Annex 3. The networking arrangements and their impact on the Channel 3 licences

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Introduction

A3.1 This annex discusses the networking arrangements between the Channel 3 regional licensees, and in particular that aspect of the networking arrangements that determines the way in which the ITV regional licensees share the costs of the network schedule. It discusses the impact of the proposal that ITV plc has made in its response to the Phase 2 PSB review consultation for a renegotiation of the level of contribution to the costs of the network schedule which is currently made under the networking arrangements between the regional licensees, and the next steps that Ofcom proposes to take.

Background

A3.2 By statute all of the Channel 3 regional licensees must participate in networking arrangements. These networking arrangements between financially independent companies allow them jointly to commission or acquire the networked portion of the ITV1 schedule and to share the costs of that networked material.

A3.3 Whilst the networking arrangements were introduced under the 1990 Broadcasting Act, the Communications Act 2003 introduced a requirement for periodic reviews of the networking arrangements. Section 293 of that Act requires Ofcom to carry out from time to time a general review of the networking arrangements and Schedule 11 sets out the tests which Ofcom must take into account, alongside its wider statutory duties, when carrying out this review. Essentially, these tests concern:

- The ability of regional Channel 3 services to be a nationwide system that can compete effectively with other UK television programme services; and

- The impact of the networking arrangements on competition.

A3.4 In addition, Ofcom is also required to consider the effect of the arrangements on the ability of the regional Channel 3 licensees to maintain the quality and range of regional programmes and other programmes contributing to the regional character of the services.

A3.5 In its submission to Phase 2 of the PSB review ITV plc says that the short-term regulatory changes for 2009 onwards which Ofcom has proposed in the Phase 2 consultation will keep the costs and benefits of the public service status of its licences broadly in balance for 2009. However, from 2010 ITV plc suggests that its licences will fall into deficit with the costs of public service obligations exceeding the value of the benefits of public service status. It therefore argues that from 2011 it will require a renegotiation of the networking arrangements between the ITV plc owned licences and other Channel 3 licences.

Ofcom's analysis of the current position of the Channel 3 licensees

A3.6 As discussed in Phases 1 and 2 of this PSB review, Ofcom accepts that the costs of public service status for ITV plc licences as a whole will exceed the benefits before digital switchover is completed. However, we believe that with the amendments proposed to regional news obligations and with the potential benefits of BBC partnerships discussed earlier in the main body of this statement the licences should be sustainable at least until the end of 2010.

A3.7 In this two year period (2009 and 2010) and based on the effect of the current ITV networking arrangements on all the Channel 3 licensees, the position in the devolved nations is that while the costs of the Welsh licence exceed its benefits, the licence viability is supported by cross subsidy from the English licences that are also owned by ITV plc. In Scotland, the costs of the regional obligations of the Scottish licences will similarly come to exceed the benefits of public service status; however, the broadcasting business of stv as a whole is projected to remain in profit based on the profitability of the network schedule in Scotland. In Northern Ireland, the benefits of the licence exceed its costs and the network schedule similarly delivers a profit, so the licence as a whole is also expected to remain in profit.

A3.8 The Channel Islands is the one area of risk. As stated in the September consultation document, Channel Television's business model is based on supplementing income from its Channel 3 licence with income from complying (readying for broadcast in terms of the Ofcom Broadcasting Code etc.) programmes from independent producers shown on the network. The public service licence currently makes a small profit but this is declining with pressure on the advertising revenue delivered by the Channel 3 service. If Channel TV's compliance income were to reduce significantly, the viability of the licence could be under threat.

A3.9 As with the ITV plc owned licensees, partnerships with the BBC should also be available in Scotland, Northern Ireland and the Channel Islands. They offer the Channel 3 licensees the potential to reduce the cost of regional news provision. This could assist them in enhancing the profitability of their public service licences.

A3.10 Looking further ahead the common ground between Ofcom and all the licensees (both ITV plc and non-ITV plc owned) is that we agree that across the network as a whole the costs of their regional Channel 3 licences will come to exceed the benefits of holding such licences before the completion of digital switchover. We also agree that the cost of regional news delivery is a key factor in creating this deficit in the licences. In short, before digital switchover is complete, the value of the Channel 3 licences will fall below the level required to support the delivery of news for every devolved nation and English region.

A3.11 Where the deficit occurs is a function of the networking arrangements which determine the way in which the cost of the network schedule is shared between the licensees. ITV plc argues that the deficit currently arises for its own licences because it is 'over-paying' for its share of the network schedule costs and it therefore argues that its contribution to the network schedule should be reduced. The effect of such a reduction would simply be to move the deficit into the licences that ITV plc does not own. This is the context for the proposals ITV plc has made for changes to the networking arrangements.

A3.12 ITV plc has argued in its submission to the Phase 2 consultation that unless substantial amendments to the networking arrangements are implemented and its relationship with the other licensees moves to a more commercial footing from

2011, it will be forced to consider relinquishing public service status. At that point, there would be no guarantee that a replacement Channel 3 licensee would be able to maintain comparable investment levels or deliver comparable reach, so such a step could seriously damage the current businesses of the other Channel 3 licensees as they could lose the strength of the current network schedule.

A3.13 ITV plc argues that the difference between the current arrangements and what it considers would be a more equitable sharing of costs between the licensees amounts to a transfer of over £30 million per year paid by ITV plc to the licensees in Scotland, Northern Ireland and the Channel Islands. The other licensees dispute that the current arrangements represent a subsidy to them.

A3.14 Both sides in this dispute have submitted further confidential evidence to Ofcom alongside their responses to the Phase 2 consultation. Among a number of points made, the non-ITV plc licensees argue that the figures that ITV plc has already put into the public domain fail to take account of the benefits that the ITV plc owned channels ITV2, ITV3, and ITV4 derive from the ability to repeat/show extended versions of programmes commissioned by ITV Network for ITV1 during their initial licence period and also do not reflect the value that these channels derive from cross promotion on ITV1. For its part, ITV plc's submission presents a detailed analysis of all the regulated cost sharing arrangements within the ITV networked system together with its own analysis of all costs and benefits of the commercial arrangements between the licensees, including those referred to above.

A3.15 Ofcom will need to consider both sets of arguments in detail in any future review of the networking arrangements.

A3.16 However, irrespective of the precise size and direction of any transfer of value between the licensees, the move which ITV plc argues for, to a commercially negotiated relationship where the other licensees' contribution to the network programme budget is based much more closely on the revenue earned from their licences, would have a very significant impact on their economics and could jeopardise their continued ability to provide news and non-news programmes for Scotland, Northern Ireland and the Channel Islands without access to external funding.

A3.17 While Ofcom does not necessarily agree with all the detail of ITV plc's arguments, we recognise that the cost of the networking arrangements to ITV plc is a significant factor in the balance between the costs and benefits to them of public service status.

A3.18 During the course of the work on the PSB review, all of the Channel 3 licensees have recognised that there is a need for a fundamental review of the arrangements.

A3.19 Under current legislation Ofcom may not approve amendments to the networking arrangements unless it has considered the likely effect of the arrangements on the ability of the regional Channel 3 licensees to maintain the quality and range of the regional programmes included in the regional Channel 3 service. This will require Ofcom to consider the economic impact of any proposed changes to the networking arrangements on the different regional licensees.

A3.20 From their inception in the early 1990s the networking arrangements have provided different degrees of benefit to the different licensees because the licences are of intrinsically different size and carry different obligations. In essence the larger licensees pay a share of the network programme budget which is larger than their share of network advertising revenue, reducing the contribution that is made by the smaller licensees. Overlaid on this is the effect of the merger undertakings given by Carlton and Granada in 2003 which limit to RPI the rate of increase in the contribution to the network programme budget by the licensees that ITV plc does not own.

A3.21 As a result, if the networking arrangements and the merger undertakings were to change in the significant way ITV plc wishes, without any change to the obligations attached to the licences, the consequences differ by licence:

- In the Channel Islands and Northern Ireland, as the smallest independently owned licensed areas, the licences could become unprofitable.

- The Scottish licences (collectively) may remain in marginal profit, especially if the benefit of BBC partnerships allows them to reduce costs – though the smaller North Scotland licence would be significantly subsidised by the larger Central Scotland licence.

A3.22 The impact of any savings in the cost of regional news production that might be made from news partnerships with the BBC is unlikely to change the basic pattern of these consequences.

The process for change

A3.23 As set out above, Ofcom is already obliged by statute to review the operation of the ITV networking arrangements on an annual basis. However, responsibility for the regulation of the non-ITV plc licensees' contribution to the network programme budget lies not only with Ofcom under the networking arrangements but also with both the OFT/Competition Commission as a result of the merger undertakings given by Carlton and Granada when they merged to form ITV plc.

A3.24 One way for the financial contribution to the networking arrangements of the different licensees to be adjusted would be through a commercially negotiated agreement between ITV plc and the other Channel 3 licensees. Were this to occur, the levels of financial contribution could potentially be reflected in revised networking arrangements. Ofcom would have to approve any modification to this effect in the networking arrangements. It would also be necessary to approach the OFT/Competition Commission to seek their agreement to appropriate changes to the Carlton/Granada merger undertakings reflecting the new commercial agreement.

A3.25 It is unclear however, whether there is a negotiated solution that will satisfy all parties, although the future of the non-ITV plc licensees is clearly dependent on whether ITV plc retains its public service status.

A3.26 In the absence of such a negotiated settlement, ITV plc would need to approach both the OFT/Competition Commission together with Ofcom to make the case for a review of the existing networking arrangements. This would then need to be considered in detail, together with the differing views of the other licensees and there would be the need for a wider public consultation. This would be a process analogous to that which is currently underway for the review of CRR and is likely to take some time.

A3.27 Ofcom recognises that with the continuing decline in the value of all of the Channel 3 regional licences, unless all the members of the network are willing participants in it, the networking arrangements cannot be sustained. While change to the networking arrangements is outside the scope of this public service broadcasting review, we acknowledge the need for the cost sharing arrangements between the Channel 3 regional licensees to be substantially reviewed if the ITV network system is to survive. Any review will however need to be mindful of the fact that alternative mechanisms to fund news and non-news provision in Scotland, Northern Ireland and the Channel Islands may then have to be found.

Next steps

A3.28 Ofcom welcomes the acceptance by all the licensees that a fundamental review of the networking arrangements will be required, a conclusion with which we agree. We will undertake further analysis of the detailed submissions made by the licensees and intend to work with them to try and arrive at new arrangements which recognise the extensive financial inter-relationships between their businesses.

A3.29 We anticipate taking this work forward in the context of our 2009 review of the ITV networking arrangements.