Ofcom's Second Public Service Broadcasting Review

Annex 7

A synopsis of Oliver & Ohlbaum's economic modelling of future scenarios for public service content

Phase One

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Introduction

1.1 As part of the PSB Review, Ofcom commissioned Oliver & Ohlbaum Associates (O&O) to work on future scenarios for, and long term economic models of, the UK TV industry. This document is Ofcom's synopsis of the work. The work has informed some of the initial findings set out in section 7 of the main consultation document.

1.2 O&O worked with Ofcom to develop a number of scenarios for production, distribution and consumption within the UK TV industry and in particular public service content. Of a range of scenarios developed, four were chosen for detailed study.

1.3 The scenarios have been used to develop a long-term economic model of the UK market for TV content. The model is based on assumptions about future platform development and audience behaviour, and the subsequent capacity for new and existing providers to secure revenues and invest in content.

1.4 The model has been tested for sensitivities to changes in the TV advertising market, and has built in potential responses from players to market conditions. Given current uncertainty in the market, and the length of the period covered, the aim of the work has been to understand the range of potential outcomes under different scenarios, rather than predict market direction.

1.5 The key outputs from the model are viewing share, revenues, original programme investment and public service content output for both the public service broadcasters and the wider market. The model extends to 2020. Within this period, we refer to the short-term (2007 until 2011), medium-term (2011 to 2014) and long-term (2014 to 2020).

1.6 Further detailed analysis has been conducted to understand the different economics of production and broadcasting for programme genres with relevance to delivering public service purposes and characteristics.

1.7 A synopsis of the development of the scenarios and assumptions, the economic model and range of outputs and the analysis of genres relevant to public service content is set out in the following sections.

Key Findings

1.8 In a rapidly changing environment, it is difficult to predict exactly how markets will evolve and what need for intervention in public service content will remain. The work has been used to assess the different potential prospects for the future delivery of public service content.

1.9 The key findings from the work, highlighted in Section 5 of the main consultation document, are:

1.9.1 There is a range of plausible scenarios that would imply very different outcomes for the market. The long term outcomes are wide ranging and highly uncertain. The direction of the industry is not predictable or singular: it may exhibit elements of the scenarios at different points.

1.9.2 The key drivers of differences between scenarios appear to be the speed of take up of new platforms and services, the rate of audience fragmentation across these and the ability of industry participants to raise revenues from audiences as they change.

1.9.3 The future growth of television advertising revenues is particularly uncertain. The outcomes modelled under the scenarios range from roughly flat revenues for the commercial public service broadcasters to annual double-digit falls, particularly in the medium to long term.

1.9.4 Revenues from new platforms and services, such as consumption of content via mobile or web, will increase. However, these are likely to be relatively modest compared with other main sources of income, shared with other parties and potentially cannibalistic of traditional revenue sources.

1.9.5 The decline of recent years in the reach and hours of viewing for the public service broadcasters is likely to continue through the digital switchover period to 2012. The rates of decline thereafter are more uncertain.

1.9.6 There is a considerable risk to the overall level of investment in original programming for the UK, and particularly to innovative or risk-taking programming within this. In most scenarios, the analysis suggests a slow but steady decline in investment in original content by UK broadcasters over the forecast period. However, in the most radical scenario, content investment declines sharply.

1.9.7 The scenarios have very different implications for the type and genres of programming provided. In all scenarios, the current financial pressures on UK children's programming and nations and regions services are likely to continue. In some scenarios, a wider range of other genres, and the amount of original UK programming within them, will be at risk. Serious factual output, arts and potentially aspects of UK drama and comedy are genres where the volume and nature of output may be at particular risk.

Developing scenarios

2.1 The future of the UK media landscape is highly uncertain. There are a wide range of possible scenarios for future market development, with very different implications for future delivery of public purposes.

2.2 The relevant market under consideration is broad, and includes a mix of public and private companies operating across a number of platforms:

2.2.1 The BBC PSB services – both its TV channels and online services

2.2.2 Commercial PSB channels (ITV1, Channel 4, Five);

2.2.3 Non-PSB television channels including portfolio channels from the commercial PSB groups e.g. ITV2, E4, Five US and other channels available on digital TV platforms e.g. Sky One, Living TV.

2.2.4 On-demand services using "closed" systems e.g. BT Vision, Tiscali and the on demand services available on the cable platform

2.2.5 On-demand services using "open" systems (primarily the internet) such as the BBC iPlayer, 4oD and other non-proprietary commercial internet video services e.g. Joost, You Tube

2.3 The impact of a number of market drivers has been assessed. The key drivers of future change in consumption and production seem to be:

- the speed of uptake of new platforms and technologies, which will make more services available in more places to more consumers;
- the speed of audience fragmentation among services i.e. whether consumers will make use of these new services, and what providers they will turn to;
- the ability of industry players to raise revenues from changes in audiences, either directly through subscription or other consumer payment, or indirectly through advertising.

2.4 The key structural change affecting the industry is the pace and range of new platform and technology uptake. In the short term, up to digital switchover in 2012, this will be driven the adoption of primary and secondary digital TV sets up to the point of analogue switch off. However, many providers are already developing and marketing non-linear on demand services, often as part of a bundled communications offer to consumers. In addition, new online and mobile network internet services are being developed that facilitate on demand viewing outside of the current "closed" platforms.

2.5 The increasing uptake of new platforms creates the potential for audiences to fragment among services. This may occur in three ways:

2.5.1 Between platforms, as IP becomes a viable delivery mechanism, and open internet content competes with traditional broadcasters;

2.5.2 Between viewing to linear and on demand content across platforms;

2.5.3 Between the choice of content providers on these services.

2.6 The viability of commercial services will depend largely on the ability to maintain revenue yield as audiences change in these ways, and particularly by targeting and raising revenues from smaller audiences as they fragment.

2.7 The key drivers outlined above have been used to develop a range of scenarios for future consumption and production of public service content. From this range, four scenarios have been selected for development. A description of these scenarios is given in the table below.

Figure 1 Scenario Descriptions

SPEED OF NEW PLATFORM AND TECHNOLOGY UPTAKE	SPEED OF AUDIENCE FRAGMENTATION: LOW	SPEED OF AUDIENCE FRAGMENTATION: HIGH
HIGH	**CONSOLIDATION** • Adoption of new technology is relatively high. • Use of linear TV platforms static. • Some viewing migrates to other platforms and internet content. • Consumers look to trusted content aggregators to navigate market. • Current players respond by acquisition / launch of new linear and on-demand services, retaining viewing across multiple platforms. Existing players consolidate share of the market in response to fragmentation. • Vertical and horizontal integration in industry leads to higher returns for a small number of large content providers and earn returns. • Less incentive for new players to invest in content.	**RADICAL FRAGMENTATION** • Take-up and usage rates for new technologies are very high. • High fragmentation of viewing by platform and operators. • Consumers divide into niches with divergent media use – blending linear, on-demand, interactive and user generated. • Audiences for linear broadcasting are mainly old, downmarket. • Advertisers seek affluent targets on other platforms. • Few operators therefore have scale or resources to fund programming.
LOW	**GRADUAL TRANSFORMATION** • Steady increase new technology adoption and usage; incremental rather than substitution. •Continued growth of DTT, and slow growth of Pay TV or IPTV platforms • Linear TV viewing continues to lead consumption. • Share of viewing to the PSBs declines to DSO, then slows. • Non-PSBs do not develop greater scale to invest. • PSBs leverage scale and investment more effectively.	**STAGNATION** • Adoption of new technology is relatively high; seen as utilities rather than new services. • Consumption of linear audio-visual material across all platforms wanes. • Freeview via DTT becomes prevalent at the expense of Pay TV. • Free To Air broadcasters retain high share of declining viewing. • Wide availability of free material on broadcast platforms and on-line, and piracy of digital content, leads to a sharp fall in investment. • Premium on-demand content remains marginal. New media entrants are unable to invest in new content.

2.8 Within each scenario, there are underlying assumptions about platform adoption and viewing behaviour by audiences, and revenues and programme expenditure for producers and distributors. The key assumptions for each of the scenarios are detailed below. These assumptions have been built into the macro-forecast model as variations from a base case "steady state" scenario.

Figure 2 Scenario Development Assumptions

	GRADUAL TRANSFORMATION	RADICAL FRAGMENTATION	STAGNATION	CONSOLIDATION
PLATFORMS	• DTT penetration increases to 2020 • IPTV penetration moderate • DSAT & DCAB low growth year on year after 2012	• IPTV penetration increases significantly to 2020 • Less "TV households" as more viewers watching web-only TV via Internet by 2020 • DTT uptake declines in late period	• DCAB penetration and DSAT fall by 2020 • DTT penetration increases share of market • IPTV subscribers growth moderate after 2012	• DSAT & DCAB penetration remain flat • DTT penetration flat after 2012 • IPTV penetration flat after 2012
AUDIENCES	• Decline in TV viewing after 2012 • Switch to more non-linear viewing in DSAT households • Low reduction in PSB share of viewing	• Average viewing hours across all platforms decline to 2012, quickly thereafter • All platforms have on-demand viewing by 2018	• Average viewing is flat to 2012, declines thereafter • BBC increases its share of viewing by 2020 • Commercial PSBs share of viewing falls proportionately	• Average viewing is flat to 2012 then declines moderately • BBC share of viewing increases by 2020
REVENUES	• Growth in ancillary revenues • 50% of ads skipped in PVR and catch-up viewing • Decline in impacts for the commercial PSBs and a increase for multi-channel	• Total traditional TV impacts fall by 12% year on year • 50% of ads skipping in PVR and catch-up viewing • Multichannel CPTs increase to level of commercial PSBs	• Commercial PSB impacts and multichannel impacts • CPTs for commercial PSBs fall	• Commercial PSB impacts fall and multichannel impacts increase • CPTs increase for the commercial PSBs
PROGRAMME SPEND	• BBC increases programme spending just above inflation • Commercial channels increase programme spending at lower rate	• Commercial PSBs significantly decrease programme spending after 2010, cutting proportion of original spend • BBC continues to hold spending flat in real terms	• All channels except the BBC reduce programme spend after 2010 • Proportion of origination spend to total budget falls for the commercial broadcasters	• Commercial PSBs increase programme spending from 2010 until 2014 • BBC increases programme spend just above inflation

Advertising market assumptions

2.9 The overall advertising market is central to the revenues of the commercial sector for audio-visual content. It is particularly important to the commercial public service broadcasters for whom it represents a very high proportion of revenues.

2.10 There is significant uncertainty as to the prospects for the TV advertising market. There are a number of extrinsic factors that can effect the growth of the advertising market, and the share of advertising expenditure within it to TV broadcasters. These are likely to be major sources of uncertainty at different points in the forecast period.

2.11 In the short-term, there is a risk of economic downturn in which, looking at historical precedents, total expenditure by advertisers may temporarily be reduced – as happened at the end of the 1980s and 1990s. In all of the scenarios, a 1% nominal decline in advertising revenue to the industry has been assumed in 2008 and 2009. Given the length of the forecast period the impact of macroeconomic fluctuations between 2010 & 2020 have been excluded from the core forecasts. However, if a down-turn were to prove more protracted, further similar reductions in advertising expenditure overall could reduce the revenues of commercial broadcasters by between 10% and 20% in real terms across the different scenarios.

2.12 In the medium to long term, the greater uncertainty is whether TV broadcasters can retain their value and share of revenue in the advertising mix given the increasing alternatives available to advertisers.

2.13 The growth in online advertising has been driven in recent years by search advertising, more akin to direct response marketing. To date, it is unclear what – if any - impact this has had on linear TV advertising – which is predominantly brand advertising, on the larger channels. However, increasingly online audiovisual content is being monetised through advertising via a combination of banner adverts, video overlays, interstitials and contextual adverts surrounding video content. This will present advertisers with the opportunity to reach niche demographic audiences via behavioural targeting methods which avoids wastage associated with linear mass audience advertising. Expenditure may be transferred from linear TV to online as a result.

2.14 The loss of revenues to TV broadcasters depends on both broadcaster responses and consumer behaviour. As audio-visual viewing moves on line, broadcasters have launched services to retain audiences and revenues. On TV platforms, broadcasters can potentially develop behavioural advertising propositions to advertisers using embedded set-top box technology. On web-based services, there is potential around audiovisual content to target adverts by content or use data collected via a return path to target viewing patterns. This would allow television to match many of the potential benefits suggested of online advertising.

2.15 The scenarios assessed in this report include assumptions around market responses to structural change in advertising options. Under more positive scenarios it is assumed that broadcasters master and control online advertising models, leading to CPT and revenue upside. Under negative scenario conditions it is assumed that third-party platform and technology platforms control such revenue streams and so limit the upside broadcasters can benefit from in the long-term.

2.16 The competition between broadcasters for TV advertising is perhaps more visible. The ability of the commercial public service broadcasters to retain their share of TV advertising will be dependent on maintaining relative audience size and relative price premium of their advertising inventory (measured as their Cost per thousand (CPT) rates) to the rest of the market.

2.17 The commercial public service broadcasters, particularly ITV and Channel 4, have historically commanded a high CPT over the rest of the market due to their higher unique reach (via analogue) and higher average audiences, the combination of which gives higher population coverage to advertisers. Post-digital switchover, potential reach of the commercial public service broadcasters will be no more than many other channels, and it is likely that the size of average audiences will decline.

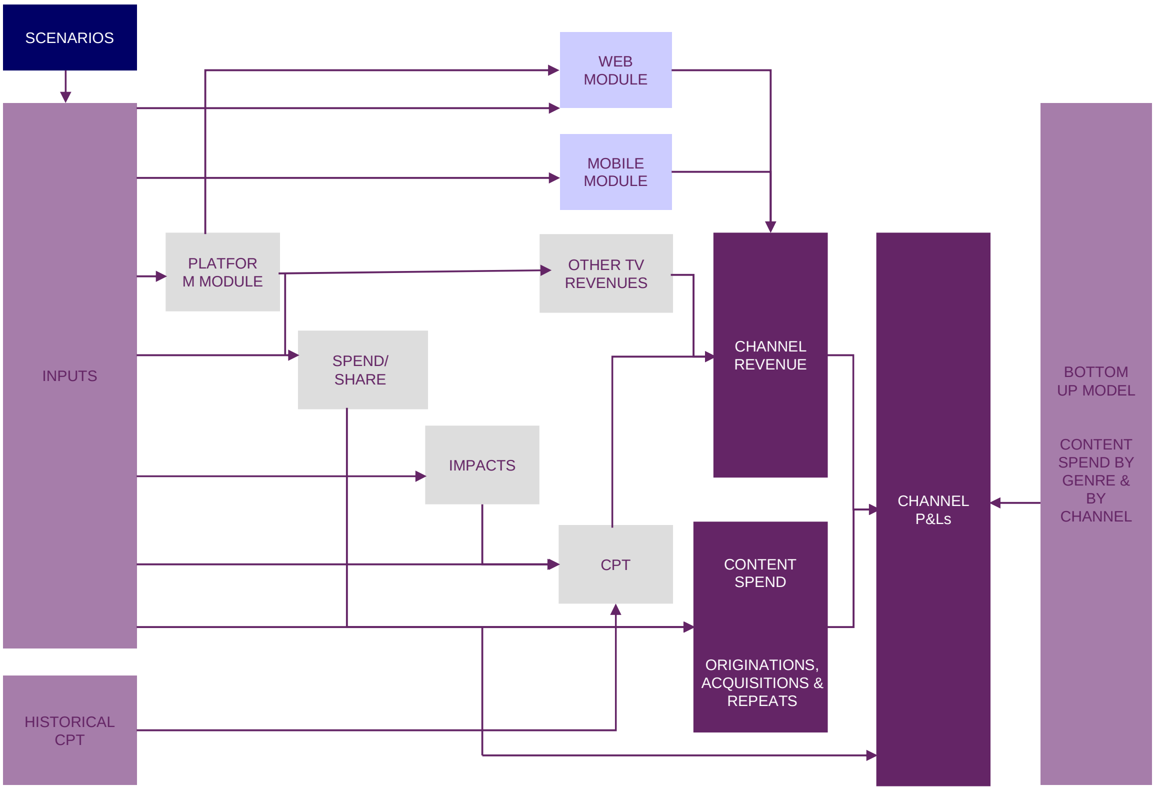
2.18 CPT forecasts are highly sensitive to changes in audience size and an ability to retain a mass-audience premium. Where audiences fragment, advertisers will, over-time, pay less for reach and mass audience in favour of paying to target high value niche audiences. Mass market brand advertisers will be able to reach the required scale of audience by buying a cheap and dispersed mix of multi-channel airtime and run-of-site type web campaigns, as opposed to being limited to traditional linear TV channel airtime.

2.19 The radical fragmentation scenario assumes that the main terrestrial channel and multi-channel CPTs rapidly converge towards a market average. By contrast, under gradual transformation the commercial public service broadcasters will retain a slowly shrinking majority share of overall impacts in the market and therefore some ability to maintain their CPT price premium.

Macro economic model

3.1 The scenarios and underlying assumptions detailed above have been incorporated into the macro economic model. The key outputs are forecasts under each scenario for audience viewing share, revenues and programme expenditure.

Figure 3 Macro Model Methodology



3.2 The modelling suggests that, under the different scenarios, there would be considerable differences in how the market develops – both to the total amount of viewing, industry revenues and programme investment, and the proportion of these that the existing public service broadcasters or public service content may represent.

Links and stabilisers in the macro model

3.3 Over the period, the key outputs are interlinked within each scenario so that the model is dynamic. For example, a decline in audience share for a commercial broadcaster is likely to lead to a fall in revenue, which may influence the broadcaster to reduce programme investment. Programme investment has, historically, been a key differentiator and driver of audiences: when reduced, audience share may decline further leading to a cyclical decline in performance.

3.4 All scenarios have been modelled using an iterative process to reflect likely broadcaster strategies and responses to changes in market conditions over the forecast period. The macro-model incorporates key feedback loops, or stabilisers, which mitigate many of the extreme positive and negative drivers within the various scenarios. These include:

3.4.1 The BBC. One likely strategic response to declining net advertising revenue (NAR) and margin pressure is reductions in original programme spend by commercial broadcasters. Given a relationship between programme spend and audience share it is likely that commercial audience levels will suffer as a result. In contrast, a well funded BBC will increasingly account for a greater proportion of total UK programming spend and so will actually grow audience share.

3.4.2 Programme source mix. At the same time as overall programme budgets are cut, investment is increasingly shifted away from expensive original programming and in-demand premium acquired programming into more cost effective acquisitions and repeats, restoring overall margins.

3.4.3 Programme spend and audience share relationship. In scenarios where fragmentation occurs broadcaster spend/share ratios (how well investment can leverage audiences) converge leading to a more static audience change from one broadcaster to another, relative to overall variations in programming spend in any single year.

3.5 Under the extreme negative conditions in the radical fragmentation scenario, the stabilisers incorporated into the model are largely unconstrained. This leads to a rapid spiral of decline for larger broadcasters. The continual drop in revenues and spend is perpetuated until the broadcaster is at a similar scale to many other multi-channel broadcasters.

3.6 The key outputs from the model under the different scenarios are set out in the sections below.

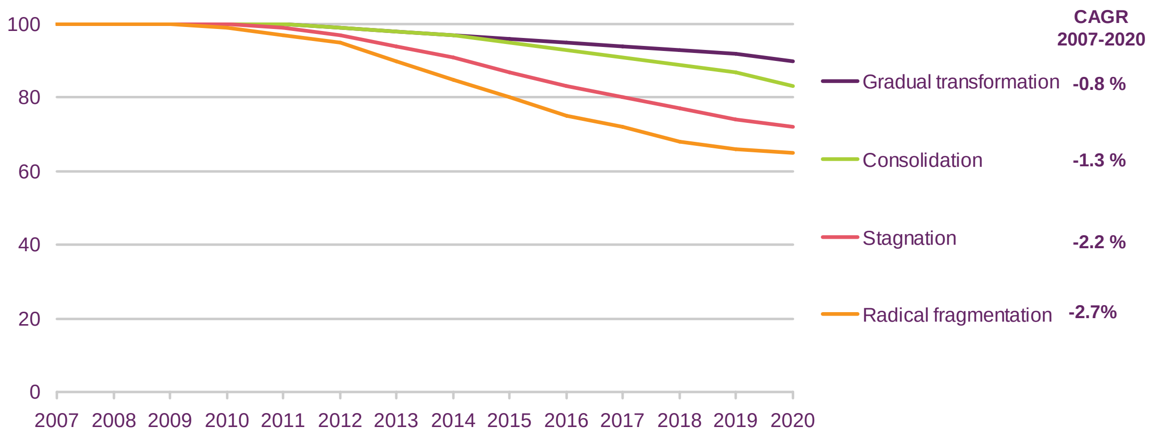
Viewing and audience share

4.1 As set out in paragraph 3.55 of the consultation document, total viewing in the UK of audio-visual content has been relatively robust. In the last four years, total average viewing hours have fallen by 2.7%. A marginal decline in viewing is expected to continue, particularly among younger audiences.

4.2 As set out in Annex 6, total reach of TV has fallen marginally since a peak in 2002. This trend is likely to increase as new platforms and services, particularly internet based, facilitate access to audio-visual content away from the TV. The proportion of viewing to linear TV platforms will decline as on-demand, time-shifting and place-shifting of content consumption become more commonplace.

4.3 The figure below sets out the model outputs for the proportion of total viewing to linear TV viewing of all channels under the scenarios. Under consolidation and gradual transformation, linear TV viewing would still represent 85% to 90% of total audience viewing of TV content by 2020. However, under radical transformation up to 40% of viewing would be non-linear, on-demand based.

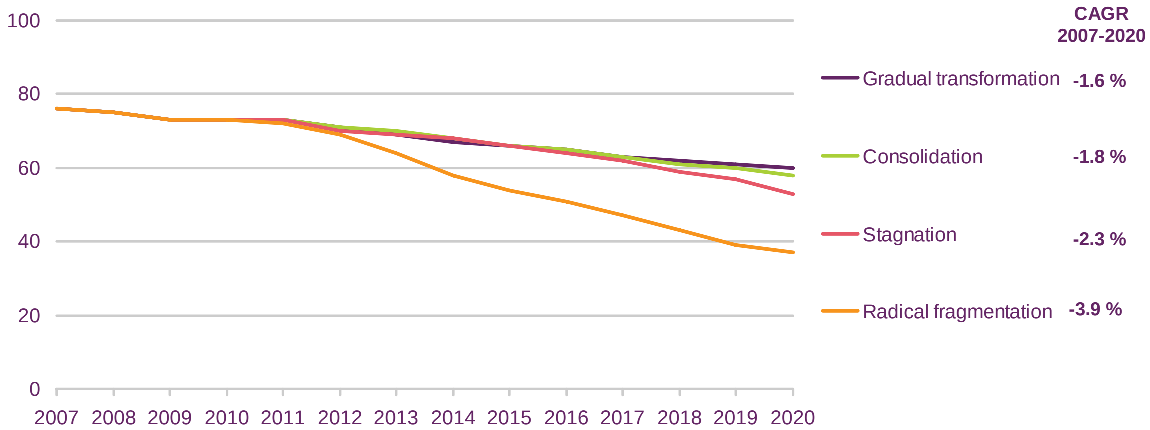
Figure 4 Linear TV viewing as a proportion of total TV viewing by scenario (%)



4.4 The model separates viewing to the public service broadcasters from total TV viewing by platform. The figure below sets out the potential proportion of total viewing to the public service broadcaster linear channels under the scenarios (i.e. total viewing minus viewing to all other services and the non-linear services operated by the public service broadcaster groups).

4.5 As viewing to public service broadcasters is likely to continue to be weighted toward linear channel viewing, the share of total viewing accounted for by the public service broadcasters is likely to continue to decline. Under gradual transformation or consolidation, the forecast suggests that viewing to all of the public service broadcasting channels may still account for 60% to 65% of total viewing by 2020. However, under radical fragmentation – where audiences migrate quickly away from linear services – the share of total viewing to the public service broadcasting channels may fall below 40%.

Figure 5 Linear TV viewing as a proportion of total TV viewing by scenario (linear and web) (%)

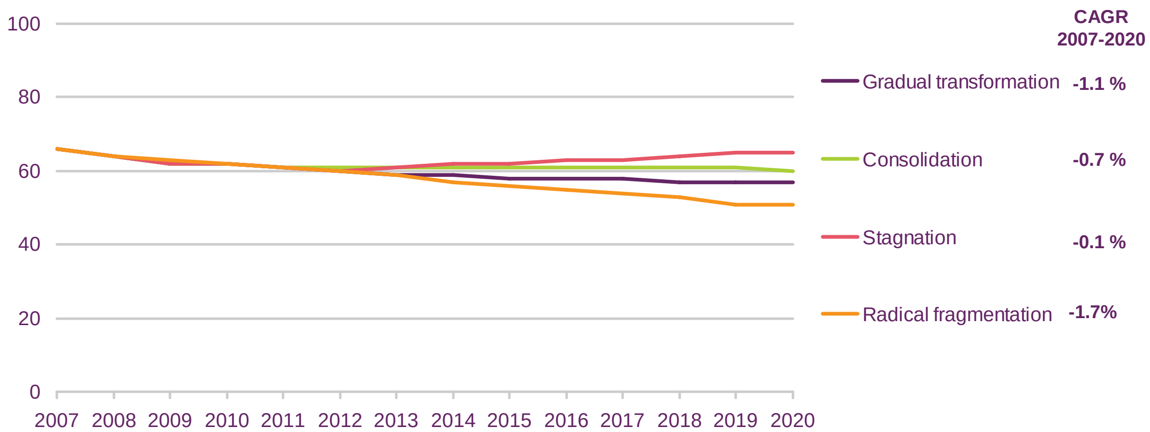


4.6 The model also separates the share of audience for linear TV viewing by different channels. This is based on the more standard audience metric of linear TV viewing share by household, as measured by BARB. As noted in paragraph 3.56 of the consultation document, in the last five years the viewing share to main terrestrial channels has fallen to 63% of TV viewing in all households.

4.7 The figure below sets out a potential range for the viewing share to the main five terrestrial channels under the scenarios. Across the scenarios, the public service broadcasters' audience share decreases consistently to digital switch over. The main single driver of change in the short term will be the households still to switch to digital TV gaining access to an increased choice of channels.

4.8 In the longer term, there is greater uncertainty in the share of TV viewing that the main terrestrial channels will represent. Under, gradual transformation and consolidation, a relatively steady decline to 55% to 60% is possible. Under radical transformation, where there are many more channels attracting niche audiences, the share of the main terrestrial channels may fall to 50%. However, under stagnation, where investment in channels outside of the traditional players will be very limited, the main terrestrial channels may recover viewing share to a similar level to 2007.

Figure 6 Main terrestrial channel audience share of linear TV viewing by scenario (%)



4.9 In all of the scenarios, the BBC family of channels is likely to experience the least decline in audience share in the long term as its ability to invest in programming is relatively certain. Under gradual transformation, the share of viewing to BBC1 and

BBC2 is likely to be constant; under radical transformation it may marginally increase as competition for audiences from elsewhere weakens. The BBC digital only services, which are well-funded compared to many other digital only channels, will add to this share of audience overall.

4.10 All of the commercial public service broadcasters may lose audience share under the scenarios. The proportional loss in audience share will be highest (over 50%) under radical transformation. However, under the other scenarios the commercial public service broadcasters would be able to mitigate the loss to about 20% of their current collective share of audience. .

4.11 This decline may be partially offset by the portfolio of channels operated separately by the commercial public service broadcasters. Under gradual transformation or consolidation, the comparative strength of the portfolios channels to the rest of the multi-channel market may maintain the share of viewing to the family of channels overall. However, under stagnation and radical transformation the portfolio channels cannot increase audience share sufficiently to compensate for the significant loss of viewing to main terrestrial channel.

4.12 As this implies, the share of viewing to all other multi-channels (operated by groups who are not public service broadcasters) would increase slowly under gradual transformation but more quickly under radical transformation as audiences migrate. However, under consolidation or stagnation the collective share of audience outside of the public service broadcaster family of channels is likely to fall as programme investment remains centred on the traditional players.

Industry revenues

5.1 As set out in section 2.1 of the Ofcom Communications Market report 2007, recent growth in the traditional sources of funding for the TV industry has been limited. Though there are areas of revenue growth in the sector, it is uncertain whether these will be reliable new revenue streams with direct returns to UK TV broadcasters. For example:

5.1.1 Growth in direct consumer revenues, via subscriptions or pay-per-view, are returns to platform operators, and not fully or directly to broadcasters;

5.1.2 Growth in secondary revenues (overseas sales, merchandising, online distribution) will in the main flow to content owners or rights holders, who will not necessarily be the original broadcaster.

5.2 The public service broadcasters currently have limited direct exposure to these sources of revenue. They operate stand-alone commercial arms that participate in these sectors. While these companies, or other third parties, may advance funding to the broadcaster for a particular production, this is on a stand-alone commercial basis.

5.3 Where revenues are directly attributable to the content of the public service broadcasters, such as consumption of video via mobile or web, there is the potential for broadcasters to share in advertising revenues or consumer payments. However, revenues may be:

5.3.1 shared more broadly among the value chain (including rights owners, content producers, broadcasters, content aggregators, advertising servers and platform operators);

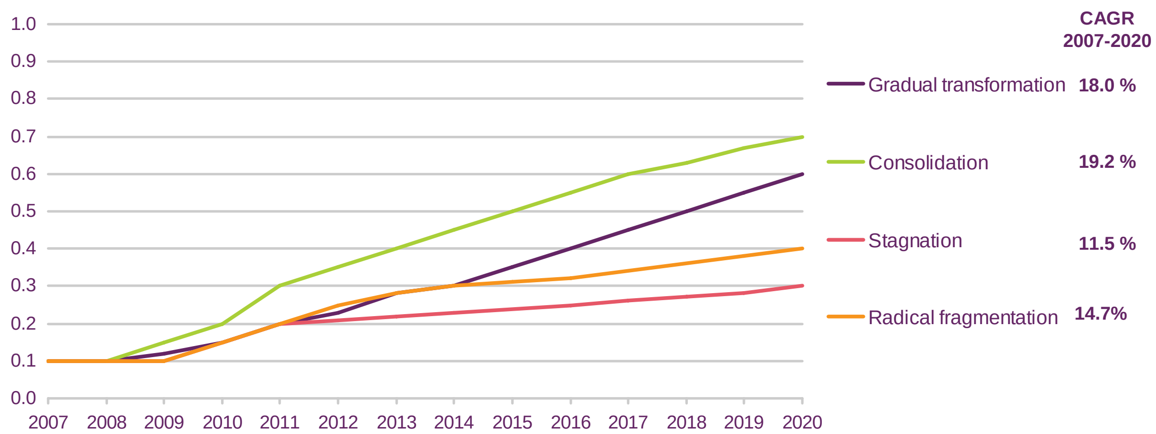
5.3.2 a result of the use of archive material, as opposed to new programming;

5.3.3 potentially be cannibalistic of current revenue streams.

5.4 Revenues are therefore likely to be relatively modest compared with the traditional main sources of income to TV broadcasters.

5.5 The figure below sets out the range of potential web and mobile revenues (both advertising and consumer payments) returned to the public service broadcasters. Under the four scenarios, content revenues via new platforms returned to the public services broadcasters are forecast in the range to £0.3bn to £0.7bn by 2020, at relatively high rates of annual growth. However, even under consolidation, where audiences are retained by the public service broadcasters partly via new media distribution, this would still represent less than 20% of the revenues earned from traditional funding sources.

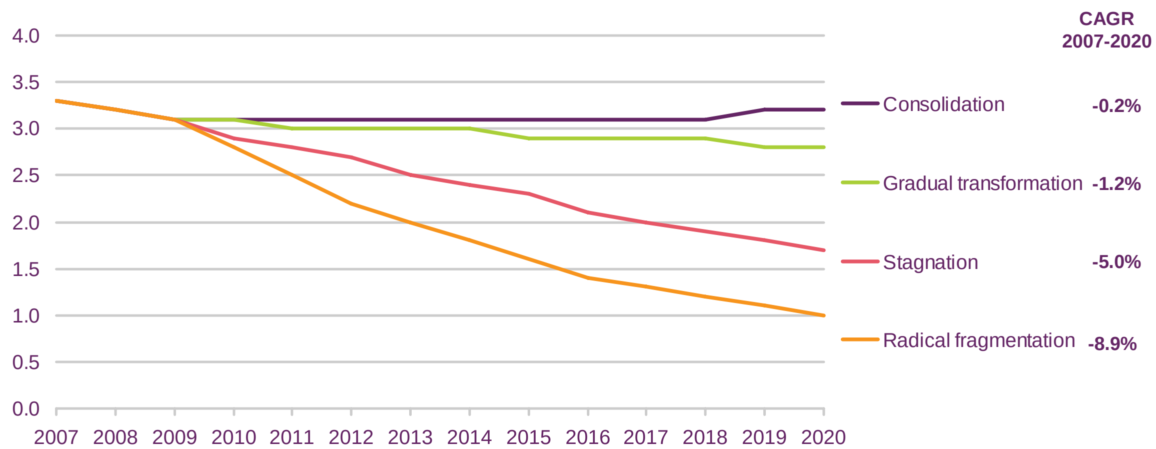
Figure 7 Web and mobile content revenues to PSBs by scenario (£BNs) (Real terms)



5.6 The figure below sets out a potential range for total UK TV market advertising revenue to all commercial channels.

5.7 As outlined in the advertising assumptions section, following the anticipated short term decline in revenues due to economic conditions, there is a very wide range of possibilities in the medium to long term. Under radical transformation and stagnation, the market may decline by -9% and -5% per year respectively to 2020. Under consolidation, TV advertising revenues are constant in real terms over the period – and uplift toward the end of the period – as broadcasters are able to retain and monetise audiences.

Figure 8 Total UK TV market net advertising revenue by scenario (£BNs) (Real terms)

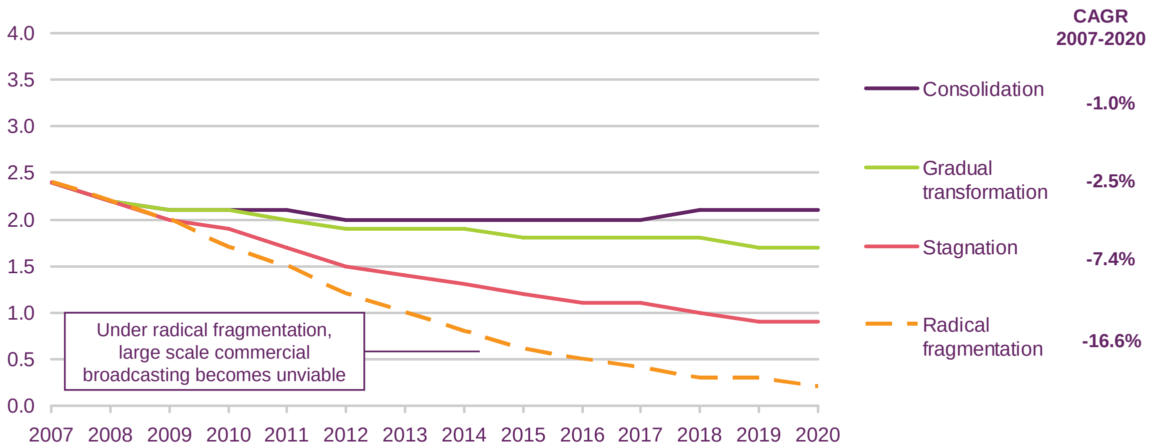


5.8 The figure below sets out the potential range for TV market advertising revenues to the commercial public service broadcasters collectively.

5.9 As, in the short term, the main terrestrial channels will continue to account for a high share of total audience, the trend in revenues is similar to that of the total TV advertising market. In the medium and long-term, there is a greater potential variation between scenarios. If the commercial public service broadcasters are able to maintain pricing premia of advertising slots to other broadcasters (under gradual transformation) or aggregate and monetise smaller audiences (under consolidation) then revenues may be held broadly in line with the total market, falling at -1% or -2% per year in real terms.

5.10 However, the fragmentation of audiences among many providers (radical transformation) or lack of available investment (stagnation) may negate this ability. Under these two scenarios, declines in revenue are likely to become self-perpetuating. If the commercial public service broadcasters lose scale and CPT price premia, their revenue decline will compound at faster rates than the market overall. Advertising revenues to the commercial public service broadcasters could fall to less than a quarter of their current levels: under this scenario a scale commercial TV model is largely unviable.

Figure 9 Commercial public service broadcaster net advertising revenues by scenario (£BNs) (Real terms)



5.11 The critical importance of scale to retaining TV advertising revenues is further underlined in the forecasts of public service broadcaster group commercial revenues. Only under the consolidation scenario, where audience levels are retained by the public service broadcasters across their family of channels, will the revenues from portfolio channels off-set any decline in revenues to the main terrestrial channels. In all other scenarios, the operation of a portfolio of channels with smaller audiences and weaker advertising price premia can at best limit the rate of decline (gradual transformation). Under radical fragmentation, the revenue of family of channels collapses as no one channel in the portfolio can earn more than the market average.

5.12 Similarly, the outlook for advertising revenue growth to multi-channels outside of the public service broadcaster groups may be weak. Without significant investment to increase scale, these channels will be competing with each other for a small share of what may be declining audiences and revenues. Revenue lost to the main terrestrial channels will not necessarily migrate to the rest of the market if individual channels are unable to attract the large audiences that advertisers have traditionally most valued TV for. Under all the scenarios, total advertising revenues outside of the public service broadcaster channels are expected to marginally decline.

Original programme investment

6.1 As noted in Section 2.45 of the consultation document, investment by the main terrestrial channels in original programming has fallen marginally in relative terms since 2002. The increasing pressure on revenues, particularly in the commercial market, is likely to put commercial broadcasters under financial pressure to reduce original programme investment if they are to preserve operating margins.

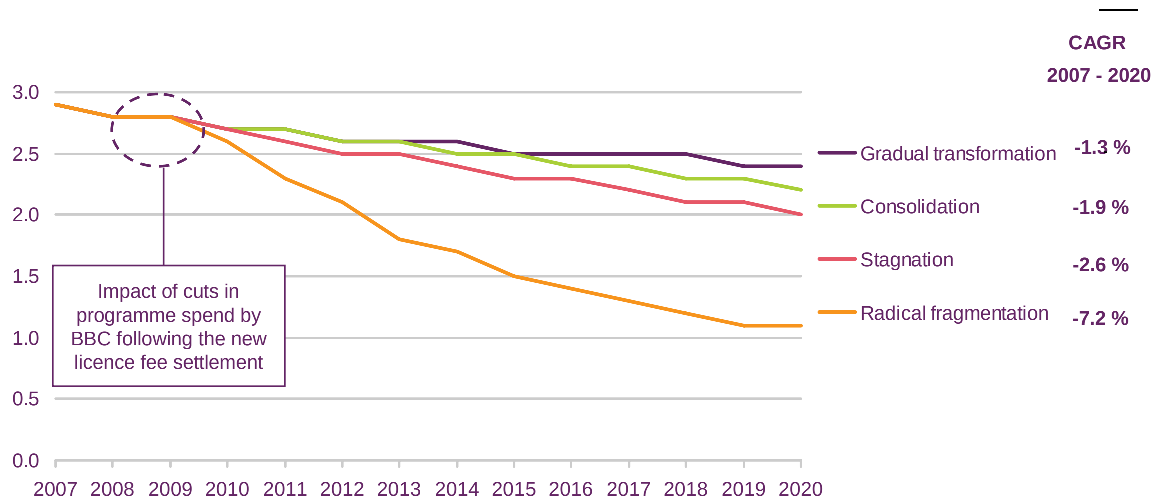
6.2 The figure below sets out a potential range for total original UK programme investment across all UK channels.

6.3 In the short term, there is likely to be a reduction in original programme expenditure commensurate with the decline in advertising revenues as broadcasters adjust costs. In the medium to long term, the decline in original programming will depend on whether broadcasters retain the ability and incentive to invest in original production.

6.4 Under gradual transformation broadcasters retain most scope for original programme investment. Large broadcasters will retain the scale to fund a range of programming: they will have incentive to try to aggregate audiences via strong content in order to maximise revenues. Under this scenario, original programme investment may broadly fall in line with revenues.

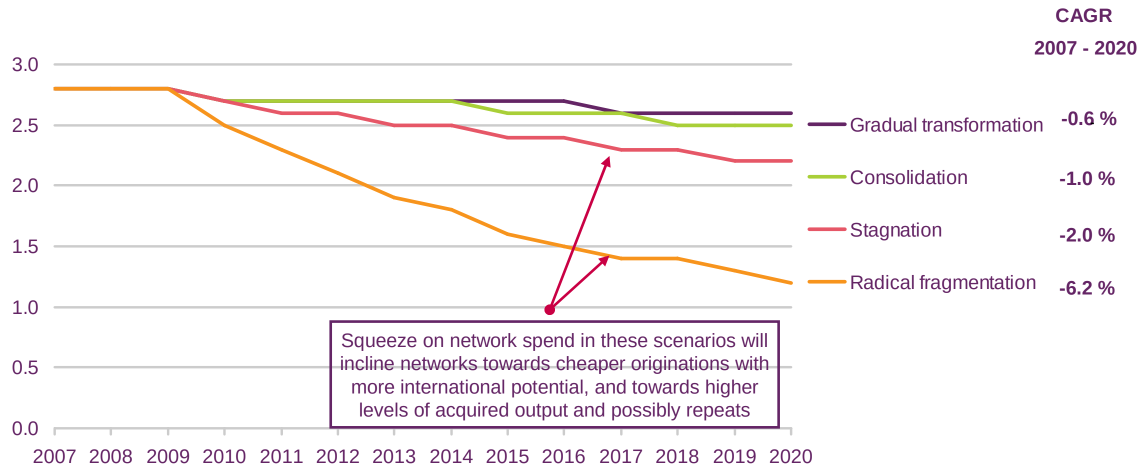
6.5 Under other scenarios, broadcasters may retain scale but there will be less incentive to invest in programming, due to either less competition for audiences (stagnation) or less available revenues for attracting them (stagnation). Under radical fragmentation, commercial broadcasters will have significantly less resources or incentive to invest in original programming. This could lead to reductions in original programme investment of over 50% in the period.

Figure 10 Total original programme investment by scenario (£BNs) (Real terms)



6.6 Under all scenarios, the main five terrestrial channels will continue to account for the vast majority of original programme investment in the market. The trends for the overall market are therefore set by the main five terrestrial channels, as in the figure below.

Figure 11 Main five terrestrial channel programme investment by scenario (£BNs) (Real terms)



6.7 Following the already announced step budget reduction in 2008, BBC original expenditure across its family of channels is likely to be relatively constant. The BBC's income is comparatively fixed: the level of the licence fee is set to be constant or slightly declining in real terms, although growth in the number of households paying the licence fee may offset this. In most scenarios it is assumed that, with a remit to original production set out in the service licences, BBC total original programme investment returns in real terms to current levels. However, for the radical transformation scenario, it is assumed that the BBC remit is dispersed to serve smaller audiences, and that original programme expenditure falls accordingly. Nonetheless the BBC will remain the largest single investor in UK original programming: its share of original programme investment is likely to increase.

6.8 It is expected that, in a mature market, the commercial public service broadcasters will all be under pressure to maintain their current, different, operating margins. The rate of reductions in original programme investment is therefore largely commensurate with the reduction in advertising revenues. Under gradual transformation or consolidation, original programming investment by the commercial public service broadcasters would fall by 25% in real terms over the period. Under radical fragmentation, where there becomes no incentive or resources for channels to spend above the market the commercial public service broadcasters may reduce their programme investment, which is comparatively high compared to the market, significantly.

6.9 The declines in programme investment by the commercial public service broadcasters are unlikely to be off-set by the wider commercial market. Under all scenarios, total original programme investment by other channels is unlikely to increase significantly beyond current levels, as the incentives to do so are weakening. The economics and the continued strength in the market of the public service broadcasters under gradual transformation or consolidation means other channels will have few further incentives to increase investment in UK original programming. Under radical transformation or stagnation, with market revenues declining overall, there is little commercial rationale to sustain investment in more expensive programming. Under gradual transformation, original programme investment outside of the public service broadcasters will remain broadly constant to current levels. Under all other scenarios, original investment from this source is likely to decline.

Public service content output

Commercial viability of programme genres

7.1 The detailed analysis of the economics of particular genres is based on a simplified comparison, for each individual commercial public service broadcaster, of the average audience per hour for the genre (from which average revenues are calculated) compared with the average cost per hour of the genre. The analysis should be read as general and indicative: there will be exceptions to the average programme performance. The figure below sets out summary analysis of the indicative current profitability in the broadcast schedules of key genres for the commercial public service broadcasters.

Figure 12 Profitable and non-profitable genres for the commercial public service broadcasters 2007 (indicative)

Schedule margin of genre for Commercial PSBs	Small audiences	Large audiences
Very Profitable		Soaps Factual Entertainment
Marginally profitable	Arts Factual National News Natural History Human Interest	UK Entertainment Non-UK Film Football Factual Drama UK Drama Series and Serials
Marginally unprofitable	Music Religion Hobbies & Leisure UK Film Current Affairs UK Sitcom Non- UK Comedy/Entertainment Other Sport	UK One-off Drama
Very Unprofitable	Nations and regional News UK Children's	

7.2 The analysis suggests that there are already key differences in the commercial viability of genres across the commercial public service broadcasters. It is clear that a number of genres relevant to public service broadcasting purposes are already relatively commercially unattractive for broadcasters. Nations and regions news and UK children's programming are clearly unprofitable genres. Current affairs, religion, UK one-off drama and UK comedy are in general marginally unprofitable.

7.3 Other genres such as non-UK comedy or non-UK entertainment are in general unprofitable for the commercial public service broadcasters but are provided in volume by the rest of the market, as are genres such as hobbies and leisure and music that serve a wide number of audience niches.

7.4 Despite low average audiences it is possible to currently extract small profits from marginal commercial genres, such as arts, serious factual and natural history. Additionally, UK film, UK sitcoms and UK single drama are popular, but as relatively expensive genres are therefore not produced in volume.

7.5 However, the provision of small volumes of some marginal genres is essential to the proposition of a "mixed genre" model under a scenario such as gradual transformation as it may preserve broad reach of a channel in order to attract the largest potential audiences to profitable genres. If broadcasters merely focused solely on the most profitable genres their schedules would be less attractive to many light viewers, leading reach and share to decline. This driver is less important under the radical fragmentation or consolidation scenarios where audiences are targeted discretely by individual content rather than an entire schedule.

7.6 In the future, under a number of scenarios, it is likely that additional genres that are currently profitable are at risk of becoming unprofitable, and less attractive to all commercial broadcasters. Genres which are currently marginally unprofitable may be at risk of becoming more so.

7.7 Under gradual transformation or consolidation, genres that currently have positive margins are likely to remain so even as audience sizes fragment, as broadcasters maintain their ability to monetise viewing. The margins of different genres would broadly remain constant.

7.8 Under a stagnation scenario, a decline of commercial revenues for channels as a whole would mean that low audience and margin genres such as arts, science and serious factual would become loss making. Conversely, radical transformation poses the greatest risk to the viability of UK drama, UK soaps, football, national news and factual entertainment as these are high cost genres dependent on attracting large audiences.

7.9 Under some scenarios, pressures on purely commercial broadcasters are likely to cause withdrawal from low margin, high costs genres such as investigative current affairs, arts, natural history programming. Under its current remit, Channel 4 could remain the only other public service broadcaster in competition with the BBC in such genres. However, Channel 4 is also likely to experience falls in margins on other genres, with many key genres (particularly UK sitcoms, arts, religion, news and current affairs) becoming unprofitable across all scenarios. It may reduce output in these genres.

7.10 Under all scenarios, non-public service broadcaster providers are likely to continue to focus on niche genres, such as music, hobbies and leisure and sport. Limited prospects for revenue growth will incentivise focus on cheaper programming (internationally acquired drama, comedy and entertainment) rather than large scale original production.

Implications for original investment in genres

7.11 Any change in the commercial viability of genres will affect the incentives of the main sources of funding – broadcasters and producers - to invest in original production in the genre.

7.12 For commercial broadcasters, the main consideration is whether an original programme in a given genre will have a satisfactory positive margin in the schedule. There may be further considerations in the case of low margin genres – such as arts or national news – where they support the channel brand or overall strategy of reaching a broad audience. If schedule margins decline overall, as under the stagnation scenario, broadcasters may hedge risk by investing in more robust genres such as soaps and dramas to withstand any drastic falls in the market.

7.13 For producers, an additional consideration is not just whether a broadcaster is prepared to commission a programme, but whether there are secondary revenues available that will make production viable or more profitable.

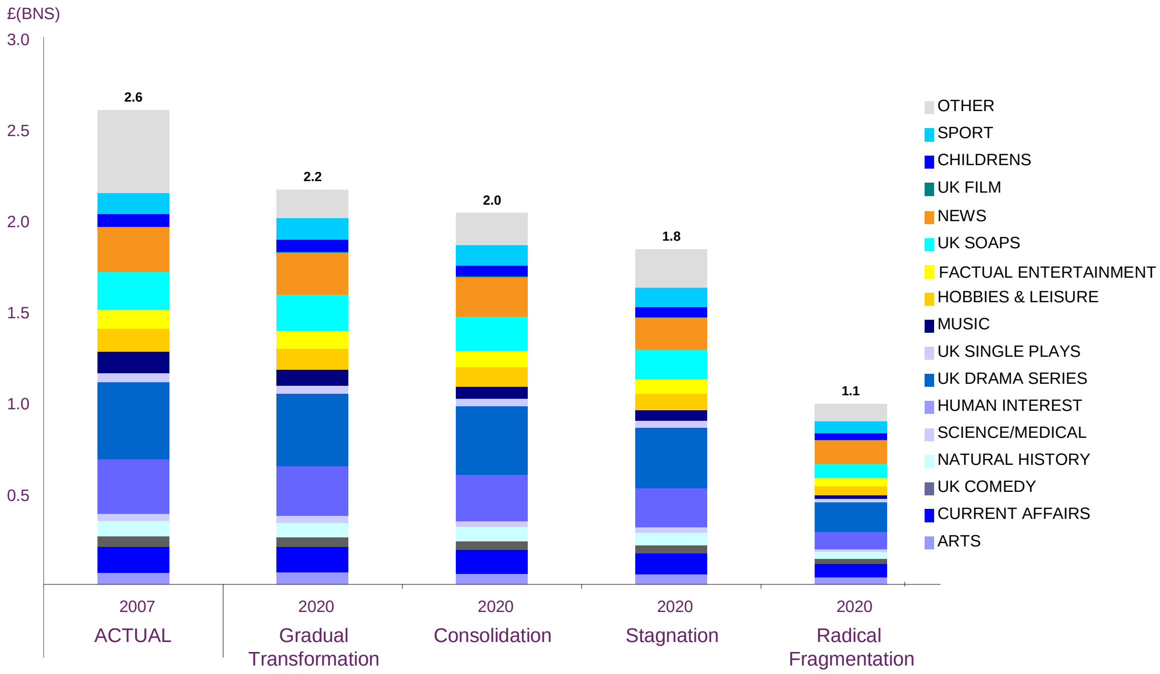
7.14 The bottom-up analysis has taken into account the prospects for secondary revenues in ten key genres where margins are low or negative: arts, current affairs, UK comedy, natural history, science, serious factual, UK drama series, UK single drama, music and hobbies and leisure. The analysis suggests that as a rough indication c.10% of producer revenues in these genres are currently generated from secondary revenues, primarily from overseas sales of finished programmes, licensing and merchandising. Under a base case, secondary revenues in the genres are forecast to grow in real terms, even where traditional sources of revenue decline. By 2020, secondary revenues are forecast to amount to around 14% of total producer revenues from these genres.

7.15 However, prospects for growth in secondary revenue differ by genre. Analysing individual genres, the analysis suggests that genres with the greatest potential (e.g. Drama, Comedy) are already fairly fully exploited, with limited potential for further growth. Additionally, these genres attracting high secondary revenues tend to already be well-funded by commissioning broadcasters. Though expensive, successful productions can attract high audiences. The support of broadcasters in funding, promoting and scheduling the production is instrumental to driving secondary revenues. With the exception of some commercial children’s programming (see Ofcom, The future of Children’s Programming[1]), genres attracting low audiences and that are unprofitable for broadcasters are unlikely to improve profitability significantly via the secondary market.

7.16 Given that the incentives for the commercial market to commission original programming in many genres may decline, and that secondary sources will generate limited growth in additional revenue, there is likely to be a decline in original programming investment across many genres. The figure below sets out modelling of the potential range of original programme expenditure in 2020 by genre under each scenario.

[1] http://www.ofcom.org.uk/consult/condocs/kidstv/

Figure 13 Original programming spend by genre by scenario (£BNs) (Real terms)



7.17 The analysis suggests a total decline in real terms under each scenario. Primarily the scale of overall decline is determined by the reduction in original programme investment, set out in the sections above. Within these, broadly, the mix of genre investment under each scenario is maintained under gradual transformation, consolidation and stagnation. The reductions in programme investment are likely to be moderately weighted toward low margin genres.

7.18 Under radical transformation, reductions in original investment in UK drama, UK soaps, UK Comedy and Sport are likely to be proportionately greater as the genres with higher up-front costs – although stronger secondary potential - can no longer be afforded in volume by commercial broadcasters.

Implications for investment in programming that meets the purposes and characteristics

7.19 Across most genres, the incentives for both broadcasters and producers to originate productions that meet some of public service characteristics are at further risk.

7.20 There is considerable variation in the risks to genres overall, the amount of original production within each, and the extent to which their output will reflect the characteristics identified with public service broadcasting. The analysis carried out by O&O traces the impact of market change at a genre level.

7.21 The analysis suggests that, under most scenarios:

7.21.1 National UK news, although low or negative margin under most scenarios, will remain important to differentiate the schedules of mass market broadcasters. However, there will be very limited commercial incentive to produce nations and regions news;

7.21.2 Arts and serious factual programming are likely to remain low-margin or loss making in all scenarios except for consolidation, and at risk of a fall in original production by commercial providers;

7.21.3 There is a risk to original production of children's, science and hobbies and leisure genres on the commercial public service broadcasters. However, in some scenarios, this may be mitigated partially by contribution from multi-channels and providers on non-linear platforms, potentially leading to increased innovation and diversity in the genres;

7.21.4 In high cost genres (such as drama and comedy) original production is likely to be more focused on programmes that can attract international sources of funding. This may well dilute the UK character, and particularly production in the nations and regions, of such programming.

7.22 It is likely that, even within genres that are profitable within the schedule or via secondary revenues, pressures on programme investment will lead to changes to the characteristics of original programming that is produced. Faced with financial pressure, broadcasters' economic incentives will be to:

- Reduce direct programme cost per hour (via lower budgets and international co-production). This will reduce both the quality and UK character of originated programming.
- Improve the "hit" rate and exploitation of programmes (via proven brands and formats, and repeats of popular series). This may impact both the volume of new series and innovation in new programming.
- Reduce risks of loss of audience share or wasted investment (by exiting unprofitable genres, and competing closely in terms of schedule composition). This may impact on the challenging nature of programming and the diversity across schedules.

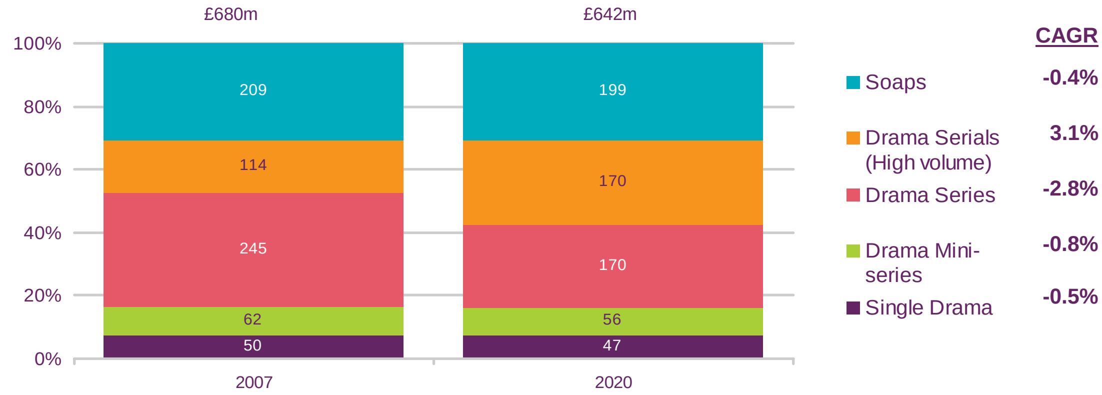
7.23 As a case study, the potential change in the composition of original programming spend in drama has been modelled. The figure below sets out how, even under gradual transformation, the focus of investment between UK drama sub-genres would be expected to change:

7.23.1 Total spend on UK original drama commissions is forecast to drop by £38 million in real terms from 2007 to 2020 under gradual transformation;

7.23.2 A shift of investment from expensive mini-series to cheaper, high volume "precinct" serials;

7.23.3 Only a small number of high budget prestige productions will be invested in, often conditional on co-production partners. These will be heavily repeated in the schedule and will be designed to attract secondary revenues.

Figure 15 Example of drama original programming expenditure mix change under gradual transformation (%)



Summary

8.1 The future of the UK media landscape is highly uncertain. There are a wide range of possible scenarios for future market development: the four different scenarios developed are all potential outcomes.

8.2 Gradual fragmentation is the most moderate of the scenarios in effect – there is a degree of fragmentation, but with the broadcasters retaining sufficient scale of audience to maintain their investment into UK originated content

8.3 Under radical fragmentation, the "stabilisers" inherent in the market – BBC maintaining a considerable licence fee settlement, audience scale maintaining the premia and resources of the main networks – are eroded. This risks a cyclical decline for commercial broadcasters where declining audience means lower revenues, forcing reduced programming investment which in turn fails to attract audiences.

8.4 Modelling based on the scenarios suggests that future prospects for delivery of public purposes are highly uncertain, particularly after 2012. However, there are a number of common themes across the scenarios:

8.4.1 audience share for the public service broadcasters is likely to continue to decline;

8.4.2 commercial broadcaster revenues are likely to remain, at best, flat in real terms;

8.4.3 total investment in original content, particularly that which reflects UK values, cultures and perspectives, is likely to decline in real terms;

8.4.4 while viewing of non-PSB channels and new services may increase, they are unlikely to fill all of the gaps left by the public service broadcasters.