.
- 6.71 Ofcom considers that, under this scenario, reductions in audience share and revenue could result that had a major impact on ITV plc's business. This would occur not only because the company's main service would be further down the EPG, but also because a large new player in position 3 would inevitably be competing for the ITV plc audience. Furthermore, the existence of a new and well-funded operator could lead to increased competition for successful programmes made by independent

⁴⁴ The positions currently occupied by ITV2 vary by platform. The channel is available at slot 6 on DTT, 118 on Sky's satellite service and 115 on Virgin's cable service.

⁴⁵ Attentional carried out a statistical analysis of the impact on audience share following a move up or down the EPG. That analysis suggested that, by applying the findings from digital-only channels which have moved down the EPG to Channel 3 output which draws a similar audience share (approximately 10% of its output), the impact on ITV plc of a significant drop down the EPG for its main channel could be between 0.3% and 2.4%.

producers, as well as a relative loss of brand prestige resulting from media coverage of the new entrant's services.

- 6.72 It is difficult to know what the impact of this possibility would be, as this would be highly dependent on the level of programme investment and type of programme content offered by the new entrant. However, it could be significantly greater than £40m.
- 6.73 We acknowledge, however, that the size of this benefit is difficult to quantify and that over the longer term, there is the potential for the benefit to be impacted by technological or regulatory developments, or by changes in consumer behaviour. This impact could either increase or decrease the value of appropriate EPG prominence.
- 6.74 In conclusion, therefore, and based on our analysis above, we consider that the value of the right to appropriate prominence to ITV plc is likely to range from £5m to £40m per annum.

Intangible benefits

- 6.75 A number of respondents to our open letter suggested that the Channel 3 and Channel 5 licensees enjoyed significant intangible benefits from being PSB operators. In particular, it was suggested that the licensees benefitted from an increase in 'brand value' by holding their licences.
- 6.76 We agree that there are intangible benefits which the licensees receive simply by virtue of being PSB operators that they would not enjoy as non-PSB operators. Such benefits might include additional media coverage, or perceived public trust in content.
- 6.77 However, placing an estimate on the level of these benefits is challenging. At the moment, we do not believe that sufficient data is available to enable us to attribute a value to these benefits, and therefore do not include explicit consideration of these in our overall assessment.⁴⁶

Summary of the commercial sustainability of the Channel 3 and Channel 5 licences

- 6.78 Figure 30 summarises our assessment of the costs and benefits associated with ITV plc's and Channel 5's licences [X].

⁴⁶ See paragraph 6.5f above.

Table 30: summary of costs and benefits of ITV plc & Channel 5 licences – £m

	ITV plc	Channel 5
Opportunity costs of PSB programming and production	[X]	[X]
Other opportunity costs	[X]	[X]
Total opportunity costs	[X]	[X]
Benefit of reserved DTT capacity	[X]	[X]
Benefit of EPG prominence	[X]	[X]
Total benefits	[X]	[X]
Net benefit / (cost)	[X]	[X]

6.79 As set out above, we consider that the opportunity costs and the benefits associated with reserved DTT capacity reflect the value of the licences over the next licence period in broad terms. Although we consider that there is a material benefit associated with the right to appropriate EPG prominence in the short to medium term, the size of the benefit is difficult to quantify. We also note that there is potential for the benefit to be impacted by technological or regulatory developments, or by changes in consumer behaviour over the longer term. This impact could either increase or decrease the value of the benefit in question.

Channel 5

6.80 Ofcom notes that in the 15 years since the service was launched, Channel 5 has only made a reported profit on four occasions. Nevertheless, as those results represent four of the last five years,⁴⁷ we consider that the existing level of obligations have been shown to be broadly sustainable in the current broadcasting environment.

6.81 Looking forward, we broadly agree with Channel 5's estimates of the costs and benefits associated with its licence. The balance of those costs and benefits appear to indicate that, in the short to medium term at least, the Channel 5 licence is likely to remain commercially sustainable and continue to deliver a modest contribution to the fulfilment of public service purposes.

6.82 However Channel 5's submission goes on to state that *further changes* [including the introduction of retransmission fees and a change in advertising minutage rules] *will need to be made to the position of all the public service broadcasters in order to ensure the PSB system can be properly sustainable for the whole decade of a new licence term*'. Channel 5 has indicated to us that such changes would be important to the future sustainability of the licence. We acknowledge the potential for future developments to impact on the value of the PSB licences, although it is difficult to quantify the effect these could have. We discuss some of the issues below.

⁴⁷ Profit in 2008 figure includes debt which was written off.

ITV plc

- 6.83 There are a number of financial costs and benefits associated with the Channel 3 licences held by ITV plc. Other than the estimate of the value of the right to appropriate EPG prominence, we believe ITV plc's estimates of the costs and benefits associated with its licences are reasonable.
- 6.84 Therefore, we consider that the value of the PSB benefits for ITV plc is likely to continue to secure the proposed revised obligations for a significant proportion of the next licence period. Whether it will continue to secure those obligations for the whole of the licence period until 2024 depends on changes to the market, technology and consumer behaviour that we are unable to predict at this point.

UTV and STV

- 6.85 Both STV and UTV have stated that they believe their current level of obligations to be sustainable for the next licence period. They place importance on both reserved DTT capacity and EPG prominence as benefits which provide sufficient value to enable them to deliver their PSB programming and production obligations.

Potential future changes which could impact on the licence value

- 6.86 Both the licensees and other respondents to the open letter made reference to a number of regulatory or legislative changes that could occur during the next licensing period which they believed would impact on the value of the licences. These changes included the introduction or otherwise of Administered Incentive Pricing ('AIP'), alongside additional aspects which might be considered as part of the Government's wider assessment of the regulatory framework in the upcoming Communications Bill.

The application of Administered Incentive Pricing

Background

- 6.87 Ofcom has a duty to ensure that optimal use is made of the electro-magnetic spectrum, for the benefit of UK citizens and consumers. Charging fees for the holding of spectrum is one way in which Ofcom can encourage current and prospective holders to make the right decisions to ensure efficient use.
- 6.88 Spectrum use is exclusionary – using spectrum for one purpose (such as broadcasting digital TV) prevents it being used for another. So when operators take decisions on the use of spectrum, they need to consider the value of other uses which are being precluded. One way of ensuring that these opportunity costs are accounted for by decision-makers is for them to be reflected in prices that have to be paid to hold the spectrum.
- 6.89 This is the principle behind Ofcom's use of AIP – the charging of annual fees for holding spectrum that reflect the opportunity cost of holding that spectrum.
- 6.90 In 2006, Ofcom consulted on proposals to implement AIP for the spectrum used for terrestrial broadcasting. Our overall conclusions from this work were that:
- spectrum used for digital terrestrial broadcasting should be subject to appropriate charges in future, in the same way as almost all other uses are or will be;

- the right time to introduce charging for spectrum used for digital broadcasting would be the end of 2014; and
- before introducing any charges, we would consider carefully any potential effects on broadcasting output, and the right options to address or mitigate them.⁴⁸

6.91 In our open letter we invited licensees to comment on the impact that the proposed introduction of AIP would have on their commercial sustainability of their existing obligations.

Licensee responses

6.92 The Channel 3 and Channel 5 licensees argued in their submissions that the introduction of AIP would have a direct impact on the level of PSB obligations that would be sustainable during the next licensing period.

6.93 ITV plc stated that, in its view, the balance between costs and benefits of PSB status would be disrupted if Ofcom were to introduce AIP on the DTT multiplexes. It did not factor AIP costs into the proposals set out in its submission, and stated that “*ITV would have no choice but to reconsider the extent of PSB obligations which it was able to sustain in the event AIP were introduced*”.

6.94 [REDACTED]

6.95 Channel 5 proposed in its submission that Ofcom should decide to waive AIP charges on public service channels, so as to “*ensure public service broadcasting requirements can continue to be met.*” It argued that public service channels have been allocated the necessary spectrum to meet licence requirements (including near-universal coverage, programming obligations and picture quality) and that therefore, because of regulatory constraints, it was not possible for the PSBs to make more efficient use of spectrum.

Ofcom’s view

6.96 Ofcom continues to believe that the principle of introducing charges for spectrum used for broadcasting is correct. Similarly, it is still appropriate that before introducing any charges, we should consider carefully any potential effects on broadcasting output, and the right options to address or mitigate those effects.

6.97 The application of AIP to broadcasting spectrum should take account of the potential impact on the ability of licensees to deliver public service broadcasting. Should it seem likely that this impact would be material, it will be important to consider any means by which the desirable level of public service broadcasting could be maintained after the introduction of AIP. We have stated previously that these means could include potentially not introducing AIP, or levying it at a reduced rate, if this was necessary to ensure that public service broadcasting requirements continued to be met.

6.98 Ofcom has usually phased in AIP fees when applying the principle to other bands of spectrum. This is because the introduction of fees of significant levels over a short

⁴⁸ See our statement at <http://stakeholders.ofcom.org.uk/binaries/consultations/futurepricing/statement/statement.pdf>

period of time raises the chance of a shock which can lead to inefficient decisions about inputs and outputs and therefore a sub-optimal use of spectrum.

- 6.99 We also note that short-term responses that are available to public service broadcasters may be limited due to a combination of coverage and programming obligations.
- 6.100 There may be more scope over the long-term for broadcasters to use spectrum more efficiently. Particularly in the context of the potential for future European harmonisation of the 700 MHz band, which has now been allocated on a co-primary basis to broadcast and mobile services, it is important that broadcasters are appropriately incentivised as their use of spectrum changes over the next licence period.
- 6.101 Consequently, our working hypothesis is to adopt a phased approach to AIP for DTT spectrum, introducing fees gradually from a lower level over an extended period. The eventual level and manner of introduction will be in a way which does not prevent delivery of public service content. During 2012/13, Ofcom will undertake analytical work to allow us to consult on implementation of AIP assessing the precise level of fees, the potential impact of these fees on broadcasting output and the appropriate timetable over which they should be introduced.
- 6.102 We also intend to test whether there are compelling arguments for differentiating between different types of spectrum users when phasing fees in, as some may face greater constraints in maximising their spectrum efficiency than others – we note that some ways for licensees to respond to increased costs may be precluded by coverage obligations. These obligations require greater spectrum usage – and hence higher implied fees – by the PSB multiplexes in comparison with the other multiplexes. Similarly, the potential for direct funding models including Government funding to safeguard content (an option we have previously discussed as a method of balancing out any material detriment to citizens or consumers from the effects of AIP on broadcasting output) may be considered inappropriate in the case of some operators. Further, different organisations may have different levels of tolerance for increased costs, especially in the short and medium term. We will carefully consider all of these arguments when determining how AIP will be implemented.

Future benefits of PSB status

- 6.103 The Communications Bill provides an opportunity for Government to consider whether and how benefits of PSB status could be reformed to further encourage the fulfilment of public service purposes.
- 6.104 The Government has already stated that it intends to explore potential new models for delivering benefits to providers of public service content as part of the review. In particular, the Government has indicated that it is seeking to look at the future regulation of EPGs and that it may seek to establish a new class of licensees that are not 'full' PSBs. These licensees could be able to seek some of the benefits of PSB status (notably EPG prominence) by virtue of their contribution to public service purposes, in particular funding of UK original production.
- 6.105 The licensees affected in this report have all made the case to us that they believe that new benefits will need to be introduced if the ambition of the Government is to strengthen, rather than simply maintain, current levels of public service delivery.

6.106 Therefore, there are a number of areas that we believe the Government could consider as part of its Communications Bill analysis:

- strengthening the regulation of EPG prominence;
- retransmission fees;
- extending must carry provisions in relation to IP delivery; and
- advertising minutage.

Strengthening the regulation of EPG prominence

6.107 The requirement for prominence of PSB services on EPGs is an existing benefit of PSB status. The source of the benefit is that viewers will come across, and potentially choose, a more prominent service before others when making viewing choices. This leads to an increase in viewing from audiences – who may not otherwise have chosen to view the service at that time – and consequently more advertising revenue.

6.108 There are likely to be significant changes to EPGs over the period of the next licences. Navigation, search and the development of smarter user interfaces will continue to evolve to meet consumer expectations. However, there are also reasons to expect that the speed at which consumers adopt new technologies will vary and that, for many consumers, the EPGs we have today will continue to be a significant entry point for accessing content.

6.109 New platforms will continue to develop their offerings. However, the services offered by Sky, Virgin and Freeview over satellite, cable and DTT are likely to remain very strong, and Youview will provide consumers with a significant new proposition. New entrants will have to consider factors such as access to mainstream content, relatively conservative consumer behaviour and, for IPTV, the potential limitations of broadband networks in delivering high quality and reliable video (in particular HD services).

6.110 With this in mind, there are a number of questions we believe the Government will need to take into account in relation to future EPG regulation including:

- whether it is desirable for the prominence regime to be more prescriptive than it is today in relation to how platforms manage their EPGs;
- whether prominence requirements should be extended across new distribution platforms, to video on demand offerings or to other forms of navigation;
- how a new system could be designed to ensure it rewarded additional, rather than current, levels of investment; and
- how a future framework ensures appropriate levels of prominence, given that by definition this advantage can only be afforded to a finite number of services.

Retransmission fees

6.111 There is currently an active debate concerning the balance of payments made between the public service broadcasters and the platforms over which their channels

are distributed. The arrangements governing these payments, generically referred to as “retransmission fees”, in principle encompasses two types of payments:

- Payments from platforms to broadcasters for the right to carry their content (“retransmission fees”); and
- Payments made by broadcasters to platforms as a contribution to platform service costs (for example, providing listings in an electronic programme guide so channels can be found easily, and regionalisation of services which ensure that viewers receive the appropriate version of the channel for their geographic region).

6.112 In principle, the balance of payments could go in either direction. In addition to commercial considerations, there are specific obligations on PSBs and platforms which may have a bearing on the outcome. For example, PSBs are under an obligation to try to ensure that PSB channels are available on all major TV platforms; BSkyB, the main satellite provider in the UK, sets charges for technical platform services which are subject to regulation requiring these charges to be fair, reasonable and non-discriminatory.

6.113 Furthermore, the Government is considering suggested alternatives to the current regulatory and legal framework, for example the imposition of a ‘must carry’ requirement on platforms or the removal of ‘must offer’ obligations on PSBs, or the adoption of a US-style ‘retransmission’ consent regime.

6.114 Any changes in this area could affect the balance of payments between PSBs and platforms, potentially to the benefit of PSBs.

Extending ‘must carry’ provisions in relation to IP delivery

6.115 Although the PSBs receive access to capacity on DTT, they are also required to make their services available via other significant platforms, such as those operated by BSkyB and Virgin. PSB channels continue to attract a significant proportion of viewing on all of the major linear platforms and therefore form part of the core portfolio of channels offered by each of these. Accordingly, broadcasters and platform operators both have incentives to ensure that PSB services are carried.

6.116 Over time, distribution on IP based platforms is likely to become more important to PSBs, with the result that new factors will become significant. The aggregators and ISPs carrying such content to consumers could contend that the distribution of PSB material places a heavy burden on their network capacity and therefore raises distribution costs without a direct transmission payment from broadcasters. This is in contrast, for example, to satellite distribution where broadcasters secure their own transmission directly.

6.117 If ISPs or IPTV aggregators elect to charge content providers for carriage, then even limited carriage payments could become relatively significant to PSBs, particularly if there is an expectation that PSB channels are to be widely available across many IP-based platforms. One option could be to consider the application of ‘must carry’ obligations to AV platforms, including IP-based platforms. Regulation on this basis could include the terms under which carriage was to be provided (e.g. at cost, or under regulated financial and quality of service terms).

6.118 Such an approach might effectively reduce the costs incurred by PSBs in securing wide distribution for public service content. It could also mitigate against possible commercial incentives that might develop over time for some platforms to favour or

prioritise treatment of other services (such as a paid-for streaming services) ahead of PSB content. However, the effects of an intervention in this area would also need to be considered carefully alongside any potential adverse effects, for example, the impact on innovation on new and emerging platforms and business models. It is certainly arguable that carriage charges would increase the incentives on broadcasters to minimise the bandwidth taken up by their services.

Advertising minutage

6.119 Finally, it is possible that the regulation of advertising minutage could be potentially used as a lever to help incentivise investment in UK content, both generally, and by the public service broadcasters in particular. This is a policy issue for Government to consider, but should this lead to changes to the legislative framework for broadcasting in the UK, or to Ofcom's duties in this area, we would then need to consider the issue further.⁴⁹

Conclusion

6.120 **Based on the submissions of the licensees and our own analysis, we are of the view that over the next licence period there could be sufficient value associated with the Channel 3 and Channel 5 licences to enable the licensees to contribute to fulfilment of public service purposes.**

6.121 **Nevertheless, a significant proportion of the benefits enjoyed by the licensees are associated with their right to appropriate EPG prominence, the value of which is particularly difficult to predict towards the tail end of the next licence period. In the long term, therefore, and in the absence of any other regulatory changes, the commercial sustainability of the Channel 3 and Channel 5 licences is to a large extent dependent on a significant benefit resulting from the right to appropriate EPG prominence.**

6.122 **We recognise that the benefits of PSB status could be reformed in the Communications Bill and that it is therefore open to Parliament to amend legislation to ensure the continued fulfilment of public service purposes. This could be required if the ambition of the Government is to strengthen, rather than simply maintain, current levels of public service delivery. The range of additional benefits that we consider could add value to renewed licences include:**

- **Strengthening or extending EPG prominence regulation;**
- **Further consideration of retransmission fees and the balance of payments between public service broadcasters and platforms;**
- **Extending 'must carry' provisions to new IP delivery platforms to ensure that consumers continue to have ready access to PSB services; and**
- **The potential to use the regulation of advertising minutage as a lever to help incentivise investment in content production, by broadcasters generally, and by the public service broadcasters in particular.**

⁴⁹ See our statement, *Regulating the quantity of advertising on television*, at: http://stakeholders.ofcom.org.uk/binaries/broadcast/Advertising_minutage.pdf

Section 7

Options open to the Secretary of State

- 7.1 In this section, and in light of the analysis above, we look at the implications for the Secretary of State of each of the three main options open to him:
- intervening to block licence renewal, requiring Ofcom to auction the vacant licences;
 - no intervention so that Ofcom proceeds with the renewal process; and
 - extension of the existing licences, potentially until after the Communications Bill is completed.

The key points covered in this section are:

In the case of Channel 3, a new award process would offer the opportunity for new entrants to reinvigorate the existing Channel 3 model based on a new package of obligations. However, the framework for obligations which could be imposed would be determined by existing legislation.

In contrast, renewal has known benefits, guaranteeing provision in areas that have traditionally played a key public service role – news for the Nations and regions beyond the BBC and high levels of original programming. However, renewal can only be offered on the basis of existing terms and may not provide the flexibility to amend the licence structure in the Nations.

In the case of Channel 5, the same considerations about stability apply, but the decision between renewal and an award process depends on whether the current licence holder or a new bidder would be more likely to make a more significant commitment to original content production.

Licence extension in either case could allow for a fuller and potentially more fundamental review of the public service broadcasting regime in the next Communications Bill.

Any decision by the Secretary of State to block licence renewal or to extend existing licences must be taken at the latest by the end of June 2013. However, we would encourage the Secretary of State to make an early decision in this matter to give the licensees certainty and to allow them and other affected parties to plan and invest accordingly.

The Secretary of State may wish to consider in the Communications Bill whether the regulatory system for monitoring and enforcing delivery by commercial public service broadcasters needs amending to reflect the transition to digital.

The decision for the Secretary of State

- 7.2 The Channel 3 and Channel 5 licensees are currently entitled to apply to Ofcom for a renewal of their public service broadcasting licences, which are due to expire at the end of 2014. The Secretary of State has the option to intervene to block renewal or to extend the current licence terms before Ofcom must decide whether or not to grant renewals to the existing licence holders.

7.3 Figure 31 below sets out the options open to the Secretary of State:

Figure 31: Table outlining options open to the Secretary of State

	Secretary of State blocks licence renewal triggering a licence <u>auction</u>	No intervention by the Secretary of State, allowing <u>renewal</u> process	Secretary of State elects to <u>extend</u> existing licences
Action	After considering this report, the Secretary of State blocks renewal if he disagrees with our assessment of sustainability or considers that there are other public policy considerations that make it appropriate to do so. The Secretary of State may block renewal in relation to the Channel 5 licence and/or the Channel 3 licences	Secretary of State decides not to exercise his powers in relation to re-auctioning or extension and Ofcom undertakes a renewal process.	The Secretary of State uses his powers under s.224 of the Act to extend one or more of the existing Channel 3 and 5 licences.
Timing	The Secretary of State formally has until 30 June 2013 to block renewal of one or more categories of licences, although Ofcom will need to develop possible proposals ahead of this date.	The Secretary of State may decide to block renewal or to extend licences until 30 June 2013. After that date, the power to block lapses and licence renewal applications must be assessed by Ofcom.	The Secretary of State has until 30 June 2013 to extend existing licences although Ofcom will need to begin work on all possible option if no decision is made ahead of this date.
Next Steps	Ofcom begins the formal process of re-auctioning the licences for which renewal has been blocked.	Once the Secretary of State has decided not to intervene, Ofcom will decide whether or not to grant the licensees' applications for renewal. If it decides to do so, it must notify the licensees of the financial terms (and, in the case of Channel 3, the geographic scope of the licence) on which renewal will take place.	The process for renewal and/or re-auctioning is delayed for the period of the extension. The Secretary of State may require Ofcom to provide an additional report before the end of the extended licence period.

7.4 In addition to the findings of this report, there are other factors which are likely to be relevant to the Secretary of State's decision, including:

- the ability and ambition of commercial providers to meet public purposes in the next licence period;
- the potential future provision, scope and role of the BBC, the Channel 4 Corporation and commercial broadcasters; and
- the Government's views on the need for a more fundamental reform of the public service broadcasting system in light of digital technology and changing patterns of consumer consumption.

7.5 These considerations may not be mutually exclusive. For example, it would be open to the Secretary of State to allow the renewal process to continue, while signalling that potential changes to PSB benefits, such as those discussed in section 6 above, may be secured through the Communications Bill.

7.6 As we set out in our interim paper, there are both benefits and disadvantages attached to each of the alternative options. These are set out in Figure 32 below.

Figure 32: Benefits and implications of the options open to the Secretary of State



7.7 The remainder of this section assess each of the three options open to the Secretary of State.

Consideration of the options for the Channel 3 licences

Considerations in relation to re-auctioning the Channel 3 licensees

- 7.8 A decision by the Secretary of State to block renewal would offer the opportunity to reinvigorate the existing Channel 3 model through an auction process.
- 7.9 There are a number of reasons why this approach might be deemed to be attractive. In particular an auction process would:
- test whether there are alternative models of provision in relation to the Channel 3 licences that potential applicants, including the existing licence holders, would be willing to bring forward;
 - give a clearer indication of the value of the licences – including difficult to quantify factors such as goodwill – by determining that value through an open auction process;
 - bring an opportunity to restructure the Channel 3 map to better reflect modern cultural identities within the UK, particularly in relation to the devolved Nations; and
 - provide an opportunity to consider more innovative approaches to the Channel 3 model.

7.10 However, this approach is not without risk. In particular, we note that:

- There would be no clarity about who or how many companies would bid for these licences until after a decision to re-auction was made;
- The impact on ITN could potentially be damaging, throwing into question its long-term future and therefore its position within the wholesale news market; and
- The re-auctioning process would take place at a time of economic difficulty, which could have a potential chilling effect on the willingness of competitors to bid.

7.11 Re-auctioning these licences in a digital environment will be materially different from the analogue auctions of the past. In 1991, new businesses were created effectively to serve licences which offered privileged access to mass audiences across the UK. Companies competed vigorously to secure this advantage. Today, within a digital framework, the licences are assets held by businesses which generally have a far broader focus than the public service licences which they operate.

7.12 A fuller explanation of the auction process is set out in Annex 1 of this report. However, central to the decision as to whether to auction the Channel 3 licences is a consideration of the terms under which an auction would take place. There are two aspects to this:

- the obligations that are set and which must be met as a condition of bidding; and
- the geographic areas for the licences to be re-auctioned.

7.13 In relation to the first point, the framework set out in the Communications Act 2003 includes a requirement upon Ofcom to impose obligations that ensure:

- the delivery of the public service remit;
- news and current affairs;
- regional content, including regional news; and
- original and independent production quotas.

7.14 Within the context of an auction process, it should be noted that Ofcom has discretion to set the level of most obligations.⁵⁰ Further, the Secretary of State could (subject to positive resolution by Parliament) either remove obligations (e.g. in relation to regional news) or seek to amend relevant secondary legislation – for example to refine the definition of original programming. It is also possible for the Secretary of State to amend the public service remit of the licences, although there are a number of procedural constraints on the exercise of this power.

7.15 Second, an auction process would require Ofcom to determine the areas for which the licences would be granted in accordance with the specific duties and powers set out in the Broadcasting Act 1990 ('the 1990 Act') and our relevant general duties as set out in section 3 of the Communications Act 2003 ('the 2003 Act').

⁵⁰ In most cases, Ofcom has discretion to judge what levels of obligations required by statute are "appropriate", "sufficient" or "suitable". In certain cases, however, programme obligations are required to be "significant" and in all cases Ofcom must set quotas on an objectively justifiable basis in line with our duties.

7.16 The 1990 Act states that:

- Channel 3 must be structured on a regional basis;
- one of the areas for which a regional Channel 3 service must be provided must be an area which “comprises, or falls within Scotland”; and
- Ofcom may licence the provision of a separate Channel 3 service at particular times of the day for two or more areas for which regional Channel 3 services are provided. A service of this nature is referred to in the Act as “national Channel 3 service”.⁵¹

7.17 Further, the 2003 Act states that Ofcom has:

- a duty to secure the availability throughout the UK of a wide range of television services which (taken as a whole) are both of high quality and calculated to appeal to a variety of tastes and interests;
- a duty to have regard to the opinions of consumers in relevant markets and of members of the public generally; and
- a duty to have regard to the different interests of persons living in different parts of the UK, of the different ethnic communities within the UK and of persons living in rural and urban areas.

7.18 In the light of these requirements, we consider the opinions of viewers, the ability of a licensee to provide a high quality service which caters for different audience interests and the availability within an area of other local television services are likely to be key determinants in identifying the regions for which Channel 3 licences should be created.

Considerations in relation to permitting renewal

7.19 On the basis of the analysis in this report, we consider that there are a number of benefits in allowing the renewal of the Channel 3 licences and therefore the continuation of the existing Channel 3 services as PSBs into the next period.

7.20 First, a renewal would create market certainty for the Channel 3 companies at a time of economic instability. It would allow them to invest in both UK news provision and original content with certainty about their future regulatory status. At a time when these companies are facing significant challenges in relation to digital distribution and potential competition from global advertising platforms such as Google and Facebook, we do not believe that the importance of certainty should be underestimated.

7.21 Second, we recognise the importance of the Channel 3 system in delivering plurality of broadcast news at a UK, Nations and regional level. In particular, we note that:

- Broadcast news continues to be the most used source of news in the UK. Seventy four per cent of people surveyed by Ofcom in 2010 said that TV was their main source of news. The next highest was the internet at 7%.

⁵¹ The GMTV licence is the only national Channel 3 service at the present time.

- Channel 3 news remains the second most viewed UK news service and plays an important role in securing plurality as the main competitor to services offered by the BBC, with audiences of 3.4m for its early evening news bulletin and 2.4m for its *News at 10*.
 - Renewal could allow the Channel 3 licensees and ITN to agree a new long term contract. If such an agreement could be reached – and there is no requirement for the Channel 3 licensees to appoint ITN as their news provider – it would offer stability to ITN and enable it to invest in equipment and staff.
 - The Channel 3 system sustains the provision of Nations news beyond the BBC in Scotland, Wales and Northern Ireland. The reach and impact offered by the Channel 3 network combined with a long-established expectation by audiences for news programming at a sub-UK level makes these services an effective carrier of national and regional news programming.
 - The Channel 3 regional news service continues to attract reasonable numbers of viewers. In certain areas (notably Border and Northern Ireland) the service outperforms the BBC, although the popularity of individual services varies across the UK.
- 7.22 Third, the Channel 3 licensees make a significant contribution to investment in UK original content, providing opportunities for the UK production sector and delivering high quality UK content across all screens in the UK. The Channel 3 network is the second biggest investor in content in the UK behind the BBC. [§]. We consider this to be a strong indication that ITV plc would continue to invest in content at levels similar to those guaranteed by the existing quotas if it was not a PSB.
- 7.23 Against that, renewal would cement the continuation into the next decade of regional news services created in the 1950s and 1960s to suit an analogue transmission framework without taking account of changes in the services used by consumers to obtain news about their area. We note that the growth in popularity of hyperlocal content online – 34% of people surveyed by Ofcom say they used community websites more often than they did two years ago – and the planned introduction of local television services designed to provide communities with content focused on the needs of specific conurbations.
- 7.24 We are also conscious that services in the Nations must recognise and serve cultural identities and evolving political structures in the context of devolution. We are mindful, therefore, that the regulatory framework in the Nations may need to develop over the next licence period if it is to reflect national and regional identities within the UK accurately.
- 7.25 From a legal perspective we note that the Act requires renewal on the basis of existing terms, except for the geographic scope of licences and the financial terms under which they are offered. However, Ofcom’s ability to amend the region for which a renewed licence may be granted – for example in order to create dedicated National licences – is reliant on the consent of the licensee currently providing a service within the affected areas.
- 7.26 Following a decision by the Secretary of State not to intervene in renewal and in the absence of such consent from the existing licensees, Ofcom would have the option of not renewing the relevant licences in order to grant a fresh licence covering a new geographic area for auction. However, the complicated and contentious nature of

such a measure should not be underestimated. In either case, we consider the findings of audience research would be likely to be a key consideration in any decision to restructure the Channel 3 licensing map in this way.

7.27 Finally, in the context of renewal it is also important to recognise the pressures that digital delivery has put on the development of commercial arrangements between the Channel 3 licensees in their networking arrangements and other contractual relationships. Although the Channel 3 licensees have been able within the context of this current process to agree new terms, it remains to be seen whether they will be able to network together effectively over the period of the next licence, as the digital environment in which they operate continues to evolve.

Conclusions on options for the Channel 3 licences

7.28 In conclusion there are a number of key issues for the Secretary of State to consider regarding the options set out above. A decision to block renewal, leading to an auction for Channel 3 licences would:

- test the value both of the regulatory intervention and through a competitive process determine the level of public service content that can be secured in return;
- offer the potential for innovative new bids, albeit with questions about the ability of any new entrant to match current levels of investment from a standing start;
- offer the Secretary of State the opportunity to reshape public service obligations, albeit in a more limited way than under new primary legislation; and
- create potential uncertainty at the same time around both of the UK's most popular television services, Channel 3 and – because of Charter Renewal – the BBC, with potential consequences for the wider creative economy.

7.29 In contrast, a process ultimately leading to the renewal of Channel 3 licences would:

- provide certainty to existing licensees, enabling them to make long-term content investments, particularly in relation to regional news provision;
- ensure continuity and prevent the possibility of significant disruption to regional services;
- secure a system which delivers plurality of news in the Nations, including the future of UTV and STV;
- preserve a regional franchise model designed in the 1950s that may come under further strain as a result of digital and online distribution methods in the next licence period; and
- potentially lead to a new contract for the provision of Channel 3 news by ITN, that would be likely to bring stability to the current news provider for Channel 3, Channel 4 and Channel 5.

Consideration of the options for the Channel 5 licence

- 7.30 In the case of Channel 5, we consider the potentially significant aspects to the Secretary of State's decision rests on an assessment as to whether renewal or re-auctioning is likely to offer the greatest level of future investment in UK news and original content.
- 7.31 In relation to this decision we note the following.
- The current owners of Channel 5 have held the licence for less than two years. The submissions we have received from Channel 5 in the process of drafting this report suggest the company is continuing its strategy of increasing investment in original content. Channel 5's own provisional figures for 2011 suggest that spend on original programming increased by [X]% to £[X]m in the first full year under new ownership.
 - The Channel 5 licence holder has recently reassessed its provision of UK news to ensure that its service provides an effective contribution to PSB purposes. To this end, we note that Channel 5's 5pm news bulletin reaches approximately 700,000 viewers, broadly comparable with the 800,000 viewers who watch Channel 4's main evening news programme.
 - As part of its delivery of high quality and diverse programming, Channel 5 currently devotes 18% of its schedule to children's programming, the only one of the main PSB services to offer such programming on a daily basis on its core channel.
- 7.32 As with Channel 3, however, an auction of the Channel 5 licence would serve to demonstrate whether any other potential bidders would be willing to offer more significant commitments to news and the production of original UK content. Within this context, we note that Channel 5 has argued that amendments to its modest PSB obligations may be necessary if the licence is to be sustainable throughout the next licence period.
- 7.33 In either scenario, the Secretary of State may also choose, within the time period set out in s.271 of the Act, to look at the public service remit of Channel 5, potentially extending it to guarantee its continuing delivery of and investment in high-quality programming for children.

The option of licence extension

- 7.34 In addition to the Secretary of State's powers under s.230 of the Act and although it formally falls outside the scope of this report, legislation does provide the Secretary of State with the opportunity to extend the current Channel 3 and Channel 5 licences. Ofcom notes that this approach would allow for a full and potentially radical review of the public service broadcasting regime in the next Communications Bill.
- 7.35 We are mindful that a lack of long-term licence certainty will, in the interim, increase pressures on commercial companies. Short-term business insecurity may increase the pressure on businesses in a number of areas, including access and terms for finance, investing for future growth and staff retention.
- 7.36 Balanced against that, the extension of the licences would allow for a full consideration by Parliament of the institutional structures required for delivering

public service content in a world of digital media. Consequently, extension would enable an assessment to be made of 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 – in the context of Charter renewal – 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 television services in the next few years could open the way for an assessment of the continuing need for English regional programming on Channel 3 or indeed the effectiveness of the existing Channel 3 framework to reflect national and regional identities within the UK.

- 7.37 New legislation could also create an opportunity to increase PSB provision by bringing additional benefits clearly within the PSB framework. For example, it would be possible to review potential licensing arrangements alongside proposals for reviewing:
- the role of EPG prominence regulation;
 - the application of retransmission fees;
 - the application of ‘must carry’ obligations to IP-based platforms; and
 - the balance of rules concerning the amount of advertising permitted on television.
- 7.38 Ofcom is also mindful that, as we acknowledged in our interim paper, the Secretary of State may wish to take account of the possible interaction between licence extension and ongoing international discussions on the future uses of the 700 Mhz spectrum band and the specific implications for DTT services in the UK.⁵²
- 7.39 Given Ofcom’s remit in this report, we have not discussed in detail with the licensees what their response would be to a decision by the Secretary of State to extend the existing licences. However, all of the licensees have indicated their preference for renewal.
- 7.40 Finally, if the Secretary of State were to extend existing licences, we would recommend that serious consideration is given to the length of that extension. A key factor in that decision is the impact on ITN of extension and how that impact could be mitigated.

Possible revisions to the regulatory framework for Channel 3 and Channel 5

- 7.41 As discussed above, today’s system of regulation is built around a system of quotas on core PSB channels which relate to the volume and value of delivery against certain defined production, genre and structural obligations.

⁵² Ofcom published a consultation *Securing long term benefits from scarce spectrum resources: A strategy for UHF bands IV and V* on 29 March. See: <http://stakeholders.ofcom.org.uk/consultations/uhf-strategy/>

- 7.42 There are a number of positive aspects to this system of regulation: it is well understood, creates clear metrics and provides an objective basis by which to analyse elements of delivery by public service broadcasters.
- 7.43 However, in considering possible contributions by the licensees to public service purposes in the next licence period, we have been conscious that, as digital technology continues to affect content delivery and consumption models, so our systems of regulation might also need to adapt to reflect those changes in the way we secure and measure public service broadcasting delivery. This could be achieved in different ways:
- At one end of the spectrum this could mean revisiting the scope and application of certain quotas to ensure each one provides a fair representation of the output which qualifies under it. It would, for example, be possible to amend the definition of original production to focus more explicitly on first run originations in peak if there were a sufficient case for doing so.
 - A more radical approach would be to assess the overall public value and economic impact of existing interventions to take broader metrics into account. This is not uncharted territory. Ofcom already oversees Channel 4's Statement of Media Content Policy, which was introduced in the Digital Economy Act and seeks to provide at an institutional level a much more detailed analysis of Channel 4 Corporation's delivery against its public service remit than exists for the commercial PSBs.
- 7.44 We believe such options are probably best considered in the context of a new Communications Bill. Therefore we have not made any recommendations about the exercise of powers by the Secretary of State to amend, suspend or remove the obligations of the Channel 3 and Channel 5 licensees.
- 7.45 However, we note that over the past decade, as we have moved to a fully digital broadcasting environment, there has been a continuing tension with commercial PSB licensees over the appropriate balance of costs and benefits in relation to the licences. Although we recognise there is uncertainty about the value of the licences in the next licence period, we also believe that the level of current obligations faced by the PSBs is approaching a set of minimum requirements for contribution to public service purposes.
- 7.46 Consequently, in the event of renewal, regulation for the next period must, in our view, be predicated on an acceptance by the licensees that there will not be a continuing negotiation about the level of the obligations. Within the terms of a more general review of the regulatory framework, it may be appropriate for the Government to consider what safeguards can be built into future legislation to prevent any further erosion of obligations in the next licence period.

Summary of relevant considerations for the Secretary of State

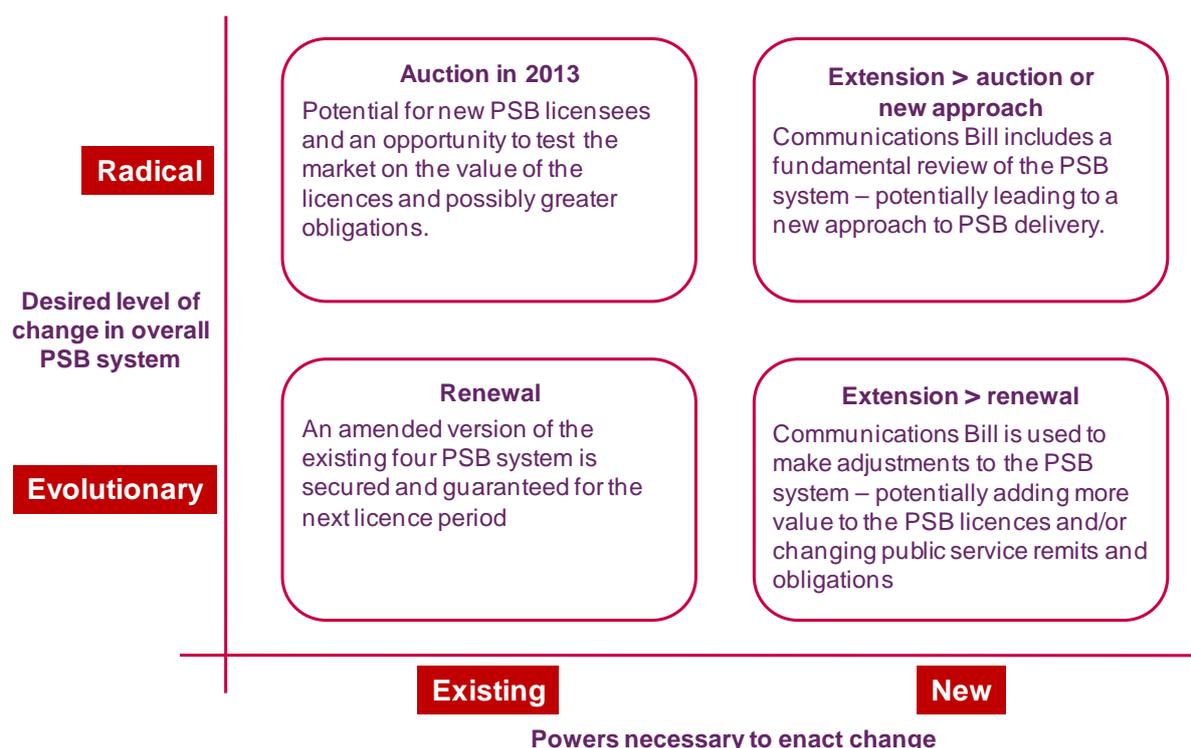
- 7.47 Further to the factors set out above, and given that each of the alternatives outlined provides a credible option for the Secretary of State, Ofcom considers that ultimately the decision for Government is dependent on:
- The desired level of change in the system for delivery of public service purposes; and

- The powers which are necessary to enact that level of change.

7.48 A model for commercial public service broadcasting based on an evolutionary approach could, in our view, be secured by licence renewal with relatively minor amendments to public service obligations within the existing regulatory framework.

7.49 However, the possibility to secure more fundamental changes also exists, either within the current four PSB system or potentially – as part of the Communications Bill process – leading to a comprehensive reassessment of the distribution of funding for public service content (see Figure 33 below).

Figure 33: Summary of relevant considerations for the Secretary of State



Conclusion

7.50 Ofcom considers that each of the alternatives outlined provides a credible option for the Secretary of State.

7.51 As we set out in our interim paper last summer, there are a number of reasons why the Secretary of State could decide that the public interest is best served by either an auction or extension of the current commercial PSB licences:

- Re-auctioning would open up the licensing process to competitive examination and could establish a more accurate value of the licences.
- Extending the licences would allow consideration of more radical changes to the public service broadcasting landscape through the Communications Bill process.

7.52 Equally, there are significant positive reasons for the Secretary of State to renew the current licences:

- **Despite significant changes in technology and evolving patterns of consumer consumption since the PSB purposes defined under the 2003 Act came into force, the commercial public service broadcasters continue to play a key role in delivering public service programming and supporting the UK content production industry.**
- **For the Channel 3 licensees, this contribution is also reflected by spend on original UK content second only to the BBC and the provision both of universally accessible UK television news that competes with the services offered by the BBC and ensures plurality in UK, Nations and regional news coverage. We note that renewal is likely to provide greater certainty for ITN in the short term.**
- **In comparison, and as a reflection of the more limited range of PSB benefits it receives, delivery by Channel 5 is more modest. In addition to its regular news bulletins, the broadcaster invested £62m in new programming in 2010, with its own provisional figures indicating a rise to £[X]m for 2011.**

Annex 1

Outline of an auction process for Channel 3 and Channel 5 licences

The auction process

- A1.1 In the event the Secretary of State makes an order that one or more of the licence categories are not to be renewed, Ofcom would be required to auction new licences for the Channel 3 and/or Channel 5 services affected.
- A1.2 The process Ofcom would be obliged to follow to award new licences is set out in s.14-17 of the Broadcasting Act 1990 (as amended) and contains a number of separate stages.

Determination of licence areas (Channel 3 only)

- A1.3 Ofcom's initial obligation would be to determine an appropriate structure for the regional Channel 3 map in the new licence period, by deciding how many regional licences should be awarded and the specific geographic areas each should cover.
- A1.4 The existing legislation requires that there must be a Channel 3 licence area which "*comprises or falls within, Scotland*". Ofcom could not therefore award a UK-wide Channel 3 licence.
- A1.5 Further, in determining a new Channel 3 map, we would also decide whether it was appropriate to set separate programming obligations for different 'sub-regional' parts of the new licence areas.

Publication of a notice inviting licence applications

- A1.6 Ofcom must invite applications for the Channel 3 and Channel 5 licences by issuing a notice. In the case of the Channel 3 licences, the notice must specify:
- The geographic areas for which we are proposing to issue licences;
 - Any sub-regional provisions within those areas; and
 - The application fee and the level of any additional payments which may be applied to successful applicants.
- A1.7 In the case of Channel 5, the application notice must specify the geographic area for which the service must be provided as well as the application fee and any additional payments that may be required.
- A1.8 In both cases, the notice would also specify the qualitative thresholds that applications would have to meet in order to be considered for an award. These thresholds are the licence conditions which must be included in the relevant licence under the Communications Act 2003 in relation to:
- Public service remit;

- programming quotas;
- news and current affairs; and
- programme production and regional programming.

A1.9 Ofcom has no discretion in relation to the setting of the public service remit threshold, since the Act simply requires that the licence includes a requirement to fulfil the public service remit for the licensed service. On the other matters, however, we anticipate that the thresholds set would include the quotas that we considered an appropriate minimum requirement for meeting the statutory obligations in relation to news, programme production and regional programming.

A1.10 Alongside this notice, Ofcom must publish general guidance setting out for potential applicants the kinds of programming that would be likely to satisfy the qualitative thresholds. We may also publish general guidance for applicants for Channel 3 licences as to the kinds of proposals in relation to networking arrangements that we would be likely to consider satisfactory.

Applications from potential licensees

A1.11 In response to our notice and guidance, potential licensees would be required to submit:

- A cash bid for each licence for which they are making an application;
- A business plan demonstrating the financial viability of the service throughout the licence period; and
- The specific programming proposals for the licence in question.

A1.12 In the case of applicants for Channel 3 licences, their applications must also include their proposals for participating in networking arrangements.

The licence award process

A1.13 An applicant that does not satisfy the quality thresholds or which is unable to demonstrate that it would be able to maintain a service meeting those thresholds throughout the licence period will be disqualified from consideration for an award.

A1.14 From those applications that do meet the thresholds, it is, in principle, the applicant submitting the highest cash bid that wins each available licence. Accordingly, an applicant could win more than one licence.

A1.15 However, it is important to note that Ofcom does have discretion to award the licence to an applicant who has not submitted the highest cash bid if exceptional circumstances apply. The 1990 Act sets out one such exceptional circumstance (although of course there may be others), as follows:

“a) that the quality of the service proposed by [an applicant other than the highest bidder] is exceptionally high; and

b) that the quality of that proposed service is substantially higher than the quality of the service proposed... by the applicant who has submitted the highest bid..."