DIGITAL BRITAIN REVIEW – INTERIM REPORT

Response by British Sky Broadcasting

March 2009

INTRODUCTION

We agree that a thriving digital sector has an important role to play in Britain's economic and cultural life. Greater access to digital communications, including television, broadband and mobile services, will play a major part in driving the UK's economic performance in the coming years and will bring significant benefits to the whole of society. And the growing diversity and quality of content available to British viewers – on television and increasingly online - will enrich people's lives, as well as being an engine of economic growth through our flourishing creative industries.

The building of Digital Britain is work in progress. The interim report (DBR) points to the "quiet revolution over the past decade" as a result of digital technology, and the benefits this has brought. Over that period we have witnessed the fast take-up of digital television, the rapid expansion of broadband services, the ubiquity of internet content from new and old media providers and the widespread application of digital technology in the creative industries from games to film and television. The common theme behind this revolution is the effective working of the market. Private enterprise has invested huge sums in creating new infrastructure, choice, innovation, and quality content for the benefit of consumers and the economy as a whole.

Sky has played a leading role in this revolution. 20 years ago we saw an opportunity to build a business by bringing choice to British television viewers. 10 years ago we led the migration to digital, seeing a further opportunity to create new products and services that would transform people's lives and change forever the media and communications industries. We were the first company in the UK to launch a digital television platform in 1998, and the first to switch off our analogue service three years later. As a result of this investment and innovation, Sky has helped to bring about a huge expansion in the range and diversity of content available to audiences in the UK. Today there are hundreds of channels on the Sky satellite platform catering to a wide range of mainstream and specialist interests, including 16 dedicated news channels, 31 children's channels and 58 channels for foreign and ethnic communities. On our own channels we have transformed the way that sport and news are covered on TV, and now we are beginning to do the same in arts, as well as increasing our commitment to original British drama and entertainment.

Through Sky+ we have transformed the way that our customers watch television, giving them control over what and when they watch. The success of Sky+, now in over 4.5 million homes, has helped to create an entirely new product category, with many imitators. We were the first broadcaster to offer a package of mobile TV channels and the first to offer our content for customers to download (legally) from the internet. We created the UK's first nationwide high definition television service, and now we are investing to accelerate the take-up of HD, the next stage of the digital revolution. We have assembled an unrivalled HD content offering with 11,000 hours of quality content a month across 32 HD channels spanning sport, movies, entertainment, documentaries and the arts. And with a new generation of Ethernet enabled Sky+HD boxes, we are in a strong position to expand the delivery of on-demand audiovisual content in future.

Through our investment in broadband we have made the internet affordable and accessible to millions of people. Sky customers can receive a free 2Mbps broadband connection and we also offer the UK's only truly unlimited download service, helping us to become the UK's fastest growing Internet Service Provider (ISP), attracting 2 million customers in less than three years. And, based on our strong understanding of what our customers want and expect, we have developed a suite of user friendly tools that help them interact with digital content and keep their families safe, including simple and easy to use parental controls on television and online, plus free security software for new broadband customers.

We fully understand the positive benefits that the digital economy brings to people's lives and we believe that the UK is well placed to reap the rewards of its digital and creative strengths. Based on the experience of the last 20 years, we believe strongly that the market is best placed to provide the investment, innovation and creativity that will drive digital take-up in future. The role of Government should be as an enabler, removing barriers to investment, safeguarding commercial incentives and allowing private enterprise to flourish in the digital and creative industries.

We therefore welcome those parts of the DBR that recognise this experience and seek to build on it. For example, the proposals to tackle the supply side barriers to NGA investment are helpful and will make it easier to deploy the required infrastructure. We also welcome the objective of making broadband universally available; although we suggest that focusing on encouraging consumer take-up – which is where the biggest gap currently exists – would have the greatest impact.

However, we are disappointed that acknowledgement and support for the role of the market is not consistently applied across the DBR. For instance, the suggestion that the BBC should become involved in driving broadband take-up by setting technical standards and developing new platforms raises concerns. As well as the potential for market distortion and illegal State aid, it sets a dangerous precedent and risks distracting the BBC from its core purpose, which is to invest in public service content and to make it widely available to licence fee payers on whichever platforms and services they choose to use.

In addition, we are concerned that further public intervention to support the UK's existing PSB institutions could distort competition and undermine the incentives for private investment in content that meets public purposes. The focus on securing additional direct or indirect subsidies to support the free-to-air advertising funded

model as the only means of providing public service content beyond the BBC ignores the growing contribution from the pay TV sector. It is also inconsistent with the DBR's approach to broadband where more people paying (a monthly subscription) for broadband access is seen to be in the public interest. In any event, such an approach is unlikely to be sustainable, as it fails adequately to address the structural changes facing the industry and further entrenches the reliance of the commercial PSBs on a single, highly cyclical, revenue source.

The market is delivering for consumers today and can deliver even more in the future. At Sky we are excited about the opportunities brought by the digital revolution, both for consumers and for our business. We invest in attractive content, products and services - without any public subsidy or regulatory obligation - because that is what our customers want, and we know that satisfying our customers is the only path to sustainable commercial success. Many other companies in the media and communications industries are similarly embracing the digital opportunity. Given the right policy framework, commercial incentives will continue to provide increased choice for consumers and promote vigorous competition between efficient service providers. At a time of considerable economic uncertainty, we believe that the best way to build Digital Britain and to reduce the burden on the taxpayer is to do everything possible to allow that to happen.

ACTIONS 1-5, NEXT GENERATION ACCESS NETWORKS

We welcome the Government's focus on removing supply-side barriers to NGA

It is well established that civil infrastructure costs make up the vast bulk of an NGA investment. Countries where NGA has enjoyed early roll-out all have one or more characteristics that reduce these costs: accessible sewers in France, widespread aerial deployment in Japan and the US, high MDU penetration in Scandinavia and Korea. The starting point for encouraging NGA investment in the UK must therefore be to address these barriers, for example sharing ducts already in the ground, making it easier for infrastructure to be deployed overhead, giving longer term certainty on non-domestic rating liabilities, and simplifying planning and other rules. Many of these are within Government's control, and we welcome the DBR's focus on them.

The market is in an experimentation phase with NGA

The UK is a unique market and the cost of and demand for NGA will be different from other countries. At present the industry neither knows the extent of demand, nor (with confidence) the cost. The whole industry is currently in an experimentation phase to try and gain a better understanding of the economics of NGA investment - BT and its wholesale customers are beginning FTTH and FTTC trials; Virgin Media is finding out whether there is demand for its higher speed services; and companies such as H2O and various community schemes are exploring the viability of city-based networks. All of these suppliers will be examining costs and experimenting with price points, applications and services, and marketing messages. As supply side barriers are removed and as there is greater certainty over the regulatory regime, the economics will change. At present therefore, and for many months at least, the likely extent or pace of commercial deployment is unknown.

Premature intervention risks crowding out private investment

While industry is in this experimentation phase, public intervention in the market – or even the possibility of it – could chill private investment. While commercial companies are testing the economics of NGA, there is a real danger that the deployment of public money could distort incentives and be wasted funding investments that would otherwise shortly be made by the private sector. Until the Government has greater clarity over the likely extent of market provision it is difficult to see how large-scale public intervention could be justified. Therefore we support the conclusion of the Caio Review (only six months ago) that for now there is no clear market failure warranting public intervention in the provision of NGA infrastructure.

The real obstacle to widespread NGA take-up may be a lack of access to existing telecoms networks

There already is a network capable of delivering high speed broadband which covers half the country - the cable network. If there is concern over the lack of retail competition leading to slow take-up, then introducing competition on that network is a solution that should be explored. While BT's network and Sky's satellite platform are open to other service providers on fair, reasonable and non-discriminatory terms, it is increasingly anomalous that Virgin Media's cable network remains closed. In particular, access to cable ducts, as proposed by Ofcom for BT's future fibre investment, would offer the opportunity for competition between end-to-end infrastructure with all of the

benefits in terms of innovation and differentiation that this type of competition typically brings.

We agree that operators should retain the flexibility to manage their own network traffic

Online business models are still at a relatively early stage of development. The introduction of any regulation that limits the flexibility of ISPs to manage their own network traffic (such as so called 'net neutrality' rules) risks significant unforeseen distortions and the potential foreclosure of innovative, risk-sharing business models.

ACTION 6, MOBILE WIRELESS NETWORKS

Market-based methods remain the best way to allocate scarce spectrum resources

For some time the UK has been a leading advocate of market-based methods of spectrum assignment, arguing that the market is much better placed to determine both technology and application than Government. Nothing has altered to change this conclusion, and we urge Government to continue to pursue this approach.

Annual charges for indefinite spectrum licences should reflect their true opportunity cost

We also support the principle that spectrum licences should be tradeable, secure property rights. It is, however, important from the point of view of both encouraging efficient investment, and competitive neutrality, that annual payments charged for spectrum (in the period beyond the initial term for spectrum that has been purchased in an auction, or for spectrum that has been gifted to its holders indefinitely) should genuinely reflect its opportunity cost. This is of particular relevance to 2G licences and the extension of 3G licences, which comprise rights to very valuable spectrum.

ACTIONS 17 AND 18, BROADBAND UNIVERSAL SERVICE COMMITTMENT

An effective universal service commitment should balance demand and availability

Around 4 in 10 households today do not yet have broadband, and the evidence is that for a majority of these it is because they do not see relevance to their lives of having access to the internet at home. We agree that there are huge benefits to society from a digitally connected nation, including the online delivery of public services and education. However, in comparison to the 40% of households who chose not to take broadband, less than 1% cannot get broadband at all, and only a few percentage points receive less than 2 Mbps. The Government needs to ensure that universal service obligations do not focus solely on delivering 100% availability at the expense of the continuing expansion of take-up. In order to avoid creating undesirable trade-offs between availability and take-up, the Government must consider what the impact will be on each when specifying the universal service obligations and how they will be funded.

A 'broadband tax' will undermine the ability of the market to continue to drive take-up

The take-up of broadband in the UK has been driven by the market, with ISPs competing to offer the most attractive service to customers. Competition is fierce and consumers are able to choose from a number of very keenly priced packages –

particularly from new entrants such as Carphone Warehouse and Sky. As a result margins are thin. The costs of any levy on industry to fund universal service delivery are therefore likely to be passed on to consumers. Such a 'broadband tax' would undermine the wider objective the Government is seeking to achieve – driving further broadband take-up. Given that the overwhelming benefits of a universal service obligation accrue to society, as the DBR spells-out, there is a clear rationale for society, through Government, to fund it.

Universal coverage should be delivered by the lowest cost infrastructure, and that is likely to be wireless

Any universal service obligation should be delivered using the lowest cost infrastructure. Since it is unlikely to be economically efficient to extend the existing copper based network, wireless is the most obvious way to address the gaps in current broadband coverage. The costs of wireless provision are coming down rapidly and will continue to do so, through scale efficiencies and the introduction of new technologies like LTE with greater spectral efficiency.

ACTIONS 19 AND 20, BROADBAND TAKE-UP

Government should support the market to deliver greater broadband take-up

As noted above, millions of households do not take broadband today because they do not perceive that it offers something that they want or need. Persuading these people that broadband is relevant to their lives is an important and challenging task. While there is a role for Government, through its Digital Inclusion Champion, in promoting awareness and benefits, ultimately it is down to ISPs to persuade people that their services are worth paying for. Service providers, like Sky, have the commercial incentives, customer relationships and marketing expertise to continue to drive broadband take-up. Government's focus should be on finding ways to encourage and incentivise innovation and investment by commercial providers so that they continue to attract new customers.

The most appropriate role for the BBC in encouraging broadband take-up is to make its content widely available on as many platforms as possible

The BBC's core purpose is to create public service content, and to make it as widely available and easily accessible as possible. Every licence fee payer has already paid for BBC content and should have the ability to access that content on whichever platforms and services they choose to use. The BBC should not favour one particular platform or technology over another, and should be scrupulously 'platform neutral' both in the way in which it makes its content available to different services and in the way it promotes its availability to viewers.

However, based on previous experience, we are concerned about the BBC's potential to distort the market by favouring its own distribution platforms and technologies over their competitors (raising potential competition and State aid issues). For many years, while claiming to adhere to the principle of platform neutrality, the BBC promoted the availability of its digital channels in ways that favoured Freeview over Sky and cable. We are concerned that the BBC is similarly intent on favouring its iPlayer service: through its extensive marketing and promotion; its proposal to entrench further the underlying technology platform by licensing it to other PSBs; and by its unwillingness

to supply BBC content to competing on-demand video services like Sky Player (it is only willing to provide a link through to the BBC iPlayer website). The BBC's "Canvas" proposals, currently being consulted on by the BBC Trust, potentially raise similar concerns.

As part of the DBR, we urge the Government to define more clearly the BBC's role in driving digital and broadband take-up. The most positive contribution the BBC can make - and one that is entirely consistent with its core purpose - is to distribute its content as widely as possible and promote its availability to viewers in a way that is platform and service provider neutral.

ACTION 7, BROADBAND ENABLED DIGITAL SWITCHOVER HELP SCHEME EQUIPMENT

The Digital Switchover Help Scheme must deliver best technology and service to vulnerable groups in a way that is platform and service provider neutral

We understand why the Government wants to ensure that those eligible for assistance under the DSO Help Scheme can receive broadband enabled set top boxes as part of the 'Standard Offer'. As currently configured, the Help Scheme is driving vulnerable groups to accept obsolete technology, and those in receipt of this equipment will eventually be faced with a second switchover in order to experience the full range of digital services on offer. Sky is already in a position to offer best in class technology and services to Help Scheme customers. Our Sky+HD set top boxes provide market leading digital recorder functionality and access to an unrivalled 32 high definition channels. They also have an Ethernet connection that will enable them to receive broadband video on demand services in future.

However, the new conditions imposed by the Digital Switchover Help Scheme, which do not allow free trial periods for a subscription service as part of the standard offer, make it very hard for Sky to offer our technology and services as the standard option under the Scheme. This decision runs counter to many of the objectives in the DBR, including the desire to drive broadband take-up which is a subscription based service (and which Sky TV customers can get for free). It also restricts choice and competition through the tender process, and has the potential to push vulnerable customers towards an inferior technology. Given this, it is more important than ever that the Government ensures the Help Scheme and Digital UK communicate the range of alternative choices available, and the benefits of all platforms (including those offering high definition and broadband services), rather than focusing on the lowest cost and 'simplest' option (typically a basic Freeview service), which fails to deliver against many of the wider objectives of Digital Britain.

ACTIONS 11-13, PROTECTING COPYRIGHT ONLINE

We welcome the proposed enforcement regime for tackling P2P piracy

We believe that reducing the level of P2P piracy is a critical issue for the creative content industries and for ISPs, and we welcome the Government's specific proposals to tackle this problem as outlined in the DBR. During the course of the negotiations under the Memorandum of Understanding (MoU) on illegal file sharing, it became clear that a voluntary solution for P2P piracy was unlikely to achieve the support of all

parties. We believe that any solution should encompass all ISPs and rights holders, otherwise the problem will migrate with the customers to those ISPs not participating and undermine its effectiveness. All fixed line ISPs should be required to participate in the proposed enforcement regime, as should all mobile broadband operators since that technology is increasingly substitutional for fixed line services.

The key to success is to combine an effective deterrent with consumer education and attractive legal offerings

None of the solutions that were considered by the MoU signatories were 'mass market' solutions. It is unrealistic to expect that punitive sanctions can be imposed on millions of broadband customers, and that ISPs would do so without proof of illegal activity. Furthermore, the impact of all solutions must take account of the Government's wider objectives of encouraging broadband take-up and investment. A solution that imposes significant costs, or risks a degradation of service for large numbers of people, runs counter to these objectives. It means that all solutions must be judged by their success, or otherwise, in changing infringing behaviour - i.e. as an effective deterrent. We believe that a considerable deterrent impact will be achieved via warning letters backed up by the credible threat of legal sanction against the most serious repeat infringers by the owners of the rights being infringed. To be effective, the communication of the warning and its consequences must be as clear and efficiently delivered as possible. It must also be supported by wider education messages about the value of copyright and the opportunity for consumers to purchase a wide variety of attractively priced legal content.

The deterrent effect will be greater and more efficient if the process is collectivised on behalf of rights holders

ISPs will be able to send much clearer warning letters to their customers if they are doing so on behalf of a third party body which is, in effect, a proxy for all of the rights owners. Clear warning letters, with the legal consequences spelled out, would act as a highly effective deterrent which should have significant impact on behaviour among the vast majority of households who receive it. In addition, centralising the collection of repeat infringer information through a separate body will make the process more cost effective and will provide the ability to cross interrogate customer data on behalf of multiple rights owners. It is quite likely that the heaviest repeat infringers of illegal music files will also be doing the same for films and games, and as such will the most appropriate target for legal action. As well as directing ISPs to send letters and for collecting the repeat infringer data provided by ISPs, this body could also be responsible for setting the criteria for which repeat infringers to prosecute and, potentially, for managing the legal process itself.

The education and commercial work of the Rights Agency should be separate from the enforcement regime

We support the objectives of a Rights Agency which would bring all parties together to discuss education and awareness and barriers to legitimate business models on a voluntary basis. These are important long term issues that require ongoing industry dialogue. However, we do not believe that this voluntary approach should be combined with the enforcement regime proposed in Action 13. The Rights Agency should be a voluntary forum for the discussion of consumer education and commercial issues on which parties can align. The enforcement regime should comprise legal requirements on ISPs to support rights holders' enforcement of their rights (by sending warning

letters and collecting repeat infringer data) and a new body established to manage the process, funded by the rights holders, who will be the beneficiaries of its success.

ACTION 10, ALTERNATIVE FUNDING MECHANISMS TO ADVERTISING REVENUES

Digital Britain should embrace pay TV as the fastest growing revenue source for the funding of UK content

Sky invests £1.3 billion per year on programming for our own channels, more than any other British broadcaster apart from BBC. Of this almost £1 billion is invested in the UK, in sports and news as well as drama, documentaries, entertainment and, more recently, the arts. As well as our own channels we support UK programming through our joint venture and third party channel partners such as The History Channel, Discovery, National Geographic, Nickelodeon and Disney, with whom we invest £300 million per year.

It is important to remember that this significant investment in UK programming is made without any public subsidy or regulatory obligations, and almost all of it meets Ofcom's definition of public service content. We invest in quality programming because that is what our customers want and expect. Our business depends on providing them with content that they value, and are willing to pay for, week in week out. And because we recognise that our customers are individuals with a vast range of interests and programme preferences, we provide a diverse choice of both mainstream and specialist content. So, for example, alongside the Ashes, Sky Sports also shows the women's cricket World Cup and alongside the Rolling Stones, Sky Arts also shows Italian opera.

Over the past 20 years, the success of the pay TV sector in the UK has been built on filling gaps in provision by free-to-air broadcasters and providing viewers with content that they value. At a time when traditional PSBs are reducing (or threatening to reduce) their on-screen investment and narrowing the range of programmes they offer, pay TV channels are investing more, and in a wider variety of genres, for example through Sky1's commitment to original UK drama, and the recent expansion of the Sky Arts portfolio.

The Government should encourage and facilitate market provision and should be cautious about the risks for further intervention

Given this track record, we are surprised, and disappointed, that the significant and growing role of the market, and the pay television sector in particular, in providing content that meets public purposes is underplayed and apparently dismissed in the interim DBR. Given the already large scale public intervention in broadcasting through the BBC (with guaranteed funding of £3.5 billion a year), the Government should be very cautious in considering any further intervention and the potential this would have to distort the market and undermine incentives for private investment. If a deficit in public service provision in a particular area is identified that the market is not able to address, the starting point should be some reprioritisation by the BBC, starting with the £100 million a year it continues to spend, inexplicably, on Hollywood programming.

ACTION 16, SECOND PUBLIC SERVICE ORGANISATION

We do not agree that Channel 4's existing model is fundamentally broken

We have set out our views on the proposed second PSB organisation built around Channel 4 in our response to the Government's letter requesting proposals from interested parties (attached as an annex). In short, while we recognise that all commercial free-to-air broadcasters face short-term challenges as a result of the advertising downturn, Channel 4 has a strong balance sheet and has accumulated sufficient financial reserves to see it through the current recession. In addition there are measures that Channel 4 could implement today that would reduce short-term pressure, begin to address the structural risk that results from over-reliance on a single highly cyclical revenue source, and leave the corporation better positioned to prosper once the economy begins to recover. These include eliminating unprofitable non-core activities and ensuring that going forward those that remain exist solely for the purpose of contributing financially to the provision of public service content on the main channel; developing new revenue streams including exploring the full potential of subscription funding (beyond the core free-to-air network); and rigorous prioritisation of programme spend to reduce reliance on expensive US imports and ensure that investment in core public service output focuses on areas not well served by other broadcasters.

Instead of allowing the current debate to be framed by the notion of a claimed "funding gap" between Channel 4's current revenue forecasts and future spending ambitions, the Government's first priority should be to ask Channel 4 to produce a plan that sets out what it could deliver if it pursued the sort of 'self help' strategy described above. Without this baseline it is impossible to have an informed debate about its future.

Structural solutions to Channel 4 could damage private investment and reduce the level of public service content provided by other broadcasters

Channel 4's status as a publicly owned but commercially self-sufficient broadcaster allows it to play a unique role – investing in public service content that the market will not deliver, while offering an alternative voice to the publicly financed BBC. We are concerned that the Government has requested only proposals that will result in major structural changes to Channel 4 - fundamentally changing this model, and therefore the entire broadcasting landscape, without properly exploring the alternatives. We note also that the prospect of structural change involving Channel 4 may be seen by some organisations as an opportunity to gain competitive advantage, solve their own commercial challenges or compensate for past strategic mistakes.

The steps that we set out in our detailed response would help Channel 4 to secure its long-term future, without recourse to public funding or further intervention and without an adverse effect on competition. Given that public finances are already under severe strain – with many more pressing needs than Channel 4's, and there are significant risks that the structural solutions being discussed (such as a merger with BBC Worldwide and/or Five) would have the potential to distort competition, undermine private investment and have a negative impact on other market players, more elaborate structural solutions should only be considered as a last resort, and then only with extreme caution. If not, the consequences of a scheme designed to secure Channel 4's future could be to weaken the provision of public service content by other

broadcasters (including the multi-channel sector), while fundamentally changing the nature of Channel 4, in both cases to the detriment of viewers.

ACTION 22, DIGITAL MEDIA LITERACY

Media Literacy should focus on internet safety and usability

We support the objective of encouraging people to take-up and use tools that will enable them to get the most out of digital services and keep their families safe. We propose a narrow definition of Media Literacy which is focused on the basic areas of teaching people how to connect and use the internet safely, with the objective of encouraging and supporting them in participating in Digital Britain. Any other activities previously considered under the broad 'media literacy' banner should be considered a distraction at this stage and should be firmly out of scope.

Trusted brands will deliver appropriate safety and usability standards

Further regulation will not improve safety and usability of online services if it disincentivises ISPs and online content providers from improving their own standards. Overly restrictive regulation, such as the mandatory provision of particular forms of parental control, could be counter productive if it reduces the opportunity for providers to differentiate their offer and attract customers through offering a better and safer service. Sky is one of the UK's most visible media and communications brands and we see usability and safety as an opportunity for commercial differentiation. We are committed to providing both the tools and information to customers that enable them to make their own decision on what material is appropriate for them and their families. We offer world leading parental control features on our digital television platform, and provide our broadband customers with parental control and security software, and continuously review what we offer to ensure it meets, and exceeds, customer expectations.

Self regulation is the best approach to dealing with content issues backed up by effective law enforcement

Self regulation is the most effective way of dealing with content which is within the control of a particular organisation and on which they can take direct action. A flexible self regulatory approach is more appropriate than legislation for dealing with rapidly evolving technologies and issues. We are a strong supporter of the Internet Watch Foundation (IWF), and regard it as a good model for self-regulation and collective industry action. Where clear laws do exist regarding acceptable behaviour or content, then law enforcement should be appropriately resourced to take action against those who break those laws. This acts as a powerful indicator that such behaviour is not acceptable online and increases consumer trust and confidence in the Internet which in turn leads to greater take-up and use of the Internet.

ANNEX

PSB2 – LETTER TO ALL PARTIES

Response by British Sky Broadcasting

March 2009

Introduction

We note the Government's open letter requesting proposals from interested parties for the future of a new public service broadcasting body (PSB2) based around Channel 4.

The invitation is extended to organisations that "have a role in the future architecture of PSB in the UK". Sky currently makes a significant contribution to the provision of high quality UK content and will play a major role in the provision of such content in future. We are surprised, and disappointed, that the growing role of the market, and the pay television sector in particular, in providing content that meets the purposes and characteristics of public service broadcasting identified by Ofcom is underplayed and dismissed as a future funding source in the interim Digital Britain Report. Instead the debate is focused exclusively on the existing PSB institutions and the ways in which these might be reformed or consolidated, and the (claimed) need for additional public intervention and subsidy to sustain them. In addition, the debate continues to promote a reliance on advertising revenue to fund the provision of public service content beyond the BBC, despite the clear evidence that such a reliance has contributed substantially to the difficulties to which the commercial PSBs have exposed themselves.

In the case of Channel 4 specifically, we do not agree that the existing model is fundamentally broken. While recognising that all commercial free-to-air broadcasters face short-term challenges as a result of the advertising downturn, Channel 4 has a strong balance sheet and has accumulated sufficient financial reserves to see it through the current recession. In addition there are measures that Channel 4 could implement today that would reduce short-term pressure, begin to address the structural risk that results from over-reliance on a single highly cyclical revenue source, and leave the corporation better positioned to prosper once the economy begins to recover. These include eliminating unprofitable non-core activities and ensuring that going forward those that remain exist solely for the purpose of contributing financially to the provision of public service content on the main channel; developing new revenue streams including exploring the full potential of subscription funding (beyond the core free-to-air network); and rigorous prioritisation of programme spend to reduce reliance on expensive US imports and ensure that investment in core public service output focuses on areas not well served by other broadcasters.

Instead of allowing the current debate to be framed by the notion of a claimed "funding gap" between Channel 4's current revenue forecasts and future spending ambitions, the Government's first priority should be to ask Channel 4 to produce a plan that sets out what it could deliver if it pursued the sort of 'self help' strategy described above. Without this baseline it is impossible to have an informed debate about Channel 4's future.

Channel 4's status as a publicly owned but commercially self-sufficient broadcaster allows it to play a unique role – investing in public service content that the market will not deliver, while offering an alternative voice to the publicly financed BBC. We are concerned that the Government has requested only proposals that will result in major structural changes to Channel 4 - fundamentally changing this model, and therefore the entire broadcasting landscape, without properly exploring the alternatives. We note also that the prospect of structural change involving Channel 4 may be seen by some organisations as an opportunity to gain competitive advantage, solve their own commercial challenges or compensate for past strategic mistakes.

The steps that we set out in this response would help Channel 4 to secure its long-term future, without recourse to public funding or further intervention. There are significant risks that the structural solutions being discussed (such as a merger with BBC Worldwide and/or Five) would have the potential to distort competition, undermine private investment and have a negative impact on other market players. Given this, and the fact that public finances are already under severe strain – with many more pressing needs than Channel 4's, more elaborate structural solutions should only be considered as a last resort, and then only with extreme caution. If not, the consequences of a scheme designed to secure Channel 4's future could be to weaken the provision of public service content by other broadcasters (including the multi-channel sector), while fundamentally changing the nature of Channel 4, in both cases to the detriment of viewers.

Sky's role in the provision of public service content

We invest £1.3 billion per year on programming for our own channels, more than any other British broadcaster apart from BBC. Of this almost £1 billion is invested in the UK, in sports and news as well as drama, documentaries, entertainment and, more recently, the arts. As well as our own channels we support UK programming through our joint venture and third party channel partners such as The History Channel, Discovery, National Geographic, Nickelodeon and Disney, with whom we invest £300 million per year.

In the context of the current debate, it is important to remember that this significant investment in UK programming is made without any public subsidy or regulatory obligations, and almost all of it meets Ofcom's definition of public service content. We invest in quality programming because that is what our customers want and expect. Our business depends on providing them with content that they value, and are willing

to pay for, week in week out. And because we recognise that our customers are individuals with a vast range of interests and programme preferences, we provide a diverse choice of both mainstream and specialist content. So, for example, alongside the Ashes, Sky Sports also shows the women's cricket World Cup and alongside the Rolling Stones, Sky Arts also shows Italian opera.

Over the past 20 years, the success of the pay TV sector in the UK has been built on responding to gaps in provision by free-to-air broadcasters and providing viewers with content that they value. Today, at a time when traditional PSBs are reducing (or threatening to reduce) their on-screen investment and narrowing the range of programmes they offer, pay TV channels are investing more, and in a wider variety of genres, for example through Sky1's commitment to original UK drama, and the recent expansion of the Sky Arts portfolio.

Given this track record, we are surprised that there has been very little consideration of the potential opportunities that pay television affords by Ofcom and Government in the wider policy debate about the future funding of public service content. And, at a time when advertising is under increasing pressure and subscription revenues are growing, we cannot understand why the commercial PSBs, including Channel 4, are not doing more to examine how pay TV could complement their core free-to-air networks and reduce their reliance on a single, highly cyclical, revenue source that in aggregate continues to decline in real terms.

Sustaining Channel 4's current model

Channel 4's business model stems from its remit and unique status as a publicly owned, commercially funded broadcaster. It is given the freedom to engage in commercial activities in order to finance the provision of programming that is not profitable, providing that it breaks even overall. Accordingly, it is able to finance the provision of public service content that the market would not deliver on its main channel from commercial activities which include both broadcasting profitable programming on Channel 4 itself and other 'non-core' commercial businesses. It is not required to pay dividends to shareholders or make a return on capital and is therefore able to re-invest any profits it makes in further public service content. The defining characteristic of this commercial self-sufficiency model is that Channel 4 must 'cut its public service cloth' according to the return on commercial activities that it is able to generate.

The Government seems to have accepted Channel 4's claim that this model, which has been the foundation of its success, is now broken. Channel 4 claims that without direct or indirect public funding it will no longer be able to meet its public service remit and invest in non-profitable content. We do not agree with this assertion. With a tighter remit and an different strategy, we believe the existing model is sustainable for the long term. This approach will not require major Government intervention and will not fundamentally alter the nature of Channel 4.

A more tightly defined remit would help to reinvigorate Channel 4's purpose (the raison d'être for its unique status) of investing in public service content that the market will not deliver, and where there is a defined public need for provision beyond the BBC

(for example, Ofcom has suggested that children's programming might be one such area). This may require some re-prioritisation, with a reduced emphasis on less distinctive programming in other areas well served by the BBC and other commercial broadcasters.

With a clear remit in place, Channel 4 should be asked to devise a strategy that maximises the amount of public service content it delivers, while remaining commercially self-sufficient. That strategy should include the following elements:

- **Judicious use of reserves** – when Channel 4 was established as a commercially self-sufficient business, safeguards were put in place to protect against a shortfall in revenue that might require it to cut investment in programming, recognising that as business funded to a large degree by advertising it would be subject to fluctuations in income. These safeguards included payments into a statutory reserve fund. In fact, Channel 4 was so successful commercially that the safeguards were never needed and were eventually abolished. Channel 4, however, has continued to build up it reserves on the back of strong growth in advertising revenue and 15 years of healthy profits from its core channel. In its latest set of accounts, Channel 4's reserves stood at £452 million, including cash and other financial assets of around £200 million. Now is the right time to use some of these funds for the purpose for which they were originally intended, allowing Channel 4 to continue to invest in public service programming at a time when its revenues are under short-term pressure as a result of the advertising downturn. Given the strength of its balance sheet and liquidity position, Channel 4 is better placed than many other UK companies to ride out the recession.

- **Elimination of loss making commercial ventures** – Channel 4's financial position today would have been even more secure had it not been for cumulative losses of £270 million in the last 10 years from unprofitable non-core commercial activities. Most of these investments have been poor by any reasonable standard, and would not have been allowed to proceed in an organisation with a more disciplined financial ethos. Going forward, it should be made explicit in Channel 4's remit that non-core commercial activities should be pursued solely for the purpose of generating income to support public service output on the core channel. They should not, as has been the case in the past, be used as vehicle to pursue 'strategic' objectives (such as attempting to build a radio business to compete with the BBC), offering a poor financial return and thus taking resources away from the core PSB channel. Any remaining loss making ventures should be exited immediately, unless there is a clear path to future returns.

- **Diversification of revenue** – developing new revenue streams such as direct payments from consumers would reduce Channel 4's reliance on a single highly cyclical revenue source, mitigate against any structural decline in TV advertising, and leave it better placed to survive any future economic downturn. Channel 4's decision to exit from subscription channels in 2004 (when it declined to renew carriage agreements with Sky and other pay TV retailers for its E4 and FilmFour channels) was a strategic mistake that has left it more exposed in the current downturn. Based on our experience of supporting our third party channel partners, we would be prepared to work with Channel 4 to create a profitable suite of pay

channels that will complement and provide financial support to its core free-to-air public service network. It is likely that other pay TV distributors would be equally willing to invest in a suite of channels from Channel 4. As well as supporting investment in original content (at a time when production budgets are under pressure), these channels could provide additional opportunities for Channel 4's viewers to watch its content and interact with its brand, helping to build a more valuable business for the long-term. If Channel 4's management were willing to engage, a deal with Sky could, potentially, be agreed very quickly, offering short-term relief as well the opportunity to gain long term exposure to the fastest growing segment of the television market.

- **Reprioritisation of programme spend** - over the past four years Channel 4 has doubled spending on imported US programmes - to £148 million per annum, in many cases paying a significant premium to outbid other UK broadcasters like Five, ITV and Sky. Over the same period its investment in original UK programmes was flat, including spend on core PSB genres like news and current affairs. Set in this context, Channel 4's recent pledge to reduce spend on acquired programmes by 20% over the next two years does not look particularly ambitious. By reducing it further and faster Channel 4 could increase investment in UK content while spending less overall and improving profitability. More generally, these decisions suggest that a fundamental review of Channel 4's programming strategy is needed. Its first priority should be to maximise the impact of its distinctive public service output, focusing on those areas not well served by other broadcasters; everything else is a means to that end.

We believe that a new strategy incorporating these elements will allow Channel 4 to emerge from the current downturn in a strong and sustainable position. The Government should therefore start by asking Channel 4 to produce a baseline plan that sets out what public service content it can provide if it pursues such a strategy, without fundamental changes to the existing model of commercial self-sufficiency.

Only if the Government is convinced, following a rigorous independent audit, that this plan would result in a material reduction in Channel 4's ability to fulfil its public service remit, and that this shortfall cannot be made up either by the BBC or by increased provision by the wider market (in response to the gaps created by Channel 4), should more radical structural solutions be considered. We believe strongly that this case has not yet been made.

Criteria for evaluating structural solutions

If, however, the Government decides to proceed to evaluate major structural solutions, it must do so against a set of rigorous criteria that put the overall interests of viewers, rather than the interests of Channel 4 as an institution, at the heart of the analysis. Any structural solution should:

- Realistically and transparently create additional value for the viewer. Shifting value from one institution to another will not ultimately benefit the viewer; it will merely compensate Channel 4 at someone else's expense. For example, if value comes

from the BBC licence fee, whether directly or indirectly, then the BBC's ability to fund programmes is reduced. This includes direct top-slicing of the licence fee as well as any joint venture with BBC Worldwide which reduces the amount of money it remits to the BBC.

- Take into account the transfer of value inherent in any enhancement of the market power enjoyed by Channel 4 at the expense of other competitors such as ITV, Five and the multi-channel sector (or whoever is left after the creation of a combined entity), whose ability to compete and invest would be diminished. For example, an enlarged entity built around Channel 4 could result in a concentration in the market for TV advertising, as well as cross-promotional advantages and a strengthened position in competing for programme rights, talent and ideas (at the expense of independent producers and other broadcasters). Any solution involving a joint venture or merger between Channel 4 and another broadcaster must be expected to be subject to appropriate merger control and the application of EU and UK competition law, as well as being compliant with EU provisions on State aid.

- Avoid mixing commercial and public money in ways that would result in a distortion of competition, promotion of inefficiency and a reduction in overall investment by the market. For example, a mixed funding regime would give Channel 4 an unfair advantage in competing with other broadcasters for programme rights (regardless of any notional internal accounting separation), undermining their ability and incentive to invest in content, while encouraging Channel 4 to act in ways that are inefficient or commercially irrational (e.g. over-paying for rights). Top-slicing the BBC licence fee to support Channel 4, directly or indirectly via a subsidy from BBC Worldwide, would create unavoidable market distortions and, as the European Commission's objection to the recent proposal for the BBC to contribute to Channel 4's digital switchover costs shows, may not be compatible with EU State aid rules.

- Not alter the nature and independence of Channel 4 such that it becomes indistinguishable either from the BBC or from its commercial rivals. For example, receipt of money from top-slicing would make Channel 4 subject to the same political constraints as the BBC. It would create, in effect, two state broadcasters with Channel 4 forfeiting the independence and freedom to take creative and editorial risks that its current model allows. A merger with Five or another broadcaster would also change Channel 4 beyond all recognition and undermine and further confuse its remit. With a minority commercial shareholder to satisfy, it would no longer be able to reinvest all of its profits in non-commercial programming. Delivery of its PSB remit would therefore need to be guaranteed through prescriptive quotas and obligations, more akin to the old (and failed) ITV system than the existing Channel 4 model.

- Pass a 'value for money test' if it involves the use of public money or increases public sector debt – including the resources of Channel 4 and BBC Worldwide which are both state owned businesses (whose profits could otherwise be used to reduce the burden on tax/licence fee payers) - to purchase privately owned assets. For example, the use of public assets by Channel 4 to purchase of a share in UKTV at full market value, potentially outbidding other interested parties, would

represent a transfer in value between Channel 4 and the current owner of UKTV. This seems unlikely to be the best use of taxpayers' money, especially at time when public finances are under considerable strain.

Conclusion

We recognise that the downturn in the advertising market will have a significant impact on Channel 4's revenues and profitability in the short term. However, it is well placed to ride out the storm and to participate in the eventual upturn in advertising. Channel 4 has a strong balance sheet and healthy cash reserves. Its unique business model means that it does not have to satisfy the immediate demands of shareholders, while the strength of its brand, programming and audience delivery gives it a solid platform for future growth. With the right strategy we believe Channel 4 could develop a more diversified business that will prosper over the long term while continuing to deliver its unique public service remit. This is what the Government should be focused on securing, not exploring ever more byzantine structural solutions that alter fundamentally the independence and character of Channel 4 and distort the market as a whole, to the detriment of viewers, and place a further burden on the public purse.