



# Channel 4 Financial Review

Statement

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## Section 1

# Executive summary

- 1.1 On 4 April 2007, we published the first phase of Ofcom's financial review of Channel 4, which comprised LEK's assessment of the Channel 4 Group's future financial prospects, Channel 4's submission on its public service contribution and our own analysis of Channel 4's remit delivery. We also published a Foreword to these reports which set out possible options for next steps in the review.
- 1.2 This statement sets out our view of the implications of these reports for the Group's funding and operating model, and for regulatory and Government policy. It also confirms what we intend to do next to address the issues raised.
- 1.3 In the most likely scenarios, LEK's analysis of Channel 4's business model points to declining profits from 2008 onwards. However in these scenarios Channel 4's cash reserves are more than sufficient to ensure the survival of the core channel until at least 2010, fluctuations in working capital notwithstanding. In more positive scenarios, LEK's analysis indicates that Channel 4's business model may be able to deliver stable profits and growing cash balances throughout the period to 2012. This suggests that in LEK's projections there are unlikely to be immediate, intractable financial pressures that would require Channel 4 to make significant reductions in its remit delivery before around 2010.
- 1.4 From 2010 onwards, LEK suggests that financial pressures on the core channel are likely to grow. The timing and extent of the pressures cannot be predicted with certainty. However, if the programme mix remains unchanged, LEK's analysis suggests that Channel 4's commercial performance is likely to deteriorate, as a result of increasing competition for its most profitable programmes, and some ongoing inflation in other programme costs at a time of flat or declining advertising revenues.
- 1.5 The Group's digital-only channels, new commercial investments and cost-cutting measures should help to reduce deficits on the core channel. But LEK's analysis suggests that they will not offset them entirely, resulting in the Group moving into deficit after 2010 (in LEK's central, most likely case).
- 1.6 The central question for Ofcom is what impact this might have on Channel 4's contribution to public service broadcasting (PSB). Our analysis indicates that Channel 4 has changed the way it delivers its remit over time, although it continues to deliver the quantifiable elements of its remit, and consistently meets or exceeds its licence obligations. Channel 4 suggests that changes have been necessary to maintain the channel's impact in a more competitive environment, but overall they have also had the effect of improving its commercial position by reducing the cost of less profitable elements of its schedule. Recent changes in Channel 4's output include an increase in hours of current affairs in peak, but a shift from serious factual programming to more accessible and commercial educational output, and reduced spend on programmes in some core PSB genres – news, arts, current affairs and religion. Over the same period, Channel 4's spend on acquired programmes has increased, partly as a result of increasing competition for those programmes, and its hours of originated programming have declined by 6% since 2001.
- 1.7 We invited stakeholders to submit evidence to inform our assessment of LEK's report and our remit analysis. Over 120 individuals and organisations provided responses.

We have considered these contributions, which make a number of important points. Various, stakeholders argue that:

- Channel 4 makes an essential and distinctive contribution to PSB, the independent production sector and the wider creative economy, and short-term and long-term measures to safeguard its contribution should be considered immediately;
- Channel 4's position in the market is stronger than LEK's analysis suggests, and there are self-help steps Channel 4 can take to shore up its financial performance. Therefore LEK's report does not indicate a need for immediate action, and may be too pessimistic about its longer-term prospects;
- The assumption that we asked Channel 4 and LEK to base their forecasts on, that Channel 4's programme mix remains unchanged, does not reflect the way Channel 4 would respond to financial pressures in practice. In reality Channel 4 has frequently adapted the way it delivers its remit over the years, and can continue to do so if it does face financial pressures in future;
- Even if Channel 4's funding model will be fundamentally weakened at some point in future, the correct response is to review Channel 4's role and strategy in the light of broader public service broadcasting objectives, rather than moving immediately to consider options for intervening to prop up its funding model;
- With respect to possible measures to support Channel 4, some advocated allowing Channel 4 to produce some programming in-house while others argued strongly against it; and
- The evidence published in Ofcom's report on Channel 4's remit delivery raises concerns about the governance and accountability arrangements for Channel 4.

1.8 Channel 4, in its public response to the first phase of the review, supports much of LEK's report, but argues that the extent and timing of financial pressures will be closer to LEK's low case than its central case, based on market trends and Channel 4's financial performance in 2007 to date. It says it will continue to look at all sensible self-help measures but disputes that significant further cost reductions can be made, without a consequent impact on Channel 4's public service contribution, commercial performance or ability to invest in new businesses that will establish future profit streams.

1.9 We agree that there is significant uncertainty about the future, both with respect to Channel 4's financial performance and the options open to it to change its programme mix and strategy in response to changing financial circumstances. We note that LEK believes that cost savings can be made, and consider that in the face of a declining business model any organisation would carefully examine all possible ways of improving efficiency. However we recognise that LEK's analysis suggests that cost savings will not be sufficient to relieve the growing financial pressures on Channel 4 over the next few years.

1.10 We also recognise that changes in the way Channel 4 delivers its remit in response to changing financial circumstances are not inherently problematic. Indeed it is a strength of Channel 4's remit, funding and operating model and regulatory regime that it is possible for the channel to make such changes from year to year. There are three factors, however, that give us cause for concern.

- 1.11 The first is that LEK's analysis describes a period of sustained and significant financial pressure, which results in Channel 4's above-average profits – which have historically funded its uncommercial programming, including much of its remit programming – being largely competed away. We agree that this is not the only plausible scenario – Oliver & Ohlbaum's work for the BBC provides another, more optimistic one. However, there are also plausible scenarios that are more negative than LEK's central case, including the scenario prepared by Channel 4 itself. We believe it would be wrong to discount entirely the possibility that significant financial problems could emerge that would affect Channel 4's ability to deliver its remit within the timeframe covered by LEK's forecasts.
- 1.12 Secondly, the most likely outcome of sustained financial pressure would be reduced investment in programming and other activity that supports Channel 4's delivery of its remit. In the long run this could have a significant impact on Channel 4's contribution to public service broadcasting. Channel 4 has a certain amount of leeway to change the way it delivers its remit without necessarily undermining its overall PSB contribution. However, recent changes in the way Channel 4 delivers its remit, which have taken place at a time of commercial health for the channel, have already acted to reduce its investment or output in some core PSB genres. Channel 4 has already indicated that its response to financial pressure will be further reductions in its PSB output.
- 1.13 Our third concern is that it is difficult currently to assess effectively the impact of changes in Channel 4's programme mix on its overall PSB contribution. Channel 4's remit is defined relatively loosely, enabling it to interpret the remit in ways that change as its audiences' needs and its financial circumstances change. However, as we noted in our report on remit delivery, at present we believe there is no framework that fully allows us or Channel 4 to measure the impact of changes in the way it interprets and delivers its remit on public purposes.
- 1.14 Based on the evidence provided by LEK, Channel 4, stakeholders' submissions and our analysis of remit delivery, our considered position is as follows:
- It is reasonably likely that Channel 4 will face increased financial pressures in the medium-term;
  - These pressures are likely to result in renewed pressure on its remit delivery from around 2010;
  - Over time, this pressure could significantly weaken Channel 4's overall contribution to the purposes of public service broadcasting; and
  - In this context, the current monitoring and reporting framework should be significantly developed to measure fully Channel 4's overall PSB contribution, to assess the impact of particular changes to its programme mix on that overall contribution and to report on these assessments.
- 1.15 When we published the first phase of the review in April, we set out four options for our next steps:
1. To recommend that further public support for Channel 4 should be ruled out for the foreseeable future;

2. To monitor Channel 4's financial performance and remit delivery closely, and review the case for future intervention again as and when there is more evidence available;
  3. To consider what limited 'safety net' measures could be put in place to mitigate this and any medium term risk, and review potential options for more significant intervention at a later date; or
  4. To move directly to make a detailed assessment of the options for intervention.
- 1.16 In the first PSB Review, we stated that a not-for-profit, commercially funded Channel 4 would be an important part of the PSB landscape, and should remain so up to switchover and beyond. The Government's White Paper on the future of the BBC also restated its support for Channel 4's public service role and welcomed Channel 4's moves to strengthen its commitment to providing high quality, diverse public service content across an increasing range of channels and platforms.
- 1.17 In this context, we believe the analysis set out above rules out the first of our options. It is likely that challenges to Channel 4's funding and operating model will grow in the medium-term, and that these could pose a risk to its delivery of public purposes. In order to inform the Government's long-term decision-making with respect to public service broadcasting, we should consider whether those public purposes will remain valid as we move into a digital era. If they do, we should consider all possible options for ensuring they continue to be met, whether by Channel 4 or by some other means.
- 1.18 Nor do we believe that our fourth option is appropriate. LEK's evidence suggests that the threats to Channel 4's PSB contribution are not immediate, and there is no need to act precipitately or without fully considering all the options. Indeed, given that many of the measures would be for Government to take forward, and would require primary legislation, it is not clear that it would be possible to introduce major structural reform quickly.
- 1.19 Our preferred approach therefore lies between our second and third options, and consideration of the timing of any intervention has been critical in reaching this decision. Our initial assessment of the short-term options available to Ofcom to relieve any financial pressure on Channel 4 suggests that these options are limited. Most of Ofcom's powers relate to Channel 4's quotas, for news, current affairs, schools programmes, out-of-London production and original programming; these measures would tend to have the effect of reducing Channel 4's public service delivery, rather than strengthening it, and so on the face of it are unattractive responses to growing financial pressure.
- 1.20 Other levers lie in Government's or Parliament's hands, and there is a wide range of possible action that could be taken. We have not attempted systematically to identify or evaluate all the options at this stage. However, it is clear that many of them would require primary legislation, and are likely to take several years to consider and implement. In addition, the Government may wish to complete its broader review of funding of PSB before initiating any particular course of action with respect to Channel 4. It has said it intends to complete this review towards the end of switchover, although it has retained the option of conducting an earlier review before the end of the decade.
- 1.21 Therefore, it could be at least 2011-12 before any long-term policy for continued delivery of public purposes is in place. Given uncertainty in Channel 4's financial prospects towards the end of this period, it may be appropriate for Government to

consider Channel 4's requests for short-term support during this period. In our assessment, and subject to the application of any relevant competition rules, short-term measures would be appropriate if they helped Channel 4 avoid making reductions in its public service delivery in response to uncertainty about its financial position. Such measures would in our view need to have the following characteristics:

- They would provide support during the transitional period, between now and (roughly) 2011-12;
- Their impact could be quantified, and known to Channel 4, with a reasonable degree of certainty;
- Channel 4 would be able to demonstrate how they would help the core channel continue to deliver its remit;
- They would not have any lasting consequences or implications that might prejudice the Government's longer-term policy for Channel 4.

1.22 With respect to our next steps in the financial review, and based on the timetable summarised above, we have reached three conclusions:

- Monitoring of Channel 4's financial performance and public service delivery should be significantly enhanced;
- We should start work on evaluating options for medium- to long-term intervention to secure public purposes in the context of the next PSB Review, which we are proposing to bring forward to begin later this year; and
- The Channel 4 Board should publicly articulate its own vision of the Group's future public service role, governance and funding, to inform our PSB Review and the Government's longer-term decision-making.

1.23 First, there is a case for significantly developing the ways in which Channel 4's financial performance and public service delivery are monitored. If the commercial environment proves less challenging than LEK expects, or Channel 4's commercial businesses deliver larger or earlier returns than anticipated, the need for intervention may be reduced or changed. But if financial pressures emerge more quickly than LEK expects, our analysis suggests that the most immediate impact might be on Channel 4's public service contribution. To understand fully the impact of pressures on Channel 4's public service model therefore requires an understanding over time of both its financial performance and its public service delivery.

1.24 The Channel 4 Board also has an interest in such an enhanced monitoring regime. In recent years it has become more important for public bodies to have systems in place to measure their impact and the return on public investment in their activities, and public service broadcasters have been part of this trend. It would not be appropriate for Channel 4 to have a governance process as elaborate as the BBC's, given its different status and funding model. Nonetheless, it seems to us that further mechanisms that enable the Board to assess the Group's current and future public service contribution would be of value as it develops the Group's public service strategy during a period of increased financial uncertainty. We anticipate that the work underway within Channel 4 to assess its public value, including a basket of measures addressing the different aspects of its remit delivery, will provide the foundation for these mechanisms.

- 1.25 We therefore intend to work with Channel 4 to put a monitoring process in place, for its financial performance and its public service delivery. We believe that this will support the Channel 4 Board in setting expectations for the Group's public service delivery, and monitoring performance against those expectations, as well as providing information that we and Government will need to make future policy. We should be clear that the purpose of such a process is not for Ofcom to take on any greater role in approving Channel 4's remit delivery, nor for Ofcom or Government to set Channel 4's strategy. Those functions remain the responsibility of the Channel 4 Board. Development of the monitoring regime should be geared to helping the Board operate effectively and transparently, and should not hinder its capacity for timely and independent action.
- 1.26 The Channel 4 Board should take the lead on developing the specific elements of this monitoring process, which should be rigorous and objective, but not unduly complex or cumbersome. Its core elements could include:
- An enhanced framework for measuring Channel 4's PSB contribution and assessing the impact of changes to the way it delivers its remit;
  - Published reports from Channel 4 on its remit delivery and its plans for the future, using this framework;
  - Reports from Channel 4 to Government and Ofcom about its financial performance and future prospects; and
  - Analysis of the links between Channel 4's financial performance and prospects and its likely future remit delivery.
- 1.27 Second, we should start work on evaluating options for medium- to long-term intervention, to inform Government's and Parliament's decision-making. We have already announced that we will bring forward the start of the next full PSB Review to late 2007, and as one element of that Review will carry out an assessment of the full range of options for the future of Channel 4.
- 1.28 There are a number of possible long-term outcomes, with different implications for Channel 4's remit, funding and accountability processes. These options need careful consideration, and given that it is likely to take some time to identify and implement the most appropriate solution, we believe we should start this work sooner rather than later. We believe that it will be important for Government to make decisions about Channel 4's future role in the context of a wider strategy for the delivery of PSB in a digital age. For these reasons, we believe it will be most effective to carry out our assessment as part of the next PSB Review.
- 1.29 Finally, it will be important during this period for the Channel 4 Board to articulate publicly its vision of the Group's role and strategy, particularly with respect to its future contribution to public service purposes, to inform our assessment and Government's decision-making. As we consider the scope for our next PSB Review, we would welcome further input from the Board on issues such as: its plans for Channel 4's role and remit in a digital age; its preferred funding and operational model; the resources required to deliver this model; and the nature of accountability arrangements, appropriate for the preferred approach. This thinking would inform both our own PSB Review and the Government's thinking about Channel 4's role in the wider PSB ecology.

## Section 2

# Introduction

### About this statement

- 2.1 On 4 April 2007, we published a set of documents that comprised the findings of the first phase of our financial review of Channel 4. These documents included an independent assessment of Channel 4's future financial prospects by LEK Consulting, our own review of Channel 4's remit delivery and a submission by Channel 4 on its public service contribution. We also published a Foreword which brought together the key findings of these reports, identified questions arising, set out options for our next steps and considered issues related to the timing of any regulatory action with respect to Channel 4. In the Foreword we requested any further evidence that stakeholders wished to provide on the analysis and conclusions presented in the reports.
- 2.2 The purpose of this statement is to:
- Clarify the main findings of LEK's analysis and our own assessment of Channel 4's remit delivery;
  - Set out Ofcom's considered position on Channel 4's continued ability to deliver its remit, based on that analysis and the evidence provided by stakeholders;
  - Draw out the implications of that analysis for Channel 4's funding and operating model, and for regulatory and Government policy;
  - Describe what we intend to do next to address the issues raised by the review.
- 2.3 We believe that the analyses prepared for this review, taken together, provide a clear account of the circumstances facing Channel 4 as it completes the transition to a digital era. It raises a number of important questions for Channel 4, Ofcom and the Government. The findings of the reports we published are summarised in section 3 of this statement.
- 2.4 We did not previously make any policy proposals, or specify how we intended to move forward, as we needed more time to consider the implications of the analysis. So we did not consult formally on the first phase of the review. However, we did want to give interested parties an opportunity to comment on the analysis and to ensure our conclusions were informed by a wide range of views. We therefore invited stakeholders to provide any further evidence that could help inform our assessment of LEK's and our own analysis.
- 2.5 Between 4 April and 11 May, we received over 120 submissions. We are very grateful to the individuals and organisations who took the time to get in touch. Section 4 of this report contains a summary of their responses. Non-confidential responses have been published on our website.
- 2.6 In section 5, we explain whether we believe that Channel 4's funding and operating model is sufficiently robust to enable it to continue to deliver its public service contribution in the medium term, based on the evidence available to us. We set out the extent to which we believe short- and long-term pressures on Channel 4's model

require further regulatory investigation and the issues related to the timing of any intervention. We also describe how we intend to take these questions forward.

- 2.7 This statement does not recommend any specific measures to support Channel 4, nor does it assess the policy options in any detail. For reasons explained below, we believe we should identify and evaluate the full range of options as part of a broader investigation of possible models for delivering public service broadcasting (PSB) in a digital environment, in our next full PSB review, which we will start later this year.

## **Background to the review**

- 2.8 We published Terms of Reference for a Financial Review of the Channel 4 Group in July 2006. This is the first time such an external review of Channel 4 has been carried out, since the channel was launched in 1982.
- 2.9 In carrying out this review, Ofcom has a number of relevant duties under the Communications Act. We are required to secure the availability of a wide range of television services, of high quality and calculated to appeal to a variety of tastes and interests, and to secure the maintenance of a sufficient plurality of providers of different television services. We must also have regard to the desirability of promoting the fulfilment of the purposes of public service television broadcasting in the UK. At least once every five years, we are required to review the extent to which the public service broadcasters have fulfilled the purposes of public service broadcasting, and to report on how it can be maintained and strengthened.
- 2.10 We proposed this project in our first statutory review of PSB, in 2004-05, in response to Channel 4's analysis suggesting that by 2009 it would face a financial shortfall that would limit its ability to deliver its public service remit. The PSB review found that historic models of PSB would break down as a result of the transition to digital TV, and that there would be steadily growing pressure on commercial public service broadcasting in the period through digital switchover and beyond. We observed that Channel 4 faced many of the same pressures on its funding model as the other commercially-funded public service broadcasters, and that this could constrain its ability to fund a wide range of high quality public service programming in future.
- 2.11 We found no evidence in 2004 of an immediate problem for Channel 4, either in terms of its financial performance or its remit delivery. However we concluded that a subsequent review would be needed before the next PSB review.
- 2.12 We announced plans for this financial review in our Annual Plan for 2006-07. Channel 4 supported the review, which was also welcomed by Government in its White Paper on the future of the BBC.

## **Objectives of the review**

- 2.13 The Terms of Reference set out the purpose of the financial review. We proposed to carry out the review in two stages – the first to assess the resilience of the Group's business model in the face of changing competitive pressures and understand the scale and timing of the funding challenges that the Group may face in fulfilling its remit, and the second, if necessary, to identify possible mechanisms to address any future pressures on its funding model.
- 2.14 This statement brings to an end the first phase of the financial review. We will take forward the second phase as part of our next PSB review, which we intend to start later this year.

## Section 3

# Findings of analysis

## LEK's financial analysis

- 3.1 We asked LEK to project the Channel 4 Group's financial performance to 2012, assuming no change in the composition and cost of the Channel 4 schedule. We are grateful to LEK for its analysis and report in support of this review.
- 3.2 LEK found no immediate, pressing risk to Channel 4. To the end of 2008, there is likely to be a slow deterioration in the Group's surplus, but no significant reduction in its cash reserves, assuming no major investment activity. Looking further ahead, in the most likely scenario – LEK's 'central case' – the Group continues to run a surplus between 2008-10, albeit at lower levels than in 2003-05. It has substantial cash reserves, and assuming a prudent strategy, involving limited investment outside the core channel and targeted cost-cutting measures, its cash reserves would remain higher at the end of 2010 than they were at the end of 2006. LEK recognises that this financial flexibility needs to be considered not just in light of filling a financial gap, but also in the context of the possible need for future investment, to generate new sources of profit and secure Channel 4's position as a multi-platform media business.
- 3.3 However, there is significant variation in LEK's potential outcomes, with a low case in which the Group is loss-making from 2009 and exhausts its cash reserves in 2011, and a high case in which the Group continues to be profitable and to add to cash reserves throughout the forecast period. LEK believes that the central case is the most probable outcome, but that the negative scenarios are more likely than the positive.
- 3.4 LEK identifies several trends driving the Group's future performance:
- Flat or declining advertising revenues on the core channel, based on a flat TV advertising market and a modest loss of viewers as take-up of digital platforms continues;
  - A one-off increase in competition for Channel 4's hit originations and acquired programming, driving up prices and reducing the channel's gross margins between 2006-09;
  - Ongoing cost inflation across the rest of the Channel 4 schedule, which although low, will continue to put pressure on the channel's funding at a time of flat or declining advertising revenue;
  - Performance of Channel 4's ancillary commercial businesses, which LEK expects to be profitable from 2007, but argues, on a set of conservative assumptions, will not make sufficient returns to offset declines in the core channel's performance.
- 3.5 Taking these effects together, LEK's evidence suggests that there is no significant risk of intractable financial challenges emerging before 2010, assuming no change in the programme mix on the core channel. Even in the low case, the Group would still have cash reserves of £90 million at the end of 2010, although this could put some pressure on its working capital requirements. Therefore there is little evidence to suggest that Channel 4's remit delivery would need to be fundamentally compromised before 2010.

- 3.6 However, it is likely that the Group will cease to be profitable around 2010, and will become increasingly unprofitable thereafter. The precise timing and extent of this deterioration is uncertain, but the probability is that deterioration will occur. LEK's assessment is that Channel 4's funding model is likely, in the medium-term, to become unsustainable, assuming that the nature and extent of its delivery of its remit remains unchanged.
- 3.7 LEK also sets out its view of the Group's ancillary commercial activities and potential for operating cost savings. It expects the Group's digital-only channels (E4, More4 and Film4) to move into profit in 2007, and to make positive returns thereafter, although it is more pessimistic about the size of those returns than Channel 4 itself. It also expects other businesses and new services to make a modest contribution to the Group. However, it does not expect that these ancillary activities will be sufficient to offset losses on the core channel after about 2010.
- 3.8 Finally, LEK identifies potential for near-term cost savings of approximately £25m per annum, although it stresses that it has not considered their longer-term impact on the business. It says there may be opportunities to reduce marketing costs, overheads, and digital transmission costs, or to use digital capacity more profitably.

### Remit delivery

- 3.9 Channel 4's submission on its remit delivery, and our own analysis, make it clear that Channel 4 has consistently delivered the quantifiable elements of its remit, and meets and sometimes significantly exceeds its core licence requirements. We found that Channel 4 has increased the amount of current affairs it broadcasts in peak, and is highly regarded by its regular viewers for its innovative programmes.
- 3.10 In other areas, the evidence suggests that Channel 4 has changed the way it delivers its remit in recent years. It spends less in real terms on current affairs, news and religious programmes than it did in 2001 or 2002, despite an overall increase in Channel 4's programme budget since that time. Spend on acquired programmes has increased, both because their cost has increased and because Channel 4 is broadcasting more hours of acquisitions. Until 2006, spend on original programmes had fallen in real terms every year since 2001.
- 3.11 The purpose of our analysis was not to judge whether these changes were right or wrong. But it may shed some light on how Channel 4 would be likely to respond to increased financial pressure in future. We noted that changes in the way Channel 4 responds to its PSB remit have taken place despite its strong commercial performance in recent years. This partly reflects Channel 4's stated ambition to ensure the ongoing impact of its service and its PSB remit at a time when consumer choice has radically increased. But the changes that have been made also have the effect of improving the channel's commercial performance, while reducing some elements of its PSB contribution.
- 3.12 It seems likely that if financial pressures become more intense over the next few years, as LEK's analysis suggests, there may also be pressure on Channel 4's PSB contribution. The Group may seek ways of adapting its remit delivery to ensure its continued financial viability; in effect, remit delivery could become the 'safety valve' which the Group opens over time to enable it to relieve financial pressures and remain viable.
- 3.13 There are some signs that this is already taking place. In its submission to us in response to LEK's report, Channel 4 notes that:

- The core channel's programme budget for 2007 is flat, representing a reduction in real terms;
  - This will result in the channel facing 'difficult decisions and trade-offs' between different types of programmes;
  - It expects to make further significant cuts to its 2008 programme budget from the level it originally envisaged.
- 3.14 The Group faces strong pressures to act in this way. It has a statutory obligation to ensure the continued delivery of the Channel 4 service, which could clearly be breached if its finances deteriorate. The Group has to publish an annual report including financial statements, which provide a means for it to be held to public account for its financial performance. It has no similarly effective obligation to report systematically on Channel 4's PSB performance.
- 3.15 To some extent, these pressures are inherent in Channel 4's model. The nature of a model that relies on commercial activities to fund public service output is that that output will always be constrained in part by the size of the commercial returns the Group can make. Channel 4's public service remit is relatively loosely defined in the 2003 Communications Act; this both enables Channel 4 to respond to its remit in the ways it judges most effective to achieve its public purposes, and helps ensure that its financial sustainability is not jeopardised by a set of highly specific obligations (notwithstanding the regulatory quotas that it has in a number of particular areas).
- 3.16 But over a period of years opening the 'PSB safety valve' could have a gradual, but cumulatively serious, impact on Channel 4's delivery of its remit. Channel 4 has recognised this, saying that: "The commercial television industry is under more competitive pressure than ever before . . . In coming years we shall be forced to steadily reduce our output of public service broadcasting, and focus more and more of our schedule on strictly commercial shows, unless we receive help in kind."<sup>1</sup>
- 3.17 This is of concern, in and of itself. But it also highlights a need to enhance the monitoring of Channel 4's PSB delivery. As our remit analysis pointed out, we believe there is currently no framework that allows us or Channel 4 to measure fully its remit delivery and assess over time the impact of changes on its overall level of PSB contribution. We and Channel 4 also need to be able to determine how the costs to its remit delivery of any particular change in its programme mix compare to the benefits in terms of future financial viability.
- 3.18 There is, consequently, a risk that during a period of sustained financial pressure Channel 4 will be strongly incentivised – arguably, even required by its funding and operating model – systematically to reduce its remit delivery, without either the Group or Ofcom being in a position to assess fully the impact of those reductions on its overall contribution to public service purposes.

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<sup>1</sup> Channel Four Television Corporation, Report and Financial Statements 2006

## Section 4

# Summary of stakeholder responses

### Overview

4.1 In total we received over 120 submissions from respondents. Some responded directly to the questions we posed in our Foreword, while others provided a general response to the issues raised by the analysis published for phase 1 of the financial review.

### Producers

4.2 We received submissions both from individual producers and from PACT. PACT's submission states that Channel 4 should remain a publicly-mandated and publicly-owned service if it is to continue to provide innovative content that acts as a creative catalyst. In PACT's view, efficiency savings are short term at best and could potentially damage the channel – it cites Channel 4's effective marketing as an example of a strength that has helped Channel 4 to stand out.

4.3 PACT does not see any merit in a move into in-house production for Channel 4, the supply sector or the audience. PACT argues:

- Channel 4's role as the largest investor in the independent production sector is fundamental in creating a healthy supply market;
- Television production remains a buyers' market and Channel 4's concern that its profitability is threatened by consolidation within the supply sector and the revised rights position is unfounded;
- Ofcom should review interventions to support Channel 4 and ensure it can compete with the BBC;
- It is debatable whether in-house production would yield cost savings as hit originations are difficult for an in-house department to produce. Channel 4 has hundreds of suppliers vying for commissions and is therefore able to keep costs competitive;
- As a publisher-broadcaster, Channel 4 has been able to pick and choose the best programming from a wide range of suppliers across the country. A move into in-house production would damage the range and diversity of Channel 4's programming and potentially waste its resources; and
- An in-house department would not impact on the rising costs in acquisitions which "appear to be the primary factor in driving cost inflation across the industry".

4.4 PACT also notes that it does not agree that the new terms of trade have made it more difficult for Channel 4 to manage costs.

4.5 PACT argues that there is the need for a long-term strategy that "positions Channel 4 as a well-funded, publicly owned service with real impact in the multi-platform world." It argues that Channel 4's core demographic is the age group most engaged with

new forms of delivery and that Channel 4 should therefore be at the forefront of new media content.

- 4.6 There were also a large number of submissions from television and film producers, mostly suppliers to Channel 4. The overwhelming majority of these wrote to give their support to Channel 4 and to urge Ofcom to put into place short-term and longer-term measures to enable Channel 4 to continue to fulfil its remit. There are a number of key issues cited by these submissions. These are:
- Channel 4's importance to the creative economies in the Nations and Regions (in particular, through Channel 4's Creative Cities initiative);
  - Channel 4's significant contribution to 'diversity of voice' in public service broadcasting;
  - The broadcaster's role in providing competition to the BBC and in 'keeping the BBC honest;'
  - Channel 4's contribution to education and democracy through the production of news, current affairs serious factual, international and multicultural programming;
  - Channel 4's historic support for the independent production sector, particularly small producers;
  - Channel 4's historic provision of creative, innovative and risk-taking programming; and
  - Channel 4's off-screen activities such as training, multicultural and disability initiatives.
- 4.7 Several producers specialising in film production support intervention to enable Channel 4 to continue its role as the 'cornerstone of the British film industry.'
- 4.8 Those submissions that comment on potential measures are opposed to any move to allow Channel 4 to produce its own programming in-house.

## **Broadcasters**

- 4.9 A number of key issues were raised by other broadcasters in response to the LEK report and Ofcom's remit analysis. Various, their views can be summarised as:
- The LEK report does not indicate a need for immediate action;
  - Channel 4 should fully investigate self-help measures before any public support should be considered;
  - In the changing environment, all the commercial PSBs face a similar set of problems to Channel 4;
  - The evidence published in Ofcom's report on Channel 4's remit delivery raises concerns about the governance and accountability arrangements for Channel 4; and
  - Channel 4's role and strategy should be considered in light of broader public service broadcasting objectives and Ofcom should consider a number of options

for delivering in a post-analogue world the public purposes that Channel 4 has historically served.

- 4.10 Several of the broadcasters argue that the base assumption we asked Channel 4 and LEK to adopt – that the programme mix on the core channel remained unchanged – was artificial. They argue that Channel 4 can and should adapt its remit delivery to suit changing financial circumstances; indeed one broadcaster argues that the statutory provisions for Channel 4 require it to act in this way.
- 4.11 One respondent suggests that Channel 4's PSB remit could be delivered in a more cost-effective fashion. Another argues that the challenge is not to try to sustain a business model which is delivering public benefit in an increasingly inefficient way but to attempt either to develop a new or varied model that does not require public support or to find a way to ensure that the PSB historically delivered by Channel 4 is delivered in the future. This respondent argues that this would not necessarily have to be through an institutionally-based funding model.
- 4.12 One respondent argues that we should have asked LEK to assess in more detail how Channel 4 could reduce its fixed costs and utilise its existing assets.
- 4.13 Responses from the broadcasters make specific suggestions regarding Channel 4's existing strategy including:
- Sub-leasing the gifted DTT capacity and reinvesting the money in the core channel;
  - Looking for creative solutions to tackle programme price inflation rather than seeking outside intervention;
  - Reducing its reliance on the largest independent producers and its reliance on a handful of titles; and
  - Allowing the broadcaster to produce some programming in-house to help it control costs.
- 4.14 However, one broadcaster cautions against allowing Channel 4 to produce in-house, citing execution and investment risks and noting that if Channel 4 makes a significant shift towards in-house production it may not be able to continue to draw on the best producer talent and ideas.
- 4.15 The BBC offered analysis, carried out by Oliver & Ohlbaum, indicating a less challenging central forecast for Channel 4 than that proposed by LEK. This analysis suggests:
- A 2% per annum nominal advertising growth rate to 2012 is more likely than LEK's assumed zero nominal growth rate;
  - The programme cost inflation and implied gross margin reduction assumed in LEK's central case is too high; and
  - LEK have underestimated the potential contribution of Channel 4's digital channels.
- 4.16 This report also argues that more detailed analysis of Channel 4's diversification strategy beyond linear TV or rights trading would be required to address the

sustainability of the Channel 4 Group and its business model beyond 2012. It argues that this makes it difficult to decide on whether any intervention is needed and what form it should take. It suggests that Channel 4 should consider raising risk capital to fund some of its diversification strategy – probably through joint ventures with commercial partners.

- 4.17 The report states that the absence of any analysis of the opportunity costs of the PSB remit on the core channel or within the non core services means that it is difficult to identify which elements of public service delivery might be causing financial difficulty and whether their public value benefits justify the opportunity costs involved.
- 4.18 The submission from Channel 4 offers support for much of LEK's report but identifies several areas where Channel 4 disagrees with LEK's analysis. It argues:
- Channel 4's share of commercial impacts may come under greater pressure than indicated in LEK's forecasts given that Channel 4's share of commercial impacts in the first quarter of 2007 was lower than LEK's forecasts;
  - There is further financial pressure from significant declines in PRTS income in recent months;
  - Competition for 'must have' shows will significantly inflate prices through to the end of digital switchover in 2012 and beyond;
  - Further significant reductions in programme costs could only be achieved by diluting Channel 4's PSB contribution;
  - Channel 4 must invest in building new businesses that can help generate profits to cross subsidise its PSB contribution and to maintain relevance either its audience;
  - The £25m of additional 'self-help' cost savings identified by LEK cannot be found without significant damage to Channel 4's commercial performance or public service delivery;
  - Any further reduction in marketing spend would put downward pressure on audiences and revenues; and
  - Releasing DTT capacity would be strategically damaging both in terms of maintaining relevance with audiences and building commercial value;
- 4.19 Channel 4's submission states that it will continue to look at sensible self-help measures but it argues that its headcount is already managed tightly, cutting new business investment is not a viable medium- or long-term strategy and that overhead costs are tightly controlled.
- 4.20 Channel 4's submission argues that growing pressures on Channel 4's finances, including the continued decline of the TV advertising market, are already having a real financial impact. It offers the following indicators:
- The 2007 programme budget is flat representing a reduction in real terms, which has entailed some difficult decisions and trade offs;
  - Channel 4 expects to make significant cuts to its 2008 programme budget; and

- The 2007 marketing budget is lower than 2006 spend.
- 4.21 Channel 4's confidential submissions to Ofcom also set out a number of other planned reductions in its public service contribution resulting from financial pressures.
- 4.22 In terms of next steps Channel 4 argues that Ofcom should:
- Immediately finalise short term forms of support via digital terrestrial capacity from the BBC and financial support for Channel 4's costs of digital switchover; and
  - Start investigating other forms of support in the medium term that should ideally be in place for 2009.

### **Advertisers and media buyers**

- 4.23 Several advertisers and media buyers responded to the Financial Review. The majority are keen to see the Channel 4 funding model future-proofed and urge Ofcom to consider long term policy options. The only specific measure proposed in these submissions is to offer Channel 4 free spectrum.
- 4.24 Several respondents note the value to advertisers of Channel 4's broad reach and its niche appeal to younger and upmarket groups. Some also cite the importance of maintaining Channel 4 as a real alternative for advertisers to ITV.

### **Other Channel 4 stakeholders**

- 4.25 Submissions were received from a number of other Channel 4 stakeholders including: MPs, financial organisations, academics, arts bodies, regional development agencies, religious organisations and digital media companies.
- 4.26 These responses note the significance of Channel 4's public service output and impact in a number of areas (including out of London production, the creative industries, religious, arts and international programming, and the development of new talent.) Some stakeholders offer examples to demonstrate that the broadcaster had already had to make cuts in some public service areas.
- 4.27 A majority of the submissions express concern that pressure on Channel 4's financial position might detrimentally affect the delivery of its public service remit on screen and impact on the work that it conducts off screen (for example through its Creative Cities initiative and its efforts in the cultural arena).
- 4.28 Some of these stakeholders suggest that Ofcom should follow a 'wait and see' approach as laid out in the third option set out in the Foreword. However, other stakeholders – citing the length of time it could take to implement long term measures – urge Ofcom and the government to provide Channel 4 with short-term financial assistance and to launch research into how to maintain Channel 4's long term financial future.
- 4.29 One respondent suggests that Ofcom investigate funding through a PSB Publisher or a 'Broadcasting Arts Council'. Another respondent notes that the BBC can be directed to make some spare digital terrestrial capacity available to another public service broadcaster at switchover.

- 4.30 There is little appetite for a 'loosening of the remit' and several stakeholders want to see an ongoing commitment to public service broadcasting and the development of 'clear measurable commitments' by Channel 4.

## Section 5

# Proposed next steps

### Implications of analysis and stakeholder evidence

- 5.1 We have reviewed the analysis set out in section 3 in light of the responses from stakeholders summarised in section 4. Taken as a whole, stakeholders made a number of important points, although not all of them were consistent. The main arguments, and our responses to them, are discussed in this section.
- 5.2 With respect to the financial analysis, some stakeholders argue that Channel 4's position in the market is stronger than LEK suggest, and that there are self-help steps Channel 4 can take to shore up its financial performance. They believe that LEK's report may be too pessimistic about its longer-term prospects, and does not indicate a need for immediate action.
- 5.3 We agree that there is significant uncertainty in LEK's forecasts, as LEK's report itself makes clear. There are plausible scenarios in which the outcomes are much more positive for Channel 4 than LEK's central case, including the scenario described by Oliver & Ohlbaum for the BBC. However, there are also plausible outcomes which are much more negative than LEK's central case – including Channel 4's own forecast. We note that the other commercial broadcasters do not fundamentally disagree with LEK's analysis of the future of the commercial TV market.
- 5.4 We also agree that there are self-help measures Channel 4 could take. LEK identified several possible areas Channel 4 could consider, and more generally, we consider that in the face of a declining business model any organisation would carefully examine all possible ways of improving efficiency. However, we also recognise that LEK's analysis suggests that cost saving measures will be insufficient to relieve financial pressures entirely.
- 5.5 We therefore believe it would be wrong to discount the possibility that financial pressures could restrict Channel 4's ability to deliver its remit in the medium-term. However, we agree that this does not constitute an argument for immediate action. LEK's analysis suggests that financial pressures should be manageable at least as far as 2010, even assuming no change in Channel 4's programme mix. Beyond this, financial pressures are likely to grow, as is the range of uncertainty about potential outcomes for the Group.

### Prospects for Channel 4's remit delivery

- 5.6 Some stakeholders argue that the assumption underpinning LEK's model, that Channel 4's programme mix remains unchanged, does not reflect the way Channel 4 would respond to financial pressures in practice. They say that in reality Channel 4 has frequently adapted the way it delivers its remit over the years, and can continue to do so if it does face financial pressures in future.
- 5.7 We agree that a central feature of Channel 4's remit, funding and operational model and regulatory regime, is the flexibility it has to adapt its remit delivery in response to changing financial circumstances, as well as to changing audience needs. The question is whether in the long run this could have a significant impact on its overall contribution to public purposes.

- 5.8 We argued in section 3 that financial pressures would almost inevitably lead to changes in the way Channel 4 delivers its remit; the evidence of the last few years, and Channel 4's own statements, suggest that these would be likely to result in reductions in spend on or output of PSB programming. As we noted in section 4, Channel 4's response to LEK's report says that its 2007 programme budget will be flat, representing a reduction in real terms, resulting in 'difficult trade-offs'; and it expects to make significant cuts in its 2008 programme budget from the level it originally envisaged.
- 5.9 If financial pressures are sustained, as LEK's analysis suggests they will be, a series of incremental changes could over time result in a much more substantial aggregate impact on the delivery of public purposes. Therefore we do not believe that the leeway Channel 4 has to adapt its remit delivery offers a solution to the underlying problem, which is its future ability to contribute to public purposes. Indeed, this leeway may exacerbate, not relieve, the potential problem.
- 5.10 This analysis suggests that there is a need to develop significantly Channel 4's monitoring and reporting framework in order to assess fully the impact of changes in the way Channel 4 delivers its remit on its overall PSB contribution. We pointed out in section 3 the risk that financial pressures could result in systematic reductions in Channel 4's remit delivery without either Ofcom or Channel 4 being in a position to assess fully the impact of those reductions on its overall contribution to public service purposes. In our view, the Channel 4 Board's ability to fulfil its duties during a period of sustained financial pressure would be enhanced by an improved framework at its disposal.
- 5.11 One respondent argues that the evidence published in phase one raises concerns about Channel 4's accountability and governance mechanisms. It claims that Channel 4 has made changes to its remit delivery without public debate, and that commercial investments have been made with an unclear purpose and without reasonable prospect of an adequate return.
- 5.12 Our concern here is with delivery of Channel 4's public service obligations, and we agree that mechanisms to measure the impact of changes on the way Channel 4 delivers its remit need to be substantially developed. This will include establishing an effective framework to measure its overall PSB contribution in the future, to assess the likely impact of future plans, and to report on those assessments.
- 5.13 Some respondents argue that if Channel 4's funding model will be fundamentally weakened at some point in future, the correct response is to review Channel 4's role and strategy in the light of broader public service broadcasting objectives, rather than moving immediately to consider options for intervening to prop up its funding model.
- 5.14 Others, including producers and other stakeholders, feel that Channel 4 makes an essential and distinctive contribution to PSB, the independent production sector and the wider creative economy. These respondents argue that short-term and long-term measures to safeguard Channel 4's contribution should be considered immediately. With respect to specific measures to support Channel 4, some respondents advocate allowing Channel 4 to produce some programming in-house while others argue strongly against it.
- 5.15 We agree that Channel 4 has a significant role in delivering some core PSB genres, which are highly valued by viewers. We made this point in our analysis of Channel 4's remit delivery. However, we also agree that if there is evidence to suggest that this role may be threatened in future, it is important to consider options for

intervention to ensure the continued delivery of public purposes in the context of wider developments in the market and in the PSB system. These should include options for fundamental reform as well as mechanisms to repair Channel 4's existing funding model. In future, public purposes may be different to those that have been identified now; new platforms or services may help to meet those purposes; new funding options or revenue streams may emerge; and new institutions may be created to address new problems. Channel 4's role should be considered in the context of answers to those wider questions.

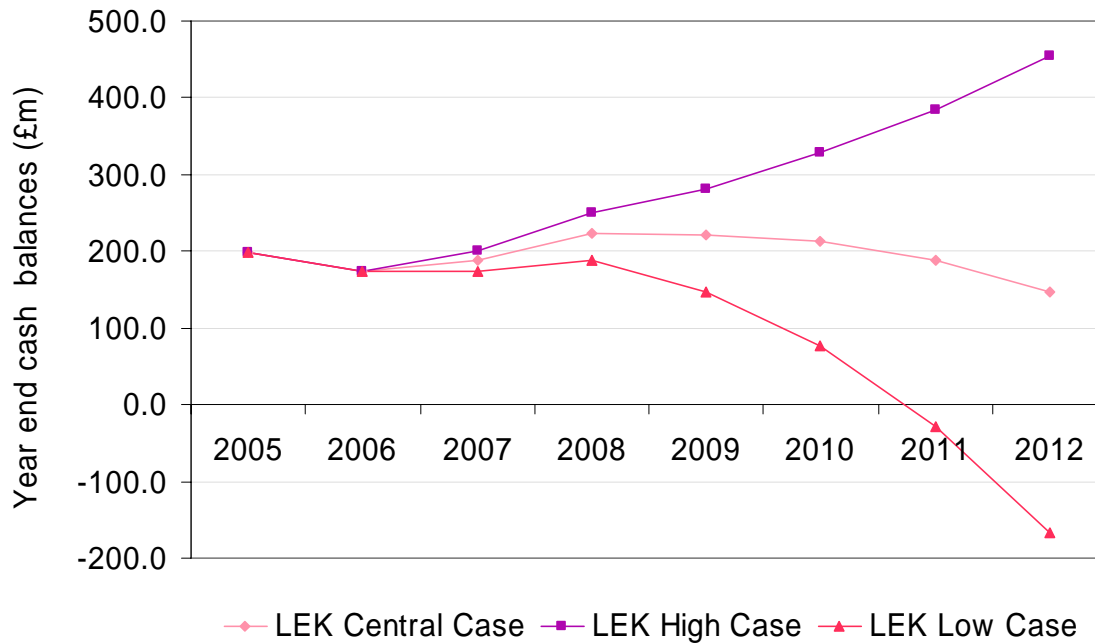
### **The nature and timing of possible interventions**

- 5.16 Our Foreword to the phase one reports considered issues related to the timing of any future intervention. On one hand, we argued that one implication of LEK's analysis was that it might be possible to monitor Channel 4's performance for another year or two, before taking any action, to establish whether in fact that action would be needed. On the other hand, we identified the risk that in this period Channel 4 may make choices in response to uncertainty that could have unintended and undesirable consequences for our longer-term objective, which is to secure the purposes of public service broadcasting as set out in the first PSB Review.
- 5.17 There are a number of possible actions available to us or Government, including:
- Measures Ofcom could implement itself;
  - Measures that do not rest in Ofcom's hands, but could be carried out by Government without primary legislation;
  - Measures that would require primary legislation.
- 5.18 We have not developed an exhaustive list of possible options to ensure the continued delivery of Channel 4's public purposes, nor done any work to evaluate their pros and cons. However, there are relatively few levers available to Ofcom other than relaxing Channel 4's quota obligations, on news, current affairs, schools programmes, originations or out-of-London production. Given that the motivation for acting would be to maintain and strengthen PSB, most of these options would seem to be counter-productive.
- 5.19 Implementation of any fundamental change is likely to lie ultimately in Government's or Parliament's hands. This would likely follow the Government's planned wider review of the funding of PSB. The Government has said that it intends to complete this review before the completion of switchover, and has reserved the option of doing so before the end of the decade.
- 5.20 We have announced that we will bring forward the start of our next PSB Review to later this year. Government may wish to take its findings into account in formulating its long-term policy on PSB, in addition to conducting its own funding review. In our judgement, this means that even on the earliest possible timetable, it might be 2011-12 before any long-term solutions are in place.
- 5.21 Figs 1-2 show LEK's forecasts of Channel 4's cash balances and earnings in its high, low and central cases over this period. They show that in the most likely case, Channel 4 will still have significant cash reserves by the time any solution is in place on this earliest timetable, although it will be losing money. However, in the low case, it could require significant levels of debt to continue to deliver its remit by the time

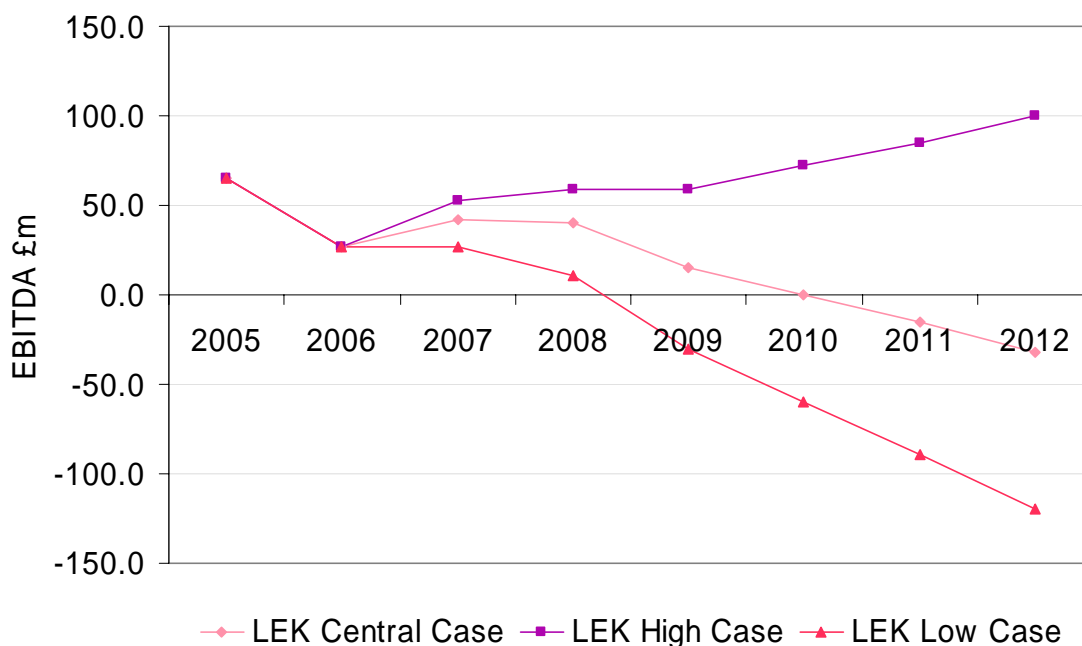
any solution is in place, which would place heavy strain on its working capital requirements and possibly require it to breach its borrowing limit.

- 5.22 If the Government did not complete its review of PSB funding until 2012, this timetable could be pushed back further. In this case, uncertainty and risk to Channel 4's public service contribution would increase significantly. There would very likely be a need for transitional measures to sustain Channel 4's public service delivery in this interim period.

**Fig 1. LEK's scenarios for Channel 4 cash balances to 2012**



**Fig 2. LEK's scenarios for Channel 4 earnings before interest, tax, depreciation and amortisation (EBITDA) to 2012**



Source: LEK

- 5.23 To summarise, taking LEK's report, our analysis of remit delivery and stakeholders' submissions together, our considered position is as follows:
- There is no immediate, short-term risk to Channel 4's funding or remit delivery;
  - But it is reasonably likely that Channel 4 will face increased financial pressures in the medium-term, with the Group moving into deficit from 2010 in LEK's most likely case;
  - As Channel 4's financial model comes under increasing pressure, its remit delivery could act as a 'safety valve' to ensure continued financial stability – there is evidence of this already happening;
  - Over time this could significantly weaken Channel 4's overall contribution to PSB;
  - In this context, the current monitoring and reporting framework for Channel 4 should be significantly developed to measure fully its overall PSB contribution, to assess the impact of particular changes to its programme mix on that overall contribution and to report on those assessments;
  - If Channel 4's PSB contribution does become threatened, there are a range of ways that the continued delivery of public purposes could be achieved; and
  - It may take some time for any appropriate intervention to be identified and implemented.

### Short-term measures

- 5.24 Given the likely timetable for long-term action, it may be appropriate for the Government to consider Channel 4's requests for short-term support, subject to the application of any relevant competition rules.
- 5.25 In our view, the merit of any short-term action would be in providing some level of transitional support to Channel 4's ability to serve public purposes while the outcomes of our review and the Government's funding review inform the Government's long-term decision-making in this area. This support would help Channel 4 avoid making reductions in its public service delivery, in response to uncertainty about its financial position in this transition period. In our view, appropriate measures would need to have the following characteristics:
- They would provide support during the transitional period, between now and (roughly) 2011-12, by which time the Government's and Parliament's vision for the PSB system as a whole, and Channel 4's role within it, may be clearer;
  - Their impact could be quantified, and known to Channel 4, with a reasonable degree of certainty. This ensures that any short-term measures act to reduce, rather than increase, the level of uncertainty Channel 4 faces;
  - Channel 4 would be able to demonstrate how they would help the core channel continue to deliver its remit;
  - They would not have any lasting consequences or implications that might prejudice the Government's longer-term policy for Channel 4. If a wide range of longer-term options is to be included, then any short-term measures should not

presume or require any particular long-term solution, at least until the Government's longer-term policy is more developed.

- 5.26 There are two options for short-term action that Channel 4 has asked Government to consider: the BBC paying its capital costs of switchover (the Secretary of State has indicated that she has made a provision for this purpose, of up to £14 million over the lifetime of the current BBC licence fee settlement); and making capacity available on one of the BBC's multiplexes for Channel 4's use.
- 5.27 These decisions are for Government to make and we have not carried out any assessment of these particular options. However, it is also worth noting that any additional capacity available on the DTT platform would have a number of alternative uses which should be borne in mind. These include the potential provision of PSB services in High Definition.

### Options for Ofcom's next steps

- 5.28 Our Foreword to LEK's report and our own analysis of Channel 4's remit delivery set out four possible options for next steps:
1. To recommend that further public support for Channel 4 should be ruled out for the foreseeable future;
  2. To monitor Channel 4's financial performance and remit delivery closely, and review the case for future intervention again as and when there is more evidence available;
  3. To consider what limited 'safety net' measures could be put in place to mitigate this and any medium term risk, and review potential options for more significant intervention at a later date; or
  4. To move directly to make a detailed assessment of the options for intervention.
- 5.29 In considering these options, it is important to bear in mind the current wider policy context. In the first PSB Review, we stated that a not-for-profit, commercially funded Channel 4 would be an important part of the PSB landscape, and should remain so up to switchover and beyond. The Government's White Paper on the future of the BBC also restated its support for Channel 4's public service role and welcomed Channel 4's moves to strengthen its commitment to providing high quality, diverse public service content across an increasing range of channels and platforms.
- 5.30 In this context, and given the analysis set out above, we believe the first option – to rule out further public support – is inappropriate. LEK's work portrays an organisation whose historically successful model is under increasing strain. There is clearly a substantial risk, either of breakdown of Channel 4's financial model, or substantial reductions in its delivery of its PSB programming. Both these outcomes are undesirable, and would in the long term result in Channel 4 not delivering its remit. We have considered ways of mitigating this risk in light of our statutory duties, including having regard to the desirability of promoting the fulfilment of the purposes of public service television broadcasting in the UK.
- 5.31 One stakeholder argues that the problems for Channel 4 are merely transitional, and that new commercial activities will eventually generate sufficient returns to support the core channel. However, given LEK's analysis, it would be rash to rely on this

possibility without having considered the alternatives, given the potential risks to public purposes.

- 5.32 Nor do we believe the fourth option is appropriate. LEK's analysis does not suggest that any near term erosion of the Channel 4 model is likely to create an immediate cash crisis that necessitates immediate intervention. Indeed, in LEK's central case, it could be argued that significant problems only emerge after 2012, when deficits begin to make substantial inroads into Channel 4's cash reserves.
- 5.33 We therefore do not believe there is a case for immediate and substantial intervention. Many of the possible solutions would require primary legislation and a much wider debate about Channel 4's future role before they could be implemented. Therefore it would not be possible for us to complete a thorough assessment of all the potential options that could lead to action in the short-term.
- 5.34 Our preferred approach therefore lies between the second and third options we described. This approach has three main elements:
- Monitoring of Channel 4's financial performance and public service delivery should be significantly enhanced;
  - We will start work on evaluating options for medium- to long-term intervention; and
  - The Channel 4 Board should publicly articulate its own vision of the Group's future public service role, governance and funding, to inform our PSB Review and the Government's longer-term decision-making.
- 5.35 First, there is a case for significantly developing the ways in which Channel 4's financial performance and public service delivery are monitored. If the commercial environment proves less challenging than LEK expects, or Channel 4's commercial businesses deliver returns larger or earlier than anticipated, the need for intervention by Government to ensure the continued delivery of public purposes may be reduced or changed. But if financial pressures emerge more quickly than LEK expects, our analysis suggests that the most immediate impact may be on Channel 4's public service contribution, not on any financial measures.
- 5.36 We therefore believe that to understand fully the impact of growing pressures on Channel 4's public service model and its financial prospects requires enhanced monitoring of both its financial performance and its remit delivery. This monitoring would have benefits for us and Government, in providing information to inform future policy-making, but also for the Channel 4 Board, which will continue to be responsible for developing Channel 4's public service strategy and delivering its remit during a period of increasing financial pressure.
- 5.37 In recent years it has become more important for public bodies to have systems in place to measure their impact and the return on public investment in their activities. Public service broadcasters have been part of this trend, with new governance processes for the BBC introduced in its current Charter. It would not be appropriate for Channel 4 to have a governance process as elaborate as the BBC's, given its different status and funding model. Nonetheless, we believe that further mechanisms to enable the Board to assess the Group's current and future public service contribution as it responds to increased financial pressure would be of value.

- 5.38 We therefore intend to work with Channel 4 to develop the monitoring process for its financial performance and public service delivery. We believe that this will support the Channel 4 Board in setting expectations for the Group's public service delivery, and monitoring performance against those expectations, as well as providing information that we and Government will need to make future policy. We anticipate that the work underway within Channel 4 to assess its public value, including a basket of measures addressing the different aspects of its remit delivery, will provide the foundation for this process.
- 5.39 The purpose of such a process is not for Ofcom to take on any greater role in approving Channel 4's remit delivery, nor for Ofcom or Government to set Channel 4's strategy. Those functions remain the responsibility of the Channel 4 Board. Development of the monitoring regime should be geared to helping the Board operate effectively and transparently, and should not hinder its capacity for timely and independent action.
- 5.40 We have not yet started to discuss with Channel 4 the specific elements of this process. The process should be rigorous and objective, but not unduly complex or cumbersome. Its core elements could include:
- An enhanced framework for measuring Channel 4's PSB contribution and assessing the impact of changes to the way it delivers its remit, taken forward by Channel 4 in consultation with us;
  - Published reports from Channel 4 on its remit delivery and its plans for the future, using this framework;
  - Reports from Channel 4 to Government and Ofcom about its financial performance and future prospects; and
  - Analysis of the links between Channel 4's financial performance and prospects and its likely future remit delivery.
- 5.41 Second, we will start work on evaluating the full range of options for medium- to long-term intervention. Given the length of time it is likely to take to put any measures in place, we should start this work sooner rather than later, even if final decisions about Channel 4's future are not reached for several years. It will also be important that we form our view of Channel 4's future role in the context of a wider strategy for the delivery of PSB in a digital age.
- 5.42 Our analysis suggests that consideration of options for Channel 4 should address three inter-related questions:
- What should be the key elements of Channel 4's PSB contribution in a digital era? (This should include consideration of whether Channel 4's model is still an appropriate way of securing PSB purposes in a digital era; and if so, whether it would be appropriate to broaden Channel 4's remit to incorporate a wider range of channels and services than the core channel itself.)
  - How should that contribution be funded?
  - How should Channel 4's accountability and reporting framework be developed to demonstrate that Channel 4 is delivering its remit in future and assess the impact of any pressures on its funding?

- 5.43 As we noted in the last PSB Review, there is a relationship between Channel 4 and other elements of our digital PSB strategy. It would therefore be most useful to consider the future for Channel 4 in the context of a wider assessment of PSB, which would identify priorities for the future of PSB as a whole and take into account the potential contributions of other broadcasters and media providers, including any Public Service Publisher (PSP). We have already announced that we will bring forward the start of the next full PSB Review to late 2007, and as one element of that Review will take forward assessment of the future of Channel 4, including its funding, remit and accountability processes.
- 5.44 Finally, it will be important during this period for the Channel 4 Board to articulate publicly its own vision of the Group's role and strategy, particularly with respect to its contribution to public service purposes. The weakening of Channel 4's cross-subsidy model suggests that sooner or later it will reach something of a crossroads. It could continue to be funded on a purely commercial basis, thereby maintaining Channel 4's editorial and operational independence but likely resulting in dilution of Channel 4's PSB delivery. Alternatively, Channel 4's public service commitment could be maintained or strengthened, and possibly extended to new services and channels, with public support if necessary and a greater level of accountability and formal governance that comes with public funding, whether direct or indirect.
- 5.45 Our analysis therefore raises a number of questions for the Channel 4 Board:
- How does it see Channel 4's role and remit developing in future? Does it wish to strengthen and possibly extend Channel 4's public service role, or does it value the independence afforded by a purely commercial funding model?
  - What is the Group's preferred funding and operational model? What would have to change to enable the Group to make the transition to this new model?
  - What resources would be required to deliver this model? What are the advantages and disadvantages of public support for this model?
  - What accountability and governance arrangements would be appropriate for this model?
- 5.46 We would welcome further input from the Channel 4 Board on these questions to inform our work in the next PSB Review, starting later this year.