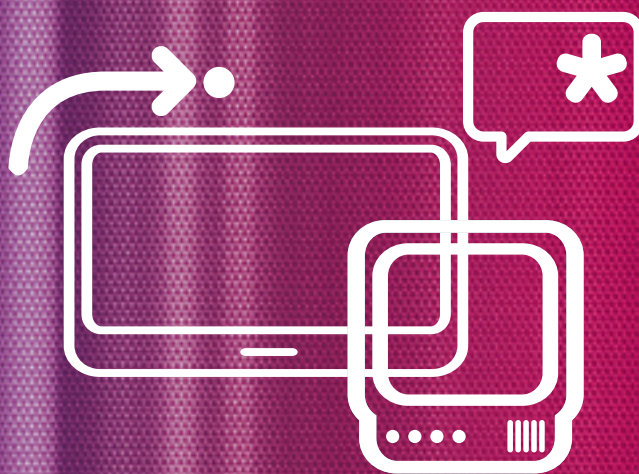


Phase 2 – Meeting the digital challenge

Ofcom review of public service television broadcasting



Closing date for responses:
24 November 2004

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Foreword

Parliament has asked Ofcom to report every five years on the health of public service broadcasting in television. We are asked to answer two questions. Firstly, ‘How well are the existing public service broadcasters – the BBC, ITV, Channel 4, S4C, Five and Teletext – taken together, meeting the public service objectives that Parliament has laid down?’ Secondly, ‘What recommendations do we make to maintain and strengthen public service broadcasting in the UK in the years ahead?’.

In Phase 1 of our first report, we undertook a detailed and long-term analysis of the programming available on the main channels, and the audience’s view of what they wanted, expected and watched. This addressed the first of Parliament’s two questions. In our Phase 1 report, we also offered suggestions on the underlying purposes of public service television, in effect the ‘why?’ of PSB. We did so because we believe that this will provide a more enduring benchmark of what people want from PSB, against changes in the market, technology and viewing tastes, than simply the current ‘what?’ or ‘how?’

We have consulted widely since the agreed date of response of Tuesday 15 June. We have received over 80 responses. We have held public debates around the UK, citizen juries, commissioned qualitative and quantitative research, liaised closely with all the key stakeholders, commissioned extensive economic modelling and analysis and looked at the main international comparators.

The responses to Phase 1 of our report bear out that a properly-funded BBC remains the central core of PSB; but that people do not want the BBC to have a near monopoly of its provision. Competition for quality drives innovation and keeps the BBC on its mettle. There was also strong support for the underlying purposes of PSB that Ofcom had suggested, as meeting both personal viewer preferences and wider social needs.

In this, Phase 2, of our report, we analyse market trends and expected changes in viewer behaviour over the coming years; and we offer some

proposals to begin to answer Parliament’s second question: ‘How can we maintain and strengthen public service in television broadcasting in the years ahead?’.

Our central conclusion is as follows: public service broadcasting has been sustained and financed over many years by a mutually reinforcing mix of institutions, funding and regulation. It is now clear that this balance will not survive the move to a fully digital television age, which on current plans will complete by 2012.

The historical compact in which public service broadcasting was provided by the commercial broadcasters in return for privileges and discounted access to the analogue spectrum, will come under increasing pressure as the audience using the analogue spectrum continues to decline. The issue is not that the commercial public service broadcasters will cease to be viable, or even strong, businesses. It is that the set of incentives which have impelled the shareholder-funded businesses to provide public service broadcasting will disappear. The PSB licences could be traded in for fully-commercial licences, which are freely available in the digital age, and which carry none of the former obligations. That in turn will increase the pressures on the not-for-profit, but nonetheless advertiser-funded, Channel 4.

Some may argue that, since this is not an immediate problem, the PSB framework and its regulation should conduct a fighting retreat until the point of unsustainability is reached in three to five years’ time. That is a respectable argument, but one we do not accept; and one that we do not believe best serves the citizen, the viewer or the consumer. Why? Because once that point is reached and absent prior measures, the PSB framework would be broken with nothing having been put in its place save monopoly provision from what would, in those circumstances, be an increasingly isolated BBC.

We do not believe that this outcome would be consistent with our statutory duties towards citizenship in this country, sustained in part through plurality and high quality public service television.

In this report we conclude that a new model for public service broadcasting needs to be developed now, before the surplus in this historical system disappears and the goodwill between public service broadcasters and the public declines.

Our aim is, as our parliamentary instruction, to create a framework that will maintain and strengthen public service broadcasting, not just in the short term but for the medium to longer term. The digital model for public service broadcasting will be different from today's analogue model in one critical respect: it will require explicit and transparent funding to replace the current opacity and implicit subsidies.

We have worked hard to ensure that our administrative timetable for Channel 3, Channel 5 and teletext licence reviews allows us to cast this framework simultaneously for all players. It also uniquely coincides with the BBC Charter Review and an opportunity to clarify the role of the public asset that is Channel 4. The alignment of all of these different pieces of analysis against a background of mutual agreement around the analogue switch-off date should make for better decisions.

The proposals that we offer in this, our Phase 2 report, should be seen as a whole. They are designed to secure a strong BBC, properly funded by a licence fee model at the core of our country's PSB and competition for quality from several sources: firstly, a not-for-profit Channel 4 enabled to focus on its core public service objectives; a regime for the shareholder-funded broadcasters that plays to their natural PSB strengths in original UK production, drama and news; and the prospect of a new mechanism, which will refresh and provide the spur to innovation that PSB needs every decade or so.

We would however like to highlight particularly the question of PSB provision in the nations. In a post-devolution UK this is a question that our analysis has shown needs to be asked afresh. This report proposes an open and extensive debate about PSB as it relates to Scotland, Wales and Northern Ireland.

As we have said, our propositions in Phase 1 have now hardened into firmer proposals in Phase 2. We believe that greater choice in the digital world will better meet the needs of the viewer as consumer, and that there is both a need and support for intervention to meet the best interests of the citizen, both throughout the UK as a whole and in recognising the particular circumstances and needs of the nations within the UK.

However, we are equally clear that this intervention needs to fit the market of tomorrow, not as it was yesterday. We recommend this report to you and encourage submissions from all interested parties during the formal consultation process, which concludes on 24 November 2004.

So, what happens next? We will consult again and will listen to the feedback. On the basis of that, we will offer our final conclusions. These, we will incorporate as conditions into the licences for ITV, Channel 4, Five and Teletext. Our conclusions will also inform the Government's decisions on when to start and finish Digital Switchover; and, we hope, will inform Lord Burns's and the Government's/ Parliament's consideration of BBC Charter review, so that PSB in television can truly be addressed in the round.

**David Currie, Stephen A. Carter,
Richard Hooper**

2. Executive summary and recommendations

- 2.1 Public service broadcasting in the UK has been sustained over many years by a mutually reinforcing mix of institutions, funding and regulation. This delicate balance will not survive the move to the digital age.
- 2.2 The historical compact in which PSB was provided by commercial broadcasters in return for access to the analogue spectrum will come under increasing pressure as the audience using analogue services declines and erodes the financial value of the licences to those who hold them. In this report, we conclude that a new model of provision will be needed in the digital age if PSB is to maintain its unique ability to reach millions of people with a plurality of suppliers providing distinctive content.
- 2.3 The digital model of PSB will be different from today's analogue model: it will involve explicit and transparent public funding to replace the current opacity and implicit subsidies; it will involve a new mix of providers; it will involve a changing approach to regulation; and it will require the use of new distribution systems alongside conventional TV broadcasting.
- 2.4 Currently, ITV1, Channel 4 and Five receive approximately £400m a year in implicit subsidies for PSB. These subsidies result from their access to the analogue spectrum. By the time of digital switchover, the declining value of the analogue spectrum will have reduced these implicit subsidies close to zero.
- 2.5 We believe PSB in the digital age should not cost any more in real terms than the current £3bn public subsidy for the TV market. But there is a sound rationale, supported by the public, for replacing part of the current £400m implicit subsidy with explicit funding to maintain plurality and competition in PSB supply in the digital age.
- 2.6 The transition to the digital age will be challenging, but holds the exciting prospect of broadcast and other visual content with distinctive purposes available to all alongside a huge increase in consumer choice. This is our vision for maintaining and strengthening PSB.

The end of the analogue PSB model

- 2.7 The TV market is changing rapidly. The majority of UK households now have access to digital TV; and in the past year another ten per cent of households acquired digital TV. Competition in the TV market is becoming fiercer and consumer choice is increasing, handing more power from producers to consumers. These are welcome developments.
- 2.8 New technologies, such as personal video recorders and broadband, also have the potential to transform large parts of the TV market into an increasingly on-demand service. Many consumers are already able to choose what they want to watch and when they want to watch it.
- 2.9 The market developments also create large challenges for all of the existing terrestrial broadcasters in the provision of PSB:
 - the BBC is in the strongest position; it has a secure funding base, but must continue to sharpen its sense of purpose and adapt to changing technology and public expectations;
 - the value of ITV1's broadcasting licence is declining and, by digital switchover, revenues from analogue TV advertising will not cover the costs of its existing PSB obligations;
 - Channel 4 will face pressure to substitute more commercial programmes for its current PSB programming in order to earn sufficient revenues to cover costs; and
 - Five will benefit from increased coverage after digital switchover, but must continue to strive to maintain audience share in a more competitive environment.
- 2.10 If we do not act now to plan new measures for the post-switchover world, there is a real risk that PSB across the system will decline, both in amount and in effectiveness. Commercial broadcasters will not be able or willing to screen PSB programming which does not produce a full commercial return; and the BBC will no longer face competition for quality.

2.11 We are committed to maintaining and strengthening PSB and have set out a citizenship-based case for PSB into the digital age. If PSB is to be maintained and strengthened, Parliament, the Government, PSB providers and Ofcom must manage the inevitable decline of the commercial analogue PSB model and create a new digital PSB model, which protects the best qualities of PSB for all.

Principles

2.12 We need to start by redefining PSB for the digital age. In our Phase 1 report, we argued that PSB should in future be defined in terms of purposes and characteristics, rather than in terms of specific types of programmes or the output of certain institutions. It should also aim to ensure that TV continues to provide high-quality material of a kind and on a scale which the market, left to itself, would not provide. This approach received wide support, but improvements to our earlier formulation were also suggested. After further consideration, we believe the purposes of public service broadcasting are:

- to inform ourselves and others and to increase our understanding of the world through news, information and analysis of current events and ideas;
- to stimulate our interest in and knowledge of arts, science, history and other topics through content that is accessible and can encourage informal learning;
- to reflect and strengthen our cultural identity through original programming at UK, national and regional level, on occasion bringing audiences together for shared experiences; and
- to make us aware of different cultures and alternative viewpoints, through programmes that reflect the lives of other people and other communities, both within the UK and elsewhere.

2.13 We believe that PSB programmes should have distinctive characteristics. They are:

- **high quality** – well-funded and well-produced;
- **original** – new UK content, rather than repeats or acquisitions;
- **innovative** – breaking new ideas or re-inventing exciting approaches, rather than copying old ones;
- **challenging** – making viewers think;
- **engaging** – remaining accessible and enjoyed by viewers; and
- **widely available** – if content is publicly funded, a large majority of citizens need to be given the chance to watch it.

2.14 Plurality is at the heart of successful PSB provision. It involves the provision of complementary services to different audiences; it ensures a range of perspectives in news, current affairs and in other types of programmes; and it provides competition to spur innovation and drive quality higher. This means that we should aim to ensure that there is more than one PSB provider of significant scale and that the production of PSB content is open to a wide range of producers. A new model for PSB in the digital age is therefore needed to avoid the outcome in which the BBC would become a near-monopoly provider of PSB in the world beyond switchover.

2.15 To achieve plurality in future PSB provision, there could be advantages in encouraging new providers into the PSB system to spur innovative ideas and fresh approaches. If new providers receive public funding for PSB, there should be a role for competition between prospective providers in order to generate the best ideas for PSB and to secure value for money.

2.16 There is a clear rationale and evidence to support the continued funding of PSB after switchover. Our research suggests that:

- the UK market would not provide the current range and diversity of TV content without the public subsidies now available, even in the digital age; and
- the public currently want to pay collectively for programming which contributes to PSB purposes and characteristics and which would not be provided in sufficient quantity by the market on a universally available, free-to-air basis.

- 2.17 So long as PSB content maintains reach and impact in the digital age, our research results suggest the public would support a similar level of public funding in real terms to that available today. If audiences for PSB content were to decline substantially in the digital age, the case for continued funding at near to current levels would be weaker. The right level of PSB public funding will change over time, so we will revisit funding levels in our next PSB review in five years' time.
- 2.18 Importantly, the PSB model for the digital age should be flexible enough to adapt to the potentially radical changes in technologies, competition and public demands that are in prospect. Over time, public service TV content and its method of distribution should evolve so that it can take full advantage of new technologies and meet changing public demand.
- 2.19 Our ambition is for an enduring and pluralist system of PSB for the digital age, with a variety of providers. It should supply content which contributes to PSB purposes and characteristics, which has reach and impact, which makes full use of new technologies and distribution systems, but which is value for money and which would not be provided in sufficient quantity by the market.

Our proposals

The BBC

- 2.20 The BBC should remain the cornerstone of public service TV broadcasting. An effective, strong and independent BBC is essential to the health of PSB in the UK. It should continue to be properly funded by a TV licence fee model.
- 2.21 The length of the next Royal Charter should run for ten years until December 2016 to take the BBC through the period of digital switchover, but it should include a substantive mid-Charter 2011 review of the BBC's funding and its progress in meeting PSB purposes and characteristics.
- 2.22 The mid-point review would coincide with Ofcom's next quinquennial PSB review. The two reviews should examine in detail the role and the funding of the BBC in a fully digital world. The advantage of a mid-Charter review is:
- that it would provide the BBC with a strong incentive to contribute to the purposes and characteristics of PSB for the whole period of its next Charter; and
 - that it would ensure that preparation for the post-switchover world occurs well in advance of 2016.
- 2.23 The BBC should strive to ensure that all its programmes, not just its services, reflect the purposes and characteristics of PSB to some degree. This should also apply to the way the BBC schedules its programmes. Our Phase 1 report identified copycat and derivative programming, and competitive head-to-head scheduling as particular concerns. We welcome the fact that some of the weaknesses in BBC schedules are being addressed by recent moves made by the BBC Governors. In future, the BBC should have regard to the extent to which Hollywood films and other expensive acquired programming meet its own public value test and could not be provided equally well, at no direct cost to the public, by free-to-air commercial broadcasters.

- 2.24 As the commercial sector faces increasing competition, there will be more responsibility on the BBC to provide those aspects of PSB which are most at risk. In particular, we believe that the BBC may need to play a greater role in the provision of a wider range of regional programming in the English regions, where the cost of provision relative to commercial value is high for other broadcasters.
- 2.25 Our Phase 1 report proposed that the BBC's other activities, including commercial activities, studio and other production resources, and indeed production should be reviewed carefully against their distinctive contribution to PSB purposes. We therefore welcome the BBC's reviews of its production and of its commercial operations. This should form an important part of the BBC's Charter review process. The review of commercial strategy should be subject to thorough independent external validation before any decisions are taken about the future of BBC Worldwide or the use of the proceeds from asset sales.
- 2.26 In relation to production, we believe the BBC should be expected to demonstrate that it has clear plans to introduce a commissioning system, outside news programming, which has fair access for independent suppliers and which commands widespread confidence across the sector. If this does not happen, and if the new codes of practice prove ineffective, further action will be needed to secure a fair role for independent producers as suppliers to the BBC.
- 2.27 In future, any BBC plans for new services should be subjected to a rigorous independent evaluation to ensure that they add public value and would not unduly displace commercial activities. Where it is unclear from independent analysis that the benefits of any new service outweigh the costs, the BBC Governors should decline to take the project forward.¹
- 2.28 To maintain its role at the heart of broadcasting in the digital age, the BBC should be properly funded. For the period of the next Charter, a TV licence fee model should continue to fund the BBC; the BBC should not carry advertising, nor should existing services become subscription-funded. We have not carried out a detailed assessment of the BBC's future funding requirements, but we think that there are two important considerations for the funding settlement over the next Charter period:
- the BBC does not envisage any growth in the breadth of its services and is rightly committed to further efficiency savings; and
 - the BBC's income will increase by more than the annual rise in the TV licence fee because the number of UK households is projected to grow. After ten years, the BBC can expect to receive an extra £230m every year, from the projected growth in households alone.
- 2.29 In order to ensure a robust financial model in the more distant future, the Government should consider the case for the BBC to supplement its income with limited subscription services to fund any future expansion. The BBC should be asked to report on the case for limited subscription services at the time of a mid-point review of its next Charter.
- 2.30 The BBC should take a leading role in the UK plans for digital switchover. As part of the moves towards switchover, the BBC should consider the scope for using new technology in the collection of the licence fee to reduce collection costs, evasion and the consequent burden on the judicial system. TV licence fee collection costs and licence fee evasion exceeded £300m in 2003-04.
- 2.31 Over the past few years the BBC has been subject to a proliferation of reviews: various services have been scrutinised internally, by Government, by Parliament, by Ofcom, by advisers on its Royal Charter and by independent experts. Our

¹ This approach is the same as that recommended by the Graf review of BBC Online, see www.culture.gov.uk

observation is that there are two underlying causes of this undesirable trend: first, that the BBC already receives a very high and rising share of public funding for PSB; and second, that there is a lack of a clear separation between the governance and the regulation of the Corporation. We believe:

- that maintaining a plurality of recipients of public funding is vital to the health of the PSB environment; and
- that clarifying the separate roles of governance and regulation of the BBC should be a central objective of the Charter review process.

ITV

2.32 ITV1 has been an important force in public service broadcasting, and the main source of competition to the BBC, for almost 50 years. Its contribution to public service purposes is sustained today in the wealth of original UK programming, particularly in drama, entertainment and factual programming, as well as its commitment to news, regional news and production outside London. Crucially, ITV1 is broadcast free-to-air and is universally available.

2.33 Over the next five years, our central ambition is that ITV1 continues to deliver universally available free-to-air PSB obligations which provide real value as part of the overall broadcasting environment. We must take account of the costs of production and the funding available. We propose to:

- maintain the current programming quotas or indicative targets for original UK production, news, current affairs, regional news and peak-time regional programming; and
- use the regulatory framework of the Communications Act to ensure that there is sufficient investment in national and international news when the next contract is awarded to ITV1's nominated news provider.

2.34 In other areas, we want to end the all-too-frequent negotiations between ITV1 and the regulator over its specific PSB obligations. The Act requires us to introduce a more flexible approach to content regulation. In these areas there will be a move

away from hard quotas for specific genres, and towards a new three-layered system that assesses the contribution of programming in terms of what ITV1 is providing and when it is scheduled, what viewers are watching, and whether audiences value what they watch. This model should maintain the public service character of ITV1 in important programming areas such as arts, children's and religion, but in ways which respond to changing public demands and market developments.

2.35 A particular challenge for ITV1 in the transition to switchover is the provision of non-news programmes for the nations and regions. Our proposals for a new framework here are set out later in this summary.

2.36 After digital switchover we propose to maintain a core level of PSB obligations on ITV1, available free-to-air on all transmission platforms: high production value UK programming, news, current affairs and, if financially sustainable, a core regional news service.

Channel 4

2.37 During the transition to the digital age, Channel 4 should remain a vital force in the provision of PSB particularly as a provider of innovative content for its target audience group. We expect Channel 4 to use its considerable financial resources to ensure it maintains a sharper focus on its public purposes, as set out in the Communications Act. We will also encourage Channel 4 to consider developing a suite of free-to-air channels in order to help meet these purposes.

2.38 In line with Channel 4's own ambitions in the years before switchover, we expect it to strive to meet its PSB remit and funding challenges through further operational efficiencies and market-based initiatives, such as increased cross-subsidies from its commercial ventures. Channel 4 should also be given sufficient freedom to form alliances, joint ventures and partnerships with other organisations. Our analysis suggests that there is every reason to expect such efforts to be successful for the next few years.

- 2.39 We do not support the privatisation of Channel 4; the channel should remain primarily not-for-profit. Not-for-profit status has provided a basis for Channel 4's unique contribution to PSB over the last 20 years and there is no reason to suppose that the same approach is unsustainable in future, particularly if new means of commercial cross-subsidy can be found.
- 2.40 We recognise that in the longer term, particularly after digital switchover, Channel 4 may face an increasing tension between maintaining advertising revenues and its PSB remit and may not be able to provide the same range of PSB programming as today. This tension did not exist in the early days of Channel 4 when its revenues were not governed by the quantity of advertising its programming generated.
- 2.41 In the event that operational efficiencies and market-based initiatives cannot deliver sufficient financial strength for Channel 4 to fulfil its PSB remit in a digital age, there may be a case for considering further action such as the transfer of income-generating assets from the BBC to Channel 4. This approach would be consistent with C4's preference for retaining a clear PSB remit based on commercial self-reliance rather than direct public subsidy. The case for any further action could be considered in our next PSB review in five years' time, which will coincide with the mid-point review of the BBC Charter.

Five

- 2.42 Five plays a modest but important role in contributing to PSB purposes, and the channel's regulatory obligations are lower than others', in part because it only has around 80 per cent terrestrial coverage. Five therefore stands to gain from its PSB status at switchover, which will bring it universal coverage in the UK for the first time.

- 2.43 Five's contribution to PSB mainly takes the form of its commitment to original UK production and to news. We will expect the channel to invest more in original production in the run-up to switchover. However, we will take a more flexible approach to Five's other PSB obligations, including the scheduling of its news programmes. This new approach will help to provide a test for the likely level of market provision of PSB programming.

Teletext

- 2.44 Prior to switchover, we will ensure that the public teletext licensee, 'Teletext', is given greater flexibility to meet its public service obligations. This may mean fewer specific page requirements. After switchover, we will seek to ensure that the digital public teletext service will have the same capacity available as now.

The nations and regions

- 2.45 The future of PSB in the nations and regions has been an important focus of our Phase 2 work. A particular challenge in the years up to digital switchover is the position of ITV1's non-news programming obligations for the English regions and nations of Scotland, Wales and Northern Ireland. These obligations are untenable after digital switchover because:
- the cost of the programming will greatly exceed the value of any privileges available to Channel 3 licensees; and
 - much non-news regional programming receives low audiences, is not highly valued by audiences. Especially in England, it has been pushed to the margins of the schedule, with low production values.

2.46 After digital switchover, it will not be possible to oblige ITV1 to produce non-news programming in the nations or in the English regions. Currently, most Channel 3 licensees in England have an obligation to screen three hours a week and licensees in the nations have even higher obligations. S4C's core service will also be affected by falling audiences and declining advertising revenue.

2.47 Our ambition is to build a sustainable and well-resourced model for PSB in the nations and regions after switchover. A new framework would include:

- a continuing and important role for ITV1 in the reflection of regional stories, characters, places and issues on its main network, with a high proportion of original production made outside London;
- a new commitment to regional programming from the BBC, in line with the Corporation's own proposals. This would include a rebalancing of obligations for non-news English regional programming between ITV1 and the BBC, which does not currently provide such programming on any scale, as well as a new local BBC news service. In adopting any new regional commitments, we suggest the BBC should undertake to support a plurality of regional producers;
- the use of new digital opportunities to provide a range of innovative local TV and new media content services up and down the country; and
- market-driven commercial national programming emerging in TV broadcasting and in many other media, as it already has for some communities in the UK.

2.48 For the English regions, we propose reducing ITV1's regional non-news programming obligation from three hours a week to 1.5 hours in 2005, with all of the reductions occurring out of peak hours. This would focus non-news regional programming in peak hours. Even this level of provision may not be sustainable before switchover. We will continue to review the options

and publish firm proposals for managing the transition in Phase 3 of our PSB review.

2.49 In parallel, we propose to raise the out-of-London production quotas to lock-in the current levels of production for ITV1 (over 50 per cent) and to explore the options for a wider dispersion of production outside London and across the nations and regions of the UK.

2.50 Many of the same considerations apply to the nations of Scotland, Wales and Northern Ireland. ITV1's non-news programming obligations for the nations will also be unsustainable after switchover whichever licensee provides it, and will need to change well in advance of that date. But the devolved nations have distinct cultural and political identities that need to be reflected in any PSB framework:

- their programming obligations are currently higher than in the English regions;
- in Scotland and Northern Ireland, SMG and Ulster are individual Channel 3 licensees, part of the ITV network but separate from ITV plc; and
- there are also particular issues surrounding minority-language broadcasting in each nation, focused on the role of S4C in Wales, the new Gaelic Media Service in Scotland and the future of Irish Gaelic and Ulster Scots broadcasting in Northern Ireland.

2.51 Responses to our Phase 1 report emphasised all these areas of difference, and we believe a wider debate is needed, incorporating input from interested parties in the nations, including Ofcom's National Advisory Committees, before we propose any changes to ITV's obligations. We would encourage those with an interest in broadcasting in the nations to take part in this debate.

2.52 We will outline our specific proposals for non-news programming obligations in the nations in Phase 3.

2.53 In the longer term, there needs to be an economically sustainable future for sufficient Welsh and Gaelic language services, using digital transmission capacity and access to adequate public funding.

Production

- 2.54 Independent producers make a major contribution to PSB purposes across a wide range of programme types. We believe there is more scope for independent production to enhance the delivery of PSB and welcome the BBC's recent commitment to fulfil their 25 per cent quota. We have recommended further progress in this area above.
- 2.55 Since the new terms of trade between broadcasters and the independent television production sector have only recently been agreed, we believe a period of time should elapse before further consideration of the relationship between broadcasters and independent producers. In 12 months' time, if it is not clear that the market is working effectively, we will take further action.

A new Public Service Publisher (PSP)

- 2.56 The preceding analysis demonstrates that all the existing terrestrial commercial broadcasters with PSB obligations (ITV1, Channel 4 and Five) face difficulties in maintaining PSB programming as the digital age approaches and the value of the analogue spectrum declines. If no action is taken, the BBC will emerge by default, as the only PSB provider of any significant scale. Such an outcome would undermine the TV broadcasting environment, which has relied on a plurality of PSB organisations and has served the UK well. Viewers would be the losers.
- 2.57 We believe that maintaining a plurality of outlets for PSB and commissioners of PSB is vital for the health of the system. If the BBC becomes a near-monopoly provider of PSB, neither the BBC's content nor that of the wider broadcasting market is likely to contribute sufficiently to PSB purposes and characteristics.
- 2.58 After careful consideration of arguments put to us and international evidence, we have rejected a

fully contestable fund – an 'Arts Council of the Air' – for PSB on a programme-by-programme basis. It would involve excessive bureaucracy and it is likely that the guardians of the fund would struggle to distribute PSB content on TV channels which had different core values.

- 2.59 Instead, we note that many of the previous big innovations in broadcasting and in PSB have resulted from new entrants shaking up the market. To refresh PSB for the digital age and to ensure a continued plurality of provision we believe that there is a need for a new publicly-funded service, which we have called a Public Service Publisher (PSP). Just as Channel 4, in its early years, had guaranteed funding and a remit to pursue public purposes with innovative ideas, we believe a new PSP could be created with similar ambitions for the digital age.
- 2.60 In this report we set out an outline proposal for a PSP, which could enhance public service broadcasting in the post-switchover world. It would aim to commission and distribute content as widely as possible, using a variety of technologies to reach households. It could also have the opportunity to explore new ways of contributing to public service purposes, unencumbered by the need to protect existing TV channels.
- 2.61 The PSP would be different to existing broadcasters. As technology progresses, we could expect the PSP to commission and distribute content on other digital distribution systems such as broadband, networked PVRs, mobile networks as well as cable, satellite and digital terrestrial broadcasting. Inevitably, in its early years in the transition to digital, much of the PSP's digital content would be more likely to resemble traditional TV programmes, but it would not be a TV channel in the traditional sense, nor would it publish books, magazines or newspapers.

2.62 The PSP might:

- operate as a commissioning and publishing body, which used public funds to stimulate the creation of innovative content, across all visual electronic media, from a range of producers;
- commission from independent producers to provide such content in identified priority areas;
- ensure that the content created was effectively promoted, branded and made widely available across all significant distribution systems;
- ensure that all its activities reflect our proposed PSB purposes and characteristics; and
- not be based in London, to strengthen production centres across the UK, and could fund new content for the nations and regions.

2.63 Importantly, the right to set up and run the PSP would be awarded after competition between rival organisations. The winning bidder would be chosen on the basis of the quality of its proposals and might operate for a set period of up to ten years, but, as with the BBC's Charter, subject to a mid-point review. At the end of the period, another competition would be held, enabling fresh perspectives and innovation to be injected into PSB in the UK.

2.64 We expect that the greatest challenge would be to ensure that the PSP achieved sufficient reach and impact to justify public funding, especially in its first few years. For this reason, we would not rule out ITV, Channel 4, Five or other existing broadcasters from bidding to operate the PSP, although the BBC would be excluded from the competition. Nor would we rule out carriage arrangements whereby the PSP secured agreements to distribute publicly funded material on analogue TV before digital switchover.

2.65 However, an equally impressive case for funding might be made by a new provider on different platforms. Any bidding organisation would have to demonstrate clear financial separation between the PSP and its other operations.

2.66 We believe the advantages of creating a PSP could be:

- it could maintain and expand the plurality of PSB in the digital world;
- it could have the potential to start from scratch in providing content which meets PSB purposes and characteristics in a digital world;
- a competitive process for choosing the PSP, which could help the best ideas to get funded, and could open up the process to the possibility of tenders from many different organisations, ranging from other broadcasters, to producers, other media publishing companies, and other creative organisations;
- as there could be a periodic competition to run the PSP, there could be a process of continuous renewal of PSB, and it could ensure an effective discipline on performance, as conditions changed;
- the PSP system could maintain the existing funding arrangements in existing TV channels and would not risk changing their culture adversely; and
- the competitive process for choosing the PSP could help to mitigate serious European state aid concerns which could arise if explicit funding were offered to an existing player.

2.67 We will work to assess and develop the option for a PSP in more detail over the next three months, incorporating proposals or suggestions we receive as part of the Phase 2 consultation process. We want to encourage the widest possible debate about the best way of ensuring plurality and competition in PSB in the digital age.

2.68 New funding for the PSP would be needed and could build up over time. As a tentative indication only, up to £300m a year at switchover (2012) could enable the PSP to provide a deliberately limited quantity of high-quality content, but not a 24-hour TV channel. We envisage that this level of funding could be enough to deliver an average per hour programme budget of around £200,000 if the PSP produced the equivalent of three hours of new content each day.

2.69 A new source of funding would be required to finance the PSP in the digital age and to replace the current implicit subsidies provided by the Government to ITV1, Channel 4 and Five. Since this would replace the current implicit subsidies for PSB, it would not constitute an additional demand on the public. In addition, the public would gain from the value created from spectrum released at digital switchover.

2.70 The initial source of funding for the PSP could come from three sources:

- tax revenues: the principle for tax-financed PSB has already been established for the BBC via the £400m it receives annually from the Department for Work and Pensions in respect of the free over 75s licence fee and the £220m it receives from the Foreign Office in respect of World Service, and the £85m S4C receives in its Government grant. Funding from tax revenues could either come from general taxation or from hypothecated spectrum-related revenues;
- an enhanced licence fee: by setting the licence fee higher than that required to fund the BBC properly would provide a secure income stream which could fund PSB in the digital age; and
- a tax on the turnover of UK licensed broadcasters: This source of revenues funds the regulation of the broadcasting industry and could be used to finance PSB, although it would raise barriers to entry, could create problems of avoidance and could reduce the funding available for programming in other broadcasters.

2.71 There are many possible variants of each of these three options. The source of replacement funding in the digital age is a matter for Government and for Parliament.

2.72 We are strongly of the view that such funding is desirable to sustain the UK's distinctive PSB environment, to maintain plurality and to strengthen the contribution of visual content to PSB purposes in the digital age.

Summary

2.73 Our proposed framework for PSB in the digital age is:

- a new mix of funding, regulation and institutions which will meet the challenges of a radically different TV market and audience demands, building on existing institutional value but also encouraging innovation and fresh perspectives in the creation and delivery of PSB;
- a well-funded BBC, producing distinctive and high quality programming, at the heart of this new system;
- plurality beyond the BBC – competition for quality in the supply of well-funded UK programming and a competition for the right to receive public funding for the best new model of PSB provision;
- a new provider, the PSP, charged with making imaginative use of new technologies and distribution systems to meet audience needs in the digital age and securely funded from either an enhanced licence fee model, tax revenues, or a tax on the turnover of broadcasters;
- a continuing role for Channel 4 as primarily a not-for-profit provider of innovative and diverse programmes for its target audience group;
- a sustainable level of PSB obligations on ITV1, focusing the channel on a set of central PSB components, before and after switchover;
- a new approach to programming for the nations and regions: regional production and, if possible, regional news on ITV, a transfer of some non-news regional obligations to the BBC and the use of digital opportunities to create a new tier of more local services;
- increased investment in original UK programming on Five, alongside a more flexible system of content regulation; and
- the provision of programming which contributes to PSB purposes and characteristics by broadcasters without specific privileges or financial incentives, as a more effective broadcasting market develops.

How to respond to this consultation

2.74 This report marks the end of Phase 2 of our review and takes account of the responses we received to our Phase 1 report. It seeks views on the conclusions we have come to and the questions we have raised. Section 8 summarises the questions for consultation.

2.75 We are seeking views from all organisations and individuals who have an interest in the future of public service broadcasting, including:

- viewers;
- television broadcasters, channels and platforms;
- production companies;
- other media organisations;
- organisations in sectors that have close ties to television (e.g. sport, the arts, film);
- anyone with a commercial or employment interest in the broadcasting industry (e.g. trade unions, trade associations);
- consumer groups;
- anyone concerned about the importance of television to the economy; and
- anyone concerned about the importance of television to citizens.

2.76 Responses will be used to inform Phase 3 of our review, and our final report.

2.77 The supporting documents to this report are available, alongside copies of our Phase 1 report and a summary of responses to it, from Ofcom's website at www.ofcom.org.uk. The website also contains links to the working papers we commissioned from other individuals and organisations during Phase 2.

2.78 Please send written or electronic responses, marked 'PSB Review – Phase 2 response' by **Wednesday 24 November** to:

Khalid Hayat
Ofcom
Riverside House
2a Southwark Bridge Road
London SE1 9HA
Email: khalid.hayat@ofcom.org.uk

2.79 If you are a representative body, please summarise the persons or organisations represented. Electronic versions of responses, in Word format, would be appreciated.

2.80 Any confidential parts of a response should be placed in a separate annex, so that non-confidential parts may be published along with the respondent's identity. If the whole of a response is confidential, including the name of the respondent, that should be clearly stated. Copyright in responses will be assumed to be relinquished unless specifically retained.

2.81 We would be grateful if respondents could complete the consultation cover sheet provided on our website – a sample is included in Annex C.

2.82 One of Ofcom's stated consultation principles is to allow ten weeks for responses. Since this is only an interim report, and represents the second of two major consultation exercises in the course of the PSB review, we have shortened this period slightly, to eight weeks.

2.83 See Annex C for a summary of Ofcom's stated consultation principles.

2.84 The Ofcom senior team with responsibility for this consultation and review are:

Ed Richards

Senior Partner, Strategy and Market Developments

Robin Foster

Partner, Strategy

Tim Suter

Partner, Content and Standards

2.85 Ofcom has also appointed a Consultation Champion, Philip Rutnam, who is responsible for the quality of Ofcom's consultation process in general. Any comments or complaints about the conduct of this consultation should be put to our consultation helpdesk on 020 7981 3003, or sent to:

Philip Rutnam

Partner, Competition and Strategic Resources

Ofcom

Riverside House

2a Southwark Bridge Road

London SE1 9HA

Email: philip.rutnam@ofcom.org.uk

2.86 Please note that you can register to receive automatic notifications when Ofcom documents are published, at www.ofcom.org.uk/static/subscribe/select_list.htm



Challenges confronting the analogue PSB model

3

3. Challenges confronting the analogue PSB model

3.1 The success of PSB over many years has been within a complex broadcasting environment for the main terrestrial broadcasters, including a range of funding sources, privileges, obligations and regulations. That environment is changing as the digital age approaches, bringing challenges to all broadcasters with PSB obligations, especially those in the commercial sector. This chapter will examine the sustainability of the analogue PSB system in the face of the changing market environment. It focuses on the following questions:

- How does the current analogue PSB environment work and how much does it cost?
- What are the important trends in consumer preferences and technology?
- How will these trends affect the analogue PSB environment?
- What is the prospective level of funding for PSB as the digital age approaches?

The current PSB environment

3.2 Public service broadcasting is financed by a patchwork of direct and indirect public subsidies alongside a similarly wide variety of obligations on the main terrestrial TV channels.

- The BBC is given privileged access to public funding and free spectrum in return for special and wide-ranging public service obligations.
- The commercial broadcasters, ITV1 and Five, are granted access to scarce analogue spectrum and other privileges, in return for commitments to fulfil certain programming obligations.
- Channel 4, although financed by advertising, is guided by its public service remit, not by the objective of making profits for shareholders. Like the BBC, it is given free spectrum and other privileges.

Figure 3.1: Obligations on terrestrial commercial broadcasters

	ITV1	Channel 4	Five
Tier 1	Basic broadcasting standards		
Tier 2	Independent production quotas		
	Regional production quotas		
	65% original	60% original	51% → 60% original
	News Current Affairs Regional News Other regional	News Current Affairs	News Current Affairs
Tier 3	Religion Children's Arts Education Documentaries	Religion Education Schools Multicultural + "innovation"	Religion Children's Documentaries Arts Education

- 3.3 The obligations on the commercial terrestrial broadcasters were described in full in Phase 1 of our PSB review and are summarised in Figure 3.1. Channel 4's obligations and privileges are qualitatively different to those of ITV1 and Five because it has a remit to innovate, to experiment, to be creative, to appeal to the tastes of a culturally diverse society, to be distinctive and to make a significant number of programmes of an educational nature.
- 3.4 The sources of public subsidy for all of the broadcasters with PSB obligations are shown in Table 3.1. All the main terrestrial broadcasters receive access to the analogue spectrum either free or at a subsidised rate, the right to appropriate prominence on electronic programme guides (EPGs), the potential for must-carry rules to be invoked on cable networks and reserved capacity on the digital terrestrial platform. In addition:
- the BBC also enjoys funding from the TV licence fee and from central Government in respect of free licences for the over 75s;

- Channel 4 benefits from never having been required to pay a dividend to the Government, its sole shareholder; and
- S4C receives funding from the Department for Culture, Media and Sport (DCMS) to finance its operations.

The financial cost of public service broadcasting

- 3.5 The cost of PSB subsidies and regulations to society can be split into two broad categories:
- the direct costs of the BBC; and
 - the indirect costs of obligations on the BBC and on commercial terrestrial TV channels.
- 3.6 The total financial cost of public service television broadcasting to taxpayers and licence fee payers is in the region of £3bn a year, with the BBC accounting for 85 per cent of public subsidy. Table 3.2 gives an indication of these costs. All the numbers in the table, apart from the BBC TV expenditure, should be treated with caution as they are based on estimates with high degrees of uncertainty.

Table 3.1: The funding sources for PSB on the main terrestrial channels

Form of subsidy	BBC	ITV1	C4	Five	S4C
TV licence	✓				
Free spectrum	✓		✓		✓
Subsidised spectrum		✓		✓	
Appropriate prominence on EPG	✓	✓	✓	✓	✓
Reserved capacity on DTT	✓	✓	✓	✓	✓
Must-carry on cable	✓	✓	✓	✓	✓
Central government funding	✓				✓
Dividend waived			✓		

Source: Ofcom

Table 3.2: Summary of costs of PSB interventions^{2, 3}

Policy intervention	Cost (£ million)
Direct expenditure	
BBC TV expenditure (2003-04)	2,320
Indirect expenditure	
Cost of free spectrum for the BBC	180
Obligations on ITV (2002)	260
Obligations on Five (2002)	10
Obligations on Channel 4 (2003)	160
Total	2,930

Source: Ofcom calculations

- 3.7 Every household that uses a TV to receive television programmes must have a valid TV licence, regardless of whether it watches BBC programmes or not. As the licence is compulsory and is not linked to viewing BBC programmes, the full annual cost of the TV licence, £121 in 2004-05, should be counted as a direct cost of PSB intervention to society. In 2003-04, the BBC raised £2,820m through the TV licence fee. A proportion of this income, £408m, comes direct from central Government in respect of free TV licences for the over 75s.⁴
- 3.8 The level of TV licence fee income is only a proxy for the annual cost of BBC TV services. The BBC's total broadcasting expenditure in 2003-04 was £2,994m including overheads, transmission costs and licence fee collection costs. The difference between this figure and the licence fee income was primarily accounted for by commercial revenues and a deficit in 2003-04. Our estimate of the BBC's total broadcasting expenditure on TV is £2,320m. Table 3.3 provides details of this figure. It includes all the costs the BBC directly attributes to TV and adds 80 per cent of common costs (such as overheads), the proportion of the BBC's allocated costs easily attributable to TV.

- 3.9 The indirect subsidies outlined in Table 3.1 involve no explicit transfer of funds, so are extremely hard to measure. In addition to income from the licence fee and from central Government, the BBC also receives its analogue spectrum free of charge. The value of this spectrum depends on the amount that other broadcasters would be willing to pay for the right to use the spectrum. Work carried out by the consultants Indepen⁵ suggests that on this basis the spectrum currently used by the BBC for analogue and digital terrestrial broadcasting would be worth about £180m a year.⁶

Table 3.3: The cost of BBC television services⁷

Category of BBC expenditure	Cost in 2003-04 (£ millions)
TV services	
BBC One	812.3
BBC Two	365.2
National and regional TV	212.3
Cbeebies, CBBC	46.2
BBC Three	99.4
BBC Four	35.2
BBC News 24	23.5
BBC Parliament	2.5
Interactive TV	15.3
Programme-related expenditure	
Newsgathering	73.5
Marketing, press, publicity and events	42.4
On-air trails and navigation	18.4
Market research	11.4
Helplines, one-off events and other programme-related expenditure	64.2
Overheads	258.9
Licence fee collection costs	119.8
Transmission costs	120.8
Total	2,321.4

Source: BBC Annual report and accounts 2003-04, Ofcom calculations

2 Figures may not sum due to rounding and exclude any costs associated with original production, out-of-London production and independent production quotas.

3 S4C is not included in this table, but will receive £85.2m in direct funding from the DCMS in 2003-04.

4 The Department for Work and Pensions compensates the BBC for the loss of income resulting from free TV licences for the over 75s.

5 *An economic study to review spectrum pricing*, www.ofcom.org.uk

6 Using a price of £1m per MHz per annum on the UHF spectrum.

7 Source: BBC Annual Report 2003-04. Based on Table 2b in the notes to the financial statements.

- 3.10 The cost of PSB obligations on ITV1, Channel 4 and Five are also difficult to measure. Each is a commercial company, financing its programming through advertising. This means that there are no direct payments from consumers or taxpayers to any of the companies for PSB programming. Instead, the cost to society of the obligations placed on the terrestrial commercial broadcasters can either be estimated in one of two ways: either, by assessing how much greater their profitability would be if they were not subject to the regulations, the opportunity cost of the obligations; or indirectly by attempting to value each funding source described in Table 3.1. We favour the former method.
- 3.11 In 2003, the Independent Television Commission (ITC) estimated opportunity costs for the most important PSB obligations on both ITV1 and Five. For each PSB programming obligation, the ITC compared the production costs of programmes in the PSB genre relative to the cost of programmes which could have been shown in their place. In addition, it estimated the advertising revenue foregone from showing explicit PSB programmes rather than the broadcasters' other programming in the same slot across the year. The ITC estimated that the sum of the opportunity costs across the ITV1 schedule was around £210m in 2002. The ITC estimated that another approximately £50m a year of non-programming costs can be attributed to ITV's regional presence, which it would not need to have if it had no PSB obligations. The ITC estimated an opportunity cost of £10m for Five in 2002, excluding costs associated with the channel's UK originations quota.⁸
- 3.12 These totals are estimates and should be treated with caution. On the one hand, they assume that the price of advertising remains constant if ITV substituted a more popular programme in place of a PSB programme. In reality attracting more viewers (more commercial impacts) by scheduling more popular programming would cause the price per advert to drop a little, reducing the estimates. But there are also reasons to believe the ITC figures could be an underestimate because they do not take account of the fact that ITV1 would be able to reinvent its schedule completely if PSB obligations were removed. The effect of a completely different schedule might be much greater than the sum of its parts.
- 3.13 Within the £210m total for ITV1, regional programming accounted for almost two-thirds of the opportunity cost, a result of the necessary duplication of programming in every ITV region. Religion and arts programming, by comparison, did not place a significant burden on ITV1 because the channel showed few hours of these genres, they were relatively inexpensive and ITV1 scheduled the programmes in slots which would not have generated much more advertising revenue had a more popular programme been screened.
- 3.14 Channel 4's remit and obligations are less specific than those of ITV1 and Five, so it is less meaningful to carry out an equivalent opportunity cost exercise. However, internal estimates using data from the broadcaster have been shared with Ofcom. Channel 4 used various techniques to estimate the opportunity cost of the Channel's remit to show distinctive and innovative programming, with the most plausible showing that PSB obligations cost Channel 4 a little over £100m. In addition, the Channel estimates that it has another £40m non-programming costs associated with its PSB remit. Ofcom has not fully verified the figures, but the estimate of £160m in total is likely to be a reasonable approximation, given the Channel's programming budget of £450m in 2003. Channel 4 has a lower opportunity cost than ITV1 because it does not have an obligation to produce regional programming.

8 In related work, the ITC estimated that if the UK-originated production quota for Five was increased substantially, it would raise this opportunity cost estimate significantly.

The recent trends in PSB funding

3.15 In the past five years, the overall cost of PSB subsidies to the BBC has risen faster than inflation. The RPI + 1.5 per cent TV licence fee settlement between 2000-01 and 2006-07 and a continued growth in the number of households has allowed the BBC to enjoy buoyant income streams for PSB programming. After adjusting for inflation, the compound average annual growth rate of BBC income from the licence fee between 1998-99 and 2003-04 was three per cent.

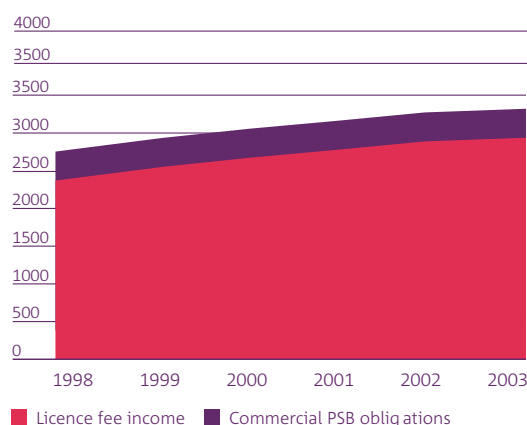
3.16 Our estimate of the implicit costs of PSB subsidies for ITV1, Channel 4 and Five was roughly £430m a year. We believe that there is considerable evidence to suggest that the implicit cost of PSB subsidies on the main terrestrial channels has fallen over the past five years. For example, in that period, PSB costs have been reduced on commercial TV channels in the following ways:

- there has been a reduction in the regional non-news programming obligations on ITV1;
- expenditure on ITV1 news has fallen;
- the ITV1 evening news has been moved from 10pm;
- there has been a reduction in the quantity of challenging programming on Channel 4; and
- Five repeatedly renegotiated its originations quota with the ITC.

3.17 We cannot, however, quantify these reductions in cost, so we have assumed in Figure 3.2 that it has remained constant after adjusting for inflation. It shows a steady increase in the overall cost of PSB resulting from the above inflation increases in the licence fee and a continued growth in the number of licences due to a growing number of households. Figure 3.3 shows that the BBC has been taking a gradually rising share of the total subsidies available for PSB.

Figure 3.2: Estimated financial cost of PSB subsidies (2004 prices)

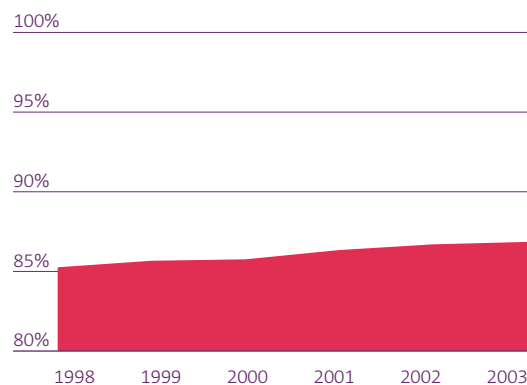
£ million 2004



Source: Ofcom calculations

Figure 3.3: BBC share of total PSB funding

£ million (2004 prices)



Source: Ofcom calculations

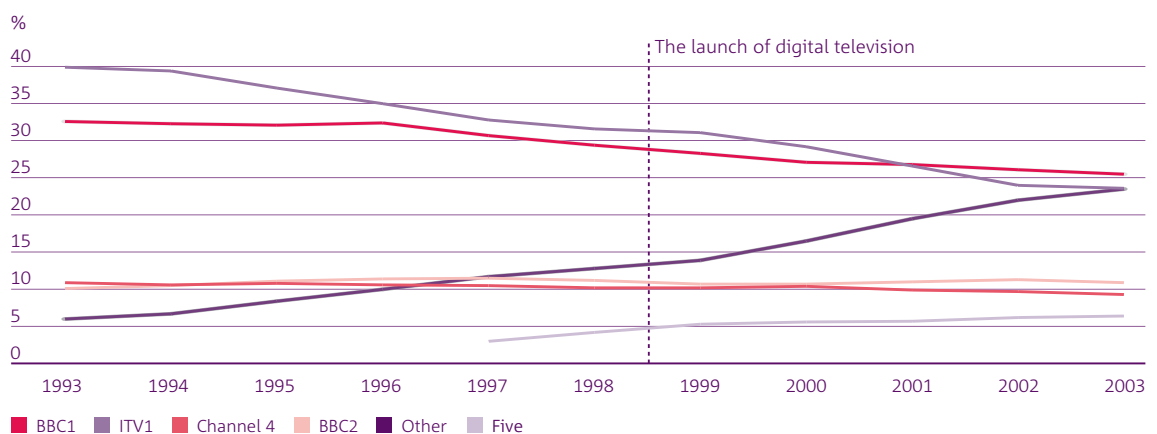
Consumer preferences and technological change

3.18 The implicit subsidies for ITV1, Channel 4 and Five, described in the previous section, depend on these companies receiving a disproportionately high level of TV advertising revenue. This enables them to fund programming which contributes to PSB purposes and characteristics. If trends in technology and/or consumer preferences move in directions which reduce the implicit subsidies for PSB on commercial channels, the level of PSB output on those channels will fall. So, the first question for the future of PSB is what are the prospects for consumer preferences and technology?

Consumer preferences and the move to digital TV

3.19 Multichannel television has existed in the UK since 1984, and by the end of 1997 around a quarter of UK households had access to analogue satellite and cable services with up to 40 channels. The launch of digital television in 1998 was followed by a proliferation of channels. As Figure 3.4 shows, this has brought audience fragmentation: the viewing shares of the main terrestrial channels have declined, with a rapidly increasing share of viewing going to multichannel services. The largest audience declines have been apparent in the two mass market channels BBC One and ITV1. BBC Two and Channel 4 have maintained audience share more successfully, although both channels have experienced small declines in audiences since the late 1990s.

Figure 3.4: TV viewing shares, 1993-2003 (percentage of all viewing)
Channel shares – all homes 1993-2003

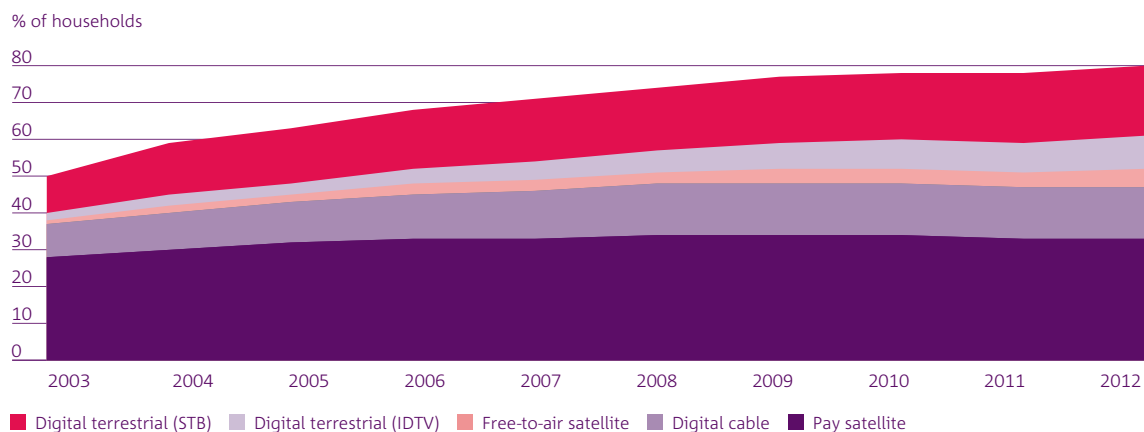


Source: BARB

3.20 It seems likely that competition for audiences and revenues will intensify in the future. In mid-2004 it is looking increasingly likely that digital switchover will have begun by 2008. Even if this date is not met, Ofcom projections shown in Figure 3.5 indicate that around 80 per cent of UK households will have adopted digital by 2012.

3.21 The move to digital has implications beyond those relating purely to the number of TV channels and the delivery of television services. Digital may usher in a range of new technologies and services, shown schematically in Figure 3.6.

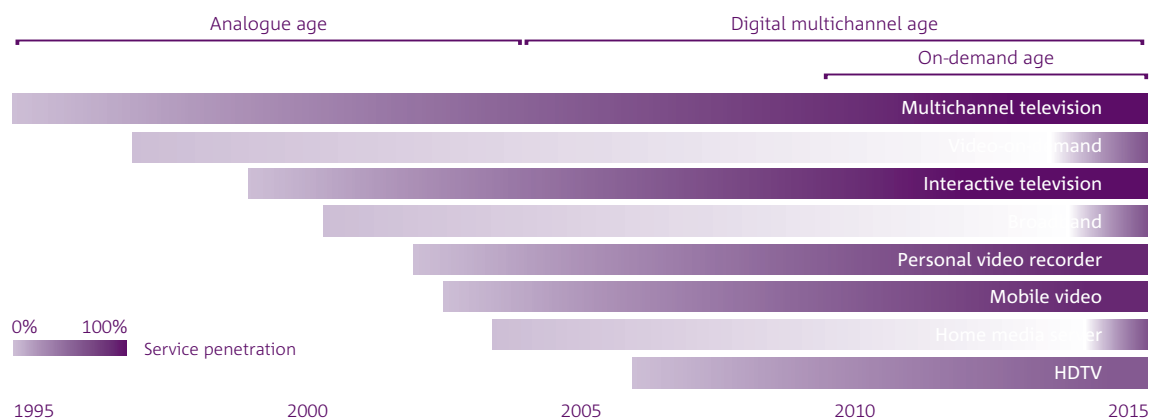
Figure 3.5: Ofcom central projection of DTV adoption, 2003 to 2012
(Assuming no digital switchover before 2012)



Source: Ofcom

This projection is built upon assumptions about consumer attitudes, purchasing intentions, DTT coverage and platform operator strategies. The forecasts are indicative only.

Figure 3.6: Potential penetration of different technologies



3.22 These new technologies are likely to have a profound impact on the way we watch TV:

- improving digital compression technology will provide the capacity to carry at least double the current number of channels in the future, although its adoption may be slowed by a lack of compatibility with existing digital receivers;
- personal video recorders (PVRs) will be increasingly commonplace and high speed DSL internet (>2 Mbps) will allow different on-demand services and interactivity;
- wireless networking will distribute media throughout the household;
- sophisticated flat LCD and plasma screens will enhance viewing;
- home multimedia servers will personalise content and allow efficient storage and access;
- increasingly sophisticated electronic programme guides (EPGs) will add powerful new functionality to the consumption of television;
- developments in payment mechanisms which could create a range of different ways in which viewers pay for the television they watch; and
- further into the future, on-demand television and mobile broadcasting could displace traditional TV schedules.

3.23 If audience fragmentation continues on current trends, the viewing share of the five main terrestrial channels could fall to 65 per cent by the end of the decade, compared with 85 per cent only five years ago. Even this estimate does not allow for major shocks in the market – such as a major strategic push to increase programme spend and audiences by a cable/satellite channel, or the disruptive effects of new technologies.

3.24 This trend will inevitably affect attitudes towards, and consumption of, PSB. Viewing of the five terrestrial channels among those aged 35 and under is already below 50 per cent. Come 2012, many people of university age and below will have little or no idea of what television was like when there were only four or five channels on air.

3.25 We expect a steady increase in the take-up of PVRs this decade. By the middle of the next decade, however, PVRs (personal video recorders) are likely to be as commonplace as video recorders are today. They unquestionably have disruptive potential, although their implications are still difficult to forecast accurately. The two most interesting behavioural implications are advertising avoidance, with obvious implications for the business models of commercial broadcasters, and also the effect on scheduling. The proportion of viewing of live television in PVR homes seems to fall so dramatically that, as PVRs become the norm, the predetermined schedule will become relatively unimportant for many viewers.

3.26 Each of these new technologies or new services has the potential to change the TV broadcasting market significantly. In almost every case, the technology will put more power into viewers' hands, removing it from schedulers and broadcasters. In most cases, they will increase choice available to consumers and further fragment the audience. On the edge of our forecasting horizon, the technological developments seem likely to put traditional definitions of TV channels and schedules under pressure.

3.27 The ultimate impact could be profound. On the positive side, new opportunities for formatting and distributing PSB content will emerge. Audiences will be able to access on-demand libraries of PSB programming. Interactive features will enhance the provision of news and educational material. Provided it remains valued by the public, these developments could strengthen the effectiveness of PSB content and will reinforce the special role such PSB television can play in our lives. On the negative side, it may be harder for PSB content to achieve reach and impact in a more fragmented environment. PSB content providers will have to work much harder to persuade viewers to access their material, and will need to find new approaches to promoting their material.

The effect of technological change on the commercial PSB environment

- 3.28 Alongside changes in viewing behaviour, there is a real risk to the funding available to sustain PSB on the commercial sector. Fragmentation of audiences and the growth of digital television have two effects on the commercial PSB environment.
- 3.29 First, they reduce the audience share of the main terrestrial broadcasters, potentially reducing their advertising revenues relative to the total income in the broadcasting market and, in turn, their profitability. This is particularly important for Channel 4, which cross-subsidises PSB programming from more profitable programmes elsewhere in its schedule.
- 3.30 Second, as analogue audiences disappear, so does the basis for the historic commercial PSB compact. This effect is important for ITV1 and Five. At present, they are content to broadcast PSB programming in return for privileged access to analogue spectrum.
- 3.31 We evaluate both of these effects in detail in a supplementary report: *Looking to the future of public service television broadcasting*, but present the main conclusions here.

The financial performance of the commercial terrestrial broadcasters

- 3.32 Ofcom has developed a detailed simulation model of the TV broadcasting market, with the help of Spectrum Strategy Consultants, to give a more informed view of the financial prospects for the large UK broadcasters over the next decade. Details of the model's structure are given in Box 3.1.
- 3.33 The model was constructed around a scenario called a 'steady state' which assumes no significant

changes in market structure, regulatory policy or trends in device uptake. As such, the steady state, does not represent our view of the most likely outcome, but rather a scenario which posits reasonably favourable market conditions for the main terrestrial broadcasters over the next ten years. To evaluate the sensitivity of this scenario, we also present here an alternative scenario which includes a range of equally plausible risks.⁹

3.34 The assumptions in the steady state are:

- the main terrestrial channels increase programme expenditure at similar levels to those of recent years;
- each channel's viewing share on each separate platform in 2003 remains unchanged and projected total viewing shares are based on the expected take-up of the different platforms; and
- there is moderate growth in television advertising.¹⁰ The model projects TV NAR to rise at a compound annual real growth rate of 2.2 per cent to 2012, relative to 2.7 per cent between 1993 and 2003.
- The commercial PSB channels' share of television NAR falls because they lose viewers to multichannel TV. However, the decline in viewing outpaces the decline in share of NAR, reflecting an increasing premium paid by advertisers for mass, albeit diminishing, audiences in an environment of greater audience fragmentation.¹¹

3.35 Under the steady state, the main terrestrial channels face growing commercial pressures as switchover approaches, but are able to sustain advertising premiums and benefit from overall market growth. Even in this relatively favourable scenario, though, their profit margins show little buoyancy over the period (see Figure 3.7).

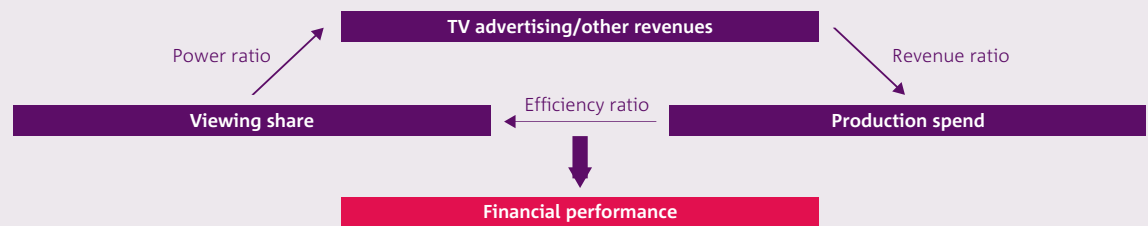
⁹ The accompanying working paper includes many other scenarios, and is available at www.ofcom.org.uk

¹⁰ Forecasts of net advertising revenues (NAR) were made on the basis of detailed econometric modelling carried out by Professor David Hendry for Ofcom, supported by PwC.

¹¹ The exception to this pattern is ITV1, for whom the Contract Rights Renewal (CRR) mechanism links share of viewing and share of NAR.

Box 3.1: The Ofcom simulation model of commercial broadcaster finances

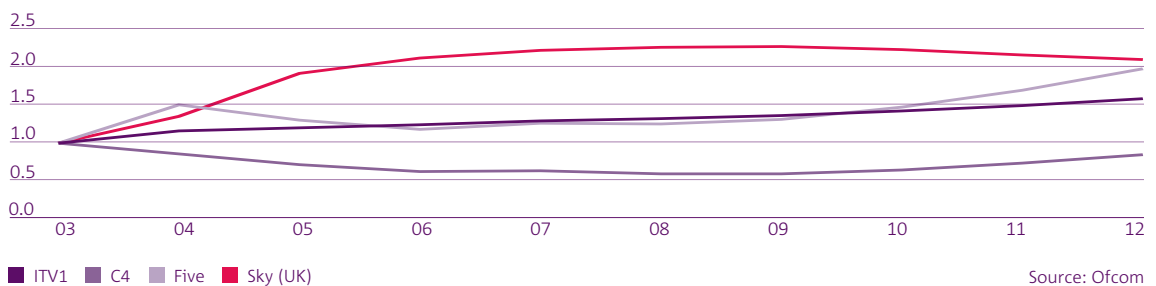
The model was based principally upon the linkages between a channel's expenditure on production, the viewing share gained from its programming, and the advertising revenues generated on the basis of these audiences. This triangular structure is illustrated in the following diagram.

Core model structure

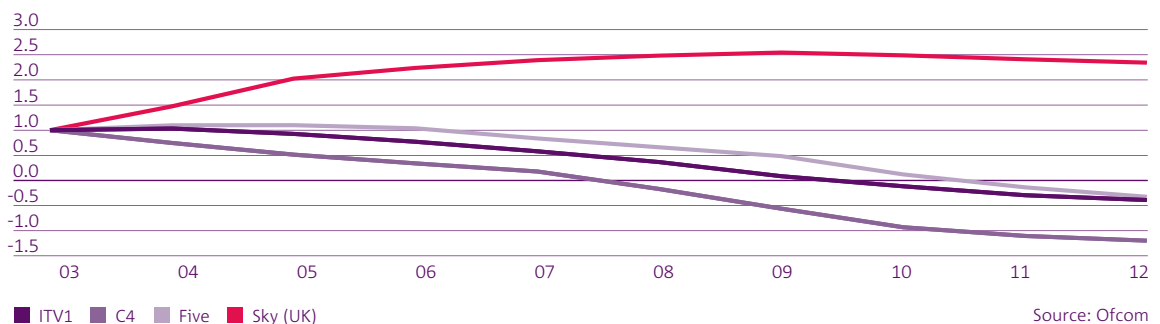
The relationships between these three variables formed the principal cross-checks for the assumptions: three key ratios were examined, and checked to make sure that the results for any broadcaster in each year were consistent with past performance. The ratios examined were: the efficiency ratio – the share of total production spend divided by share of viewing; the power ratio – share of total advertising revenues divided by viewing share; and, the revenue ratio – proportion of total revenues spent on programming

Figure 3.7: Steady state profit margins 2003-12

(Index of earnings before interest, tax, depreciation and amortisation. 2003=100)

**Figure 3.8: Downside risks scenario, profit margins 2003-12**

(Index of earnings before interest, tax, depreciation and amortisation. 2003=100)



3.36 The steady state scenario is unlikely to reflect the real world outlook. To assess the sensitivity of the projections to the assumptions, we also devised a series of alternative scenarios.¹² One scenario was designed to evaluate the effect of equally plausible risks.

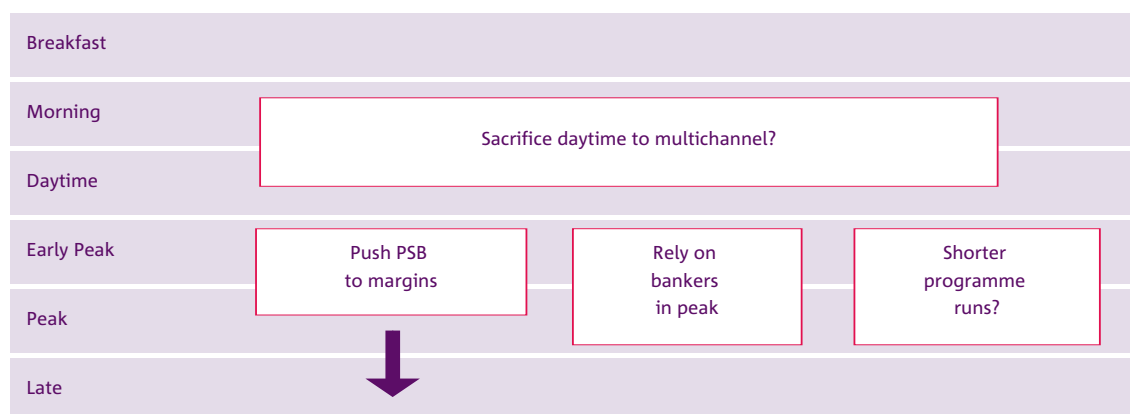
3.37 The assumptions in the plausible risks scenario are:¹³

- viewers adopt digital platforms at a faster rate;
- viewing migrates onto other channels more rapidly as they invest more in programming and build audience loyalty and critical mass;
- viewing shares for the main commercial terrestrial channels fall and their revenues begin to ebb, beginning a vicious circle of falling viewing shares, falling revenue and falling programme budgets;
- the take-up of PVRs is faster, which impacts on advertising revenues; and
- ITV loses its dominance in the advertising-funded TV market.

3.38 Once we incorporate the effects of various downside risks into our model, the outlook looks less bright for the public service broadcasters. As Figure 3.8 shows, the combination of these factors is extremely damaging to the financial health of commercial public service broadcasters. Simply unravelling the set of relatively optimistic assumptions that make up the steady state would place increasing pressure on PSB obligations. None of the commercial channels would be able to make a positive operating profit by 2010.

3.39 The downside risk scenario shows that the financial performance of the commercial terrestrial broadcasters is extremely sensitive to the development of the TV broadcasting market. At best, the channels are likely to maintain their current profitability; at worst they would be forced to change their strategies radically, to maintain viability.

Figure 3.9: Effect of financial vulnerability on Channel 4 incentives



¹² Details are given in the accompanying working paper *Looking to the future of Public Service Television Broadcasting*, at www.ofcom.org.uk

¹³ None of the variables have been modelled with unrealistic values. Details are given in the accompanying working paper.

3.40 The effect of even just one of these sensitivities could be to provoke serious financial problems for Channel 4 in particular. Its underlying profitability is central to its ability to commission and schedule PSB programmes. If its profitability were to be threatened over the next few years, it would face a strong incentive to commission more programmes of a more popular variety, which would have a much lower opportunity cost and would contribute less towards PSB purposes and characteristics. Figure 3.9 shows the possible responses.¹⁴

3.41 However, Channel 4 also has a potential upside. Our preliminary analysis suggests that further potential exists for Channel 4 to reduce costs and increase the contribution made by commercial ventures and alliances. Including these effects in our model would improve Channel 4's financial outlook, at least in the medium term.

The PSB compact

3.42 The second effect of consumer and technological change is on the commercial channels' ability and willingness to maintain the PSB compact, the situation in which they accept broadcasting licences with PSB obligations in return for access to scarce analogue spectrum.

3.43 Regardless of their profitability as broadcasting companies, there are two implications for the main players in the market if digital adoption continues to grow:

- privileged access to the analogue spectrum reduces in value to the commercial public service broadcasters. The revenue from analogue advertising is no longer the only source and possibly not the main source of income for commercial broadcasters; and
- there are alternative routes to market. In the past, the main broadcasters had a single (analogue-only) route to market which meant they had no choice

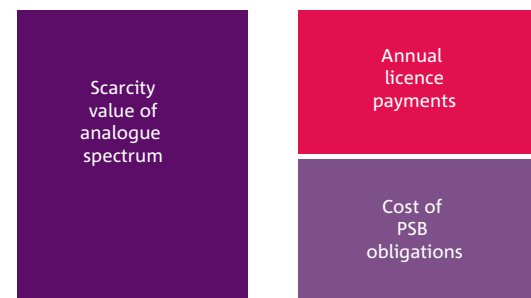
but to take part in the PSB compact. But in the multichannel world, the routes to market have expanded: from analogue-only to include broadcasting over digital terrestrial, digital satellite and cable platforms.

3.44 In the past, and currently, ITV1 and Five have been prepared to absorb the costs of PSB obligations because they have received discounted access to the analogue spectrum. Indeed, on top of the PSB obligations, both broadcasters also paid a levy to the Treasury in respect of the additional value of the analogue spectrum over the PSB obligations. In 2003, the Channel 3 licensees paid £239m to the Treasury; Five paid £33m.

3.45 But from the perspective of the commercial public service broadcaster, the nature of the compact means that these costs of access to the analogue spectrum need to be balanced against the benefits derived. At present, the costs to commercial companies of accepting PSB obligations and paying for access are offset by the benefits arising from access to the spectrum. The net result is a broad equilibrium position as shown in Figure 3.10.

Figure 3.10: Paying for commercial PSB: 2003
(illustrative only)

£m



¹⁴ Industry practitioners have told us that Channel 4 has increasingly marginalised PSB over the past decade, taking fewer risks on programming with lower opportunity costs.

3.46 When digital penetration is much higher, the compact between the commercial broadcaster and society may break. As Figures 3.11 and 3.12 show, as digital penetration increases, at some point the costs of PSB obligations exceed the scarcity value of the analogue spectrum so the compact is no longer viable. Figures 3.11 and 3.12 are illustrative only and does not pre-empt Ofcom's determination of PSB obligations and licence fee payments in the coming year.

Figure 3.11: Paying for commercial PSB: 2010
(illustrative only)

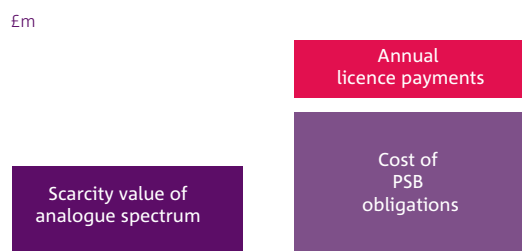
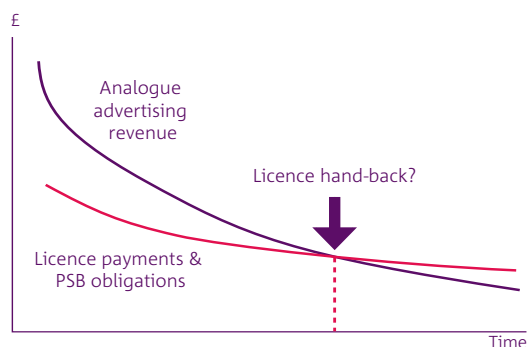


Figure 3.12: Illustrative costs and benefits of PSB obligations for fully-commercial broadcasters



3.47 After digital switchover, the problem is likely to intensify. While estimates of the residual value of guaranteed capacity on DTT multiplexes vary, it is highly unlikely that any such value will be sufficient to offset the costs of PSB, were the latter to be maintained at the current level.

3.48 If this situation were to arise, then the commercial broadcasters may face a strong economic incentive to seek an alternative route to market – one which would impose few if any of the costs of PSB status. For instance, a commercial broadcaster might simply choose to gain carriage on DTT, Sky and/or cable on a purely commercial basis. In so doing, the broadcaster would incur additional costs, such as the cost of carriage on digital platforms; and the broadcaster would also lose any remaining analogue advertising revenue which it continues to earn.

3.49 Even as digital switchover approaches, analogue advertising revenue will decline, so the 'cost' of giving up PSB status becomes smaller as the digital age approaches whereas the costs of meeting PSB obligations are much more constant. Figure 3.12 shows an illustration of the likely trends of costs and benefits of maintaining PSB status for ITV1 and Five.

3.50 This analysis does not mean that commercial broadcasters will completely withdraw from PSB. While the future is by its nature uncertain, some programming that meets PSB purposes may well be retained. For instance, the US networks all provide news bulletins, despite the lack of any requirement to do so. The programming under threat would be that which is either expensive to produce, such as regional programming, or relatively unattractive to large audiences, such as more challenging programming.

3.51 These pressures are likely to be more intense for ITV1 than for Five, for two main reasons:

- the PSB obligations on Five are far less significant than those of ITV1, and so impose fewer additional costs on the Five business; and
- in audience terms, Five is likely to benefit from the process of digital switchover, since switchover will allow it to be universally available for the first time.

Prospective PSB funding

3.52 The preceding analysis shows that there is a serious risk that the traditional PSB compact will break down as the digital age approaches: abstracting from efficiency improvements, reduced scarcity value of spectrum will reduce the ability of Channel 4 to cross-subsidise PSB from more profitable programmes; the costs of PSB obligations for ITV1 are likely to exceed the benefits from scarce analogue spectrum; and the BBC's income, while growing, is likely to fall relative to the total income in the TV broadcasting market.

3.53 In such a world, PSB will be under threat. Figures 3.13 and 3.14 assume that the TV licence fee is uprated in line with inflation after 2007, the growth of households matches the forecasts of the Office of the Deputy Prime Minister and that the digital age reduces the implicit funding of commercial broadcasters of PSB from the start of digital switchover in 2008. They show:

- the real level of PSB funding is likely to continue to rise between 2004-05 and 2007-08 and to begin to fall thereafter. The real level of total PSB funding is likely to fall from about £3.5bn to around £3.2bn in the five years until 2012. As a share of national income, PSB funding is likely to fall from 0.25 per cent today to 0.225 per cent by 2012;

- the BBC will begin to take a rapidly increasing share of PSB funding and consequently a much more important role in PSB programming; and
- by the end of the period, it is likely that the BBC will be the only significant PSB provider of any scale, if no action is taken to maintain PSB on other channels.

3.54 Figure 3.13 shows that as the digital age approaches there are three clear periods of PSB funding.

A. Declining room for manoeuvre. This period has already started. Although the value of the analogue spectrum is declining, adjustments could be made in the imminent reviews of the terms of the Channel 3 and Channel 5 licences. The PSB obligations need not necessarily be substantially altered because they are still broadly affordable. Channel 4 should be able, via a range of self-help options, to continue to support its PSB obligations.

B. Declining PSB obligations. This period will start once the scarcity value of the analogue spectrum has fallen close to the opportunity cost of the PSB obligations on ITV1 and Five. It could occur well within five years. We should expect great pressure to reduce the PSB obligations alongside increasingly credible threats from these companies to hand back their digital licences. To avoid this threat becoming a reality, Ofcom would have to consider reducing PSB obligations on ITV1 and Five. Channel 4 would face increasing difficulty in cross-subsidising challenging PSB programming from other parts of its schedule. But self help, in the form of further operating efficiency improvements and raising revenues from its other successful commercial ventures, might enable it to use other forms of cross-subsidy to replace the cross-subsidy within Channel 4's output, which is likely to become more difficult to sustain.

C. The digital age. After digital switchover, the only PSB obligations that Ofcom could secure on ITV1 and Five, without new funding streams, would be equivalent to the value of the remaining privileges for commercial broadcasters with PSB obligations. We currently believe these are unlikely to be worth much more than £25m a year (see Box 3.2).

Figure 3.13: Prospective level of PSB funding (2004 prices)

£ million (2004 prices)

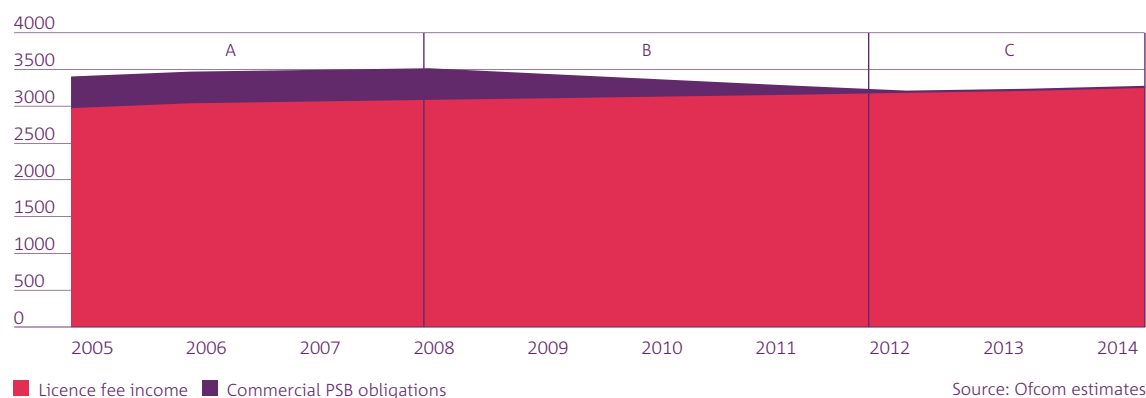
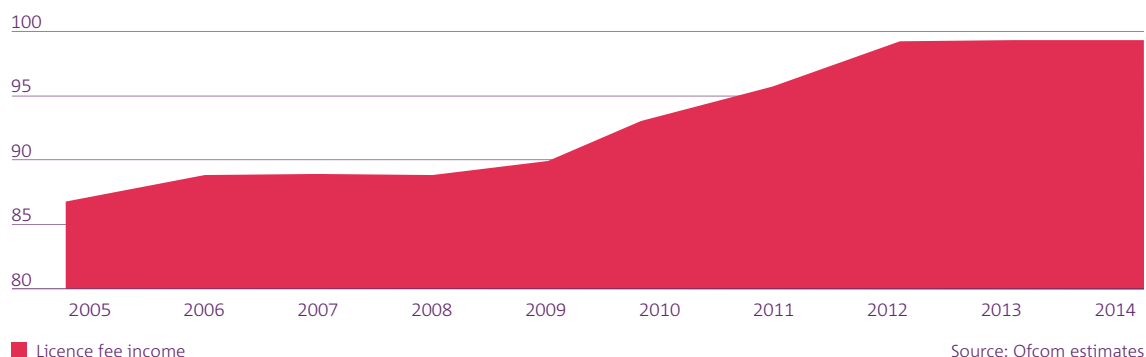


Figure 3.14: Prospective BBC share of PSB funding

%



PSB in the digital age

- 3.55 In the digital age the scope for implicit funding of commercial PSB is not zero. Though they would not benefit from scarce analogue spectrum, commercial broadcasters with PSB obligations would still be entitled to appropriate prominence on EPGs, reserved capacity on digital terrestrial TV and must-carry rules on cable networks as shown in Table 3.1. Channel 4 would still benefit from the Government not demanding a dividend to be paid. In addition, there might also be some scope for introducing spectrum pricing waivers in future for broadcasters with PSB obligations, if Ofcom decides to introduce administrative incentive pricing into the broadcasting spectrum.
- 3.56 In addition, broadcasters with PSB obligations would benefit from guaranteed access to DTT spectrum.
- 3.57 There is a wide margin of uncertainty around these figures. But there is no doubt that the potential for implicit PSB subsidies in the digital age is much reduced. Without a new source of funding, commercial broadcasters will only be willing and able to provide a minimum floor of PSB other than that which is consistent with their direct commercial interest.

Implications for the future of PSB

- 3.58 The analysis suggests that public service broadcasting will be under increasing pressure as we move towards and into the fully digital world:
- commercial public service broadcasters may face the incentive to seek other routes to market; and
 - Channel 4 may face a reduction in the margin available to support PSB purposes.
- 3.59 If there is no change to the policy environment, there is a real chance that the broadcasting landscape will evolve in such a way that the provision of PSB will fall substantially. The evidence suggests that the current pluralistic environment for PSB in the analogue age would not be sustainable in the digital age. If no action is taken, the BBC is likely to emerge as the only broadcaster able to contribute significantly to PSB purposes.

Box 3.2: The value of PSB status in a digital world

Gifted DTT capacity

It presently costs around £3m per channel to get carriage as a commercial channel on a DTT multiplex. Post-switchover, there will be an expansion in the number of channels, although their potential viewing share will also increase. Though highly uncertain, £3m per channel slot remains the best estimate of the future value of this privilege. The current main terrestrial channels receive more than one slot on DTT for their PSB obligations.

Appropriate prominence on Electronic Programme Guides (EPGs)

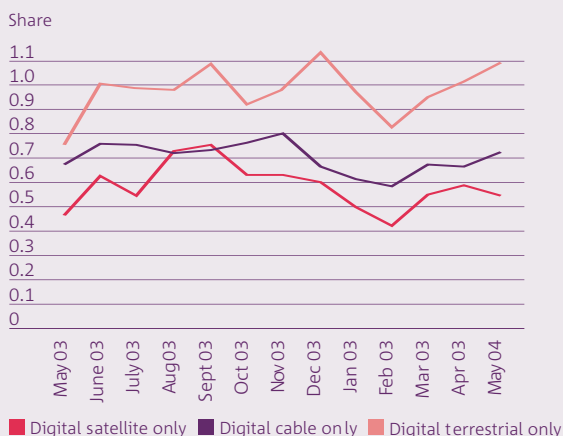
EPG positioning, especially at or near the top of the first page of a genre category, is perceived to deliver significant value to broadcasters. Channels with PSB obligations are guaranteed appropriate prominence on an EPG.

To attempt a valuation of EPG prominence for PSB channels on digital platforms, we examined the period from May 2003 to May 2004 looking at the channel share for BBC Three and BBC Four on Sky, cable and Freeview. These figures take into account the movement of BBC Three and BBC Four onto page 2 of the Sky EPG that occurred in June 2003.

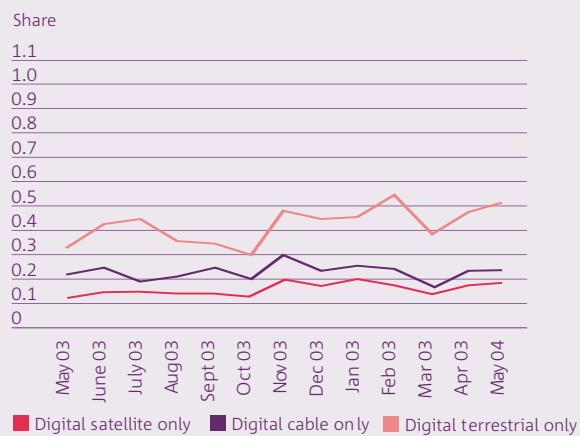
Figure 3.15 illustrates the channel shares across all three platforms for the period May 2003 to May 2004.

Figure 3.15: Audience share of BBC Three and BBC Four

BBC Three



BBC Four



Across all three platforms Sky, Freeview and cable there were fluctuations from May 2003 to May 2004. The data show that when BBC Three and BBC Four were moved to page 2 of the Sky EPG on 18 June, BBC Three experienced a rise in channel share on the satellite platform immediately after the position change, but it was transitory. There were no significant movements in the relative BBC Four share on the satellite platform.

As a natural experiment in the value of EPG position, the experiences of BBC Three and BBC Four do not suggest a high value can be placed on EPG position. However, EPG positioning makes it easier for viewers to sample channel content, boosting ratings in the short term, and providing opportunities for the cross-promotion of content and affiliated channels. It may be, therefore, that positions near the top of page 1 on the EPG could have a more significant value than those occupied by BBC Three and BBC Four.

Must-carry rules

Since cable companies have a strong incentive to attract the main terrestrial channels to their networks, and this is likely to continue after digital switchover, must-carry rules are unlikely to have a high value except when they are applied to low audience, specialist channels with PSB obligations.

Waiving spectrum charges

According to the Indepen/Warwick Business School study carried out for Ofcom, DTT spectrum is likely to be priced at £1.2m/MHz. Each DTT multiplex requires $6 * 8$ MHz to achieve national coverage (based on the higher power attributed to PSB multiplexes to help them get the best coverage). $6 * 8 * £1.2m = £57m$ per multiplex per annum for the PSB multiplex.

The number of TV channels per multiplex depends upon the coding scheme used, but if we assume six then we get $£57m/6 = £9.5m$ per TV channel per annum.

However, the launch of FreeSat will affect the Indepen calculation, which is based on the cost of connecting customers to satellite (as an alternative to DTT) and assumes a smart card is needed. If this is no longer the case then the charge per MHz based on the Indepen algorithm would fall to £670,000 per MHz per annum. $6 * 8 * £670,000 = £32m$. Divided by six channels, that equates to £5.4m per TV channel per annum.

A broad estimate for the value of any spectrum pricing waiver, were it to be introduced for PSB channels, would therefore be between £5m and £10m per channel each year.

Calculation

Adding together the value of any potential spectrum pricing waiver and that of gifted DTT capacity, and allowing for a small benefit from EPG prominence and must-carry rules, the monetary value attached to PSB status in a digital world appears to be modest. It seems unlikely to exceed £25m per year, and could be substantially less. This analysis does not pre-empt our reviews of licence terms for Channel 3, 5 and Teletext licensees, which will be based on the most up-to-date information available.



How much PSB should society
fund in the digital age?

4

4. How much PSB should society fund in the digital age?

- 4.1 Section 3 concluded that the existing model of PSB funding will become unsustainable as we move into the digital age. Before we set out options for a new model to maintain and strengthen PSB in the digital age, we need to determine what is likely to be the right level of public funding to support PSB purposes and characteristics. This is inevitably a question without a precise answer because neither the costs of PSB nor the benefits are easy to determine.
- 4.2 There are three relevant arguments for constant or higher real levels of PSB subsidies:
- **Enduring citizenship benefits of PSB.** If the gap between people's expectations as citizens of PSB and market provision remains constant or grows, there will remain a strong case for continued public subsidy of PSB.
 - **Public appreciation.** If public appreciation of PSB remains high, the case for continued funding is strengthened.
 - **Public desire to pay collectively for PSB.** If there exists a widespread desire to pay collectively for PSB so that it can be received widely, the case for continued or greater funding is maintained.
- 4.3 However, in the digital age, there are likely also to be three arguments for lower real levels of PSB subsidies:
- **Market provision.** In the digital age, the market is likely to provide some of the range and diversity of programming previously ensured by PSB obligations, so part of the consumer rationale for subsidising PSB declines.
 - **Diminishing citizenship benefits of PSB.** If it becomes more difficult to persuade people to watch programmes which contribute to PSB purposes and audiences for such programming decline, PSB's effectiveness in benefiting people as citizens may decline.
 - **Diminishing value for money.** If the audiences for programmes which contribute to PSB purposes decline, so would the value for money of subsidising such programming. The value for money of PSB subsidies is already declining as viewers have migrated to multichannel TV. While the cost of programming on the five main terrestrial channels rose by 16 per cent between 1998 and 2003, the cost per viewer hour rose by 28 per cent.
- 4.4 Our analysis in this chapter is derived from four pieces of evidence:
- an estimation of what the UK market would provide without PSB funding;
 - an assessment of the extent to which public funding displaces private expenditure on TV services;
 - international comparisons of the effects of PSB funding to assess what the UK receives for the public funding it provides; and
 - detailed new audience research into valuations of PSB when costs are attached explicitly to evaluate public appreciation of PSB and willingness to pay collectively for it.
- 4.5 We conclude from these analyses that there remains a strong case for continued funding at real levels similar to those of today, but accept that that case might change in future if broadcasters' ability to provide citizenship benefits changes significantly.

The TV market without PSB interventions

- 4.6 Public intervention in the TV market in the UK is so extensive that evaluating its effect becomes almost an impossible task. Nevertheless, we concluded that there was value in assessing how the market might appear without any intervention in order to get a sense of the value added by the current PSB model. Using a range of inputs – the history of the TV market in the UK, international comparisons, the size of the potential UK market, Ofcom experience and the help of consultants Mediatique and McKinsey – we estimated the broad parameters of a free market in TV broadcasting.
- 4.7 We have split the analysis into broadcast platforms, channels, finance and programme content and present summaries of our analysis here.

Platforms

- 4.8 Our assessment suggested that all the three broadcasting platforms – terrestrial, satellite and cable – would exist in a world without PSB intervention. Analogue terrestrial TV would have developed – as it has across the world – but digital TV platforms would also have emerged. Commercial incentives, particularly in relation to premium sports and movie content would have led to the establishment of satellite and cable TV even without PSB intervention. Given the considerable interest in operating digital terrestrial television (DTT) multiplexes after ITV Digital folded, and the evident consumer demand for free-to-view digital TV, it is likely that a DTT platform could also have competed against analogue terrestrial satellite and cable TV, even without PSB interventions, although the extent of its geographic coverage might have been more limited.

- 4.9 Digital switchover would be considerably harder to achieve without PSB interventions, though the existence of spectrum trading and pricing could change this. An unintended, but welcome, consequence of PSB subsidies is that they can provide a platform-neutral lever to help co-ordinate the switchover process by securing the active participation of broadcasters with PSB obligations. The BBC, in particular, is likely to play a large part in ensuring its success.

Channels

- 4.10 In a world without PSB interventions, there would be a range of free-to-air networks, with reasonable levels of advertising funding. This occurs in almost every country with or without PSB regulation. As in other countries, it is likely that a more developed market would sustain a relatively small number of high audiences advertising-funded channels rather than a complete fragmentation into hundreds of tiny channels. It is probable, though, that advertising income would be spread more evenly across these channels, in contrast to the current UK market position, which is characterised by a very large share for ITV1.
- 4.11 In the absence of licence fee-funded content on the BBC, there would be audience demand for better funded and potentially more niche channels than exist in today's market. Alongside the main networks, there would be a larger number of niche channels funded by a mix of subscription and advertising.

Programme finance

- 4.12 Total funding available for TV programmes would, however, be significantly less than in today's UK market. Total advertising revenue would be similar or possibly even lower than current levels. TV advertising raised £3.2bn in 2003. Advertising levels per head in the UK are similar to other comparable economies and there are few reasons to believe that a large increase in the supply of advertising impacts that would result from a more commercially-orientated market would attract much greater revenues rather than lower prices per impact. It is likely that if there were four or more large advertising-funded networks with more intensive competition to sell advertising airtime, the premium in advertising rates now enjoyed by ITV1 and Channel 4 would not exist, so total advertising revenue could even be slightly lower than today.
- 4.13 Subscription revenues would be somewhat higher, but would not fully replace the lost licence fee income. UK subscription revenue as a share of national income is lower than that of the US but higher than in most other European markets. Since the UK TV market already has a high level of subscription revenues relative to most other comparable countries and households are used to paying the licence fee on top of this, it is likely that, in the absence of the licence fee, pay TV subscriptions would rise, but only to replace some of the current PSB subsidies.
- 4.14 A very simple read-across from the US would imply the potential for a further £860m a year in subscription income, according to Mediatique's analysis. This is equivalent to about one-third of the BBC's current expenditure on TV.

Programme content

- 4.15 TV channels would rely more on lower-cost TV programming, although higher production-value content would still exist, as it does in other markets around the world where costs are recovered by multiple releases and access to pay-TV as well as advertising revenues. With less revenue in the TV market and at least as many large TV channels, the TV market without PSB interventions would produce programming which was on average significantly lower-cost than today, but with some high-cost 'event' programming still available in the mix. It is possible that high-cost programming would be released first on pay channels, only reaching free-to-air channels some time later. Reducing the cost per hour of programming could be achieved by more repeats, cheaper types of programming, more acquired material and/or greater efficiency in programme production. It is unlikely that the whole shortfall could be met from efficiency savings.
- 4.16 The fully commercial TV market would not support as much high-cost originated comedy and drama as is provided in today's model. It is likely that the UK market is large enough to support some subscription services for high cost originated drama and comedy as shown in Box 4.1, but not on the same scale as HBO in the US. The quantity of high-cost comedy and drama would be likely to be considerably lower in the absence of PSB interventions even if the price of talent were to fall. Cutting edge TV drama and comedy, which has high production values but is also high risk, would struggle to find funding.
- 4.17 Overall, programming would feel more commercial. Free-to-air advertiser-funded content would be aimed largely at 18-49 year olds, the most attractive audience for advertisers; programmes for pay TV channels would be targeted at those audience groups willing to pay for such material.

Box 4.1: The potential for a UK version of HBO

Ofcom, in conjunction with Mediatique, has conducted an exercise to gauge the feasibility of a UK version of the US channel HBO.

Subscription channels with large programme budgets are more viable in the US due to the size of the US market. A three to four per cent market share is enough to ensure both commercial viability and high programme budgets. HBO spends around £400m on programming.

How much money might a UK HBO generate?

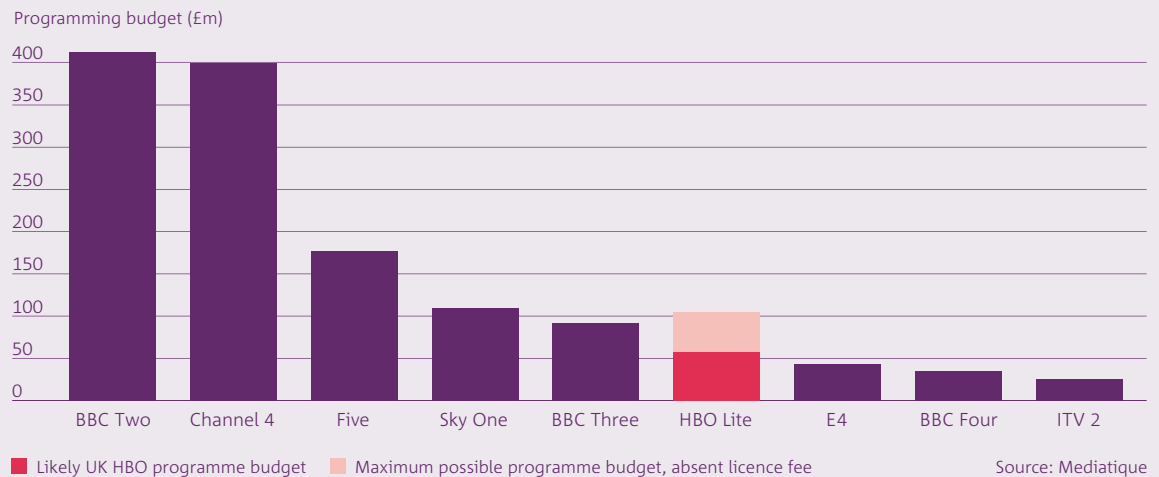
About 30 per cent of all US multichannel homes subscribe to HBO. HBO receives about \$80 per household a year and spends around \$28 per household on programming, with original programming budget accounting for about \$15 per household.

If the UK followed the US experience, a UK HBO would have around 4m subscribers; its total programming budget would be £61m, of which £32m would be spent on original programming. As Figure 4.1 shows, this suggests that a UK HBO would have a programming budget 50 per cent greater than that E4, but 30 per cent less than that of BBC Three. If the original programming budget for a UK HBO were around £32m, it would cover only a limited number of hours of high-quality programming.

Even if the licence fee did not exist, freeing up consumer expenditure, and pay-TV penetration rates reached US levels, a UK HBO would only generate an estimated £113m programming budget, less than the current budget of Sky One.

Figure 4.1 illustrates the potential programming budget of a UK HBO compared to other UK channels.

Figure 4.1: Programme budgets for UK TV channels

**Conclusion**

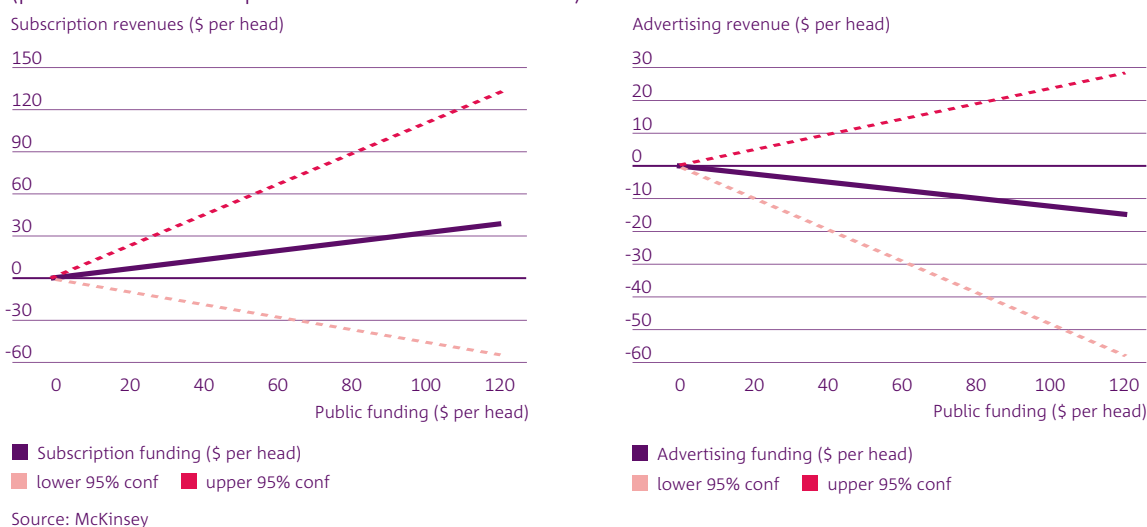
Even with more optimistic assumptions on pay-TV penetration, it is not possible to generate a programme budget of any great size for a UK HBO. As such, while an HBO-type channel could be viable in the UK market, it would be unlikely to possess the funds needed to make a contribution to PSB purposes on the scale currently provided by even the BBC's digital channels.

Public funding of PSB and inefficiency

- 4.18 Potential economic inefficiencies could arise from the current system of PSB. Public subsidies might crowd out private investment in programming. There could be lax cost control in the broadcasters that do not have to face market disciplines in programme production. Each would represent an additional burden on society.
- 4.19 We wanted to test whether further evidence could shed more light on the question of whether public funding of PSB crowded out private expenditure. We commissioned McKinsey to undertake an international comparison of the determinants of private expenditure on TV services, taking into account the different sizes of markets in different countries, and other factors important to the level of funding.

- 4.20 The two charts in Figure 4.2 below show the results of the model built by McKinsey. The solid line shows the predicted effect of public funding on subscription and advertising income respectively. The dotted lines show 95 per cent confidence intervals. In the first chart, we found a very weak positive relationship across countries between the level of public funding per head and the level of subscription funding per head. But the relationship was not strong enough to be statistically significant. For advertising, we also failed to find a statistically significant relationship between the level of public funding in different countries and the level of advertising revenues per head.
- 4.21 The fact that we did not find a statistically significant relationship between public funding and private expenditure does not mean that the BBC does not have a negative impact on certain areas of the private broadcasting industry in the UK, only that it was not evident in cross-country comparisons of TV funding at an aggregate level.¹⁵

Figure 4.2: Relationship between public funding and subscription advertising revenues
(predicted relationship and 95% confidence interval)



15 Difficulties in generating consistent TV expenditure data across many countries render the results provisional.

4.22 The BBC's level of public expenditure might have a significant impact on smaller commercial channels or on new and emerging markets. Separate advertising demand modelling work undertaken on behalf of Ofcom¹⁶ suggests that the BBC's ability to take share from some specialist niche cable and satellite channels could be extremely important for their viability.¹⁷ Uncertainty about the BBC's future investment and programming plans might deter commercial investors from launching services in new areas. However, we do not have sufficient evidence to prove or to disprove the existence of overall crowding-out efficiency losses from the public funding of the BBC in aggregate.

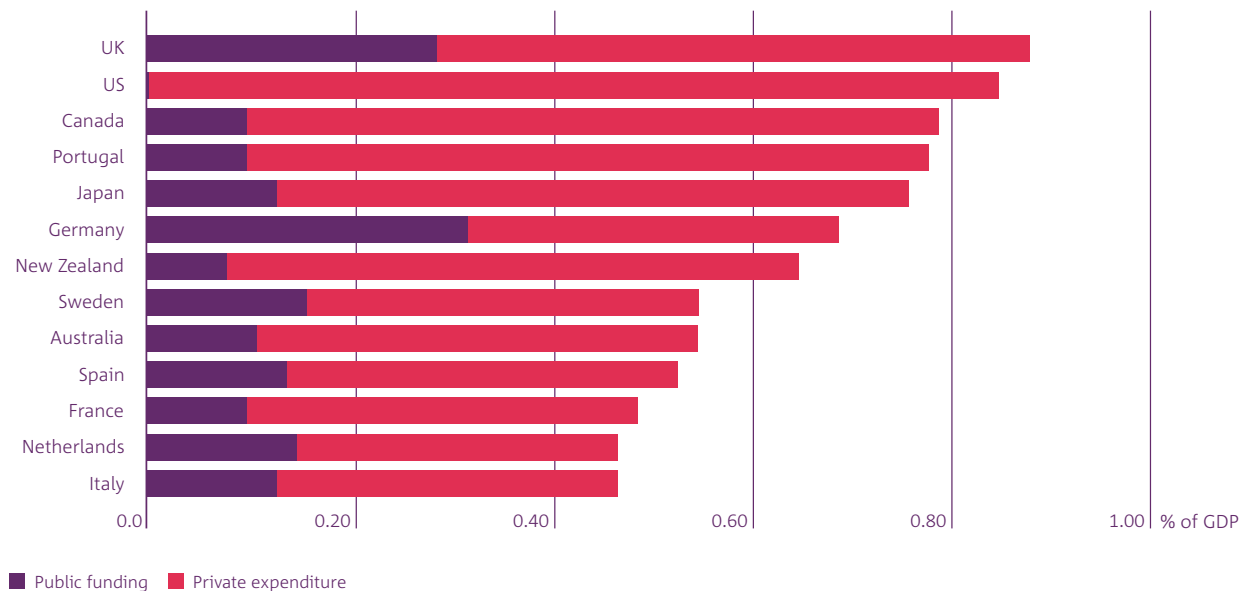
4.23 It will continue to be important to analyse the effects of crowding out as more evidence becomes available. At present, however, without strong evidence of crowding-out, the important policy questions are whether PSB subsidies are encouraging TV programmes which meet PSB purposes and characteristics and whether they provide value for money.¹⁸

International comparisons

4.24 Public funding of broadcasting in the UK delivers more investment in programming than would otherwise occur, and the evidence for any 'crowding out' of private investment is relatively weak. But how does the UK compare with other countries in terms of the total amount of funding provided?

Figure 4.3: Public and private funding of broadcasting services

Expenditure as a share of GDP



Source: McKinsey

¹⁶ Work undertaken by Professor David Hendry, PriceWaterhouseCoopers, an expert independent panel and Ofcom.

¹⁷ The Ofcom advertising model has a much higher estimated elasticity for exclusively cable, satellite and DTT channels. Niche channels therefore can be expected to lose significant revenues if their audience share is hit by the presence of BBC competition.

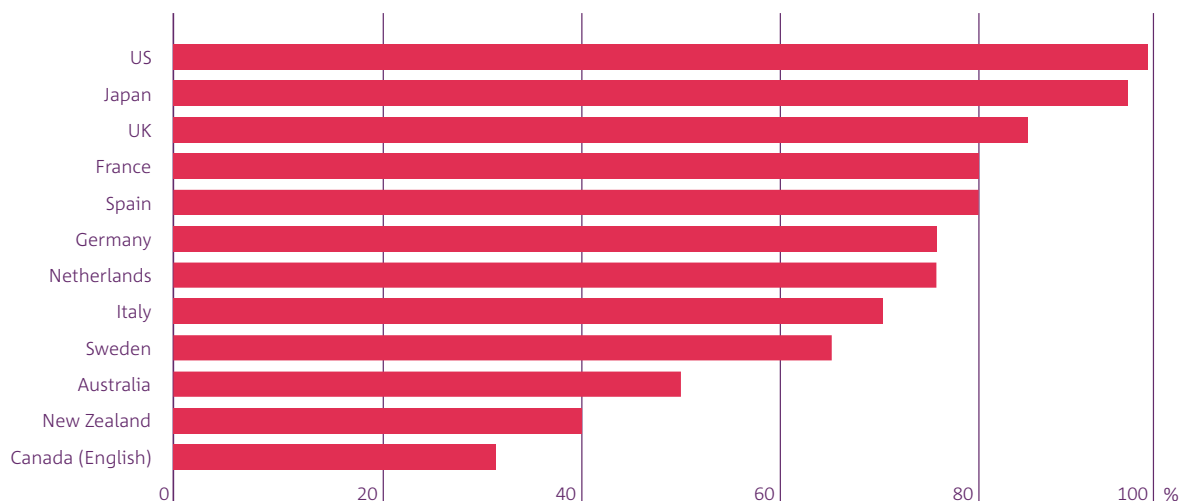
¹⁸ More detail on the efficiency aspects of the BBC's new digital services are presented in a recent Ofcom submission to the DCMS review of the BBC's new services.

4.25 Public intervention in television is commonplace around the world. In most countries, the State was the first broadcaster, and despite the evolution of global media markets, almost every Western government continues to support PSB television and to fund it to some degree. Figure 4.3 shows that while the UK spends more than any other country as a share of national income on broadcasting, it also has a high level of public funding of broadcasting services.¹⁹ The US stands out for funding its broadcasting almost exclusively from private sources.

4.26 For the high levels of public and private expenditure on TV services, the UK receives one of the highest levels of domestically originated programming in the world and much higher

domestic originations than most other English speaking countries outside the US. Figure 4.4 shows the high level of UK originated output and Figure 4.5 shows that UK viewers still watch more output in broadly defined PSB genres than viewers in other countries. It is difficult to explain precisely why domestic production and PSB viewing are so solid in the UK market, and to what extent the actions of Government and regulators, rather than the demands of viewers, have been decisive. However, it is likely that the system of broadcasting institutions and regulation that has developed over the past 50 years must have made a significant contribution to our strong and distinctive model of PSB.

Figure 4.4: Domestically produced output – % of peak output produced from home market, 2003



Source: McKinsey analysis

19 Licence fees and grants from general taxation.

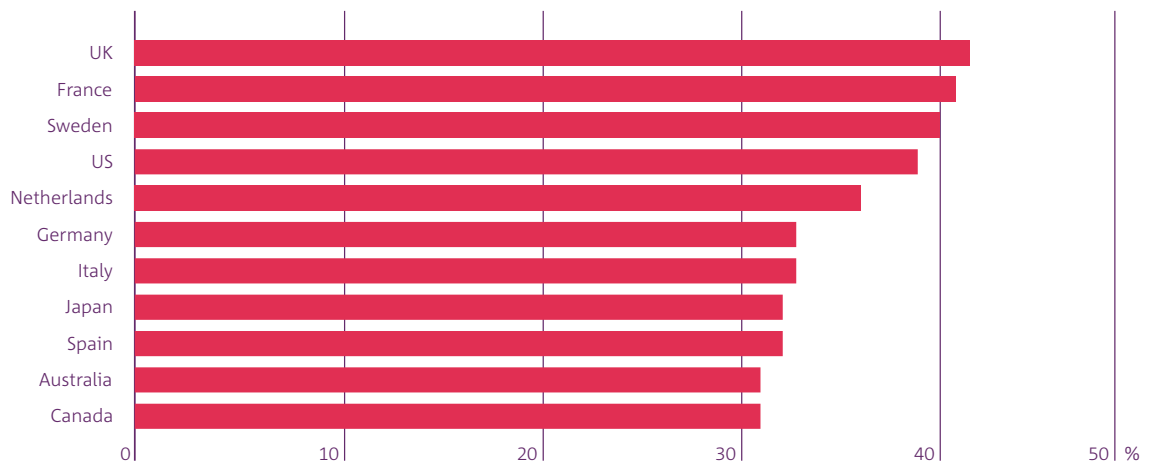
4.27 International comparisons are instructive only to a limited extent. But they show that UK funding of broadcasting, from both public and private sources, is high. As the preceding analysis showed, the likelihood is that the funding of broadcasting would be considerably lower if public funding did not exist and would place the UK in the mid-table of funding of broadcasting around the world. It is likely, too, that the share of domestically produced output in the UK would also fall.

Audience research

4.28 An important determinant of the right level of public funding is the amount that the public wish to pay collectively for TV broadcasting services. Since the current system involves an element of compulsion, there are no market mechanisms available to measure willingness to pay.

4.29 After considering many methods of valuing PSB (see Box 4.2), Ofcom commissioned MORI to undertake a study of public attitudes to PSB funding. The detailed research results are presented in a supporting working paper.²⁰ We wanted to determine how much PSB the public were willing to pay for in the future, once the current analogue model was no longer sustainable – and how much they were prepared to pay.

Figure 4.5: Viewing of PSB genres²¹



Source: McKinsey analysis

²⁰ *Valuing PSB: the view from the audience*, at www.ofcom.org.uk

²¹ PSB genres broadly defined as 'cultural, factual, news and children's'; quantity of viewing measured as audience share on 'major channels' – those accounting for 70-80 per cent of total audience share in each country.

- 4.30 The focus of the research was to evaluate how much the public valued PSB when real costs were attached to it, but the research also probed what types of programmes were most highly valued and public attitudes towards different funding mechanisms. The research attempted to articulate the important trade-offs in an easily understandable way, using indicative TV schedules for different scenarios. Respondents were able to talk about programmes they knew and understood rather than unfamiliar concepts.
- 4.31 The scenario presented to participants was that in the future advertising revenues would no longer be able to fund PSB obligations on ITV1, Channel 4 and Five. The respondents had to choose between five different scenarios by the end of the day's workshop. Each scenario was represented by an illustrative day's TV schedule. Reduced BBC funding was represented by an increase in repeats on BBC One and BBC Two as well as the replacement of higher-end programming with cheaper material. Increased BBC funding was illustrated by increased levels of high-cost drama and even more local news. On ITV, Channel 4 and Five, the illustrative schedules included or removed different types of regulated programming such as news, regional news, regional non-news, current affairs, arts and religion. The schedules were devised by Ofcom after discussions with broadcasters.
- 4.32 The participants were able to choose between five different scenarios, labelled **A** to **E** here.²² As is clear from table 4.1, schedule **A** had the most PSB while **E** represented considerably reduced PSB provision and funding.
- 4.33 The respondents were first asked to choose between the five different schedules without any indication of the relative costs and purely on the basis of their personal preference. In each case they discussed the relative merits of different schedules at some length. At this stage, the preferred option was **A** (much increased PSB provision), although **E** (considerably reduced PSB provision on the BBC and on other channels) was the most preferred option among many younger individuals who already had digital TV.
- 4.34 When people were asked to consider what was best for society rather than for themselves, a strong consensus among all the groups was that **A** remained the most preferable set of programmes for society as a whole with **E** the least preferable. This result was consistent with our Phase 1 research which showed the public appreciate programming which contributes to PSB purposes and characteristics. Those that had favoured **E** as their personal preference tended to agree, after discussion, that the schedule with fewer PSB programmes did not provide a sufficient range of programmes for everyone in society.

Table 4.1: Scenarios tested for PSB funding in the future

Scenario	Funding of BBC	Obligations on ITV1, Channel 4 and Five	Public funding cost relative to today	Absolute level of the TV licence fee
A	More than today	More than today	+ 50%	£181
B	As today	As today	+25%	£151
C	As today	None	0	£121
D	Less than today	As today	0	£121
E	Less than today	None	-25%	£91

²² A different labelling scheme was used in the deliberative forums to avoid leading the participants.

Box 4.2: Measuring willingness to pay for PSB

Many research techniques can offer insight into the public's willingness to pay for PSB, each with their own advantages and disadvantages.

Surveys of public attitudes to the TV licence fee

As the BBC dominates PSB funding, surveys of public attitudes to the TV licence fee can provide a useful proxy of public attitudes towards funding PSB.

For our Phase 1 report, we carried out a survey of 6,000 households, which included questions on the licence fee. It found the majority supported the concept of a licence fee when giving a spontaneous response. But the support for the licence fee varied by nation and region and by the way people watched TV: Sky households were considerably less supportive, for example, than DTT households. Figure 4.6 shows the national and regional breakdown of support for the licence fee.

Figure 4.6: Responses to the question “Do you support the general idea of the licence fee?”



Source: IPSOS

Our findings complement a similar exercise carried out for the Department for Culture, Media and Sport as part of its review of the BBC's Royal Charter. It found that:

- The licence fee was widely considered to be the best – or the ‘least worst’ – way to pay for the BBC for the next Charter, although there is some support for other options, particularly in combination with the licence fee.
- The public's view of the value for money delivered by the BBC was equivocal, with 46 per cent saying it delivered fairly good or very good value for money, compared to 43 per cent taking the opposite view.

Surveys of public attitudes such as these do not, however, directly link the costs of PSB to the benefits of PSB programming. They are not necessarily therefore a clear guide to the public's willingness to pay for public service broadcasting. They also tend not to describe to people what TV would look like if the licence fee did not exist, an omission that is likely to bias the results.

Quantitative willingness to pay studies

It is possible to ask the public directly how much they are willing to pay for PSB, either thinking for themselves or thinking for society. Many such studies have been carried out for goods or services which do not have a direct market value. The BBC has undertaken such a study as part of its approach to measuring the public value of its services. Its research concluded that given the choice of paying a certain level of the licence fee or having the BBC taken away from them:

- 81% of people said they would be willing to pay the current level of £10 a month;
- 42% said they would be willing to pay £20 a month;
- 19% said they would be willing to pay £30 a month; and
- 9% said they would be willing to pay £40 a month.

The benefit of this type of research is that it provides clear figures which are easy to interpret. But contingent valuation exercises such as these contain some serious drawbacks. First, it is very hard to ensure that the questions posed provide discrete and understandable options to choose between, as often the alternatives to the status quo do not exist and are hard to encapsulate. In this case, the removal of the BBC is a difficult concept. Second, the questions posed do not reflect the real options available to people because some current BBC programmes would be produced free-to-air by the market. Furthermore, asking people to make trade-offs between different scenarios requires readily-understood elements, which in turn requires consensus over what constitutes PSB programming and how it can be described: both of which are the desired outcomes rather than the component parts of such research.

For these and other reasons, then, we decided to move to a qualitative approach.

Qualitative research techniques

The main alternative to quantitative estimates of willingness to pay for PSB is to take a qualitative approach to the problem. The advantages of qualitative research for a difficult problem such as PSB funding are that it allows us to:

- probe more deeply the reasoning behind the public's decisions;
- ask much more detailed and sophisticated questions;
- explain the policy choices and the consequences of decisions people make;
- probe the difference between individual preferences and the preferences people hold for society and whether they understand the different concepts; and
- present much more varied choices, presented in ways that people understand.

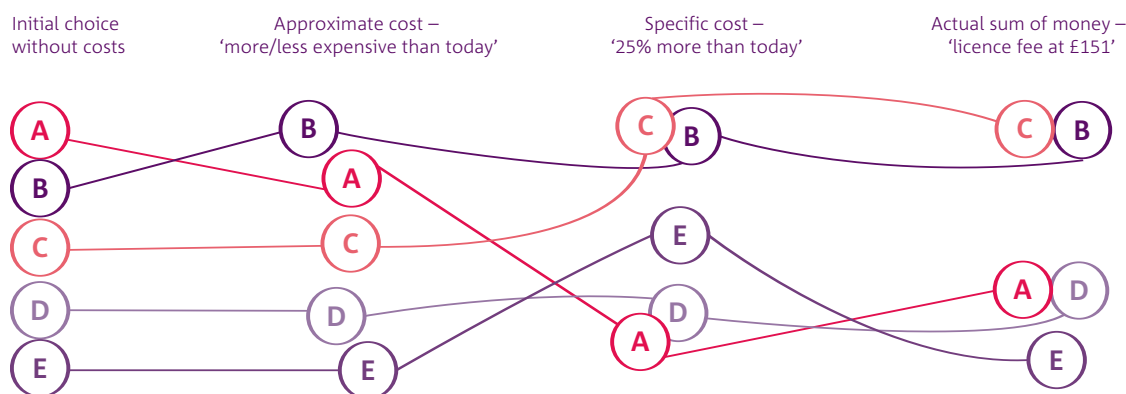
There can be three drawbacks of qualitative research in this context, however:

- It remains difficult to gauge how respondents would react to the reality rather than the rhetoric of the option, even when moderators can probe the reasoning behind their decisions.
- The outcomes are not statistically robust. Recorded attitudes could be informed by sample selection biases or be skewed by dominant voices in a group. The outcomes cannot be seen as necessarily representative of the UK as a whole.
- It is possible for the groups to be biased by moderator interventions and lines of questioning.

We chose a qualitative approach to valuing PSB because we felt it was the only way to present the real policy choices to the public rather than an unrealistic proxy of the real policy choice. The results are not statistically robust, so no summary statistics for the work exist. But we believe this is a virtue of the research rather than a problem – our goal in this research has been to understand how the public thinks and feels about PSB provision once costs are attached, and to gain some broad indications of the levels of PSB and the levels of funding people feel comfortable with.

- 4.35 When the participants were told the approximate costs of each schedule, their preferences changed. Schedule **A** was described as “much more expensive than you spend today” and on that basis it lost a significant amount of popularity. Instead, schedule **B** (same level of PSB programming as today but costs rise by 25 per cent) became the most preferred option. When the participants were given the relative figures in Table 4.1, option **C** (same costs as today but no PSB obligations on commercial channels) rose in popularity to challenge **B** for the most preferred schedule.
- 4.36 Finally, when the actual costs of the different schedules were given as pounds per year, it reinforced the consensus that the two most popular options were **B** and **C**. This corresponds to a maintenance of the current style of programming on BBC One and BBC Two with some relaxation in the obligations on ITV1, Channel 4 and Five and a willingness to support a level of subsidy between £121 and £151 per household a year. The figures were designed to be simple for participants to grasp rather than exact representations of the relative funding of different broadcasters with PSB obligations. The results are summarised in Figure 4.7.
- 4.37 This project was deliberately designed as a qualitative enterprise, and therefore the results cannot be used firmly as evidence of opinion across the population as a whole. However, the results achieved nonetheless suggest that there may be broad consensus over the following:
- when costs are not an issue, people generally prefer schedules with more PSB-style programming relative to less, particularly when asked to view things from the perspective of what is best for society as a whole;
 - attitudes to PSB programming change considerably once costs are included. The centre of gravity of opinion changes towards doing less PSB. This result is important for any surveys which measure the public’s appreciation of PSB without including the costs of funding PSB;
 - overall, once realistic costs are attached, the public tends to want to pay for a slightly lower level of PSB than that provided today but higher than the level which would exist if only the BBC was funded to produce PSB programming at its current level; and
 - the BBC is generally thought to be better at providing PSB than ITV1, Channel 4 or Five.
- 4.38 The value of the qualitative research was that it gave an indication of what the public thinks is the right general level of funding for PSB in a world where implicit funding is no longer possible. It suggests that the level of explicit funding should be higher than today after adjusting for inflation. But the public would also want to see some of the existing obligations on commercial terrestrial TV channels dropped in return for a slightly lower level of compulsory funding. It would suggest a level of explicit funding of PSB between £121 and £151 a household at 2004 prices. This equates to a total level of PSB funding for TV, broadly the same as today in real terms.
- 4.39 These results should not be taken as precise indications of the right level of PSB funding, but as an indication of how the public’s views change, and for what reasons, once they are informed about the costs attached to PSB provision.

Figure 4.7: Summary of how preferences changed through the day



Source: MORI

Conclusion

4.39 Determining the right scale and scope of PSB funding is difficult because its effects on the market are uncertain and the public’s willingness to pay for PSB cannot be measured directly. Our research evidence in four separate areas has provided some clear answers:

- it is highly unlikely that a free market in TV would provide the range of services now on offer free-to-air although a reasonable range is likely to be offered on a subscription basis;
- international evidence shows that the UK subsidises PSB more than any country except Germany, but benefits from a relatively high level of original production and output of TV which contributes to PSB purposes;
- we could not find a statistically significant negative impact of public funding on private income sources for TV services except for specialist niche channels. Our analysis suggests that in the absence of public funding, advertising revenues are unlikely to rise significantly, if at all, and any additional subscription income is likely to be small compared with the loss of licence fee income; and

- the public agree that the current level of PSB funding is broadly right – they might be prepared to pay slightly more, but not enough to sustain the full level of PSB currently produced by commercial networks.

4.40 These four diverse pieces of evidence suggest that as we move into the digital age, we should seek to find replacement funding for the implicit subsidies provided by access to scarce analogue spectrum so that we can fund PSB to roughly the same level as today.



The important issues for PSB in
the digital age

5

5. The important issues for PSB in the digital age

5.1 Maintaining and strengthening public service broadcasting in the digital age will require a new model, fit for a world in which Government and regulators can no longer extract value from a scarce TV distribution mechanism. If no policy action is taken, the BBC will become the sole PSB provider of any real scale, with implications for governance and regulation of the Corporation and most likely for the quantity and value of PSB content available to viewers. If there is to be a new digital-age PSB model, explicit subsidies such as those already received by the BBC will have to replace the implicit subsidies currently received by its competitors.

5.2 This section will examine the important general issues for PSB in the digital age, concentrating on the three most important questions:

- How important is plurality in PSB supply?
- How should PSB be delivered? and
- How should PSB be funded?

5.3 Our analysis of PSB delivery includes a discussion of the role of not-for-profit institutions in PSB, and assesses the right mix between competition for subsidies and the maintenance of existing institutional value.

5.4 The funding of PSB in the digital age will involve a shift towards more explicit subsidies. We ask what sources of funding could exist for the BBC and for other PSB providers in the digital age. Though we believe that different funding mechanisms have strengths and weaknesses, it is important always to acknowledge that all funding mechanisms (including the current implicit subsidies to ITV1, Channel 4 and Five) are collective and compulsory transfers of resources from households to PSB providers with Government acting as an intermediary. The differences between funding sources should always be viewed in this light.

Plurality in the supply of PSB programming

5.5 If PSB policy continues unchanged, the BBC will emerge by default as the only PSB provider of any real scale. Commercial broadcasters will screen some programmes which contribute to PSB purposes because some will be profitable and because others are necessary to enhance their brand. In addition, there will be a small amount of implicit subsidy left for PSB in giving certain broadcasters preferential access to the digital spectrum. The scale of these prospective elements of commercial PSB should not be exaggerated; compared with 2004, the digital world will not support anything like the current amount of PSB on commercial TV channels.

5.6 Section 3 showed that the BBC already accounts for about 85 per cent of the subsidies flowing into PSB and the choice for TV in the digital age is whether PSB should become almost exclusively a BBC preserve.

5.7 The advantage of allowing the BBC to receive almost all the public funding for PSB is simplicity. Policy could concentrate on managing the inevitable reduction in the PSB obligations on commercial channels and ensuring the BBC was well-governed and regulated to meet PSB purposes and characteristics. The disadvantage would be a lack of competition in programmes which meet PSB purposes and a reduction in plurality of voice.

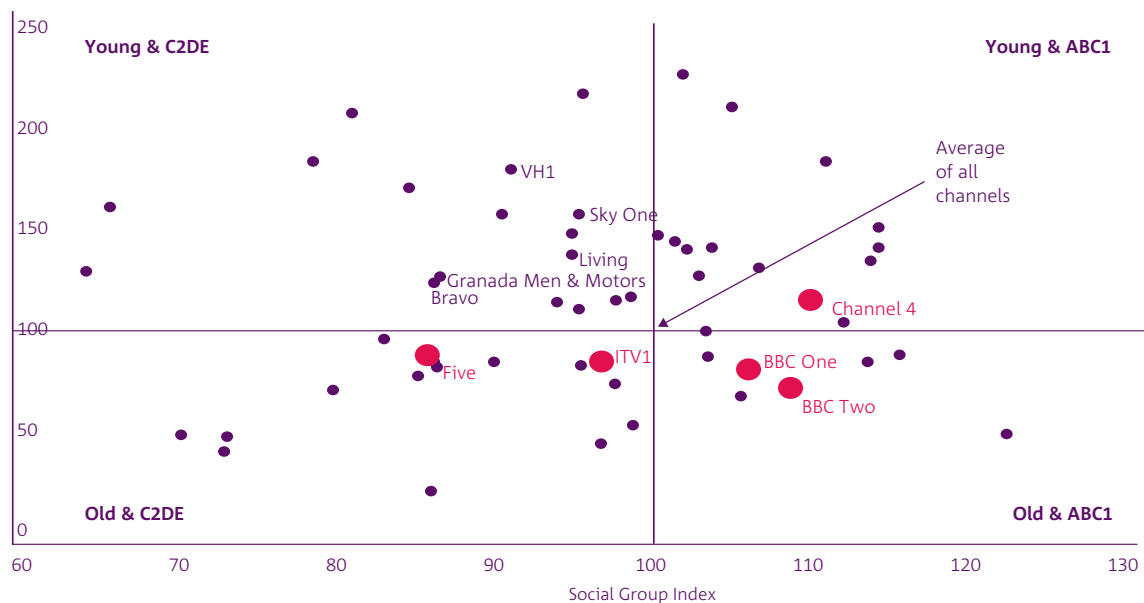
5.8 Our Phase 1 document stated that competition and plurality was important, but that plurality must be assessed against the increased complication plurality brings. We have divided our analysis into three: plurality in PSB outlets, commissioning and production.

PSB outlets

- 5.9 If the BBC received almost all PSB funding and other TV channels followed commercial logic alone, the potential advantages would be that:
- unnecessary duplication in PSB programming would be eliminated;
 - competition for quality could be maintained because BBC programmes and channels could set standards and condition audience expectations, forcing the rest of the industry to follow; and
 - for many types of programmes, there is effective competition between the BBC and unsubsidised PSB providers – in popular drama for example, the competition for viewers is likely to ensure that standards on both the BBC and on ITV1 remain high.
- 5.10 Set against these possible advantages, we have collected significant evidence from industry practitioners, audiences and the BBC²³ to support the counter-view that a BBC near-monopoly would damage PSB:
- A plurality of providers contributing to PSB purposes is necessary to create competition for quality across a full range of programming. In recent years, for example, the scale and scope of arts and history programming on commercial PSB channels has helped to focus the BBC on improving its own provision. If competition for quality programming which contributed to PSB purposes did not exist, pressure on the BBC to raise its game would be reduced.
 - A plurality of PSB providers prevents any single institution becoming the monopoly arbiter of taste or opinion in any one area of programming.
 - Plurality allows benchmarking exercises between similar distributors to compare how well they are meeting PSB purposes and their respective value for money.
 - If many channels are producing quality programming which reflects PSB purposes and characteristics, it is more likely that it will remain a core part of broadcasters' schedules and prevent challenging programming from being marginalised in schedules.
 - Different broadcasters are able to reach a wider range of viewers in different demographic and socio-economic groups, as Figure 5.1 shows. There is every reason to expect that in the digital age, the reach of PSB programming would be higher if it were distributed by a range of suppliers.
 - Similarly, different TV channels provide content attractive to different audiences, even within the same genres. Channel 4's approach to current affairs or Five's arts programming are distinctive from that which the BBC provides.

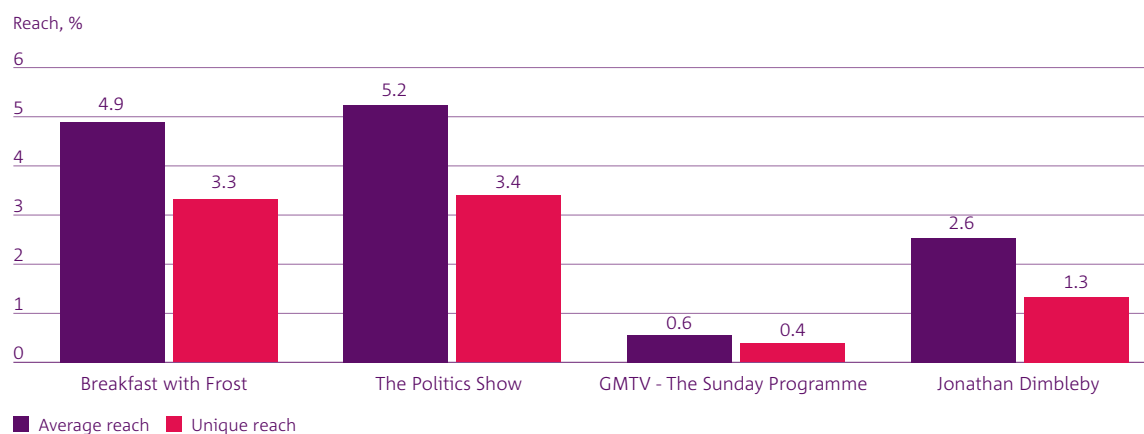
23 The BBC said: "We understand the arguments in favour of plurality in public service programming, and strongly support the ongoing contribution of ITV1, Channel 4 and Five as investors in high-quality British programming across a wide range of genres." *Building public value: renewing the BBC for a digital world*, June 2004.

Figure 5.1: Profile of analogue terrestrial channels: age & social grouping



Source: BARB 2003

Figure 5.2: Reach of Sunday morning current affairs



Source: BARB, Sunday 14 March 2004 (Reach = 5 mins+)

5.11 Figure 5.2 shows the audiences for Sunday current affairs programmes. It demonstrates that though many viewers watch more than one of these programmes, the majority of the audience watches only one of the programmes. The reach of current affairs programming would therefore be cut as would the outlets for different voices if the market developed so that the BBC gained a near-monopoly of PSB subsidies.

5.12 We commissioned an external working paper²⁴ by Professor Phillip Schlesinger of the University of Stirling on the value of institutions and plurality in PSB supply. He concluded that having PSB largely or exclusively limited to one institution would have a number of undesirable effects: it would tend to be identified with what that institution produces, undermining any attempt to develop an independent analytical conception of PSB; it would not be subject to the pluralistic competition of other institutions operating within a broadly similar remit; the gulf would grow between PSB values and those of the rest of a market overwhelmingly driven by a commercial logic; and it would make the future sustainability of PSB more vulnerable because everything would hang on the fate of the BBC.

Commissioning

5.13 Commissioners are accountable to viewers and have an incentive to buy the best ideas available. But relationships matter in TV commissioning and if there was only one commissioner for producers of PSB programming to approach, it is likely that some good ideas for programmes would not be produced. A plurality of commissioners is therefore important for ensuring that good ideas which contribute to PSB purposes reach our TV screens. It also creates broader competition for ideas between channels, and adds to the likelihood

that the best PSB programmes make it onto the screen. Producers have told us that they place a great value on the existence of a range of commissioners in different institutions.

Production

5.14 Plurality in production of PSB could readily be achieved with only the BBC receiving funding for PSB. So long as its commissioning system were to choose the best ideas from a range of producers, BBC dominance of funding should not, in itself, affect the production sector or the BBC's contribution to PSB purposes. But it would rely on the BBC developing a transparently meritocratic commissioning system. If not, the contribution to PSB would also be adversely affected by dominant supply at the production level.

Assessment

5.15 Competition for viewers without competition in the supply of PSB visual content is unlikely to encourage the best possible PSB programming on the BBC. There is little evidence to suggest that the existence of more than one PSB provider has resulted in the duplication of content in any genre. Even in news, each TV channel has targeted a different audience with a different editorial approach. The risk of leaving subsidised PSB provision to the BBC alone is great: the lack of competition in broadcasting PSB programming risks leading to complacency, inefficient production, lack of innovation, lower quality programming, a narrowing of perspectives and the loss of PSB programming for certain groups. If possible, competition should be sustained at all points in the value chain: production, commissioning and PSB outlets.

24 Philip Schlesinger: *Do institutions matter for Public Service Broadcasting?* at www.ofcom.org.uk

Options for delivering PSB in the digital age

5.16 In the digital age the PSB environment should encourage contributions to PSB purposes and characteristics with flexibility built into the means of delivery. The analysis in Section 3 showed that if there is to be a significant contribution to PSB other than the BBC, explicit funding will need to be available to replace lost implicit funding. The first question we need to consider is how best might such funding be deployed in the interests of maintaining plurality in the supply of PSB and in meeting PSB purposes.

5.17 We have divided the options into three broad groups:

- a fully contestable PSB fund, often termed either an Arts Council of the Air, or a Public Broadcasting Authority;
- direct payments to existing PSB institutions, such as Channel 4; and
- competition between prospective PSB providers for long-term funding.

A fully contestable PSB fund

5.18 In a fully contestable funding system, a new public body would be established to allocate money to particular PSB programmes or streams of programming. Such a public body is often called an Arts Council of the Air or a Public Broadcasting Authority. Broadcasters and/or producers would bid for public funding that could either fully-fund or part-fund the costs of a programme. To avoid the chance that the production of a programme could receive funding without distribution, any programme receiving funding would have to demonstrate it had an agreed slot in a broadcaster's schedule. The PBA could start by funding programming on traditional TV channels but could also fund PSB on other distribution mechanisms as technology developed.

5.19 The aim of the PBA would be to cover the opportunity cost arising from the production of PSB programming relative to the alternative of screening a more obviously commercial programme. This way it would attempt only to fund what the market would not provide.

5.20 Contestable funding along similar lines has been suggested by important voices in the broadcasting industry for many years: initially by the Peacock report in 1986, and more recently by the Broadcasting Policy Group chaired by David Elstein. Similar organisations exist in countries such as New Zealand (NZ On Air), and many countries have film funding councils with similar remits for longer films for cinematic release. Currently, proposals for a contestable PSB fund are being debated in Ireland.²⁵ For this report, we conducted a new analysis of the NZ On Air experience, including detailed research in New Zealand – see Box 5.1.

5.21 A contestable fund for PSB would have certain advantages:

- it maximises the amount of competition for PSB provision because competition occurs between many suppliers and on a continuous basis;
- the high degree of competition for funding should add to the quality of PSB programming and should also drive innovation; and
- the central funding body would be able to use the bidding process to exercise control over costs and to avoid duplication, derivative PSB programming and aggressive scheduling.

5.22 But there would also be many risks involved with moving to a contestable fund for PSB programming:

- The introduction of a PBA could duplicate many costs, in particular those associated with programme commissioning. Commissioning decisions would need to be taken both by the broadcaster and subsequently by the PBA. Both would need to agree if either wanted to modify

25 www.bci.ie/consultation_english.pdf

the programme idea. There would be a serious risk of proliferation of bureaucracy.

- Multiple commissioners in different organisations would reduce the chance that innovative programmes were funded because only safer programmes would stand a reasonable chance of receiving approval from both organisations.
- PSB programming would become fragmented across a wide range of channels, making it harder for viewers to find and diminishing its contribution to PSB purposes.
- It would be difficult to secure agreement with commercial channels for the distribution of programming that was not a good fit with the rest of their schedules.
- There would be a serious risk that the efficiency of funding would be compromised by subsidising content that would have been produced anyway. For example, the most important success of NZ On Air has been to support locally-produced content, something that is less of a concern in the UK market.

- The model is best suited to a limited scale of subsidised PSB. If the UK public wants to maintain the current considerable scale of PSB funding, the PBA would have to be a large organisation. This would create an additional risk that it could begin to follow its own agenda rather than PSB purposes and characteristics. Strong Parliamentary oversight would be required.

5.23 In our view, the risks in establishing a fully contestable PSB fund outweigh the potential benefits. The risk of creating a large, bureaucratic funding authority, which would struggle to achieve PSB purposes in partnership with commercial broadcasters, is too high. We do not favour this approach for maintaining and strengthening PSB in the digital age.

Direct grants paid to existing PSB institutions

5.24 Explicit grants to ITV1, Channel 4 and/or Five could replace the current implicit subsidies. As today, in this model none of the organisations would have to compete with each other for PSB funding, although they would have to comply with set PSB obligations and report annually on their success in contributing to PSB purposes. The

Box 5.1: Contestable funding of PSB in New Zealand

Overview of the current NZ system

Most public funding for TV content in New Zealand is distributed via NZ On Air. It spends around £25m a year in total. Over the past two years, TVNZ (the state-owned broadcaster) has also received a small amount of direct funding from Government. Much of the NZ On Air fund is contestable, and is allocated on a programme-by-programme basis. Producers must have the agreement of broadcasters to commission and schedule the programme before they can receive funding. To be eligible for funding, the programme must be broadcast on a channel which can reach more than 90 per cent of the population. Recently, Prime, the third broadcaster in NZ alongside TVNZ and TV3, crossed that threshold.

Among the acknowledged successes of the system are:

- It has kept the 'PSB flag' flying, during 15 years which have seen NZ adopting an ultra-free-market approach to broadcasting.
- It has kept NZ-originated content on screen, when the commercial interests of the broadcasters would have led to much more acquired programming.

- It has opened up the independent production sector. Previously, the vertically integrated TVNZ had a stranglehold over television production.
- It has engineered some competition for local programming between the two main broadcasters, TVNZ and TV3, and arguably has generated better and more cost-effective content as a result.

But there are clear weaknesses to the system, too:

- It has proved much easier to persuade the broadcasters to show local programming that fits with their commercial objectives than the more ‘PSB’ types of content. TVNZ and TV3 have often only been prepared to place minority-interest programming around the margins of the schedule even where NZ On Air funding has been available.
- Broadcasters resent the ‘second guessing’ that they say characterises NZ On Air’s decision-making – increasingly, they assert, NZ On Air has been getting involved in editorial decisions, such as casting and script approval.
- It is not obvious that there is a lot of contestability in the system – roughly 80 per cent of funding goes each year to TVNZ, 20 per cent to TV3 – and producers/broadcasters claim to have a pretty good idea of what NZ On Air wants to see proposed to it each year.
- There is a relatively simple approach used in determining how much NZ On Air should invest to get a programme on air – standard rates for different genres on each of the channels, for example. So it is not clear whether public funding is being used efficiently, or whether it reflects the true opportunity cost to broadcasters of showing the programme.
- Some producers argue that because the system involves persuading both broadcasters and NZ On Air to put in funding, there is less risk-taking and innovation – tried and tested ideas are more likely to get funded than new ideas.
- The system encourages ‘games playing’ by the broadcasters, who aim to get public funding, even for programmes they would have made anyway.

The current debate in NZ

With the advent of the present Labour government in 1999, broadcasting policy was reviewed, and some changes were made:

- It was felt that the NZ On Air system, while successful in promoting local content, did not effectively ensure the provision of PSB, interpreted more widely.
- It was decided to reverse the strategy of the last decade, and a new Charter for TVNZ was introduced. Rather than being prepared for sale as a purely commercial broadcaster, TVNZ is now expected to pursue wider public interest objectives. In return, it has been allotted a small amount of direct funding.

Currently, the NZ debate is focused on the relationship between direct funding for TVNZ and funding channelled via NZ On Air and the optimal balance between the two.

broadcasters would be free to harness technological changes and to use alternative distribution systems to reach the public with PSB programming in the digital age.

5.25 The potential advantage of funding long-established institutions, particularly those such as Channel 4 with a remit closely aligned to the purposes of PSB, is that they have long experience in PSB programming and their organisations are imbued with an ethos to promote PSB purposes and characteristics. Their brands are well known and trusted and they have a well of audience loyalty on which they could draw.

5.26 The risk is that direct funding would:

- Change the organisations' character if they were to rely on annual explicit public subsidies. Their culture would change with the risk that they became more interested in annual funding decisions rather than PSB programming.
- Holding broadcasters to their PSB obligations might become increasingly difficult in the digital age. Improvements would be required in the measurement of PSB obligations, the contract specification of any PSB remit, benchmarking between different broadcasters and accountability.
- There would be a continued risk that public subsidy would be paid to organisations without much effect on the broadcast output. Regulators would never know for sure what the broadcasters would have transmitted in the absence of subsidy.
- The lack of any competition for PSB funding could reduce incentives for innovation in programming ideas and efficiency in programming execution.
- Funding broadcasters directly might give rise to EU state aid concerns. European policy only allows PSB subsidies to cover the cost of a clear PSB remit. Only a more competitive route to distributing subsidy for PSB may satisfy these concerns.

5.27 In our view, direct funding of PSB institutions may be of value for those, like Channel 4, which already have an ethos to promote PSB purposes. But the risks outlined are serious and may be difficult to overcome.

Competition for long-term PSB funding

5.28 A third option is to create competition for the role of commissioning and distributing visual PSB content in return for public funding for a fixed period.

5.29 This is a model that blends the two approaches above by introducing competition for PSB funding for the first time, but attempts to minimise the bureaucracy and deadweight costs associated with programme-by-programme contestable funding and the lack of a distribution mechanism.

5.30 We would envisage that the existing terrestrial broadcasters could bid for long-term public funding, as could other potential PSB providers so long as they had the necessary skills to commission PSB programming and that their ideas for distribution would ensure the content would have reach and impact. All bidders would have to ring-fence their publicly-funded activities from other commercial operations.

5.31 The right to receive public funding would be awarded after a competitive process. Bids would be sought from potential operators for proposals to use public money to meet PSB purposes. The winning bidder or bidders would be awarded a long-term financial commitment to commission and distribute PSB for a specified period, after which the funding would be put out for competition again. In effect, a new PSB service would be created, but one born out of competition for innovation, ideas and approach.

5.32 The funding made available in this way could initially be used to concentrate on broadcast TV, but might quite rapidly create opportunities to break away from the conventional TV channel model of existing PSB.

5.33 The advantages of creating a new mechanism for the funding and provision of PSB in the digital age are:

- It would create the opportunity to explore new ways of contributing to PSB purposes, unencumbered by existing mindsets or by the need to protect existing TV channels.
- Competition to operate a new PSB service would encourage efficiency and innovative ideas.
- A fixed period commitment would enable new institutional value to be created and help to minimise transaction costs.
- The financial commitment would be subject to review and renewal, which would help to align its incentives with PSB purposes and provide an ability to withdraw public funding if it failed to contribute to PSB purposes.
- The winning bidder would have control over commissioning and distribution of its content which would involve much less bureaucracy than the alternative of a Public Broadcasting Authority.

5.34 The potential risks of this approach are:

- That there would be insufficient interest outside existing broadcasters, so the process could become an expensive means of awarding public money to ITV1, Channel 4 or Five.
- That it might be difficult to regulate the winner's activities shortly before the next competition, especially if it had little interest in submitting a bid to retain its contract for another period.
- That the incumbent could become entrenched, reducing the likelihood of a future competitive spur. In those circumstances the quality of provision would tend to fall.
- That the new institution would not have automatic access to the analogue spectrum before digital switchover, so would face difficulties in achieving reach and impact for its programming.

Assessment

5.35 Table 5.1 summarises the options for delivering PSB in the digital age.

5.36 Our analysis suggests that the costs of a fully contestable PSB fund would clearly outweigh the benefits. Direct support for Channel 4 has slightly greater potential merit, but also serious difficulties. We prefer the creation of competition between prospective PSB providers for funding.

5.37 In our view, there is significant potential for a new service to contribute to PSB purposes in the digital age, chosen after a process of competition and renewed regularly. It could secure plurality in PSB provision and would not place a long-term bureaucratic burden on PSB content. We will work to assess the options over the next three months and include many of the most important questions in Section 6.

5.38 It could be argued that awarding the long-term commitment to a not-for-profit organisation might help to mitigate some of the risks involved with the creation of a new service – its incentives might be more easily aligned to core PSB purposes than those of a profit-maximising body. However, we do not think any particular type of organisation should automatically be excluded from public funding to provide PSB – in addition to the BBC. A detailed case for and against funding not-for-profit organisations is presented in Box 5.2. This is an issue on which we would welcome consultation responses.

Box 5.2: The role of not-for-profit organisations

The organisational structure of PSB providers can be important in ensuring that the organisations deliver the remit determined by society. In Phase 1, we suggested that not-for-profit organisations would tend to align themselves more directly with PSB purposes.

Our proposals in Section 6 for a strong and well-funded BBC would guarantee that a substantial contribution to PSB would be provided by a not-for-profit organisation. The remaining question is whether all publicly-funded PSB should also be not-for-profit organisations in the digital age. This is a difficult principal-agent problem with many dimensions.

The general problem of aligning incentives

PSB policy should align the incentives of PSB providers with those of society. Clearly, this could be problematic for profit-making PSB providers, where there can be a conflict between profit maximisation and PSB purposes. In these circumstances, regulation will always be difficult because the company will have incentives to comply to the minimum extent with its PSB obligations or to attempt to secure subsidies for programmes it would show anyway.

Not-for-profit organisations do not suffer from this conflict of interest; good management can instil a PSB ethos into a not-for-profit organisation. But it would be naïve to believe that all not-for-profit broadcasting organisations always operate to maximise their public objectives regardless of other motives. Not-for-profit organisations must therefore have effective governance arrangements if they are to remain efficient and to align their interests with those of PSB.

In some circumstances it is also possible for no conflict of interest to exist in a profit-making organisation. Where the future profits of a company depend on its reputation for PSB programming, a profit-making company has a powerful incentive to meet public purposes because that also maximises long-term profits.

The problem of specifying contracts for PSB

PSB is not a well-defined output that can easily be measured. This creates a difficulty in ensuring that any PSB providers are meeting their commitments. While certain of the current PSB obligations are easy to measure – for example, quotas for original production or the number of hours of news programming – where the obligations are quality, innovation or distinctiveness specifying a precise PSB contract becomes almost impossible. In these circumstances, it is more likely that a not-for-profit organisation will have incentives that are better aligned with public purposes.

Disciplining organisations when they fail to meet PSB purposes

In contrast, where a problem exists because an organisation has not contributed to PSB purposes, it would be easier to discipline a profit-making organisation. Fines can be imposed on the shareholders of a profit-making company, an effective disciplinary device. There are fewer effective regulatory remedies for not-for-profit organisations.

Inefficiency

Not-for-profit organisations are more likely to be inefficient because they do not have a strong incentive to cut costs. Resources are also more likely to be allocated inefficiently within the organisation where there tend to be fewer clear incentives for managerial efficiency based on profitability.

Assessment

The trade-offs between profit-making and not-for-profit organisations suggest that, alongside the central role of a publicly funded not-for-profit BBC, we should not rule out any type of organisation from receiving funding for PSB in the digital age. We recommend that any new recipient of public funds for PSB should be required to demonstrate that their incentives are well aligned with PSB purposes and characteristics; and that the management can run an efficient and effective organisation.

Table 5.1: Summary of PSB delivery options in the digital age

Method	Advantages	Disadvantages	Assessment
Direct support for Channel 4			
	Maintains current institutions	Intrusive regulation of C4	Clearly practicable, but suffers from a lack of any competition for funding
	Simple	No competition for PSB funds	
	Builds on audience loyalty	State aid issues Changes to C4 culture/ incentives	
Fully contestable PSB fund			
To distribute funding to individual broadcasters and commissioners on a programme-by-programme basis	Intense competition for PSB funding	Bureaucratic	Undesirable, as the costs significantly outweigh the potential benefits
	Funds focused on programmes with high PSB content	No guarantee of broadcaster involvement Duplication of commissioning process Deadweight loss	
Competition between PSB providers for long-term funding			
Allow organisations to bid for a long-term financial commitment to provide PSB content or services.	Competition for PSB	Problems with ensuring contractual obligations are met	Most attractive if the impact/reach challenge can be met
	No state aid issues	New providers may take time to build reach and impact	
	Renewable public commitment		
	Provides incentive to produce high quality PSB		

Options for funding PSB in the digital age

5.39 Any public funding for PSB is a transfer of resources from households to a broadcasting organisation with Government acting as an intermediary. This section will examine options for funding the BBC and other PSB providers in the digital age.

Funding the BBC

5.40 The BBC has received income from a licence fee since 1922, when radio licences cost 10 shillings. The current TV licence is a compulsory levy on household ownership of a TV receiver. It costs £121 a year for a colour TV in 2004-05 and will rise at inflation plus 1.5 per cent until April 2007. As was discussed in Section 3, the BBC currently also receives income from central Government in respect of free licences for the over 75s, from its commercial operations and implicit funding from subsidised access to the analogue spectrum.

26 Including direct government grant in respect of free TV licences for the over 75s.

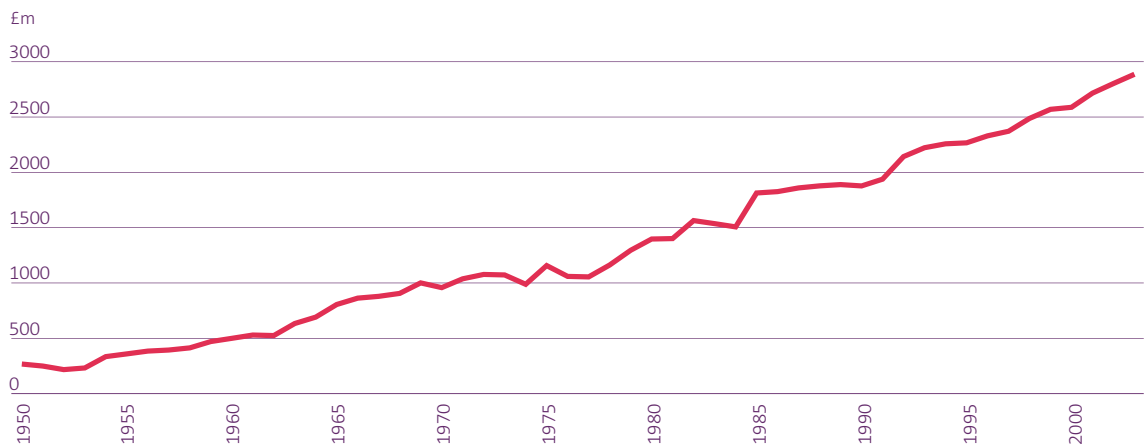
TV licence fee income

5.41 A detailed historical breakdown of BBC TV's costs is not possible to produce, but a reasonable proxy of BBC TV's cost to society is the income from the licence fee.²⁶

5.42 Figure 5.3 shows the level of the licence fee income, adjusted for inflation, since 1950. Four reasons explain the buoyancy of BBC revenues:

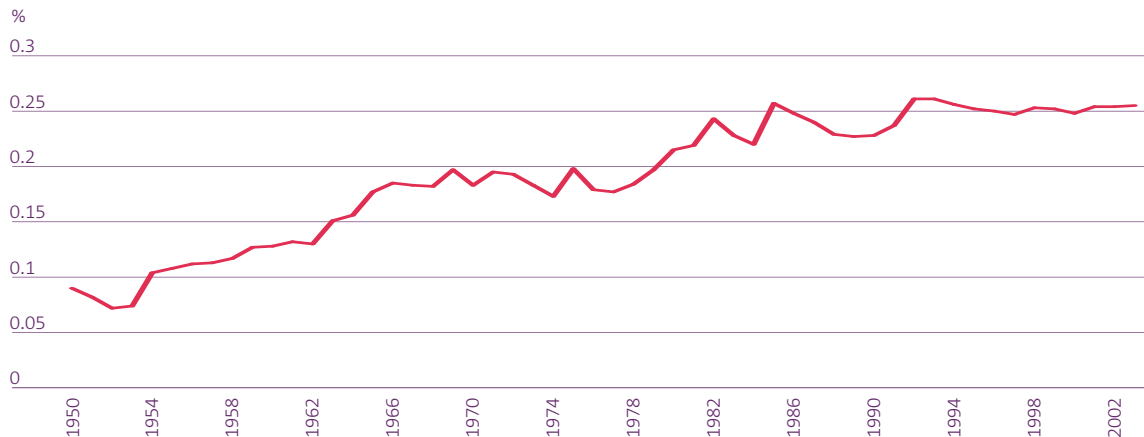
- the proportion of households owning a radio or a TV has risen consistently over the period;
- households have migrated from radio to black and white TV, and then from black and white to colour TV, providing the BBC with increased revenue per household;
- the number of households in the UK has increased significantly; and
- above inflationary licence fee settlements, particularly the current settlement from 2000-01 to 2006-07.

Figure 5.3: Real licence fee income: 1950-2004 (£ million – 2004 prices)



Source: BBC Annual Reports and ONS

Figure 5.4: Licence fee income as share of gross domestic product



Source: BBC Annual Reports and ONS

5.43 As a public service, the BBC is not alone in enjoying significant real increases in expenditure through much of the last century. The BBC's income as a share of gross domestic product is arguably a better measure of the buoyancy of BBC income. Figure 5.4 shows that even as a share of GDP, BBC revenues have risen, although they have remained roughly constant as a share of GDP for the past 20 years.

5.44 The arguments for and against the TV licence fee have been well-rehearsed over many decades. To its detractors, the TV licence fee is:

- a regressive tax;
- inefficient to collect, with collection and evasion costs of 11 per cent of licence fee income;
- unpopular – a significant proportion of the population object to paying it;

- the amount a household pays is not linked in value to the quantity of BBC programming a household watches; and the amount a household pays is not linked to the number of TV receivers a household owns.

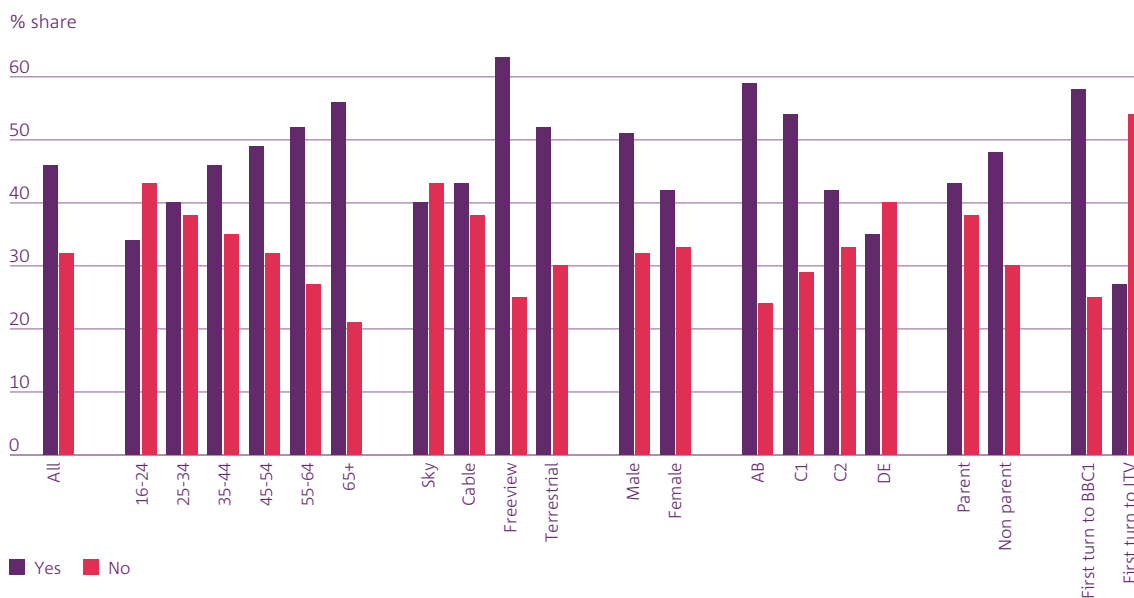
5.45 To its supporters, the TV licence fee provides:

- independence from Government;
- a transparent system for holding the BBC to account; and is
- the least worst alternative funding mechanism for the BBC.

5.46 We wanted to understand more about public attitudes to the licence fee and commissioned questions in our Phase 1 survey of 6,000 households. Figure 5.5 shows the net support for the licence fee increases with age and is higher in terrestrial households relative to satellite or cable households. Higher social classes are more supportive of the licence fee, as are non-parents.

Figure 5.5: Support for the licence fee varies along expected lines

Do you support the general idea of the licence fee? Base: all respondents



Source: Ofcom/IPSOS UK

5.47 These results show the licence fee has moderate support in the UK, although its support might be undermined in future as the younger generations, more used to other funding mechanisms for TV grow. These results are consistent with other surveys such as the recent DCMS survey as part of the BBC's Charter review.²⁷

5.48 As part of our qualitative research into the funding of PSB undertaken by MORI on behalf of Ofcom, we attempted to probe attitudes towards the licence fee further. After choosing how much PSB respondents wanted to fund they were provided with a series of options for funding including the licence fee, direct government grant and voluntary subscription.

5.49 We found that when forced to reflect on the possible alternatives, the public's view of the TV licence fee became considerably more accepting than it had been at the start of the day. After a day's thought about the issues of PSB funding, support for the licence fee rose strongly and it was by far the most favoured means of funding PSB, even among those who had initially been hostile.

5.50 The reason for this support was linked to the public's attitude towards TV and PSB in general. While most people could see the potential for many TV programmes to be beneficial for society, the overwhelming feeling among the groups was that TV was primarily a source of entertainment. As such, they were staunchly against almost any redistribution in paying for the BBC or for PSB on other outlets.

5.51 Unlike health or education, in which they saw merit in richer households paying more, they thought that no one, particularly not the unemployed, should receive a subsidy to watch TV based on a progressive tax. The licence fee gained in popularity as it seemed to accord with the vast majority view that TV was a consumption good for which everyone should pay the same if they wanted the opportunity to watch the same programming, and quite different in principle to services such as health and education.

5.52 Our qualitative research provides stronger support for the licence fee or other flat-rate charges than is often found in less in-depth studies. It suggests that the public are not concerned about the TV licence fee's regressivity. Rather they appreciate the flat-rate nature of the licence fee because they view TV as primarily a consumption good where everyone pays the same.

Advertising

5.53 There is no doubt that the BBC could attract significant amounts of advertising funding. But the exact amount cannot be determined because any estimates of the responsiveness of the price of advertising to supply can only be applied to small changes in supply.

5.54 If the BBC were to take adverts, it would revolutionise the advertising market, with highly uncertain effects. All that can be said with any degree of certainty is that the price of commercial impacts would fall significantly, reducing the revenues of all other UK broadcasters. And while the overall level of TV advertising expenditure might rise, it would not rise by much, implying that advertising revenues would not provide a secure and stable source of funding for PSB on the BBC or on other commercial broadcasters. For this reason we believe that requiring the BBC to raise supplementary funding from advertising would not be desirable.

Voluntary subscription

5.55 There is also little doubt that the BBC could raise significant amounts of money by becoming a subscription service. Subscription would have many attractive consequences, the most important being that people would no longer be forced to pay for the BBC. Having to attract subscription revenue would also encourage greater efficiency within the corporation.

27 www.bbccharterreview.org.uk

5.56 But the citizenship rationale for funding PSB suggests that programming which furthers PSB purposes and characteristics should be made widely available. Subscription, by its nature, would not deliver this objective. Poorer people would save paying the licence fee but would probably have to pay more than now if they wanted access to BBC programming.

5.57 There is scope, however, for the BBC to introduce certain subscription services to supplement its licence fee income in the distant future. A BBC premium subscription channel could, for example, show first-runs of popular BBC entertainment programmes before they were screened on a free-to-air BBC channel. The potential advantage of a BBC subscription service to supplement the licence fee is that it would give the BBC greater buoyancy in its income without raising the licence fee and allow it to make and screen programmes, which might not otherwise be produced. That way, it could enhance the viewing of both subscribers and non-subscribers while continuing to meet PSB purposes and characteristics.

5.58 A subscription BBC channel would be similar in principle to the introduction of higher licence fees for TV in the 1950s and for colour TV in the 1970s: those wishing to pay for additional services would pay the equivalent of a higher licence fee. Unlike the current situation in which everyone pays for the BBC's digital channels but just over half the population can watch them, a BBC supplementary subscription channel would only be funded by those that wanted to watch its programmes²⁸. The next Charter should require the BBC to consider the case for limited subscription services to top-up its income and to report these plans back to Government for review in the last years of this decade. That way, a decision could be taken on a supplementary subscription BBC channel in time for digital switchover.

Assessment

5.59 A licence fee model should continue to fund the BBC properly for as long as it retains broad public support. The level of the licence fee for the BBC should reflect its role in society and its contribution to society. We would recommend that advertising on the BBC should be ruled out as should direct government funding and full subscription. There is scope in future, however, both to consider modifying the nature of the TV licence fee (see below) and potentially to introduce supplementary subscription funding.

Funding plurality of PSB provision in the digital age

5.60 A new source of explicit public funding is required to maintain plurality of PSB supply in the digital age. There are many options but only three realistic sources of funding:

- licence fee payers, through some form of enhanced licence fee;
- taxpayers, through some form of Government expenditure or tax revenue foregone; and
- UK licenced broadcasters, through a tax on the turnover of their broadcasting operations.

5.61 The source of replacement funding for PSB in the digital age is a matter for Parliament.

Enhanced licence fee

5.62 Income from an enhanced TV licence fee could be shared between the BBC and other organisations in three ways:

- a division of licence fee income;
- the allocation of the income the BBC receives from Government to others; or
- the sale/transfer of BBC assets with the proceeds allocated to other organisations.

28 The Davies Report in 1999 on the future funding of the BBC proposed the idea of a higher digital licence fee, a very similar principle. (www.culture.gov.uk)

- 5.63 In each case, the logic would be first to fund the BBC properly so that it could fund its remit and subsequently to determine how much additional income other providers would need to ensure plurality of PSB supply.
- 5.64 Our Phase 1 proposition that consideration should be given to providing other PSB suppliers with some licence fee revenue proved controversial, not least at the BBC, where it was felt that sharing the licence fee among various PSB providers would break the direct connection between the BBC and the British public.
- 5.65 As part of our qualitative audience research into funding PSB, we probed the question of whether the public wanted the licence fee to remain exclusively a BBC source of income. The research,²⁹ conducted by MORI, found there was little concern among the public about the concept of more than one broadcasting institution receiving income from the licence fee. There is, however, a risk that support for an enhanced licence fee, or for its allocation, might erode over time.
- 5.66 Once the level of funding for the BBC has been determined, there is scope for an enhanced licence fee model to fund plurality of PSB supply, either in the automatic buoyancy that comes from an increasing number of households, or in an increase in the level of the licence fee.
- 5.67 There could also be advantages in sharing licence fee income from either of the latter mechanisms. See Box 5.3 for more details of how an asset sale to finance plurality of PSB could operate. If, in future, the income³⁰ provided to the BBC by the Department for Work and Pensions in respect of free TV licences for the over 75s was allocated to other organisations, it would ensure that the BBC's funding was fully separated from government, while the elderly would still have access to all BBC and other PSB services. In addition, both options would guarantee that the link between current licence fee payers and the BBC was maintained intact.

Taxpayer funding

- 5.68 Direct funding by Government could provide a secure and progressive source of funding for other PSB providers, or indeed the BBC. Taxpayers already contribute to S4C's finances in this way and the BBC receives over £400m a year from the Department for Work and Pensions.³¹ But there are three significant disadvantages: first, it could call into question the independence of broadcasters; second, direct tax-payer finance would involve significant redistribution, which the public does not seem to support in relation to TV services; and third, there would be question marks over the security of funding given the many pressures on the public purse. On the other hand, the Government has already demonstrated its concern about the regressivity of the licence fee through its support for the over-75s.
- 5.69 Currently, the Treasury foregoes Government revenue by subsidising the analogue spectrum for all the terrestrial broadcasters (see Section 3). The concept and the economics of revenue foregone are identical to that of Government expenditure, although they do not always count explicitly as government expenditure under some government accounting conventions.
- 5.70 In the digital age, there will be little ability for implicit subsidies linked to spectrum to fund PSB (see Section 3). But one potential future stream of revenue, which the Treasury could forego, is the income raised by spectrum pricing. At present, the DTI provide Ofcom with £86m to cover the direct costs of managing the spectrum, but in 2004-05 the predicted level of total spectrum fees collected is £138m. That leaves a surplus in excess of £50m per year, which should rise over time if the value of spectrum-related revenues rises faster than costs.
- 5.71 If that money were ring-fenced for hypothecated spending on broadcasting, it could fund a significant degree of plurality and competition in PSB. Such a form of hypothecation has some attractions, but two clear disadvantages:

29 A full write-up of this research is available in the associated working paper, *Public attitudes to PSB funding*, at www.ofcom.org.uk

30 £408m in 2003-04.

31 S4C received £81.5m funding from the Department for Culture, Media and Sport in 2002 to finance its operations, alongside advertising revenue.

Box 5.3: Income from the BBC's commercial operations

The BBC runs a wide range of commercial activities under the banner of BBC Worldwide and BBC Ventures (BBC Broadcast, BBC Resources and BBC Technology). BBC Worldwide returned £141m back to the BBC in 2003-04 and BBC Ventures returned £7m in the same year.

The Davies Review³² recommended that the Corporation make better use of its commercial operations to generate the maximum possible revenue for its core activities. While the amount of income has risen, it is still not clear that the BBC itself is the most efficient entity at generating such income (for example, in the way it has exploited its archive) and BBC Technology is already being prepared for privatisation. It is legitimate to ask whether more income would be generated were the whole of the BBC's commercial operation placed in private hands.

In our view, it is important first to take the right decisions regarding the BBC's commercial strategy before considering what to do with any money that is realised. We welcome the BBC's review of its commercial strategy as part of this process, but believe that before any significant decisions are taken there is a need for a further independent review to ensure licence fee payers get value for money. If that review finds that certain of the BBC's assets could be better used in the private sector, the Government and the BBC should consider how an asset sale or transfer might work.

If an independent review recommends the sale of the BBC's commercial operations, the proceeds could be used to finance PSB from other providers in the digital age. One option could be to privatise the whole of BBC Worldwide and use the additional public money raised to fund PSB by other providers. It could raise enough extra funding to establish secure income for PSB in the digital age. But it would be a complex and risky operation, and the quantity of funds released would not be guaranteed. An alternative way to establish a more regular stream of income could be to license access to the BBC's archive on a five or ten-yearly basis. The added complications of such an arrangement – the need to compensate existing rights holders and the difficulty in terminating the arrangement at the end of a licence period – might be difficult to overcome, however.

In both scenarios, there would be a risk that BBC producers' incentives would not necessarily be aligned to those of the rights holders', reducing the value of those rights over time.

If it were possible to allocate the proceeds of a BBC asset sale to other PSB providers, that would also represent a sharing of the licence fee. In that scenario, the licence fee would have to rise to ensure the BBC was properly funded. If the BBC itself collected the proceeds of an asset sale, that might constitute an argument for an adjustment in the level of the licence fee.

32 *The Future Funding of the BBC*, (1999), (www.culture.gov.uk)

- It is often unattractive and unwise to hypothecate revenues if their source is not closely aligned to the area of expenditure. Income from spectrum pricing in general has little in common with expenditure on PSB.
- In practice, the future of spectrum income is also uncertain. As more spectrum becomes available, the prices charged may well decrease.

Turnover tax

- 5.72 The regulation of the broadcasting industry is currently financed by a levy on the turnover of companies operating in the TV broadcasting sector. In 2004-05, Ofcom received £26.2m from TV licence fees.
- 5.73 The same approach could, in principle, apply to the funding of PSB. All broadcasters wishing to secure a UK broadcasting licence could be required to fund PSB.
- 5.74 The attraction of this source of finance would be that the cost of PSB would be met by the industry, although there are four drawbacks to such a funding mechanism:
- it would raise barriers to entry into TV broadcasting;
 - the levies might be relatively easy to avoid by broadcasting into the UK from other jurisdictions;
 - the tax would reduce the funding available for programming, thereby reducing the quality of TV broadcasting; and
 - the definition of a TV broadcaster and the specification of relevant turnover is likely to become more difficult in the digital age.

Assessment

- 5.75 There is no easy choice available for the future funding of PSB. All three mechanisms outlined above have potential benefits and costs. All, directly or indirectly, impose costs on households.
- 5.76 Ofcom is absolutely clear that this issue is ultimately a matter for Government and Parliament.



Proposals for maintaining
and strengthening PSB in the
digital age

6

6. Proposals for maintaining and strengthening PSB in the digital age

6.1 If policy remains unchanged, the PSB environment in the digital world is relatively easy to envisage. The BBC will be the only broadcaster with sufficient non-market funding to provide large quantities of PSB. We believe this environment would be unlikely to maintain, let alone strengthen, PSB in the UK.

6.2 A debate should start now on how best to maintain plurality of PSB supply in the digital age. This section contains our specific proposals for debate in the Phase 2 consultation. Some are proposals for immediate Ofcom action, some are intended to inform the BBC Charter review process, and some could be implemented only after a change in legislation, and hence are for Government and Parliament to consider. Taken together, they aim to maintain and strengthen PSB in the digital age.

6.3 Our aim is to design a new model for the digital age, characterised by:

- a new mix of funding, regulation and institutions which will meet the challenges of a radically different TV market and audience demands;
- competition for high-quality TV and a plurality of supply in commissioning and distribution of visual content;
- a well-funded BBC as the cornerstone of PSB;
- secure funding for a plurality of PSB providers;
- competition for the right to receive public funds and to procure the best ideas for PSB; and
- more focused PSB obligations for other broadcasters in sustaining UK production and high-quality news where this is still possible.

The BBC

6.4 The future of the BBC is a matter for the review of the BBC's Royal Charter. Our role is to provide analysis of the BBC in the wider PSB environment as an input into the Charter review. We believe that the BBC is and should remain the cornerstone of PSB in the UK.

The length of the next BBC Royal Charter

6.5 The BBC has been granted a Royal Charter for a ten-year period ever since the first Charter in 1927. There are some reasons to consider a shorter Charter in this review:

- The BBC has increased programming which is closely related to PSB purposes and characteristics in parallel with the start of the Charter review process. The existence of the review is therefore an effective disciplining device on any tendency to chase ratings at the expense of programming which meets PSB purposes.
- The six-year period from December 2006 is likely to encompass digital switchover, after which changes to the BBC's remit might become necessary. A shorter Charter would enable those changes to be included in a more timely fashion.
- Technological change in the broadcasting market has accelerated and a ten-year review could become severely out-of-date by the end of the next Charter if it were to run until 2016.

6.6 A counter argument is that with digital switchover only likely to be complete in 2012, a ten year Charter would give the BBC stability for the years running up to switchover and for the first few years thereafter. And only after sober reflection of the effect of switchover in practice will it be possible to determine a new Charter with any guarantee of its suitability to the fully digital world.

6.7 On balance, we recommend that the length of the next Royal Charter should run for ten years until December 2016 to take the BBC through the period of digital switchover but it should include a substantive mid-Charter 2011 review of the BBC's funding and its progress in meeting PSB purposes and characteristics.

6.8 The mid-point review would coincide with Ofcom's next PSB review. The two reviews should examine in detail the role and funding of the BBC in a fully digital world. The advantages of a mid-Charter review are:

- that it would provide the BBC with a strong incentive to ensure that the BBC contributes to the purposes and characteristics of PSB for the whole period of its next Charter; and
- that preparation for the post-switchover world occurs well in advance of 2016.

BBC programming

6.9 Our research in the Phase 1 report uncovered evidence of derivative formats and copycat programming on all channels, including BBC channels. At times in recent years, the BBC has not been adequately focused on its public service remit in all of its activities and on all of its channels.

6.10 After considering the responses to our Phase 1 consultation, we remain of the view that the BBC should strive to ensure that all its programmes, not just its services, reflect the purposes and characteristics of PSB to some degree. These should apply to the way in which it schedules its programmes (see annex A for further analysis of scheduling issues).

6.11 We welcome the fact that some of the weaknesses in BBC schedules are being addressed by recent moves made by the BBC Governors. Our Phase 1 report identified copycat and derivative programming and competitive head-to-head scheduling as particular concerns. In future, the BBC should have regard to the extent to which Hollywood films and other expensive acquired programming meet its own public value test and could not be provided equally well, at no direct cost to the public, by free-to-air commercial broadcasters.

6.12 In our Phase 1 report, we raised questions over whether the BBC pays sufficient regard to the different communities within the UK or whether it should provide more in the way of national, regional and local TV programming. We welcome the BBC Governors' ambition to improve the Corporation's performance in this area.

6.13 As the commercial sector faces increasing competition, there will be more responsibility on the part of the BBC to provide those aspects of PSB which are particularly at risk. In particular, we think that the BBC may need to play a greater role in the provision of a wider range of regional programming in the English regions, where the cost of provision relative to commercial value is high for other broadcasters.

Production

6.14 Our Phase 1 report proposed that the BBC's other activities, including commercial activities, studio and other production resources, and indeed production should be reviewed carefully against their distinctive contribution to PSB purposes.

6.15 We welcome the BBC's review of production, announced as part of the Charter review process. Until 2003, the BBC has failed to meet its quota to commission 25 per cent of its programmes from independent production companies. Responses to our consultation pointed out that there are some benefits of having significant production activity there within the BBC – in terms of reduced transaction costs, common PSB values and contribution to production training. But there remains the serious risk that BBC in-house producers are favoured over independent suppliers to sustain its production resources rather than in search of the best programme ideas. This would not be a good use of public spending. The BBC, itself, recognises it should make commissioning a more open, fair and balanced system. The BBC is committed to establishing a level playing field between in-house and independent production, to ensuring that independents receive a fair commercial deal and to making sure that the

25 per cent independent television quota is at all times a floor, not a ceiling.

- 6.16 We believe the BBC should be expected, by the end of this year, to demonstrate that it has clear plans to introduce a commissioning system, outside news programming, which has fair access for independent suppliers and which commands widespread confidence across the sector.

BBC's commercial strategy

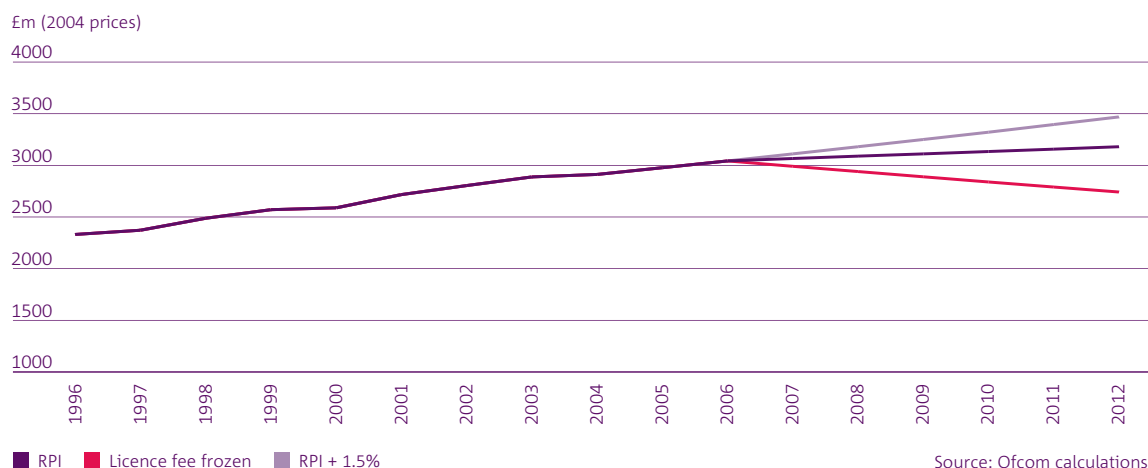
- 6.17 We also welcome the BBC's review of its commercial strategy. This should form an important part of the BBC's Charter review process and be subject to careful independent external validation before any decisions are taken about the future of BBC Worldwide or the use of proceeds from asset sales.
- 6.18 The best way of achieving greater value from commercial exploitation of BBC rights might be

to privatise the BBC's commercial operations. In any event, we believe that greater access to BBC rights by organisations outside the BBC will both enhance the value of those rights and help the development of a more competitive commercial sector.

The level of the TV licence fee

- 6.19 To maintain its role at the heart of broadcasting in the digital age, the BBC should be properly funded.
- 6.20 There are many possible characterisations of a stable and well-funded BBC. Figure 6.1 shows the effect on licence fee income of three assumptions for the licence fee after 2006-07:
- an increase in line with inflation;
 - a freeze in the licence fee; and
 - a continuation of the 1.5 percentage point above inflation increases the BBC has enjoyed since 2000-01.

Figure 6.1: Real level of licence fee income under different scenarios



6.21 If the licence fee increased in line with inflation, the total income from the licence fee would rise faster than inflation because the projected increase in the number of households over the next decade would keep the BBC's real income growing at about 0.75 per cent a year.

6.22 We have not carried out a detailed assessment of the BBC's future funding requirements. For the period of the next Charter, a TV licence fee model should continue to fund the BBC; the BBC should not carry advertising, nor should its existing services become subscription-funded. But we think that there are two important considerations for the funding settlement over the next Charter period:

- the BBC does not envisage any growth in the breadth of its services and is rightly committed to further efficiency savings; and
- the BBC's income will grow by more than the annual rise in the TV licence fee because the number of UK households is projected to grow. After ten years, the BBC can expect to receive an extra £230m every year in real terms from the projected growth in households alone.

6.23 In order to ensure a robust financial model in the more distant future, the Government should consider the case for the BBC to supplement its income with limited subscription services to fund any future growth in the BBC's services. The BBC should be asked to report on the case for limited subscription services at the time of a mid-point review of its next Charter.

BBC new services

6.24 The BBC's presence and its potential for entry into niche markets threatens the viability and health of some commercial broadcasters, and risks distorting the market to the detriment of UK consumers. A particular issue is uncertainty about the BBC's investment levels and channel/service remits.

6.25 Our Phase 1 report highlighted the importance of allowing the market to develop its provision of PSB-type output further. Given this, our view is that in future, any BBC plans for new services should be subjected to a rigorous independent test to ensure that they would not excessively displace commercial activities. Where it is unclear from independent analysis that the benefits of any new service outweigh the costs, the BBC Governors should decline to take the project forward.³³ We also suggest that to expedite any future reviews of new BBC services, a common methodology of appraisal should be agreed by the BBC Governors and Ofcom and published in advance of any review. This would ensure a more transparent process and reduce the costs associated with such reviews.

6.26 The market impact of the BBC's existing digital services should be included in the mid-point Charter review against the backdrop of emerging commercial services and the scope for commercial provision of PSB content by the market.

33 This approach is the same as that recommended by the Graf review of BBC Online, see www.culture.gov.uk

Digital technology

- 6.27 The BBC should continue to take a leading role in the UK plans for digital switchover. As we noted in our Phase 1 report, digital TV delivers significant benefits to consumers in terms of greater competition and choice. A fully digital world will remove many of the consumer market failures associated with the analogue TV market.
- 6.28 As part of the move towards switchover, the BBC should consider the scope for using new technology in the collection of the licence fee to reduce collection costs, evasion and the consequent burden on the judicial system. TV licence fee collection costs and licence fee evasion exceeded £300m in 2003-04.
- 6.29 Over the past few years the BBC has been subject to a proliferation of reviews: various services have been scrutinised internally, by Government, by Parliament, by Ofcom, by advisers on its Royal Charter and by independent experts. Our observation is that there are two underlying causes of this undesirable trend: first, that the BBC already receives a very high and rising share of public funding for PSB; and second, that there is a lack of a clear separation between the governance and the regulation of the Corporation. We believe:
- that maintaining a plurality of recipients of public funding is vital to the health of the PSB environment; and
 - that clarifying the separate roles of governance and regulation of the BBC should be a central objective to the Charter review process.

Options for creating plurality of PSB suppliers in the digital age

- 6.30 The primary aim of any PSB supplier in addition to the BBC should be to contribute to PSB purposes. It should also involve securing reach and impact and value for public money. That way it would meet the rationale for public intervention in television broadcasting.
- 6.31 We have considered and rejected two models for PSB in the digital age:
- An Arts Council of the Air/Public Broadcasting Authority/contestable fund to co-finance programming which contributes to PSB purposes and characteristics on existing TV channels. We have rejected the idea because we believe it would be bureaucratic and would face many difficulties in attempting to place programmes on TV channels which felt that PSB programming did not fit with their audience mix and ethos.
 - Direct funding of an existing commercial broadcasting institution such as ITV1, Channel 4 or Five. This would not generate any competition for PSB funding or any corresponding discipline, would create serious regulatory difficulties in ensuring public money is spent effectively, could simply subsidise shareholders of the companies, and would be likely to raise European state-aid concerns.
- 6.32 To address the declining effectiveness of the commercial analogue PSB model we propose the creation of a new PSB environment for the digital age. Our vision is in part a reinvention, exploiting new opportunities that the digital age will create, and in part an evolution, reflecting market and technological change.

A new Public Service Publisher (PSP)

- 6.33 Section 5 concluded that a new mechanism for contestable funding of PSB could be created, with a periodic competition to run PSB services.
- 6.34 In this section, we set out an outline proposal for a Public Service Publisher (PSP). We have used the term ‘publisher’ deliberately, to emphasise that it would commission, not produce, content and that it would use all electronic forms of visual media, not just broadcasting, to reach its audience.
- 6.35 The PSP would aim to commission and distribute content as widely as possible, using a variety of technologies to reach households. It could also have the opportunity to explore new ways of contributing to PSB purposes, unencumbered by the need to protect existing TV channels.
- 6.36 As technology progresses, we could expect the PSP to commission and distribute content on new digital distribution systems such as broadband, networked PVRs, mobile networks as well as cable, satellite and digital terrestrial broadcasting. Inevitably, in the early years of the transition to digital, much of the PSP’s digital content would be more likely to resemble traditional TV programmes, but it would not be a TV channel in the traditional sense, nor would it publish books, magazines or newspapers.
- 6.37 The PSP might:
- operate as a small commissioning and publishing body, which would use public funds to stimulate the creation of innovative content, across all visual electronic media, from a range of producers;
 - commission from independent producers to provide such content in identified priority areas;
 - ensure that the content created was effectively promoted, branded and made widely available across all significant distribution systems;
 - ensure that all its activities reflect our proposed PSB purposes and characteristics; and
 - not be based in London, to strengthen production centres across the UK, and it could fund new content for the nations and regions.
- 6.38 Importantly, the contract to run the PSP would be awarded after a process of competition between different organisations. The winning bid would be the one which best met PSB purposes and characteristics and had the best proposals for distributing the content so as to achieve significant reach and impact. The successful bidder could be given gifted capacity on the digital terrestrial platform and would be free to arrange carriage deals on other platforms, including analogue before switchover.
- What assets could the PSP have and how much would it cost?**
- 6.39 The assets and funding of the PSP could be:
- access to public funding as outlined in Section 5; and
 - access to the DTT spectrum and other privileges available to content providers with PSB obligations.
- 6.40 The conclusion from Section 4 is that the net cost of PSB funding in the digital age should be similar or a little lower than today in real terms. This suggests that the total budget for a fully-functioning PSP at switchover (2012) could be up to £300m a year. As a tentative indication only, this is slightly lower than the programming costs for Channel 4, but higher than those of Five and any digital channel apart from premium sports and film channels. This sum could enable the PSP to provide a deliberately limited quantity of high-quality content, but not a 24-hour TV channel. We envisage that this level of funding could be enough to deliver an average per hour programme budget of around £200,000 if the PSP produced the equivalent of three hours of new content each day.

Would the PSP co-fund content with advertising revenue?

- 6.41 We would not at present envisage that the PSP would co-fund its programming with advertising revenue. Similar to the early years of Channel 4, this would enable the winning bidder to have revenue certainty and would minimise the incentive to produce content which appeals to advertisers rather than to a broad audience. Without advertising, there would also be fewer concerns about the PSP competing against existing broadcasters for advertising impacts in an increasingly competitive broadcasting market.
- 6.42 The lack of co-funding would reduce the quantity of content that the PSP could produce, but we believe the gap that it needs to plug is not for quantity but for certain areas of quality visual content, which are unlikely to be supplied outside the BBC in the digital age – co-production with other producers and broadcasters would, however, be possible.

How might the management of the PSP be chosen?

- 6.43 Through a competitive process. Bidders could compete to win the right to manage the PSP on the basis of the programme ideas they had. The contracts could either be well-defined or they could be more flexible. In the former case, the bidders would compete to commission, produce and distribute a tightly-specified range of programming for a fee; in the latter, competition would extend to an evaluation of the merits of each bid's programming ideas.

Should the PSP be one organisation or many?

- 6.44 We believe that unless difficulties over creating a well-known route to market can be overcome, a single PSP is likely to have greater impact and still provide enough competition for the BBC in

quality TV. The advantage of a single PSP would be that its scale would give it a significant presence in the market which would enable it to increase its reach and impact.

How long would the PSP contract last?

- 6.45 We would expect the PSP to be offered a contract lasting up to ten years, but with a mid-point review of funding and purposes – in line with the pattern we propose for the next BBC Charter.
- 6.46 This would be long enough for the PSP to establish a reputation for quality content, but short enough for a periodic review and renewal process to be an effective discipline on the winning organisations and to provide sufficient competition in the provision of PSB.

Would the PSP be a not-for-profit organisation?

- 6.47 The general organisational structure of PSB providers in the digital age was discussed in Section 5, in which we suggested that no organisational structure should be ruled out. The ethos in not-for-profit organisations is in some ways more likely to be aligned with PSB purposes than in fully-commercial organisations. But there would be some disadvantages in a competitive process in which only not-for-profit organisations were encouraged to apply. In particular, fewer organisations would be likely to compete for a not-for-profit licence, and not-for-profit organisations may be less efficient in delivering good value for money. For this reason, we would not rule out profit-making organisations from bidding to become the PSP, but any bidding organisation would have to demonstrate clear financial separation between the PSP and its other operations.

How would the PSP establish itself?

- 6.48 In order to gain reach and impact, it is likely to be necessary for the PSP to be established while the analogue PSB model still exists. That would ensure a smooth transition from the analogue model to the digital PSB model. Programming commissioned by the PSP might be screened by a terrestrial TV channel if it could agree a partnership arrangement with one of the current commercial channels.
- 6.49 After digital switchover, the likely development would be that the PSP would use its own digital TV channels and other technology to distribute content.

Would existing broadcasters be able to bid to run the PSP?

- 6.50 We would envisage that any of the existing commercial broadcasters would be able to create vehicles to bid for the public funding available, but to ensure competition and plurality, the BBC would be excluded from the process. The advantage of this model might be to blend the benefits of competition, existing institutional value and an analogue distribution platform in the run-up to the digital age.
- 6.51 However, the bidding for the PSP would not just be restricted to existing broadcasters. One of the attractions of a new service is that it could create an opportunity for many different types of organisation to put forward new ideas for PSB and new approaches to delivering PSB.

Assessment

- 6.52 The advantages of creating a PSP would be:

- it would maintain and expand the plurality of PSB in the digital world;
 - the PSP would have the potential to start from scratch in providing content which meets PSB purposes and characteristics in a digital world;
 - a competitive process for choosing the PSP could help the best ideas to get funded, and could open up the process to the possibility of tenders from many different organisations, ranging from other broadcasters, to producers, other media publishing companies, and perhaps more widely to other creative organisations;
 - the periodic competitive process would maintain a discipline on the managers of the PSP to contribute effectively to PSB purposes and characteristics;
 - many of the most significant innovations in broadcasting and PSB have resulted from new entrants shaking up the market. As there could be a regular competition to run the PSP, there would be a process of continuous renewal of PSB as conditions change;
 - the PSP would maintain the existing funding arrangements in the existing TV channels and would not risk changing their culture adversely; and
 - the competitive process for choosing the PSP could help to mitigate serious European state-aid concerns which would arise if explicit funding were offered to an existing broadcaster.
- 6.53 But creating the PSP could also entail significant risks that would need to be considered carefully:
- some of its functions might replicate the remit which already exists for Channel 4;
 - there is no guarantee that a new organisation could contribute more effectively to PSB purpose and characteristics; and
 - it may be difficult to ensure that the PSP gets reach and impact without an existing brand, a large loyal audience or an analogue distribution mechanism. Even with a brand and copious cross-promotion, the BBC has found it difficult to attract viewers to BBC4.

6.54 We would expect the PSP to move in step with changing technology so that it could build and then retain reach and impact to provide competition for high-quality visual content. It would have the opportunity to explore new ways of contributing to PSB purposes, unencumbered by the need to protect existing TV channels. It could also have an upfront role to play in providing content for evolving broadband services.

6.55 We have only presented an outline proposal here, and we will work to assess this option in more detail over the next three months. We would welcome a wide-ranging debate on all the issues we have raised, as part of the Phase 2 consultation process.

PSB on other commercial channels in the digital age

Channel 4

6.56 Over the next few years, Channel 4 will remain a vital force in the provision of PSB on a suite of free-to-air channels, and particularly as a provider of innovative content for its particular target audience group. We will work over the next year with the channel on developing the new framework for regulation, based on creative dialogue and our proposed new approach to measuring PSB, but with a clear and sharper focus on public purposes.

6.57 In the digital age, one model for achieving plurality of PSB supply involving Channel 4 could be to provide the broadcaster with explicit funding to replace its current implicit funding linked to the scarcity value of the analogue spectrum.

6.58 Section 3 showed that even after self-help and other initiatives, if funding is not provided in the digital age, Channel 4 might face considerable pressure on its ability to fund the same range of high-quality PSB programming. While it might be able to maintain its audience share in the digital age by changing its programming so that it

contributes less to PSB purposes and characteristics, it might be less able to maintain its contribution to PSB and maintain audience share simultaneously.

6.59 We believe there would be serious risks involved in providing direct funding of Channel 4:

- it could involve an open-ended financial commitment from Government, which would not encourage efficiency at Channel 4;
- it may be difficult to exert direct control over how management would spend the public funds, particularly as there has been a widespread perception that Channel 4 has shifted PSB programming out of peak already;
- any model involving regular review of Government funding would be seen as compromising the channel's editorial independence;
- it would not involve competition for funds and thereby risks generating less than an optimal level of new ideas and innovative ways of meeting PSB purposes;
- mixing together PSB and commercial activity risks diluting public purposes and making performance harder to measure;
- there may be competition concerns and EU state aid concerns associated with the provision of funds directly to an organisation; and
- there would be only two broadcasters with significant PSB obligations in the digital age, fewer than currently exist.

6.60 On balance, we believe that direct funding of Channel 4 would be inferior to creating a new provider of PSB involving an element of contestability for its funding. Channel 4 would, however, be free to bid to operate the PSP.

6.61 We recognise that in the longer term, particularly after digital switchover, Channel 4 may face an increasing tension between maintaining advertising revenues and its PSB remit and may not be able to provide the same quantity of PSB programming as today. This tension did not exist in the early days of Channel 4 when its revenues were not governed by the quantity of advertising its programming generated.

6.62 But in the event that operational efficiencies and market-based initiatives cannot deliver sufficient financial strength for Channel 4 to fulfil its PSB remit in a digital age, there *may* be a case for considering further action such as the transfer of income-generating assets from the BBC to Channel 4.

ITV1

6.63 Maintaining and strengthening PSB on commercial terrestrial channels in the transition to a digital world will be complex and the outcome is inherently uncertain. While the current system is broadly sustainable for the next few years, it will cease to function effectively once switchover is complete. As Section 3 showed, ITV1 is unlikely to wish to hold broadcast licences which contain onerous PSB obligations after digital switchover, as would Five or any other fully-commercial broadcaster.

6.64 That does not mean that there would be no privileges for being a broadcaster with PSB obligations. We believe that, alongside publicly-funded PSB, a second category of broadcaster could exist in the digital age that met certain limited specific PSB obligations in return for privileges. We believe that this implicit contract could be made attractive to ITV1 and Five, and potentially for other broadcasters, which do not currently have PSB obligations.

6.65 Against that background, ITV1 will have an important continuing role to play as a key part of a healthy digital PSB system. It will compete strongly for audiences, production talent and will help to keep other PSB content providers on their toes. Its limited privileges would be able to secure at least:

- high production value UK originated programming;
- accurate and impartial news;
- free-to-air broadcasting which is universally available; and
- possibly regional news, subject to the financial position after switchover.

6.66 The privileges on offer to the commercial tier broadcasters with PSB obligations would be:

- appropriate prominence on EPGs;
- gifted capacity on digital terrestrial multiplexes;
- must-carry rules on cable networks; and
- potentially a waiver from spectrum pricing if it is introduced for broadcasters.

Five

6.67 Five stands to gain from its PSB status after switchover. It will secure universal coverage for the first time. Its PSB role in future will be to contribute to original UK production, but we expect the channel to be largely market-driven.

Programming in and for the nations, regions and localities of the UK

6.68 We will also need a new framework for programmes in the nations and regions after switchover. Emerging digital technologies offer rich potential for the future to develop local, regional and national services that meet citizen-consumer needs considerably more effectively than the

current model of provision by the main networks. We expect to see an expansion of dedicated commercial services exploiting broadband networks, interactive new media capabilities and digital TV to deliver integrated news, information and entertainment at a very local level.

- 6.69 Viewers tell us that they would prefer more local news to the current model of regional provision, although news at national level will remain important. The English regions are often too large to be relevant to most viewers, who tend to live most of their day-to-day lives within at most 25 miles of their homes and be most interested in news and community issues within that range. City TV services supplemented by broader coverage (at, say, region or county level) in more rural areas, along the lines of most local radio stations and newspapers, may prove to be the most effective models.
- 6.70 As we move towards a digital world, more spectrum may be available for widely accessible local services delivered to a high transmission standard. The BBC has already expressed its intention to develop 50-60 local services providing 'ten minutes an hour of genuinely relevant local news and information', initially over broadband but potentially later on digital TV. Given the importance of plurality in the provision of public service broadcasting, we may want to take steps to ensure there is adequate competition in the supply of local news.
- 6.71 Broadband also offers the possibility of highly sophisticated local TV services. Services such as Italy's FastWeb demonstrate the potential for high-quality TV and video services delivered over the internet; FastWeb is already serving a low but rapidly growing subscriber base.

6.72 Currently, local TV is provided by restricted service licences (RSLs), broadcasting on analogue frequencies which will cease to be available after switchover, and isolated examples on cable or satellite TV. The analogue broadcasting environment holds considerable disadvantages for local TV, including transmission problems and uncertainty over digital switchover, which has made long-term licensing and business planning impossible.

6.73 There can be no guarantees of automatic digital licences for local TV at this early stage of switchover planning. However, a range of options exist that enable Ofcom to take a fresh look at both the licensing and spectrum allocation process for local television services. These include:

- using one of the slots on a proposed seventh national multiplex to carry local television services in a wide number of locations. A seventh multiplex would be capable of reaching around 75 per cent of UK households if broadcast from 200 transmission sites;
- allocating a single UHF channel for local TV throughout the UK, which could cover up to 50 per cent of the UK; and
- allocating a low-capacity multiplex in designated areas of the UK for local TV, using one interleaved channel from the existing six multiplexes. This could allow most major towns and cities to have one frequency assigned for local TV, and may also facilitate the provision of a Gaelic service in Scotland.

6.74 Our preliminary assessment is that all these options would allow the development of local TV services in specific towns and cities, or parts thereof, without a substantial impact on current plans for digital switchover; although they need to be evaluated in comparison with other possible uses of the spectrum freed up by switchover.

- 6.75 For the time being, however, local TV remains a largely untested model. It will take several years for it to become properly established. In the meantime, there is still a need to maintain a significant, competitive and high-quality supply of programming for the nations and regions of the UK from the major broadcasters. But in due course we might expect regional programming in the English regions to be supplemented by something significantly more local, which many viewers say they would prefer.
- 6.76 The issues in the devolved nations are rather different. Local TV will have a part to play there in the same way as it will in the rest of the UK. But there will also be an ongoing need for TV that informs the entire nation about its distinctive political and cultural life, and that reflects and reinforces diverse local identities. Specifically, we must ensure a sustainable future for Welsh and Scottish Gaelic language services. We anticipate that digital transmission capacity and access to adequate public funding should be available to support all three services.
- 6.77 In addition, there is a need to ensure that UK-wide TV takes sufficient account of the diversity of the nations, both in terms of news coverage of policy and government that is sensitive to the different implications of issues in the different nations, and in reflecting the full range of the UK's nationalities in non-news programming. Currently the supply of network programming from the nations is too low; we will seek to ensure this is increased in future.
- 6.78 We set out a more detailed analysis of national and regional programming in a supplementary document published alongside this review. *Reshaping TV for the UK's nations, regions and localities* is available at www.ofcom.org.uk.



Ofcom's approach to PSB regulation in the transition to the digital age

7

7. Ofcom's approach to PSB regulation in the transition to the digital age

7.1 The next five to seven years, running up to digital switchover, will be a period of transition. This section first analyses the general approaches we could take to the PSB obligations in ITV1 and Five's licences before, during and after switchover. It then presents our proposals for the regulation of each of the TV channels in the immediate future, including Channel 4, and that of the independent production sector. It also puts forward our proposals for the future of programming for the nations and regions – a supplementary document, *Reshaping TV for the UK's nations, regions and localities*³⁴ contains much of the background information which has contributed to these proposals.

The level of specific PSB obligations on ITV1 and Five

- 7.2 ITV1 and Five currently must meet a long list of programming quotas and production quotas in return for their access to the analogue spectrum. As Section 3 explained, the system of programming quotas will not be sustainable into the digital age. If the quotas are not relaxed by the time of switchover, the companies will choose to broadcast using routes to market without expensive PSB obligations attached.
- 7.3 There are four ways that we might react to this scenario.

Hold the line

- 7.4 Option one would be to hold ITV1 and Five to their existing PSB obligations, and manage the decline in the value of their licence by decreasing payments over time. This would allow us to extract the maximum value from the spectrum in terms of PSB programmes in the short term. However, the point would still be reached (certainly by switchover or more likely before it) where the costs of that programming began to exceed the benefits to the channels of PSB status and spectrum. At that point, there would be a strong incentive either for the licences to be handed back or for PSB obligations to be reduced or avoided.

7.5 The advantage of this approach is that it maintains the current PSB obligations on ITV1 and Five for as long as is possible. For it to be the best choice, we would have to be sure that the current obligations on these channels were effective in reflecting the purposes and characteristics of PSB.

7.6 The main risks of this option would be:

- that our estimate of the cost of the PSB obligations could be considerably lower than the companies' internal estimates and that the licences are handed back earlier than we currently envisage; and
- that our regulatory stance precipitates a strategic decision by ITV to move earlier to a non-PSB model, perhaps even the option to be part of a subscription package rather than a free-to-air broadcaster.

Manage the transition

- 7.7 Rather than reducing the burden only in terms of licence payments, under option two we would adopt a strategy of incremental deregulation. We envisage that licence payments would decline, perhaps with annual adjustments, over the period, with a planned 'glide path' over the full period of the digital replacement licence. Thereafter, there would be a gradual reduction in PSB obligations matching the residual value of the analogue spectrum. The decline in the obligations and the trigger points would be included in the digital licences so that the licence payments could be set accordingly.
- 7.8 This would reduce the risk that the licences would be handed back and the obligations could be reduced in accordance with their value. As the transition was managed, the central components of ITV1's obligations – news, regional news and original UK production – would be maintained for longest.

34 *Reshaping TV for the UK's nations, regions and localities* is available on the Ofcom website, www.ofcom.org.uk, or in hard copy on request.

- 7.9 In either of these two options, whether or not licences were handed back, the schedule would only retain those aspects of PSB that were worth something to the channel's brand – news, perhaps some regional news and original production – after digital switchover. The difference might be that in a managed transition, we could retain some regulatory control over those remaining elements of provision, e.g. to ensure that news was well-resourced and of high quality.
- 7.10 The main risks with this option are similar to the previous option, although probably slightly delayed in their timing. Additionally, this option could cause annual negotiation on the precise level of PSB to be delivered with the result of increasing the regulatory cost considerably and creating uncertainty in the marketplace.

Move to a sustainable level of PSB obligations now

- 7.11 A third option would be to remove some of the PSB obligations from ITV1 and Five immediately and reflect this new level in the licence terms, which could be renewed next year.
- 7.12 This would be the right option to follow if some of the current obligations were not contributing to PSB purposes. It would also reduce the risk that the licences would be returned by the broadcasting companies, and would create a more certain regulatory framework, without the need for annual negotiations between Ofcom and ITV1. Greater certainty would help Ofcom and the Government manage PSB in the system as a whole, and might create incentives for ITV1 to sustain its position as a leading investor in high production value UK programming across a range of genres.

Cash out the PSB obligations

- 7.13 The fourth option would be to create a more transparent relationship with ITV1 and Five by removing the whole range of existing PSB obligations and extract the full value of analogue spectrum in the form of licence payments. With Government permission, this money could then be used to fund PSB programming directly – at first on ITV1, Channel 4 and Five but over time on other widely available channels. This would, in effect, create the conditions of the digital age now. Over time, the amount of funding available would decline in line with the value of spectrum, so if we wanted to maintain the same level of PSB provision we would need to find a new source of funding.
- 7.14 This option would require Government agreement and a firm valuation of the current PSB obligations, neither of which currently exist.

Assessment

- 7.15 We propose to make some changes now to the regulatory burdens of ITV1 and Five, to make the system more sustainable. That will allow:
- a greater degree of regulatory certainty in the short term, helping the commercial channels to plan for the future;
 - changes to be incorporated in any review of financial licence terms; and
 - consideration of the impact on PSB in the parallel review of the BBC's Charter.

The sections below set out our specific proposals for each channel and for programming in the nations and regions. We recognise, however, that in some areas further changes will be needed to manage the transition to digital switchover, and our Phase 3 report will consider those transitional issues in greater detail.

Our specific proposals for the transition to the digital age

ITV1

7.16 ITV1 has been a major force in public service broadcasting, and the main source of competition to the BBC, for almost 50 years. Its contribution to public service purposes is sustained today in the wealth of original UK programming that it supplies free-to-air, particularly in drama, entertainment and factual programming, as well as its commitment to news, regional news and production outside London.

7.17 Over the next five years, our central ambition is that ITV1 continues to deliver universally available, free-to-air PSB obligations which provide real value as part of the overall broadcasting environment, while reflecting that the costs of production and the funding available.

7.18 We propose to:

- maintain the current programming quotas or indicative targets on original UK production, news, current affairs, regional news and regional current affairs; and
- use the framework of the Communications Act to ensure that there is sufficient investment in national and international news when the next contract is awarded to ITV1's nominated news provider.

7.19 In other areas, we want to end the all-too-frequent negotiations between ITV1 and the regulator over its specific PSB obligations. We will introduce a more flexible approach to Tier 3 content regulation. The Communications Act requires us to move away from hard quotas for specific genres, and towards a new three-layered system that assesses the contribution of programming in terms of:

- what the PSB channels are providing and when it is scheduled;
- what viewers are watching; and
- whether audiences value what they watch.

In assessing value, a close link will be made to the core purposes of public service broadcasting. This model will aim to maintain the public service character of ITV1, in the important programming areas such of arts, children's and religion, but in ways which respond to changing public demands and market developments (perhaps using new cross-genre approaches and new ideas for scheduling). As part of the annual review process, we will be interested not just in the availability of such programming, but evidence of commitment from licensees to ensure it is well-funded and effectively promoted.

7.20 After digital switchover we propose to maintain a core level of PSB obligations on ITV1, available free-to-air on all transmission platforms – high production value UK programming, news, current affairs and, if financially sustainable, a core regional news service.

Channel 4

7.21 During the transition to the digital age, Channel 4 should remain a vital force in the provision of PSB. It should focus on the reflection of diverse and alternative perspectives and the provision of innovative content for its particular target audience group. We expect Channel 4 to use its considerable financial resources to ensure a sharper focus on its public purposes, as set out in the Communications Act – our annual review of Channel 4 will focus on delivery against that core PSB remit.

7.22 Channel 4 today has to resolve the tension that exists between its need to maintain advertising revenues and its desire to fulfil its PSB remit – this is a tension that did not exist at the channel's inception. Section 6 suggested that in the longer term there may be a case for considering whether Channel 4 will need new streams of income if it is to sustain its contribution to PSB at the current level. At least for the next few years, however, we do not presume that this will be necessary.

- 7.23 We expect Channel 4 to strive to meet its PSB remit and funding challenges through self-help, further operational efficiencies and market-based initiatives, such as increased cross-subsidies from its commercial ventures. It should also be given sufficient freedom to form alliances, joint ventures and partnerships with other organisations, and to put together a portfolio of free-to-air services. Our analysis suggests that there is every reason to expect such efforts to be successful for the next few years.
- 7.24 We do not support the privatisation of Channel 4: the channel should remain primarily not-for-profit. Not-for-profit status has provided a basis for Channel 4's unique contribution to PSB over the last 20 years and there is no reason to suppose that the same approach is entirely unsustainable in future, particularly if new means of commercial cross-subsidy can be found.

Five

- 7.25 Five plays a modest but important role in contributing to PSB purposes, and the channel's regulatory obligations are lower than others', in part because it only has around 80 per cent terrestrial coverage. Five therefore stands to gain from its PSB status at switchover, which will bring it universal coverage in the UK for the first time.
- 7.26 Five's contribution to PSB mainly takes the form of its commitment to original UK production and news. We will expect the channel to invest more in original production in the run-up to switchover. However, we will take a more flexible approach to Five's other PSB obligations, including the scheduling of its news programmes. We would also consider any application from Five for a review of the financial terms for its digital replacement licence.
- 7.27 Our proposed, more flexible approach to Five should help to provide a test for the likely level of market provision of PSB programming in the absence of detailed regulation.

PSB in and for the nations and regions

The challenge

- 7.28 The future of PSB in the nations and regions has been a particular focus of our Phase 2 work. A particular challenge in the years up to digital switchover is the position of ITV1's non-news programming obligations for the English regions and nations of Scotland, Wales and Northern Ireland. These obligations are untenable after digital switchover because:
- the cost of the programming will greatly exceed the value of any privileges available to Channel 3 licences; and
 - much non-news regional programming receives low audiences and is not highly valued by audiences and has been pushed to the margins of the schedule, with low production values.³⁵
- 7.29 The current position is therefore neither sustainable nor desirable in either the English regions or the nations.

The digital future

- 7.30 Post-switchover, our vision of a well-resourced and sustainable service includes:
- a continuing and important role for ITV1 in the reflection of regional stories, characters, places and issues on its main network, with a high proportion of original production made outside London;
 - a new commitment to regional programming from the BBC, in line with the Corporation's own proposals. This would include a rebalancing of obligations for non-news English regional programming between ITV and the BBC, which does not currently provide such programming on any scale, as well as a new local BBC news service. In adopting any new regional commitments, we suggest the BBC should undertake to support a plurality of regional producers;

³⁵ The detailed arguments about the future of ITV's regional programming are considered in a supplementary document published alongside this review: *Reshaping TV for the UK's nations, regions and localities*, available at www.ofcom.org.uk.

- the use of new digital opportunities to provide a range of innovative local TV and new media content services up and down the country; and
- market-driven commercial national programming emerging in TV broadcasting and in many other media, as it already has for some ethnic minority communities in the UK.

Immediate proposals

- 7.31 For the English regions, we propose cutting ITV1's regional non-news programming obligation from three hours a week to 1.5 hours a week (in a typical region) in 2005, with all of the reductions occurring out of peak hours. This would focus non-news regional programming in peak hours. Even this level of provision may not be economically sustainable up to switchover, however. We will therefore continue to review the options and will put forward some firm proposals for managing the transition to switchover in Phase 3 of this review.
- 7.32 Different considerations apply to the nations of Scotland, Wales and Northern Ireland. ITV1's non-news programming obligations for the nations will be unsustainable after switchover and will need to change well in advance of that date. But the devolved nations have distinct cultural and political identities that need to be reflected in any PSB system – these are explored in more detail in Box 7.1. We therefore believe a wider debate is needed, including input from Ofcom's National advisory committees, before we propose immediate changes to ITV's obligations.
- 7.33 After this debate, and with input from the nations, we will outline our specific proposals for non-news programming obligations in the nations in Phase 3. In the longer term, there needs to be an economically sustainable future for Welsh and Gaelic language services, using digital transmission capacity and access to adequate public funding.
- 7.34 In parallel, we propose to raise the out-of-London production quotas to lock-in the current levels of production and to encourage a wider dispersion of production outside London and across the nations and regions of the UK.

The independent production sector

- 7.35 Independent producers make a major contribution to PSB purposes across a wide range of programme types. Proposition 9 in our Phase 1 review suggested that we consider raising the quota of programming which broadcasters must commission from independent producers.
- 7.36 We believe there is more scope for independent production to enhance the delivery of PSB and welcome the BBC's recent commitment to ensure that the 25 per cent production quota represents a floor not a ceiling. But we have been persuaded that now is the wrong time to change the independent production quota.
- 7.37 Since the new terms of trade between broadcasters and the independent television production sector have only recently been agreed, we believe a period of time should elapse before further consideration of the relationship between broadcasters and independent producers. In 12 months' time, if it is not clear that the market is working effectively, we will take further action. We would expect to consider:
- the effectiveness of the existing quota;
 - the transparency of the commissioning process;
 - the extent to which the new codes of practice have helped the market to function more effectively;
 - the appropriate definition of an independent producer, both at UK level and in the nations and regions; and
 - the case for tougher action or for alternative solutions.

Box 7.1: The different role of PSB in the devolved nations of the UK

Scotland, Wales and Northern Ireland are culturally and politically distinct parts of the UK. Devolution, with the creation of National Parliaments and Assemblies, has both reflected and extended widespread engagement in local news, issues and current affairs in the recent past. Television therefore has an important role to play at the national level. This is further accentuated in Wales, where the national press is far weaker than in England or Scotland, and in Northern Ireland, where the community places a particular value on the impartiality that television can bring to political coverage. In Scotland, there is considerable history of keen national interest in separate broadcast provision. However, in the absence of any PSB obligations, it is unlikely that national programming would be available on anything like the current scale in these three nations. The future of the current regulatory set-up is therefore of critical importance to citizens in those areas of the UK.

In each nation, there are different issues for Ofcom to consider, and we therefore propose to engage with them separately. The existing broadcasting structures are different in each case:

- regional programming obligations are mostly higher than in the English regions, but in the sparsely-populated Grampian region non-news requirements are actually lower;
- in Scotland and Northern Ireland, SMG and Ulster are individual Channel 3 licensees, part of the ITV network but separate from ITV plc; and
- in Wales, S4C exists as a Welsh language service in place of Channel 4 (although showing much of the Channel 4 schedule out of peak) and receives direct Government funding through the Department for Culture, Media and Sport in London.

There are also some shared issues, most notably the limited extent to which any of the nations are represented in UK network programming – our Phase 1 report noted that only two per cent of first-run network programmes were made in Scotland in 2002 and only one per cent in Wales. In response to Phase 1, there were a number of calls to increase the level of national production for network broadcasting, both on ITV1 and the BBC. There were three other significant issues raised in all three nations, all of which need further consideration:

- the wish for increased autonomy in commissioning and scheduling decisions at the national level, and in particular for greater flexibility in the networking arrangements that apply to Channel 3 licensees;
- support for better minority language services, whether in Welsh, Scots, Gaelic, Irish or Ulster Scots; and
- the suggestion that the BBC should play a greater role in providing programmes in and for the nations.

Summary

7.38 Taking Sections 7 and 8 together, our proposed future framework for PSB is:

- a new mix of funding, regulation and institutions which will meet the challenges of a radically different TV market and audience demands, building on existing institutional value but also encouraging innovation and fresh perspectives in the creation and delivery of PSB;
- a well-funded BBC, producing distinctive and high-quality programming, at the heart of this new system;
- plurality beyond the BBC – competition for quality in the supply of well-funded UK programming and a competition for the right to receive public funding for the best new model of PSB provision;
- a new provider, the PSP, charged with making imaginative use of new technologies and distribution systems to meet audience needs in the digital age and securely funded from either an enhanced licence fee model, tax revenues, or a tax on the turnover of broadcasters;

- a continuing role for Channel 4 as primarily a not-for-profit provider of innovative and diverse programmes for its target audience group;
- a sustainable level of PSB obligations on ITV1, focusing the channel on a set of central PSB components, before and after switchover;
- a new approach to programming for the nations and regions: regional production and, if possible, regional news on ITV, a transfer of non-news regional obligations to the BBC and the use of digital opportunities to create a new tier of more local services;
- increased investment in original UK programming on Five, alongside a more flexible system of content regulation; and
- the provision of programming which contributes to PSB purposes and characteristics by broadcasters without specific privileges or financial incentives, as a more effective broadcasting market develops.

7.39 The foundations of the analogue PSB model that so many of us grew up with will gradually erode as we approach switchover. The time has come to recognise that we will need a new model of PSB for the digital age, building on existing institutions and perhaps creating new ones. If we are to be prepared for the digital age and if we are to succeed in maintaining and strengthening PSB, in line with the wishes of Parliament and the Communications Act 2004, then there must be a full public debate today. This document sets out Ofcom's contribution to the debate.



Section 8: Questions for consultation

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8. Questions for consultation

The end of the analogue PSB model

We have concluded that if we do nothing to change the existing PSB model, there is a real risk that PSB across the system will decline both in amount and effectiveness.

Question 1: Do you agree with our analysis that the existing PSB system will not survive the move to the digital age, and may decline before then?

The continuing case for public funding of PSB

Our analysis suggests that:

- there is a clear rationale for PSB from a citizenship perspective;
- the UK market would not provide the current range of and extent of high quality television content without public subsidy, even in the digital age; and
- the public still want to pay collectively for programming that contributes to PSB purposes.

Question 2: Do you accept that public funding for PSB continues to be justified as we approach switchover, and should remain broadly at a similar level to that provided today?

Principles for a future PSB system

We consider that a plurality of PSB providers needs to exist, to provide alternative perspectives and competition for ideas.

Question 3: Is plurality vital to the future of PSB?

In addition, we suggest that a future PSB system will need to evolve to take full advantage of new technologies to meet changing public demand and attain real reach and impact.

Question 4: Will PSB need to take a new form, across new technologies, in future? If so, which technologies should PSB embrace in the digital world?

The BBC

We consider that the BBC should remain the cornerstone of PSB, striving to make sure all its programmes reflect the purposes and characteristics of PSB. It should be granted a ten-year Charter, but with a mid-point 2011 review of its funding and its progress in meeting PSB purposes and characteristics. We believe that the proliferation of reviews to which the BBC is now subjected is in part a consequence of a lack of a clear separation between the roles of governance and regulation, and that a clarification of roles this should be a central objective for Charter Review.

Question 5: Do you agree that the BBC should remain the cornerstone of PSB, but that there ought to be mid-Charter review and a clarification of the roles of governance and regulation?

We have concluded that the BBC should be properly funded by a licence fee model and we identify factors which should be taken into account in deciding the level of the licence fee for the next Charter. We also suggest that in future, the Government should consider allowing the BBC to supplement its income through limited subscription services. New technological means of collecting an electronic licence fee ought to be considered, to cut collection and evasion costs.

Question 6: Do you agree with our proposals on the future funding of the BBC?

ITV1

ITV1 has an important future in the PSB system, even in the digital age – it provides a wealth of free-to-air, original UK programming, particularly in the drama, entertainment and factual genres. In the short term, we propose maintaining the current quotas or indicative targets on original production, news, regional news and other regional programming in peak-time while adopting a more flexible approach to the regulation of other content. After switchover, we propose to maintain a core level of PSB obligations on ITV1: UK-origination quotas, news, current affairs and – if sustainable – a core regional news service.

Question 7: Do you think we have judged ITV1's PSB role correctly, both in the short term and the longer term?

Channel 4

We think Channel 4 should remain a vital force in the provision of PSB in the transition to the digital age, particularly as a provider of innovative content to its target audience. We expect it to use its considerable financial resources to ensure a sharper focus on its public purposes, and to meet funding challenges through self-help, operational efficiency and increased cross-subsidy from commercial ventures. It should be free to form alliances, joint ventures and partnerships. However, the channel should remain primarily not-for-profit and should not be privatised.

Question 8: Do you agree with our proposals for the role of Channel 4, and are we right to ask Channel 4 to look to self-help and joint ventures to fund PSB for the foreseeable future?

We recognise that in the longer term, particularly after digital switchover, Channel 4 may face an increasing tension between maintaining advertising revenues and its PSB remit and may not be able to provide the same range of PSB programming as today. In the event that improvements cannot be made which deliver sufficient financial strength for C4 to fulfil its PSB remit in a digital age, there may be a case for considering further action, such as the transfer of assets from the BBC.

Question 9: Should other means of support for Channel 4's remit be considered in the longer term? If so, what form should they take?

Five

We think Five can continue to play a modest but important role in contributing to PSB purposes, and stands to gain from PSB status at switchover, when it will attain UK-wide coverage for the first time. In future, we suggest Five's contribution to PSB will mainly take the form of a commitment to original UK production and news, and we will expect the channel to increase investment in production in the run-up to switchover. However, we will also adopt a more flexible approach to the regulation of specific genres and to the scheduling of news on the channel.

Question 10: Are we right to take a more flexible approach to the regulation of PSB on Five?

Programming for the nations and regions

Our long-term vision for the nations and regions includes: a role for ITV1, particularly in national and regional production, a sharing of non-news regional obligations between the BBC and ITV1; a new range of innovative local TV services; and a sustainable future for Welsh language and Gaelic services.

Question 11: Do you support this long-term vision of programming for the nations and regions?

In the short term, we propose a reduction in ITV1's English regional non-news programming from three hours to 1.5 hours, but with a focus on peak hours programming. In the nations, different cultural and political considerations apply – non-news programming will still be unsustainable after switchover, and will need to change before then, but we want to engage in a wider debate before proposing any changes. Separately, we propose to raise out-of-London production quotas on ITV1 to lock-in current levels of production and to encourage a wider dispersion of production outside London and across the nations and regions of the UK.

Question 12: Do you support our specific proposals for the future of regional programming on ITV1?

Question 13: What do you think a sustainable model for PSB in the nations would be?

Production

We believe there is more scope for independent producers to enhance the delivery of PSB. We welcome the BBC's recent commitment to fulfil its 25 per cent quota, and the new terms of trade between broadcasters and independent producers. We believe a period of time should elapse before further consideration is given to the relationship between the two. We are giving the major players 12 months to ensure that the market works more effectively, before taking further action.

Question 13: Do you think this is the right approach? What issues should we take into account in judging whether further action is needed in 12 months' time?

Competition for the supply of PSB

We assessed three models for maintaining plurality and competition in the supply of PSB in the digital age: a fully contestable fund; direct public funding of Channel 4; and competition between new providers of PSB. We favoured the third approach.

Question 14: Do you agree with our assessment and preference for a system which introduces competition for the provision of PSB?

A PSP

We have set out an outline proposal for a Public Service Publisher (PSP). The PSP would be the first provider of PSB content designed specifically for a digital world. It would commission a small amount of high-quality visual content and distribute it across a range of electronic media. Its greatest challenge would be to attain reach and impact, and for that reason we would not rule out existing broadcasters from bidding to run the service as a ring-fenced operation. The initial service would run for up to ten years, subject to a mid-point review.

Question 15: Is the idea of a PSP one worth pursuing? If so, what form should the new service take? How should a PSP be awarded?

New funding would have to be found to establish a PSP, either from an enhanced licence fee, or from tax income, or from a new tax on UK broadcasters' turnover. We have set out the advantages and disadvantages of each.

Question 16: What do you think the best source of funding would be?



Annex A: Immediate challenges in defining and regulating PSB

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Annex A: Immediate challenges in defining and regulating PSB

A.1 At the outset of this review we asked whether television was special, and concluded that it is. It can benefit society as well as entertain individuals and it retains a unique ability to deliver those benefits to millions of people. In Phase 1 we attempted to establish a sustainable conceptual framework for public intervention in the television market and defined PSB in terms of a set of purposes and characteristics. A period of discussion, consultation and reflection has helped us to refine those arguments. We have already published a full summary of consultation responses (available on our website at www.ofcom.org.uk), but the key results are summarised below.

A.2 There were many areas of broad consensus:

- The terrestrial broadcasters have only partially fulfilled the requirements of the Communications Act – there have been important shortcomings in delivery.
- There is a sustainable rationale for PSB. The market will continue to under-provide programming that we value as citizens and as a society. PSB should in future be defined in terms of the broad purposes it aims to fulfil.
- Digital technology has brought significant and permanent change to the broadcasting industry, and further change will follow. Ofcom will almost certainly need to consider new ways of maintaining and strengthening PSB for the longer term.
- The BBC should remain a strong public institution undertaking a wide range of activities. However, the Charter Review process needs to consider how standards of quality and innovation can be better upheld, and what model of governance and regulation is required to do that.
- Plurality and competition in the supply of PSB is important – the BBC is not enough.

A.3 There were also areas of disagreement among respondents:

- How best to incorporate the broad purposes and characteristics of PSB into a workable regulatory framework.
- The significance of ‘reach and impact’ and how they should be measured.
- The scale and pace of digital change and the implications for PSB, in particular:
 - the extent to which digital take-up and (ultimately) switchover will affect the ability of commercial channels to meet PSB obligations over the next five years;
 - the likelihood of the market (in the form of non-PSB broadcasters) providing PSB programming in future;
 - whether, conceptually, switchover will alter the market failure rationale for PSB in the longer term; and
 - more importantly, what sort of regulatory response is required.
- How plurality is best delivered – whether in production, broadcasting or commissioning, or all of these.
- The extent to which any additional funding is necessary, beyond the licence fee and existing forms of indirect subsidy, and if so where it should come from.
- How funding is best distributed – whether we need to maintain PSB institutions other than the BBC, and what role competition for funding should play.
- In delivering PSB, where the balance should be struck between not-for-profit and profit-maximising organisations.
- The future of Channel 4.

- A.4 Many of the issues that proved contentious in Phase 1 relate to the future of PSB, and are addressed in the main body of this report. This appendix tries to provide our answers to three of the more immediate questions:
- Why do we need to use public funds and regulation for PSB?
 - What should PSB look like?
 - How can broadcasters' contributions to PSB best be measured?
- A.5 The first question revisits our rationale for funding PSB, which we outlined in our Phase 1 report, and presents our revised purposes of PSB. It examines why TV can justify large quantities of public subsidy and is subject to intrusive content regulation when public intervention in other media is much lower.
- A.6 The second question asks what the characteristics of a high-quality PSB programme should be. We provide a more detailed analysis of the important characteristics and explain in greater depth what it means to expect PSB programming to have reach and impact. One of the issues we analyse is whether there can be a rationale for public funding of programmes which do not contribute to PSB purposes and characteristics in their own right. We have also included some further analysis of the factors that might encourage innovation in PSB programming, and an update on the work we are doing to make sure PSB provides a safe viewing environment for children.
- A.7 The third question relates to the means of measuring PSB delivery in a new regulatory framework, and we set out our first assessment of how such a framework might work.
- A.8 A final section provides a summary of the work we have done to review the future of Teletext as a PSB provider.

Why do we need to use public funds and regulations for PSB?

- A.9 When there were only a few TV channels, the primary public rationale for funding and regulating broadcasting was to ensure that it delivered an adequate range and balance of programming and catered for minority tastes as well as for those of the majority. As such, PSB attempted to address the way a free TV broadcasting market would otherwise fail consumers.
- A.10 In our Phase 1 report we suggested that in future this form of market failure would diminish as digital technology developed. This prediction sparked a significant, but often abstruse, debate. In an accompanying working paper to the Phase 2 report, Professor Martin Cave has provided a detailed explanation of our case; what follows is a more simplistic summary.
- A.11 Consumer market failures are likely to exist in TV broadcasting where there are only a limited number of advertising-funded commercial channels. Broadcasters in such markets are likely to be motivated by the need to deliver large audiences to advertisers and will tend to cluster around the middle ground. There is no mechanism to capture or to exploit the strength of preference that certain groups of viewers have for a different sort of programming.
- A.12 In a fully digital world, with the potential for many TV channels, this problem will be mitigated. Low barriers to entry and the wide availability of encryption and conditional access technology make it possible for a TV programme to be screened if its total revenues (either from advertising, from subscription or from pay-per-view) exceeds its total costs. A more effective market will be able to function. As with almost all other markets, however, we do not expect a future digital TV to match all the criteria

necessary to be defined in economic theory as perfectly competitive.

A.13 The question is whether the remaining consumer market failures in TV broadcasting constitute a rationale for PSB intervention in its current form.

A.14 We received many submissions on this issue with a considerable number of responses asserting that the TV broadcasting market would remain imperfect. The main objections and our responses are given below:

- Many responses suggested that aspects of market failure would still exist in a digital world. Our Phase 1 document accepted this. Our contention is that the TV market would become more effective, not that it would become perfect. And as it becomes more effective, the rationale for public intervention on the grounds of consumer market failure will diminish.
- Some responses suggested that a market on the model outlined above will not deliver the range and balance of free-to-air programming that UK viewers are accustomed to. This may be true (see the analysis in Section 4), but is not the point of our analysis. Our argument is that the market may be able to function better in future, not that it will necessarily function in a way that delivers the current range of free-to-air programming – that would depend on the costs of production, the tastes of consumers and on their willingness to pay, just as it does in the book publishing market, the music market, the games market and many others.
- Some responses argued that since the current generation of DTT set-top boxes have no conditional access capability, a more effective market in TV broadcasting would be some way off. There is truth in this. Our response is that although the consumer market failures might be slow to diminish, this does not alter the fact that they will diminish. Moreover, the lack of conditional access capability does not provide a strong rationale for PSB funding. Rather, it suggests that one possible policy for the future

should be to ensure that conditional access functionality becomes more widely available.

- Some responses said that regardless of conditional access technology, TV broadcasters would always be able to supply any programme to an additional viewer at no additional cost, so the efficient price of an individual TV programme should be zero. The analysis is true only in a narrow technical sense. It ignores the fact that TV is not unique in being an industry with high fixed costs and low variable costs. Publishing, film, telecoms, airlines, software, music, pharmaceutical and even car manufacturing share many of the same characteristics without the same degree of subsidies and regulations. More importantly, effective markets exist in these industries and market failures have been mitigated. In publishing, for example, newspapers bundle individual stories together so the cost of any one article is indeed zero. In TV, we believe that a combination of bundled subscription services, windowing, free-to-air advertising channels and increasing capacity and ever-declining barriers to entry would reduce consumer market failures and would allow TV broadcasting in a fully digital world to resemble a reasonably effective market.
- Respondents who argued that the price of TV services should always be zero based their arguments on the principles of welfare economics. If these theoretical principles are extended to include the effects of investment or innovation,³⁶ the theoretical results do not always suggest that the most efficient price of TV services is zero. Above-cost pricing is needed if there are to be strong incentives to innovate and to invest in improving TV or any other market.³⁷ The innovative and popular new TV services offered by multichannel providers since the 1990s show the potential advantages of above-cost pricing in many circumstances.

A.15 In conclusion, we believe that PSB intervention is not needed to rectify consumer market failure in a fully digital world. As such, a different

³⁶ i.e. by treating the world as if it could change rather than as if it is always static.

³⁷ The accompanying working paper by Professor Martin Cave provides more detail on this point.

rationale is required if large subsidies and intrusive content regulation is to remain justifiable in the digital future.

- A.16 A more effective consumer market is already evolving in digital television, but we believe there will remain a convincing rationale for public intervention on citizens' behalf. Television has a unique ability to reach millions of people with content that the market would under-provide or would not be widely available, but that can make a significant contribution to our society.
- A.17 In Phase 1, we suggested that the rationale for PSB funding and regulation should be in contributing to the projected **outcomes** of any PSB intervention. We described these outcomes as PSB purposes, and differentiated them from more usual measures of **outputs** such as types of programming, or **inputs**, such as particular institutions, levels of funding or types of producer. There was widespread support for our definition of PSB in terms of the purposes to which it contributes.

What should PSB look like?

- A.18 In Phase 1, we suggested there were four enduring purposes of PSB from the citizen's perspective:
- **to inform ourselves and others and to increase our understanding of the world**, through news, information and analysis of current events and ideas;
 - **to reflect and strengthen our cultural identity**, through high quality UK national and regional programming;
 - **to stimulate our interest in and knowledge of arts, science, history and other topics**, through content that is accessible, encourages personal development and promotes participation in society; and
 - **to support a tolerant and inclusive society**, through the availability of programmes which reflect the lives of different people and

communities within the UK, encourage a better understanding of different cultures and perspectives and, on occasion, bring the nation together for shared experiences.

- A.19 These purposes also attracted considerable comment. Many people felt that the fourth purpose was unduly ambitious in asking television to provide a means of social engineering. There was some confusion about the distinction between the second and fourth purposes, which both refer, in different ways, to aspects of cultural diversity. And it was suggested that an additional purpose of PSB should be to support the provision of high-quality television as an art-form in itself.
- A.20 In response we propose revising the fourth purpose to focus on encouraging debate between different perspectives from different cultures, in the hope that such debate may in turn support a more tolerant society.
- A.21 We also agree that it would be useful to draw a clearer distinction between the fourth purpose and the broader contribution that TV can make to the nation's cultural identity. Cultural identity is most likely to be fostered by original UK production, not only at an aggregate level but also through programming made in and for the nations and regions. There is also a certain cultural value to be drawn from the 'water-cooler effect' that can result from shared viewing experiences,³⁸ although it is likely that advertiser-funded programming would succeed in bringing viewers together for shared experiences without any public funding. We believe, therefore, that there is a citizenship rationale both for PSB programming that can cater for the widest possible range of audiences (not only those that are commercially attractive to advertisers, or can afford to pay for subscription television) and for the sustenance of UK production on a large scale across a wider range of genres than the market might supply.
- A.22 We are not convinced, however, that a fifth purpose of PSB should be to support the

38 An argument in support of the value of this effect is made in the BBC/Work Foundation report *Watching Alone. Social Capital and Public Service Broadcasting*, May 2004.

production of TV as art. There should be space for high-quality, highly original programmes that set standards, innovative, challenge and do not necessarily always have a high reach. Those are necessary characteristics of PSB programmes rather than arguments for making programmes in the first place. The necessary characteristics of PSB content are discussed in further detail in the next section.

A.23 Our revised set of purposes for PSB are as follows:

- **to inform ourselves and others and to increase our understanding of the world** through news, information and analysis of current events and ideas;
- **to stimulate our interest in and knowledge of arts, science, history and other topics** through content that is accessible and can encourage informal learning;
- **to reflect and strengthen our cultural identity** through original programming at UK, national and regional level, on occasion bringing audiences together for shared experiences; and
- **to make us aware of different cultures and alternative viewpoints**, through programmes that reflect the lives of other people and other communities, both within the UK and elsewhere.

A.24 To qualify as PSB, a programme must aim to fulfil one of the four purposes that we have set out. In our Phase 1 report we suggested that while not every programme on a commercial PSB channel would always reflect those purposes, all BBC programmes should strive to do so to some degree. The BBC have agreed that this is an appropriate distinction.

A.25 PSB programming should also have certain characteristics. Our Phase 1 report suggested that PSB programming needed to be:

- **high quality**: properly-funded and well-produced;
- **original**: new UK content, rather than repeats or acquisitions;
- **innovative**: breaking new ideas and re-inventing genres and formats, avoiding duplication;
- **challenging**: making viewers think, questioning established views; and

- **widely available**: if content is publicly funded, it needs to be made as widely available as possible. In practice, that means it must be free at the point of delivery, even where some digital models of delivery do not provide a universal service in the same fashion as analogue broadcasting.

A.26 No one has argued against any of these qualifying characteristics, and we remain convinced that they should form the basis of any PSB system. Not every programme will be able to match every characteristic, but the vast majority should reflect most of them. Any future system established to assess the effectiveness of PSB should track performance against these characteristics.

A.27 In addition, we now suggest that a further characteristic should be that programming is **engaging**. It must remain attractive to viewers if it is to have reach and impact (see below). The schedule should include programmes that are enjoyable and accessible as well as high-minded.

A.28 PSB programming should also be independent of any particular political or commercial interest – that means upholding the most rigorous standards of **impartiality** and **accuracy**, across the schedule as a whole, in order to set a standard that the rest of the industry has to follow. This may become more important in future if the number of sources of news and information continues to swell and the present distinction between different media becomes more blurred.

A.29 In the sections that follow, we ask how PSB programmes can best fulfil some of these purposes and characteristics.

Could PSB be more innovative?

A.30 Phase 1 revealed that viewers and industry leaders felt that there was a lack of innovative programming on the public service broadcasting channels. In particular, viewers complained of copycat formats and competitive scheduling. For Phase 2 we investigated this issue further to find out whether there were identifiable economic, cultural or strategic factors, within broadcasters and production companies, that encouraged or discouraged innovation.

- A.31 We asked broadcasting professionals (from the PSB channels, cable and satellite channels and the independent sector) to nominate what they considered to be the three most innovative programmes on the PSBs over the last few years. By far the most popular choice was *Big Brother*. This was followed by *Wife Swap*, *Who Wants To Be a Millionaire*, *The Office* and *Brass Eye*. Many of those who nominated these programmes felt that they were innovative because they had ‘changed television’.
- A.32 We then conducted a series of further interviews with the producers and commissioners involved with innovative programmes, asking them to consider whether there were any structural factors common to innovative programmes. Table 9.1 summarises the opinions that were put forward.
- A.33 Several broad suggestions were made by those we interviewed as to how innovation might be better promoted:
- the devolution of the creative capital of the industry into more hands;
 - encouraging a sellers’ market;
 - encouraging the growth of a healthy independent sector that is in a position to negotiate with broadcasters;
 - allowing the PSB channels access to funding; and
 - entrusting commissioning editors with more decision-making power.
- A.34 These suggestions need to be considered, even if they do not always translate into firm policy proposals. In Ofcom’s view, the key issues emerging are:
- plurality in programme supply, including the future of the independent production sector;
 - plurality in commissioning; and adequate funding to create space for development and risk-taking – a key concern being the role for public funding alongside the commercial sector.
- A.35 All of these issues are discussed in the main body of this report.
- A.36 Our framework for the assessment of PSB suggests that we will need to continue to develop better ways of measuring the innovative content of programming, possibly based on audience appreciation and industry peer review in addition to the rather simple quantitative indicators (e.g. proportion of new series) used in our Phase 1 analysis.
- Can PSB still work in a more competitive age?**
- A.37 In Phase 1 we noted that to justify significant levels of public investment, PSB would have to continue to reach millions of people, with a blend of popular and challenging content. We concluded that “PSB must achieve reach and impact to be effective” and that the challenge of doing so “suggests that regulation should break away from narrow obligations specifying hours of certain types of programming across the schedule”.
- A.38 This proposal proved contentious for some respondents. Some expressed concern that an emphasis on reach and impact, and a move away from specified genres, could signal the end of serious documentary, current affairs, arts and religious programming as part of the PSB mix. This concern has been heightened by the analysis suggesting that it is these dedicated genres that are most threatened by new modes of digital viewing behaviour and least supported by the general public.
- A.39 We still believe that reach and impact is important for the justification of significant public funding of PSB, but we felt that we should examine further what it should mean for a PSB programme to have ‘reach and impact’. We have carried out some further analysis of viewing behaviour to help us. There are at least two questions to answer:
- Can serious, challenging or niche programming still achieve sufficient reach or impact to justify public funding in the digital age?
 - Can overtly ratings-driven programming be deserving of public funding on the basis that it can bring viewers to other, more serious content?

Table 9.1: Important drivers of innovation in TV

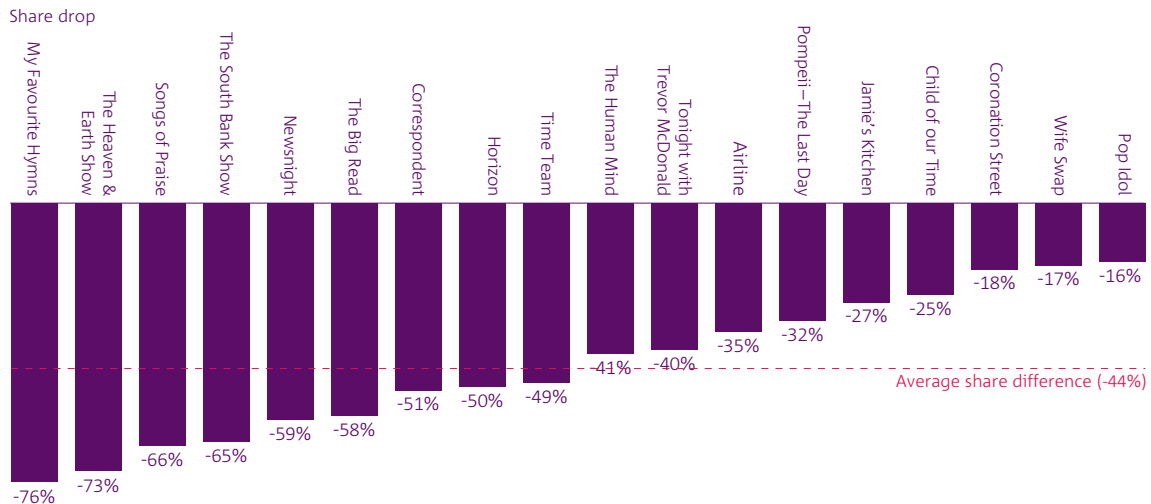
Factors that it is felt may discourage innovation	Factors that it is felt may encourage innovation
<p>Real decision-making power lies in the hands of too few people (this is across the board but the BBC came in for particular criticism).</p> <p>Advertisers press for 'more of the same'.</p> <p>Smaller programme budgets and stringently defined 'slot prices' discourage innovation, because the amount of money available to producers restricts their ability to experiment.</p> <p>There is insufficient money available for research and development.</p> <p>Most independent production companies operate with such tight profit margins that they are unable to invest in development. They are also in no financial position to negotiate with broadcasters.</p> <p>Multichannel television leads to 'me too' commissioning.</p> <p>There is a shortage of talent or a dearth of training within the television sector. This has led to a small pool of people with the ability to develop and/or produce factual programmes or write drama.</p> <p>The vulnerability of innovative programmes in the schedules due to competitive scheduling.</p>	<p>Investment in and commitment to research and development (by the independent sector and by broadcasters).</p> <p>Devolved commissioning (with commissioners controlling their own 'pot of money' and able to back their own hunches), within the overall channel strategy.</p> <p>A healthy independent sector in a position to negotiate with broadcasters.</p> <p>The 'right to fail' without subsequent professional or commercial punishment.</p> <p>Creative space to give new programmes the chance to succeed.</p> <p>Proactive broadcasters who spot and encourage new talent.</p> <p>A 'chain of trust' between the commissioner and the producer extending all the way to the contributor.</p> <p>A 'binary relationship' between the commissioner and the programme maker, allowing creative conversations.</p>

Serious and challenging programming

A.40 The Phase 1 report featured the following chart, renamed Figure 9.1 here, suggesting that it tended to be more challenging programming that suffers most in multichannel homes compared with its audience share in analogue homes. The implication of Figure 9.1 was that serious and challenging programming was destined to lose reach and impact in the digital age, reducing the rationale for its public funding.

A.41 To develop our analysis, we have considered three arguments in support of the future of serious and specialist programming. First, it can be argued that whatever the share difference in multichannel homes, these programmes still reach a very large audience. Second, over a given period of time the audience for a whole series of programmes could be even larger, and more diverse, than that for a single programme. Third, it has been suggested that the majority of the audience for this sort of content currently consists of terrestrial-only viewers and that existing multichannel homes never watched much of it even before they switched. The total audience will therefore be more stable during and after switchover than Figure 9.1 implies. We will address each of these points in turn.

Figure 9.1: The share difference of selected programmes in multichannel households compared with terrestrial analogue-only households



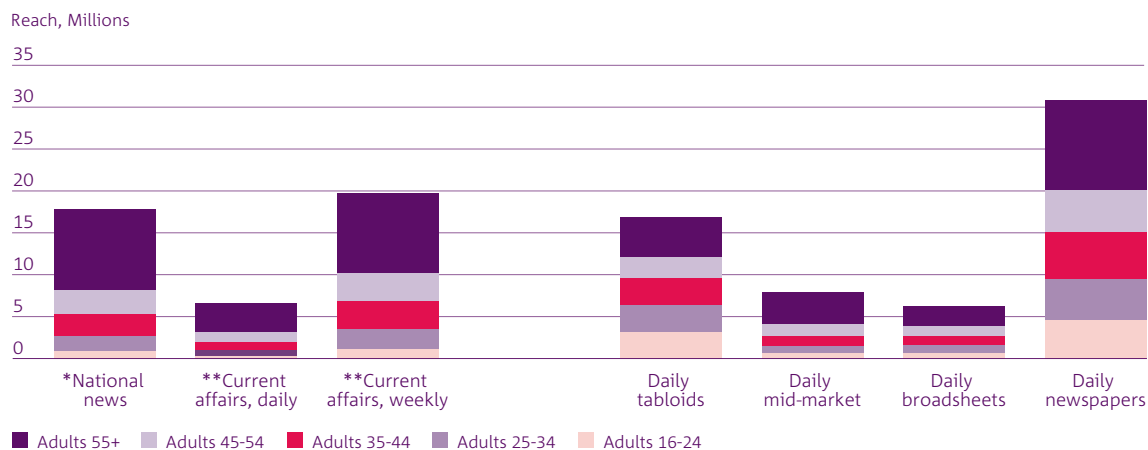
Source: BARB (Average series share)

Comparative daily reach

A.42 At headline level, the average daily reach of TV news at 18m is still much lower than the total daily reach of national newspapers. However, a more appropriate comparison, given the relatively serious editorial content of TV news and current affairs programming, is probably with broadsheet and mid-market papers, excluding tabloids. On this basis, TV news has a greater daily reach than broadsheet and mid-market newspapers combined. TV current affairs programming with a reach of 6.6m viewers, is marginally greater than the average total readership of all national daily broadsheet papers combined – 6.2m. Mid-market newspapers (*Daily Mail*, *Daily Express*) have a slightly greater daily reach, however, at 7.8m readers.

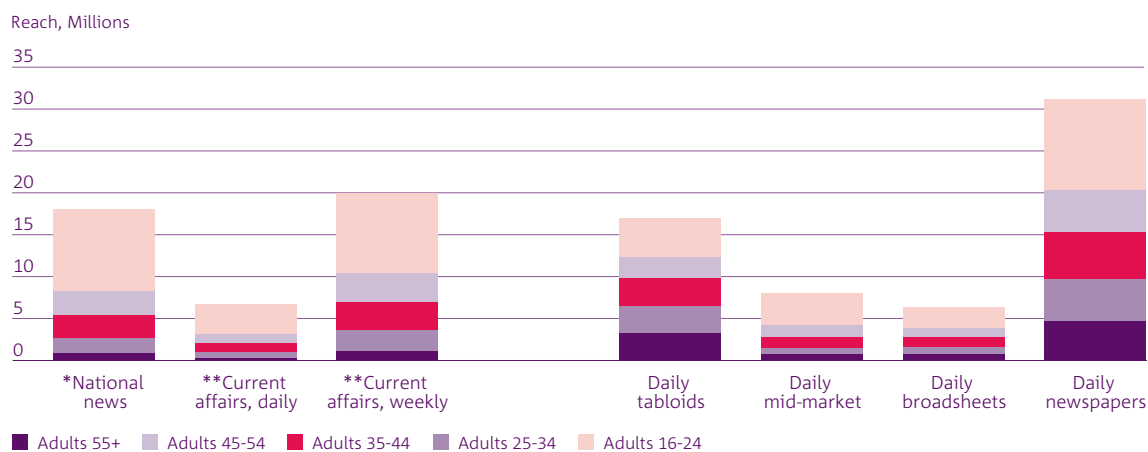
A.43 When audience profiles are examined in more detail, in Figure 9.2 and Figure 9.3, it becomes clear that newspapers are better at reaching younger audiences, while TV current affairs has a broader appeal across social classes. Broadsheet and mid-market newspapers both reach around 1.5m 16-34 year olds each day, compared to 1.0m viewers of current affairs in the same age group. But current affairs reaches an average of 3.4m C2DE viewers each day, compared to 0.7m broadsheet readers and 2.9m mid-market newspaper readers.

Figure 9.2: Audience profile by age – TV news and current affairs vs newspapers



Source: BARB March 2004, Terrestrial networks only/NRS 2003, The Advertising Statistics Yearbook 2004
 *National news: 5+ mins daily reach – BBC One Ten O’Clock News & Six O’Clock News, BBC Two Newsnight, ITV1 early and late evening bulletins, Channel 4 News, Five News (17:30 & 19:00)
 **Current affairs: Based on BARB definition current affairs pol/econ/soc. Daily reach: 5+ mins, weekly reach: 10+ mins

Figure 9.3: Audience profile by social class – TV news and current affairs vs newspapers



Source: BARB March 2004, Terrestrial networks only/NRS 2003, The Advertising Statistics Yearbook 2004
 *National news: 5+ mins daily reach – BBC One Ten O’Clock News & Six O’Clock News, BBC Two Newsnight, ITV1 early and late evening bulletins, Channel 4 News, Five News (17:30 & 19:00)
 **Current affairs: Based on BARB definition current affairs pol/econ/soc. Daily reach: 5+ mins, weekly reach: 10+ mins

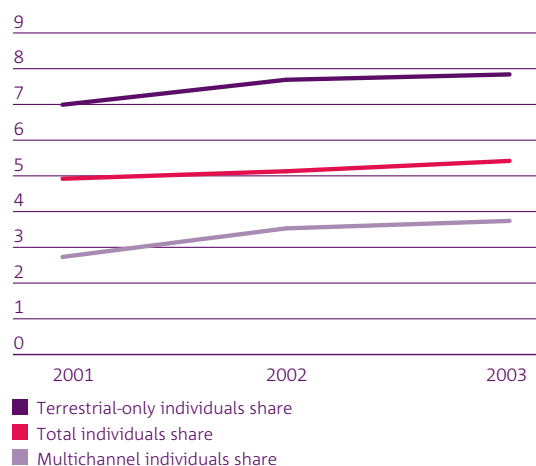
Reach across a series of programmes

- A.44 The two graphs, Figure 9.2 and Figure 9.3 illustrate the enormous daily reach of terrestrial TV news in comparison to both daily current affairs and daily quality newspaper readership. While the weekly reach of newspapers will also be higher than the daily reach, the weekly aggregate reach of current affairs programming is much higher than its equivalent daily reach. Current affairs TV programmes reach 19.8m viewers a week.
- A.45 The audiences for individual programmes also reflect this trend, showing that the reach of a whole series or week of programming can be significantly greater than that of any particular programme. For instance, only about 30 per cent of viewers of *Newsnight* in a sample week or the *South Bank Show* in a sample month watch two or more programmes. As a consequence, *Newsnight* alone reached around 5.5m people in total in the week we analysed and the *South Bank Show* reached over 8m in a sample month. Challenging programming on TV still has the capacity to reach very large numbers of people.

The effect of digital take-up

- A.46 Though Figure 9.1 implies a stark future for certain challenging PSB programming as the digital age draws nearer, we wanted to look further at the extent to which later adopters of digital TV would behave in the same fashion when given a greater range of channels to choose from as did earlier adopters. We wanted to investigate whether the behaviour of the most recent switchers gave us any reason to expect this to be true.
- A.47 We started by looking in detail at the recent trends in audience share of some of the more serious programmes. Although these programmes tended to lose overall share between 2001 and 2003 (as did most terrestrial programming), their decline was not always precipitous and they occasionally managed to increase audiences. Figure 9.4, for example, shows that *Correspondent's* audience share increased over the period 2001-03, in multichannel as well as terrestrial-only homes.
- A.48 More importantly, later switchers to digital TV might be less likely to avoid more serious and challenging programming than early switchers. It is not clear, therefore, that digital television will in future automatically continue to reduce the core audience for serious programming at the rates suggested by recent data. We wanted to find out whether there were discernible differences in the trends in audience shares of more popular and more serious programmes over the past three years.
- A.49 First we generated a prediction of the change in share from the difference in shares shown in Figure 9.1 and the growth of multichannel TV since 2001. Then we compared this prediction with the actual shares recorded by programmes. Figure 9.5 shows the results for some of the less challenging programmes and Figure 9.6 shows the results for a selection of more challenging programmes.

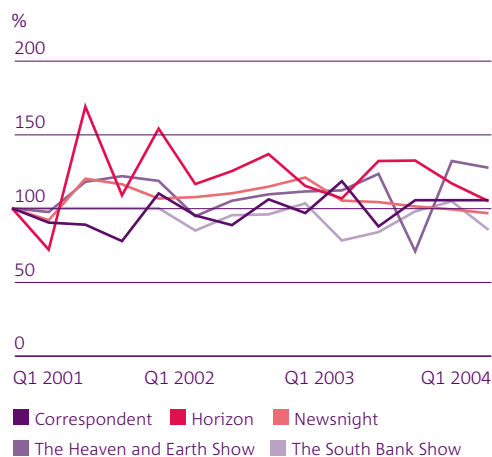
Figure 9.4: Audience share trends for Correspondent (2001-2003)



Source: BARB. Average annual figures.

Figure 9.6: The ratings performance of more challenging TV programmes

(Percentage difference between predicted and actual audience share for challenging programming)



Source: BARB

Figure 9.5: The ratings performance of less challenging TV programmes

(Percentage difference between predicted and actual audience share for less challenging programming)

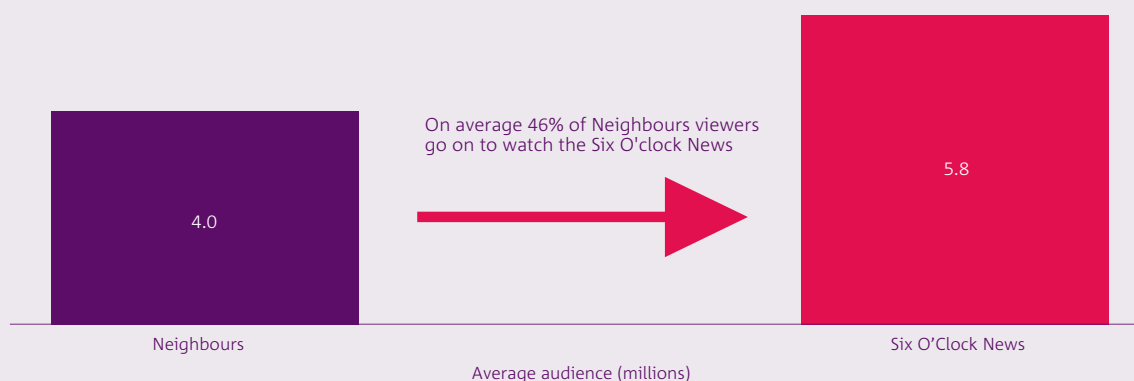


- A.50 Each graph shows the performance of each programme compared with the prediction. So, for example, *Horizon*, in Figure 9.6 performed better than the prediction in 2001, 2002 and 2003, but gradually lost share and by 2004 had an audience share of the size predicted using the 50 per cent share difference between analogue and multichannel homes and the growth of multichannel since 2001. The fact that *Horizon* ended the period close to its prediction implied that it did indeed lose share over the period as more households adopted digital.
- A.51 There is little discernible pattern in either of Figure 9.5 or Figure 9.6. Extending the analysis to a greater range of programmes, though not illustrated here, provides even less of a pattern. This is instructive, implying that there are few consistent trends in evidence between popular and more challenging programming. Considerable deviations in both directions implies that a wide range of factors other than digital take-up or the extent of serious/popular content determine a programme's audience share. Serious PSB programmes can still perform well if they are well-made, competitively scheduled and engaging.
- A.52 Taking this analysis alongside our findings on comparative audience size and reach, we conclude that some types of serious, specialist and challenging programming, given adequate support by broadcasters, may be able to remain more effective in a digital world than our Phase 1 findings implied.
- A.53 The justification for continued funding, however, depends on programme-makers finding effective ways to engage audiences. It then depends on broadcasters in general, and the BBC in particular, promoting and scheduling serious programming on channels which large numbers of people watch and at times that are convenient. Complacency in placing serious programming at the margins of the schedule will lead to a loss of reach and a gradual loss of the rationale for some of the underlying justification for PSB funding in the first place.
- Ratings-drivers**
- A.54 One issue of particular relevance to the BBC is whether programming which contributes little in itself to PSB purposes is still justifiable because it is able to introduce viewers to other, more serious programming. Our analysis in Phase 1 suggested that popular programmes were no longer successful in delivering large audiences to more serious and challenging programmes that followed. We wanted to examine a more subtle issue about the 'inheritance' effect in Phase 2. We took the example of *Neighbours*, an imported drama without any obvious PSB purposes or characteristics, in order to examine whether the types of viewers *Neighbours* attracts were kept by the *Six O'Clock News* that follows it.
- A.55 Box 9.1 shows the results of this analysis in detail; it shows that *Neighbours* is not successful in creating a large inheritance effect for the *Six O'Clock News* either in numbers or in the type of viewer. The majority of younger *Neighbours* viewers go in search of alternative entertainment as soon as the programme finishes. Indeed, on the contrary, it seems more likely that the news may increase the audience for *Neighbours*, bringing in older viewers who might otherwise not be watching.
- A.56 Further analysis of a wider range of programming would be needed before we can be confident of the general applications of this finding. It seems likely, though, that it will be increasingly difficult for broadcasters to use a very popular 'commercial' programme in a crude way to lead viewers to an immediately adjacent more 'serious' programme unless the serious programme is more carefully designed to engage with the audience group concerned.
- A.57 The wider implications for the future of PSB channels are mixed. The potential for schedules to provide any of the so-called 'serendipity effect' will be negligible in future if viewers simply turn away from PSB programmes they have not actively chosen to watch. The challenge for PSB channels in future will be to find better ways of exploiting audiences' loyalty to popular programmes – through cleverer scheduling and cross-promotion of more serious content.

Box 9.1: The Neighbours effect on the Six O'Clock News

At first glance, it looks as if *Neighbours* might raise the audience of the *Six O'Clock News*. Figure 9.7 shows BBC One performs strongly in the half-hour *Neighbours* is shown (5.30pm to 6pm) and in the half hour of the news programme, and almost half of *Neighbours* viewers go on to watch the news.

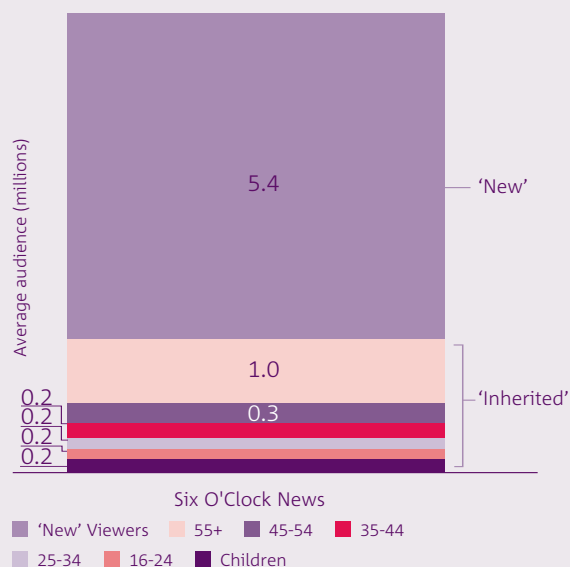
Figure 9.7: Programme inheritance, sample week, BBC One 17.30 to 18.30



Source: BARB

The news, however, in peak time, gets a larger total audience than *Neighbours*, and the viewers inherited make up only 32 per cent of the audience for the news. Figure 9.8 illustrates their demographic make-up.

Figure 9.8: Audience breakdown for inherited vs new viewers, Six O'clock News



Source: BARB, 2003

It is older viewers who make up an overwhelming percentage of the inherited audience, and older viewers who make up the majority of the audience for the news, as Figure 9.9 shows.

Figure 9.10 reveals that younger *Neighbours* viewers turn away at 6pm and switch over to entertainment programming on BBC Two, Channel 4 and Five.

Figure 9.9: Channel profile for BBC One, weekdays

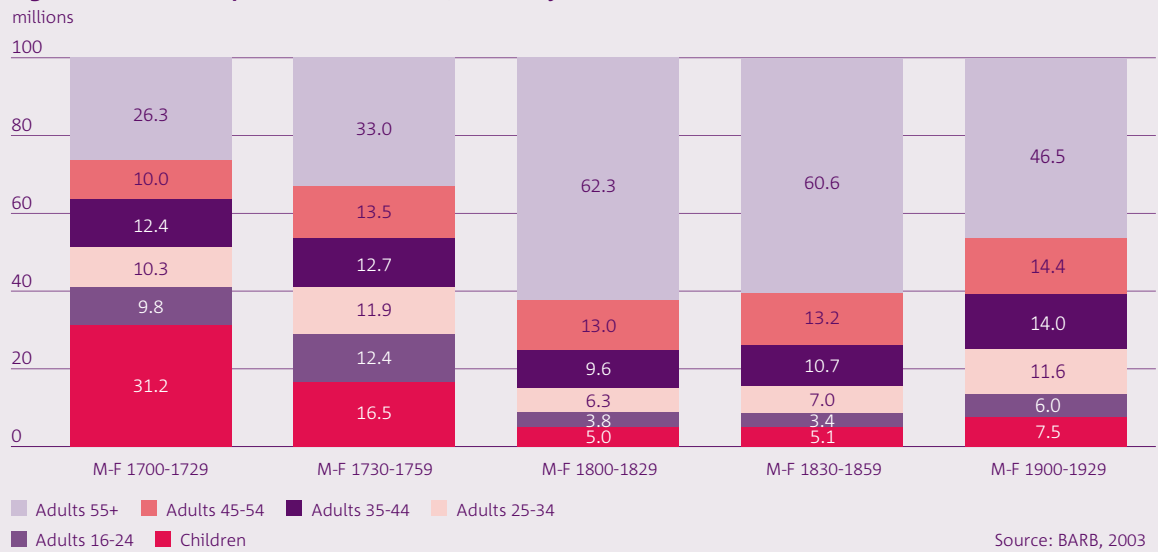
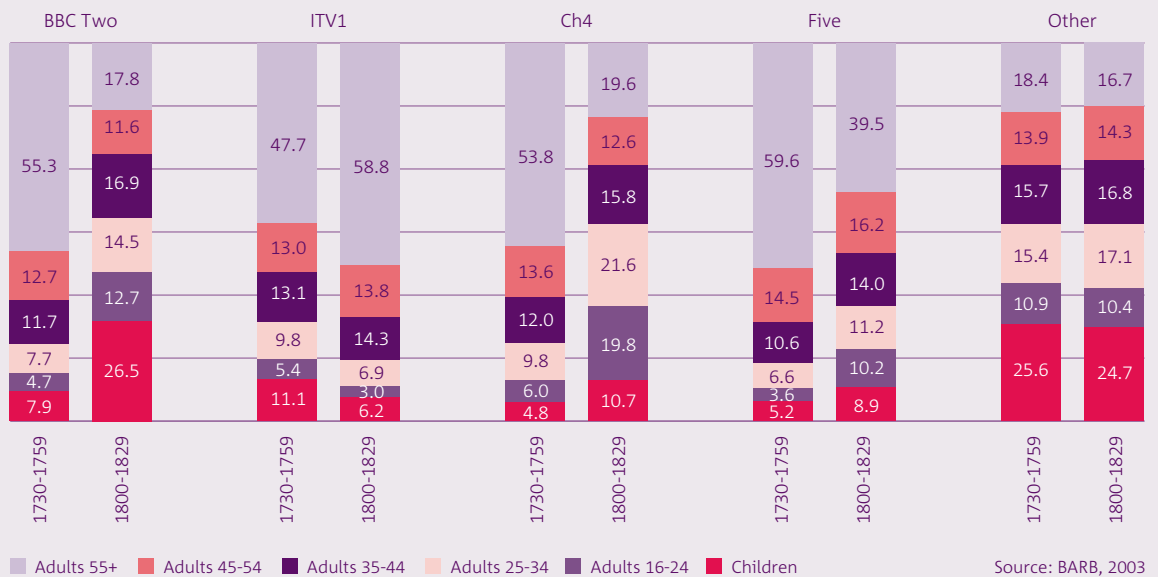


Figure 9.10: Other channel profiles, weekdays



Little inheritance effect can be deduced, therefore, from *Neighbours* to the *Six O'Clock News*. If *Neighbours* contributes in any way to PSB purposes, it does not do so through the inheritance effect.

Assessing reach and impact

A.58 When we say that PSB needs to have reach and impact, we do not mean that every PSB programme needs to bring in a large audience every time. The reach and impact of some types of specialist programming can be much more significant than individual audience figures suggest. Where programmes can be shown to be achieving results in this way, they should remain an important part of PSB provision in future. Where they cannot, or where programmes do not contribute to PSB purposes and characteristics, there is little justification for public funding.

A safe environment for children

A.59 In response to our Phase 1 findings and also in the context of wider public and political concern over the content of pre-watershed programming we are carrying out further analysis to inform Ofcom's Content Board as they consider this issue.

A.60 There are a number of different strands to our research analysis:

- an examination of the terrestrial schedules between 5pm and 9pm, and between 7pm and 9pm where relevant, to see whether genre diversity has narrowed over the past eight years;
- interviews with industry practitioners to gather views on the issues at stake. In addition, we are grateful to the broadcasters who held a seminar in early summer to discuss soap opera, and who fed back to us their points;
- further review of our Phase 1 questionnaire to examine responses of parents, soap fans, etc;
- qualitative research which addresses two main questions. First, is the concern about a safe viewing environment specific to television or one related to media consumption and daily life more generally? Second, what do viewers think should be the appropriate regulatory or broadcaster response (if any) once they are taken through the options and their consequences?; and
- further quantitative survey to focus on the extent to which pre-watershed content is appropriate for children.

A.61 In other words, in this qualitative commission we are seeking to frame any viewer concern about TV content within the context of society and other media. Groups of parents (and non-parents) will be divided into soap fans and non-fans, and we shall also be talking to 14-18 year olds about their own views of the appropriateness of the content – for themselves and for their younger siblings. Groups will be convened across the UK, and the findings will be presented to the Content Board in the autumn.

A.62 A decision will then be made about the next steps necessary in examining this issue.

A new regulatory framework

A.63 Our Phase 1 document suggested that our more flexible approach should be arranged around the purposes and characteristics we have defined for PSB. Our consultation exercise has revealed that while few people support the old system of box ticking, many in the industry retain significant concerns about the potential efficacy of a different approach, particularly for commercial broadcasters. The work to develop a new model is still in progress, but this section sets out in more detail how it might work.

The aims of a new approach

A.64 Quotas are easy to measure in quantitative terms but do not always provide the best insights into the quality of PSB programming. The aim of a new system would be to offer a more flexible approach to measurement, using a range of tracking and measurement techniques based on the three-layered system of assessment we used in Phase 1 of this review:

- **output:** what are PSB channels providing?
- **reach/impact:** are viewers watching?
- **value:** do audiences appreciate what they watch?

A.65 Elements of each are already in use, by Ofcom and/or by the broadcasters. But a more coherent approach is desirable.

A.66 Key aims for measurement tools in the future include:

- any proposed changes to existing forms of measurement should be proportionate, cost-effective, and non-burdensome;
- a framework of different measures ought to create a common, core set of benchmarks for success, sensitive to particular channel and audience needs and requirements;

- no one measure of PSB should be dominant. Rather, a series of interlinked tools should all contribute to the measurement currency; and
- while commercial confidentiality will be respected, it is to be hoped that over time, access to research can be widened, so that greater knowledge of programme tastes and viewing habits is more readily available, for instance to the independent and academic sectors.

A.67 How would a new system differ from what we have now? It would:

- develop a consistent and coherent set of data across the industry;
- place more emphasis on the level of investment broadcasters make in programming;
- track audience perceptions and opinions; and
- allow industry expert/peer review to replace subjective or discretionary judgements by the regulator.

Different tiers of regulation

A.68 We will retain a relatively limited tier of concrete quotas and targets where these can usefully be set. At Tier 2 of the Communications Act framework we have a statutory requirement to measure performance in such terms (for example, for UK original production and the provision of news and current affairs). These quotas are an effective means of regulating a minimum floor of PSB provision.

A.69 Beyond Tier 2, we will put together a wider set of information to track broadcasters' performance against key PSB purposes. To do so we will use the output-impact-value model, and our aim will be to use no more than three or four measures for each element to assess performance against each of the purposes and characteristics we have set out. The

aim is to assess PSB delivery in the round and by each broadcaster at a relatively high level. For example, we should be interested in trends in the provision of range and diversity rather than whether an individual programme should be classified as ‘PSB’. We should be interested in audience perceptions and satisfaction in, for example, levels of innovation, not necessarily in whether ‘x’ hours of new programming was scheduled in peak viewing hours during the year.

- A.70 In terms of **output**, that will mean assessing the hours of programming in different genres, its scheduling in different day-parts and the amount of investment put into it. The limitations of strict genre definitions can be mitigated by adopting a new, more flexible cross-genre system.
- A.71 Impact can be measured by analysing audience share and reach and tracking how memorable and stimulating programming is from viewers’ perspectives.
- A.72 Value could be assessed through tracking studies of audience appreciation, peer review and analysis of cost per viewer hour. We are currently working with broadcasters to investigate the practicality of such an approach.

The scope of the new model

- A.73 The new model can most easily be used to establish a creative dialogue with not-for-profit PSB broadcasters – the BBC and Channel 4 – for whom there are no conflicting motives. In future, particularly post-switchover, the regulatory burden on ITV1 and Five will have to be eased, and it may be more realistic to rely on a smaller number of firm quotas and targets. However, in the period running up to switchover we will need to adopt the output-impact-value model to Tier 3 regulation of all designated PSB channels. Consultation with the broadcasters is continuing, but we aim to keep the system as streamlined and focused as possible.
- A.74 In time, we hope that the information collected in the course of regulation will also be sufficient to form the evidence base for future Ofcom PSB reviews as well as a wider range of research and analysis in the broadcasting sector.

The future of Teletext

- A.75 The Communications Act requires us to evaluate the ‘public teletext provider’ as part of the PSB review. The public teletext licence is currently held by Teletext Limited (‘Teletext’). We focus here on thinking about the role of the public teletext service in the transition to the digital age. For more information on the background to Teletext’s role as a public service broadcaster, see Box 9.2.
- A.76 Looking to the future, however, we recognise that the main challenges are likely to relate to the future of the digital teletext service. Consequently, our proposals for Teletext focus primarily on the role of the digital service.
- A.77 The move to the digital world brings with it both new opportunities and challenges for Teletext. The company has highlighted that it may face pressures due to a lack of capacity on the DTT platform, especially if Teletext were to receive less capacity after digital switchover.

Box 9.2 : The role of Teletext as a public service broadcaster

Teletext Limited currently operates services across all television platforms (analogue terrestrial, DTT, DSAT and Digital Cable). However, only the 'PSB' services are relevant for this review. Specifically, the PSB requirements on Teletext relate only to the analogue terrestrial services on ITV1 and C4/S4C, and the main Teletext and TV listings services on the DTT platform. These are the services which will be covered by the Digital Replacement licence issued to Teletext, and are also the services relevant to the PSB review and to the discussions on digital switchover.

Teletext's overall public service remit is set out in the Communications Act. The Act requires the public teletext services to provide a range of high quality and diverse text material. It specifies that there will be an analogue public teletext service and a digital public teletext service, and that the public teletext service must fulfil its remits on both of these services. In addition, the Act also refers to the requirement for news provision and regional obligations for the public teletext service.

A number of more specific requirements – characterised in terms of main pages in specific areas – are set out in Teletext's current broadcasting licence. Ofcom's ongoing monitoring of performance against these licence obligations shows that Teletext has met – and in most cases has exceeded – its licence obligations. Overall, the licence requires 319 main pages in particular areas; Teletext has actually provided 499 pages in these areas.

As such, we believe that Teletext has met its remit, and has therefore played a useful role in delivering PSB purposes on the analogue and digital services – particularly in relation to the delivery of news, information and regional content.

A.78 We put forward three proposals:

- In order to maintain the digital public teletext service in a sustainable form **after switchover**, we will seek to ensure that it will have the same capacity available as is available now.
- **Prior to switchover**, we will ensure that the digital replacement licence reflects the limited capacity available by giving Teletext greater flexibility to meet its public service obligations – that may mean fewer specific page requirements, for example.
- Teletext should also be granted greater flexibility in the definitions of its obligations on its analogue teletext service prior to switchover.

A.79 These recommendations will offer Teletext greater flexibility of operation on both its analogue and digital services. But, in accordance with the Communications Act, Teletext will still be required to ensure that its services contribute to PSB purposes and characteristics by providing a service equivalent in all material respects to that provided today. Ofcom will pursue further discussions with Teletext to take these proposals forward in the context of the digital replacement licence process.



Annex B: Regulatory impact assessment

10

Annex B: Regulatory impact assessment

- B.1 The analysis presented in this Section represents a Regulatory Impact Assessment (RIA), as defined by Section 7 of the Communications Act 2003. You should send any comments on this RIA to us by the closing date for this consultation. We will consider all comments before deciding whether to implement our proposals.
- B.2 RIAs provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making and are commonly used by other regulators. This is reflected in Section 7 of the Act, which means that generally we have to carry out RIAs where our proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. In accordance with Section 7 of the Act, in producing the RIA in this document Ofcom has had regard to such general guidance as it considers appropriate, including related Cabinet Office guidance.

Policy Objective

- B.3 The Communications Act requires Ofcom to review the effectiveness of public service television broadcasting, and to report on how it can be maintained and strengthened. This report represents the output from the second phase of the review, and sets out our key policy proposals for maintaining and strengthening PSB.
- B.4 Before discussing the policy options we have considered in developing our proposals, it is worth noting that our policy objective can be framed specifically in terms of the purposes and characteristics of public service television broadcasting. Following responses to our Phase 1 consultation document, we believe that these purposes are:

- **to inform ourselves and others and to increase our understanding of the world** through news, information and analysis of current events and ideas;
- **to stimulate our interest in and knowledge of arts, science, history and other topics** through content that is accessible and can encourage informal learning;
- **to reflect and strengthen our cultural identity** through original programming at UK, national and regional level, on occasion bringing audiences together for shared experiences; and
- **to make us aware of different cultures and alternative viewpoints**, through programmes that reflect the lives of other people and other communities, both within the UK and elsewhere.

- B.5 We believe that PSB programmes should have distinctive characteristics. They are:

- **high quality:** well-funded and well-produced;
- **original:** new UK content, rather than repeats or acquisitions;
- **innovative:** breaking new ideas or re-inventing exciting approaches, rather than copying old ones;
- **challenging:** making viewers think;
- **engaging:** remaining accessible and attractive to viewers; and
- **widely available:** if content is publicly funded, a large majority of citizens need to be given the chance to watch it.

- B.6 Our objective is to secure the purposes and characteristics of PSB set out above. In addition, we have sought to develop proposals which reflect the least intrusive intervention necessary to meet these goals, in terms of cost and market impact.

Risk assessment

B.7 A wide-ranging review of the PSB intervention is necessary, not least because the rapidly changing broadcasting environment is creating new challenges for the provision of public service television broadcasting. The move towards the fully-digital world will result in a decline in the value of the analogue spectrum, and so will reduce the commitment of commercial broadcasters to delivering PSB. There is a risk that – if no changes are made to policy regarding PSB – the provision of PSB might decline as we move closer to digital switchover. This would result in an outcome that is not consistent with our objective of maintaining and strengthening PSB.

Our approach to the review of policy options

B.8 This section sets out the main policy options we have considered in the light of the above. It is important to note, however, that we have not included a detailed assessment of all of these options within this section. This is primarily because Ofcom's work programme in Phase 2 of the PSB review has reviewed all possible policy options in detail – and so this document in its entirety can be viewed as comprising a detailed review of policy options and a regulatory impact assessment. To this end, the discussion below necessarily makes reference to other sections in this report where the issues are discussed in more detail. The reader is therefore advised that this RIA should be read in conjunction with the other sections of the report. In addition, it should be noted that some of the policy options will be explored in more detail in Phase 3 of the PSB review.

B.9 Our regulatory impact assessment required a three-stage decision-making process.

B.10 First, we considered whether to intervene or not because the market will provide the purposes of PSB.

B.11 Second, if we were to conclude that at least some PSB intervention needs to be retained, then we needed to consider the following options for PSB intervention:

- meet PSB objectives through one institution only (the BBC); and
- secure plurality of PSB provision through institution(s) additional to the BBC.

B.12 Third, if plurality is considered important, we needed to assess the options for securing plurality.

B.13 We considered options at each stage in turn.

Stage 1: The scale and scope of the PSB intervention

B.14 The primary consideration concerns the extent to which the market would provide the purposes of PSB in the absence of intervention. Our analysis in Section 4 of the main report is relevant to this issue. In that section, we showed that a 'no intervention' option would impose both costs and benefits. While it has not been possible to quantify these in detail, our view was that the costs are likely to exceed the benefits, and so no intervention is justified. Specifically:

- the main benefit of a no intervention option would be the money saved in funding the PSB intervention. As we show in Section 3, the overall PSB intervention costs around £3bn per annum;
- but intervention on the current scale broadly secures the provision of a range and diversity of high-quality services: our international comparisons suggest that the high cost of the PSB intervention allows the UK to benefit from a relatively high level of original production and output of TV which contributes to PSB purposes;
- the public funding of UK PSB does not seem to generate a significant negative impact on private income sources for mainstream TV services. Therefore, the costs of any 'crowding out' appear minimal; and

- our audience research shows that the public agrees that the current level of PSB funding is broadly appropriate.

B.15 On this basis, we rejected the option of rolling back the PSB intervention significantly, and concluded that society should fund PSB broadly to the same level as today. This would require replacement funding in future because the implicit subsidies provided by access to scarce analogue spectrum will decline with the move to the fully digital world.

Stage 2: Do we need plurality in PSB provision?

B.16 Having examined the scope of the PSB intervention, the second stage of our assessment required a consideration of whether institutions other than the BBC should deliver PSB. Our view was that plurality of PSB provision was important, but could only be justified if the benefits of plurality outweighed the costs associated with the increased complication that plurality would bring.

B.17 We discussed these issues in detail in Section 5, where we noted that the potential benefits of a situation in which the BBC received sole funding, were:

- unnecessary duplication in PSB programming would be eliminated;
- competition for quality could be maintained because BBC programmes and channels would compete with each other; and
- for many types of programmes, there is effective competition between the BBC and unsubsidised PSB providers – in popular drama, for example, the competition for viewers is likely to ensure that standards on both the BBC and on ITV1 remain high.

B.18 But set against these possible benefits, we have collected significant evidence from industry practitioners, audiences and the BBC³⁹ to support the counter-view that a BBC near-monopoly would damage PSB:

- a plurality of providers contributing to PSB purposes is necessary to create competition for quality in broadcasting. In recent years, for example, the scale and scope of arts and history programming on commercial PSB channels has helped to focus the BBC on improving its own provision. If competition for quality programming which contributed to PSB purposes did not exist, pressure on the BBC to raise its game would be reduced;
- a plurality of PSB providers prevents any single institution becoming the monopoly arbiter of taste or opinion in any one area of programming;
- plurality allows benchmarking exercises between similar distributors to compare how well they are meeting PSB purposes and their respective value for money;
- if many channels are producing quality programming which reflects PSB purposes and characteristics, it is more likely that it will remain a core part of broadcasters' schedules and prevent challenging programming from being marginalised in schedules;
- different broadcasters are able to reach a wider range of viewers in different demographic and socio-economic groups. There is every reason to expect that in the digital age, the reach of PSB programming would be higher if it were distributed by a range of suppliers; and
- similarly, different TV channels provide content attractive to different audiences, even within the same genres. Channel 4's approach to current affairs or Five's arts programming are distinctive from that which the BBC provides.

39 The BBC said: "We understand the arguments in favour of plurality in public service programming, and strongly support the ongoing contribution of ITV1, Channel 4 and Five as investors in high-quality British programming across a wide range of genres." *Building public Value: Renewing the BBC for a digital world*, June 2004.

B.19 Overall, we concluded that the benefits of plurality of PSB provision outweighed the costs. Competition for viewers without competition in the supply of PSB content was unlikely to encourage the best possible PSB programming on the BBC. There was little evidence to suggest that the existence of more than one PSB provider has resulted in the duplication of content in any genre. Even in news, each TV channel has targeted a different audience with a different editorial approach. The risk of leaving subsidised PSB provision to the BBC alone would be great; a lack of competition in broadcasting PSB programming risks leading to complacency, inefficient production, lack of innovation, lower quality programming, a narrowing of perspectives and the loss of PSB programming for certain groups.

B.20 On this basis, we rejected the option of providing PSB solely through the BBC, and concluded that plurality of PSB provision should continue to be secured.

Stage 3: What is the best way of securing plurality?

B.21 We identified three broad groups of options for securing plurality of PSB provision as we move into the digital age. These groups are:

- a fully contestable PSB fund, often termed either an Arts Council of the Air, or a Public Broadcasting Authority;
- direct payments to existing PSB institutions, such as Channel 4; and
- competition between prospective PSB providers for long-term funding.

B.22 These alternatives were discussed in more detail in Section 5, where we considered the advantages and disadvantages of each option in detail.

B.23 In our view, there was significant potential for a new service to contribute to PSB purposes in the digital age. It would give the UK plurality in PSB provision and would not place a long-term bureaucratic burden on PSB content.

B.24 Our discussion in Section 6 concluded that the creation of a new service would be likely to generate greater benefit than direct funding of Channel 4 or the creation of a contestable fund, but with fewer costs incurred. More detail regarding the creation and potential role of a PSP (Public Service Publisher) is set out in Section 6 of this report. At this stage, we are not in a position to carry out a detailed review of the possible market impact of the new service: proposals for a PSP are at a relatively early stage, and we will work to assess this option in more detail over the next three months. However, we are able to note that, since we do not envisage the total amount of PSB funding to increase following the creation of a PSP, and we want the PSP to fill a gap left by the market in contributing to PSP purposes. We expect that the overall market impact of the future PSB intervention (after the new service was created) would not exceed that associated with the current intervention.



Annex C: Consultation principles

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Annex C: Ofcom's consultation principles

There are seven principles which we will follow for each written consultation.

Before the consultation

1. Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

2. We will be clear about who we are consulting, why, on what questions and for how long.
3. We will make the consultation document as short and as simple as possible, with a summary of no more than two pages. We will try to make it as easy as possible for respondents to give us a written response. If the consultation is complicated, we may provide a shortened version for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.
4. We will normally allow ten weeks for responses, other than on dispute resolution.
5. There will be a person within Ofcom who will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. This individual (who we call the consultation champion) will also be the main person to contact with views on the way we run our consultations.
6. If we are not able to follow one of these principles, we will explain why. This may be because a particular issue is urgent. If we need to reduce the amount of time we have set aside for a consultation, we will let those concerned know beforehand that this is a 'red flag consultation' which needs their urgent attention.

After the consultation

7. We will look at each response carefully and with an open mind. We will give reasons for our decisions and will give an account of how the views of those concerned helped to shape those decisions. We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish on our website all of the responses we have received. We would prefer for people and organisations to give us views which they would be happy to see in public. However, if those who have responded to a consultation tell us that some or all of their views must stay confidential, we will respect this.

We will also:

- list these seven principles in every consultation document that we publish;
- run a consultation helpdesk – to help organisations such as small businesses and consumer and community groups make their views heard in response to our consultations; for more details contact Philip Rutnam on 020 7981 3585, and;
- keep a table on our website at www.ofcom.org.uk listing all current consultations, those recently closed and (as far as possible) those we are planning in the near future. The table will include a brief summary of each document.



Annex D: Consultation
response cover sheet

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Annex D: Consultation response cover sheet

In the interests of transparency, we will publish all consultation responses in full on our website, www.ofcom.org.uk, as soon as possible after the consultation period has ended, unless a respondent specifies that all or part of their response is confidential. We will also refer to the contents of a response when explaining our decision, unless we are asked not to.

We have produced a cover sheet for responses (see next page). Please send one with your response as this will speed up our processing of responses and, if you wish it, enable you to indicate clearly any confidential material that you do not want us to publish. We will keep your completed cover sheets confidential.

We strongly prefer to receive responses in the form of a **Microsoft Word attachment to an email**. Our website therefore includes an electronic copy of this cover sheet, which you can download from the 'Consultations' section of our website.

Please put any confidential parts of your response in a separate annex, so that they are clearly identified. This can include information such as your personal background and experience. If you want your name, contact details, or job title to remain confidential, please provide them in your cover sheet only so that we don't have to remove them from your response.

Ofcom consultation response cover sheet

Basic details

Consultation title: Review of public service broadcasting: Phase 2

To (Ofcom contact): _____

Your name: _____

Representing (self or organisation/s): _____

Address (if not received by email): _____

Confidentiality

What do you want Ofcom to keep confidential?

Nothing ☐

Name/contact details/job title ☐

Whole response ☐

Organisation ☐

Part of the response ☐

If there is no separate annex, which parts?

If you want part of your response, your name or your organisation to be confidential, may Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

Yes ☐ No ☐

Declaration

I confirm that the correspondence supplied with this cover sheet is a formal consultation response. It can be published in full on Ofcom's website, unless otherwise specified on this cover sheet. If I have sent my response by email, Ofcom can disregard any standard email text about not disclosing email contents and attachments.

Name _____ Signed (if hard copy) _____

