Final report

Mediatique

Ofcom

PSB review: Investment in TV genres

1st December 2014

Content investment decisions at the PSBs are ultimately determined by the balance of financial outcomes, objectives and wider practical considerations

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- The decision to commission or produce a programme within a certain genre is subject to a financial assessment at every commercial PSB
- At present, a programme's ability to secure a positive margin contribution is a primary influence on decision making; however, all the PSBs recognise that a systematic focus on broadcasting *only* profitable genres would lead to a reduction in the overall diversity and attractiveness of the channel leading to declines in total reach and viewing share
- As a result, decision making is also strongly influenced by the potential contribution of a programme to the channel's policy remit, its overall strategy and brand health and each organisation's corporate objectives (including financial motives and broader strategic interests relating to diversification, creativity and longevity of content assets)
- Programme-specific analyses are also complemented – or sometimes overruled – by a "gut feel" or "editorial feeling" that a particular show would work and would be successful commercially or creatively
- All investment decisions are ultimately made on the basis of balancing these objectives against budgetary constraints and commercial realities, including shifts in audience behaviour/taste, input cost trends and the strategies/schedules of rival broadcasters

Determinants of genre allocation at the PSBs

The PSBs' public policy remit and legislative obligations (e.g., quota fulfilment)

The requirements to schedule around recurring series, recommissions and one-off events – including the relative cost of certain genres

Changes in technology and consumer behaviour that alter the balance of return between first-run and other windows

Broader strategic considerations ("brand health", relationships with talent), including internal practices and the attitudes/experience of management

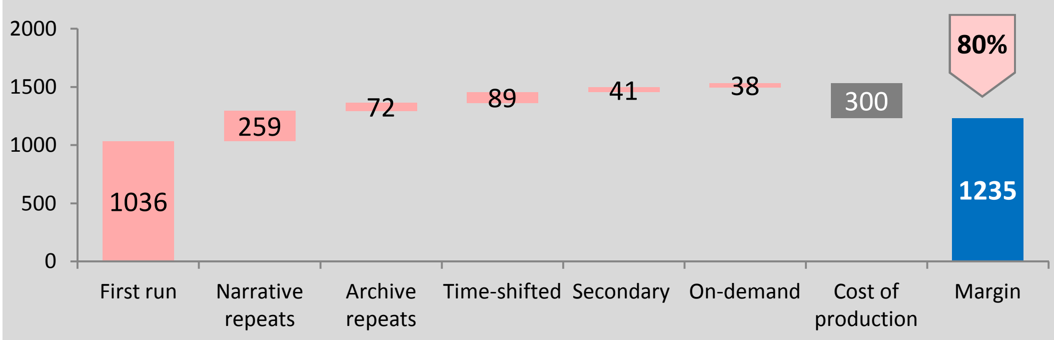
Competitive dynamics, and the scale/scope of investment at other broadcasters

Investment decisions are influenced by the potential of certain programmes – and genres – to optimise revenue across multiple windows and territories: this is typically the primary prism through which shows are assessed

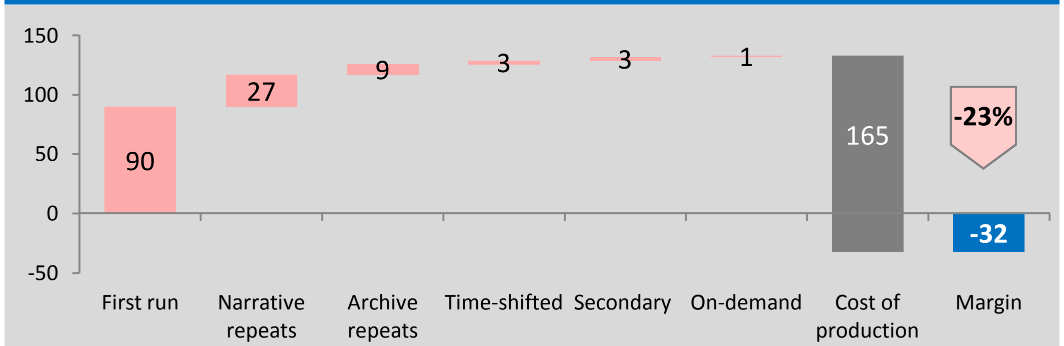
- Financial performance is a crucial corporate objective for all the commercial PSBs – with ITV and Channel 5 seeking to maximise returns and Channel 4 seeking to break-even, all within the constraints of their wider policy remit
- However, this picture is becoming more complicated with multiple components to investment economics and shifting audience behaviours altering the balance between live and non-linear viewing
- Across all genres, first-run audiences and narrative repeats remain the cornerstone of revenue generation
- The scope to secure secondary revenues varies substantially by genre, and the potential to generate revenues outside the primary broadcast window could tip the balance to produce a programme – this is particularly the case where primary revenues may not be sufficient to offset significant upfront production costs (e.g., in drama)

Profit/loss margin

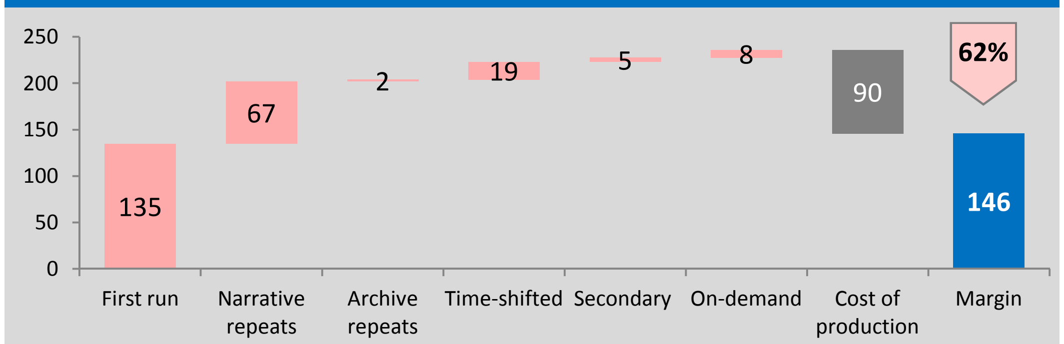
Gross profit margin contribution: ITV soaps, peak hours 2013 (£000, %)



Gross profit margin contribution: C4 religious, peak hours 2013 (£000, %)



Gross profit margin contribution: C5 factual ent, peak hours 2013 (£000, %)



Source: Mediatique model

Differences among corporate objectives at the commercial PSBs generate variations in their strategies and roles within the PSB arena...

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Strategic positioning within the PSB regime

ITV

- The removal of prescriptive output obligations in arts, religion and music has seen ITV focus on drama and entertainment in its peak schedule, although it still retains a broad genre mix including news and documentaries
- ITV's strategic focus remains the delivery of mass-market audiences; it also seeks to retain universal reach (being part of "the national conversation") and to maintain parity with the BBC
- Such a strategy has resulted in a bias towards returning series and repurposing of existing programme/format brands. However, the business is seeking to optimise value across multiple windows and has invested in international distribution, ownership of production and has augmented the means by which audiences can be monetised (e.g., ITV Encore, ITV Player)

Channel 4

- Channel 4's PSB commitment is sustained by its remit: peak-time output remains the most diversified of the commercial PSBs
- The channel is driven by commercial incentives, but is willing/able to commission programmes that do not necessarily maximise audiences and to run losses on key genres (notably drama, arts and religious)
- Recent weakness in core audience share has lead to pressure on margins across PSB genres, and programme budgets are set to decline marginally in 2014 to aid meeting a target of break even after two years of significant loss at operating level
- Of all the PSBs, Channel 4 has the most agnostic view of audience engagement across all its digital properties (core channel, portfolio channels, on-demand), although still secures a premium for delivery on core Channel 4
- The business remains focused on delivering 16-34 audiences, but values creativity, diversity and seriousness of output. It has been willing to use its core channel as a test-bed for format innovation (e.g., recent innovative shows and formats including *Gogglebox*, *Stand Up to Cancer*)

Channel 5

- Channel 5 is the most commercial of all the PSBs, reflecting its relative immaturity. As such, the channel has historically been more reliant on repeats, repurposed content, acquisitions and cheaper hourly content costs
- The channel has focused its commissioning on programmes that maximise audiences among its core demographic, and retains a reliance on Big Brother, acquired drama and films
- Nevertheless, the channel has carved out a niche is children's content and has recently invested further in innovative drama (e.g., *Suspects*)

On a total returns basis basis, the best performing genres vary by channel: ITV (soaps, documentaries, sport), Channel 4 (documentaries, hobbies/leisure, films), Channel 5 (factual entertainment, documentaries, films)

- There is a wide disparity in profitability and commercial attractiveness among genre and broadcaster:
  - A number of genres remain commercially attractive, including drama, factual entertainment and entertainment
  - Other genres, including those with very strong PSB attributes, are commercially challenged and increasingly unattractive for the commercial PSBs – including arts, religious and current affairs
- It is instructive that recent changes to the PSB regime, including the removal of output prescriptions on arts, religious and music programming has resulted in their marginalisation or removal from the schedules of the commercial PSBs
- The commercial attractiveness of certain genres can be complemented or offset by the broader strategic objectives we have identified – all the PSBs see a strategic merit in retaining diversity of genre within their schedules and are not minded to focus too narrowly on only the best-performing genres
- The PSBs are incentivised to maximise audiences across their schedule. Investment in genres that secure large audiences can offset concerns over a genre's profitability by helping to maximise reach and share – both of which are crucial to retaining commercial salience with advertisers and agencies
- There is some correlation between audience size and profitability – but more marginal genres that are less represented in the schedule are able to produce some positive financial contribution to overall channel outcomes, and can also serve to attract a broader range of audience groups and cater to varying tastes

Our analysis has focused on analysing genre profitability via a calculation of gross margin – we summarise our broad approach below...

- In analysing commercial returns by genre, we have calculated gross margin, taking account of total revenues and the cost of production (i.e., (revenues – production costs) ÷ revenues). This necessarily excludes any overheads, distribution, marketing and other costs and is therefore not indicative of a broadcaster's overall net profitability
- We have developed a framework to capture all components of value for programmes broadcast on the commercial PSB channels. This covers the core revenues generated from primary broadcast (including repeats, sponsorship and distribution on other linear channels in the relevant group portfolio) and ancillary revenues from on-demand distribution, merchandise and format/programme sales
- Crucially, these outcomes also account for the impact of PVR usage and ad-skipping. Currently adverts that are ad-skipped during time-shifted viewing do not contribute to commercial impacts, and therefore those genres that are more likely to be viewed on a time-shifted basis include a higher proportion of foregone advertising revenue
- Our analysis is based on an annual database of programmes broadcast in peak across the PSB channels in 2013, tagged as to broadcaster, genre, duration, viewing audience, viewing share and the proportion that was live/consolidated. Our focus on peak-time audience reflects the significant contribution of peak viewing to overall outcomes
- Programme costs are estimated from various sources (including tariff schedules, primary interviews); for the avoidance of doubt, PSBs did not provide detailed cost per hour data
- We have presented outcomes for the key genre categories across the PSB regime, including sub-genres where relevant
- We have also analysed decision making at the BBC and Sky, as these provide useful benchmarks for analysing the commercial PSBs – and the content strategies of the BBC and Sky are themselves important influences on content investment at the commercial PSBs
- Our analysis has also been generally informed by interviews with senior executives, controllers and strategists at the PSBs and Sky

Each genre's commercial attractiveness varies among the three PSBs – notably, ITV is able to leverage its scale to offset higher production costs, whereas Channel 4's remit allows it to incur losses across a wider genre mix

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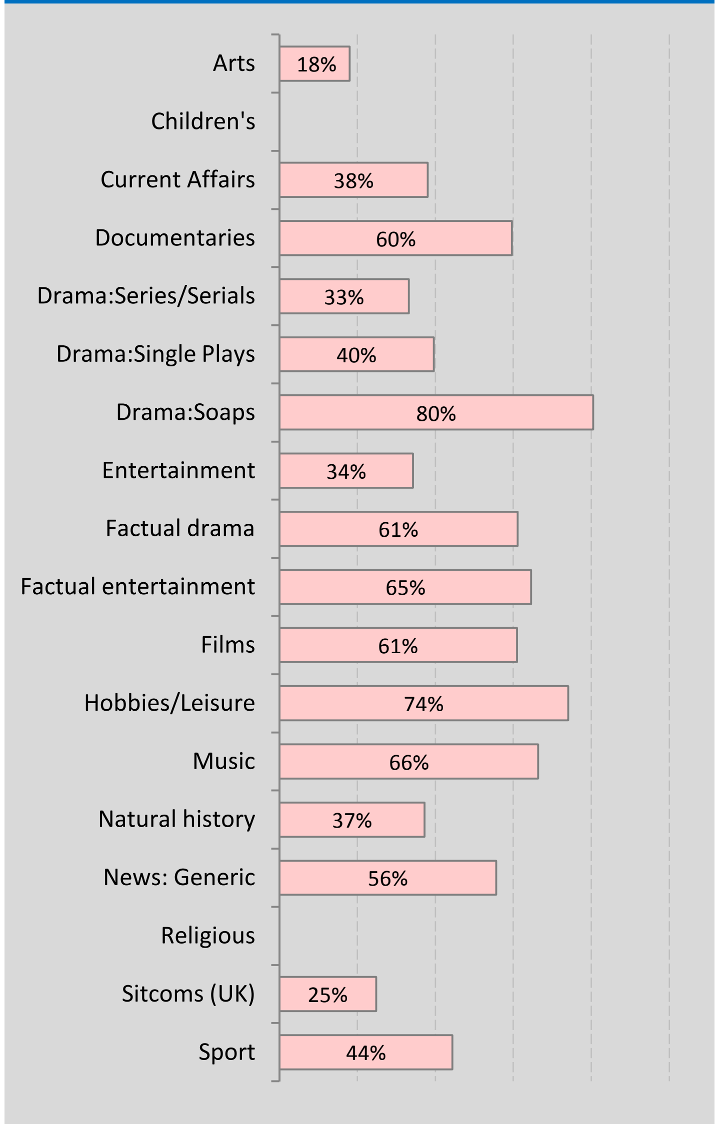
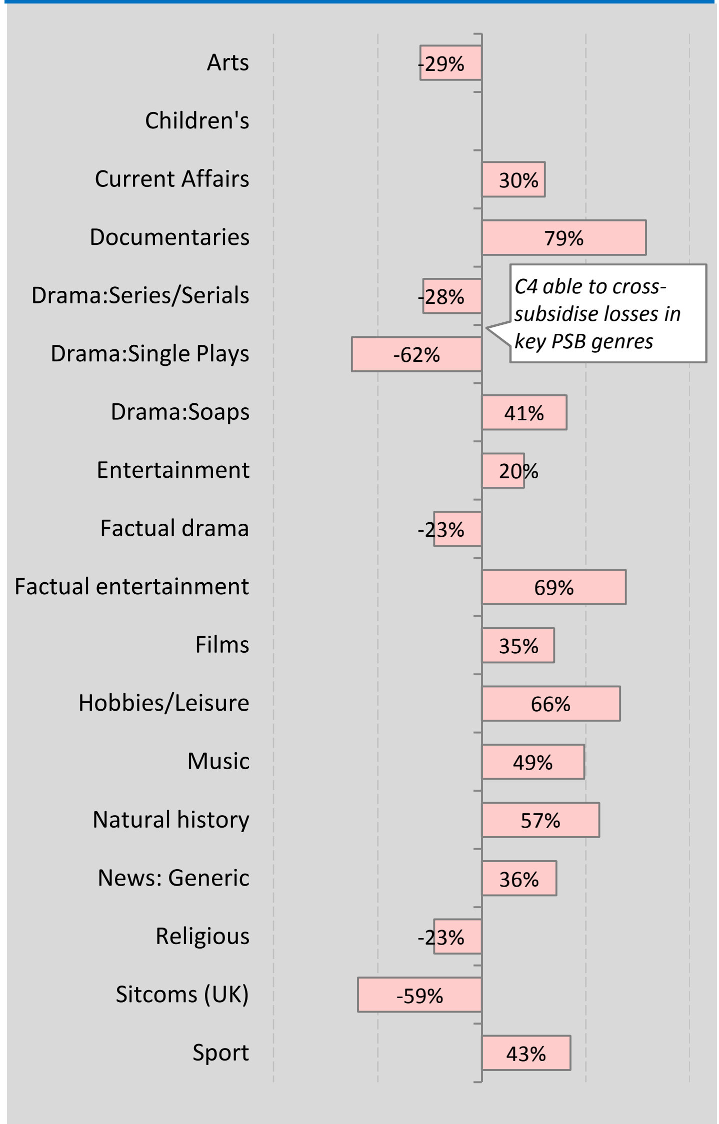
All figures show gross profit/loss margin

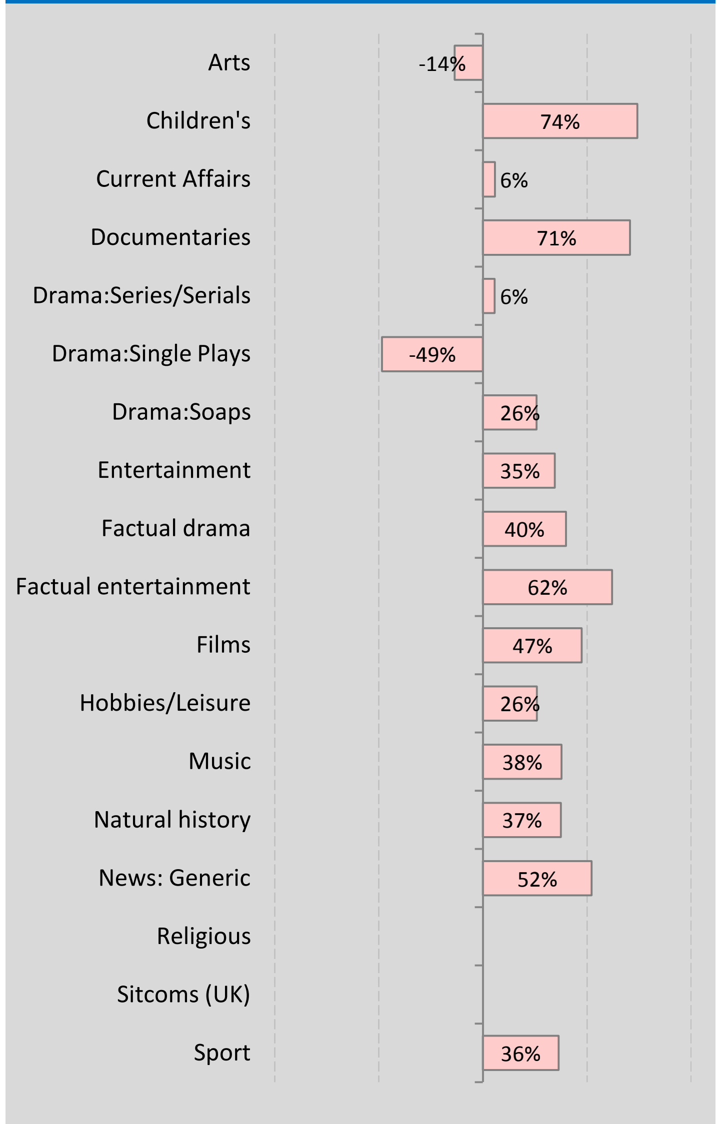
ITV gross profit margin contribution, by genre (peak hours 2013, %)



Channel 4 gross profit margin contribution, by genre (peak hours 2013, %)



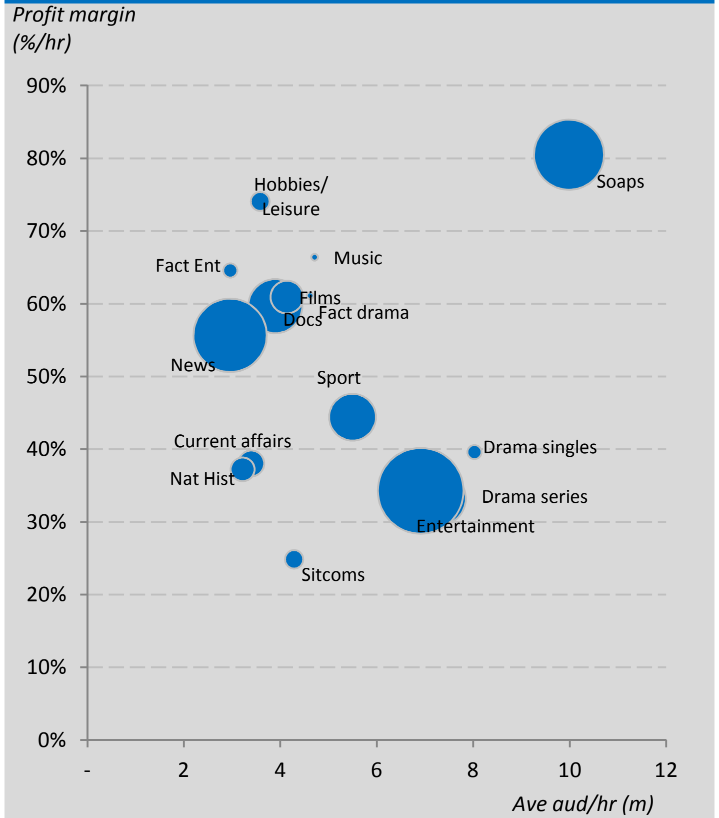
Channel 5 gross profit margin contribution, by genre (peak hours 2013, %)



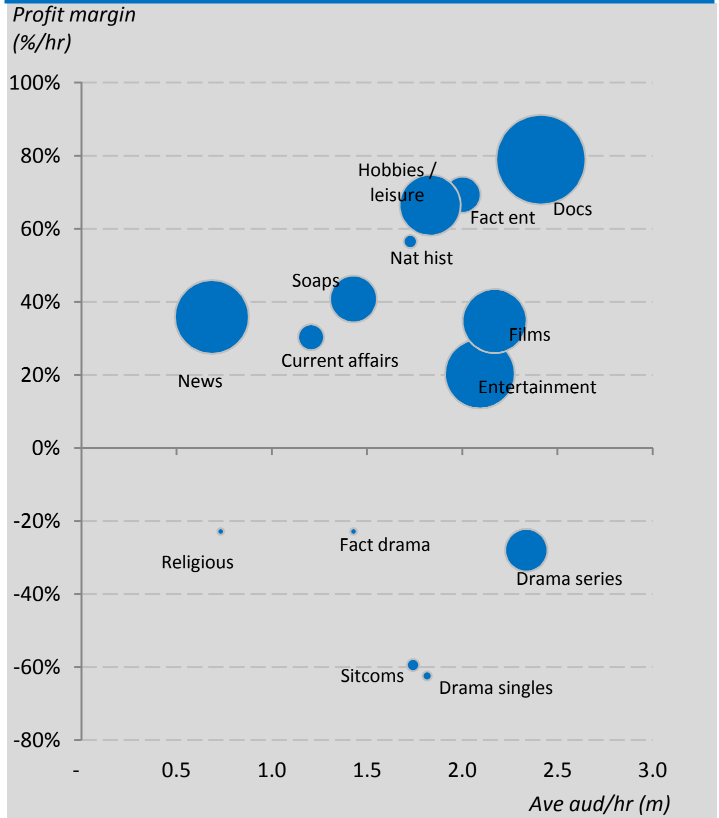
Source: Mediatique model. Genres with no written % indicate absence of programmes from that channel's schedule

There is some correlation between the scale of audiences secured by each genre and its profitability, although some genres that secure small audiences can still secure a positive contribution...

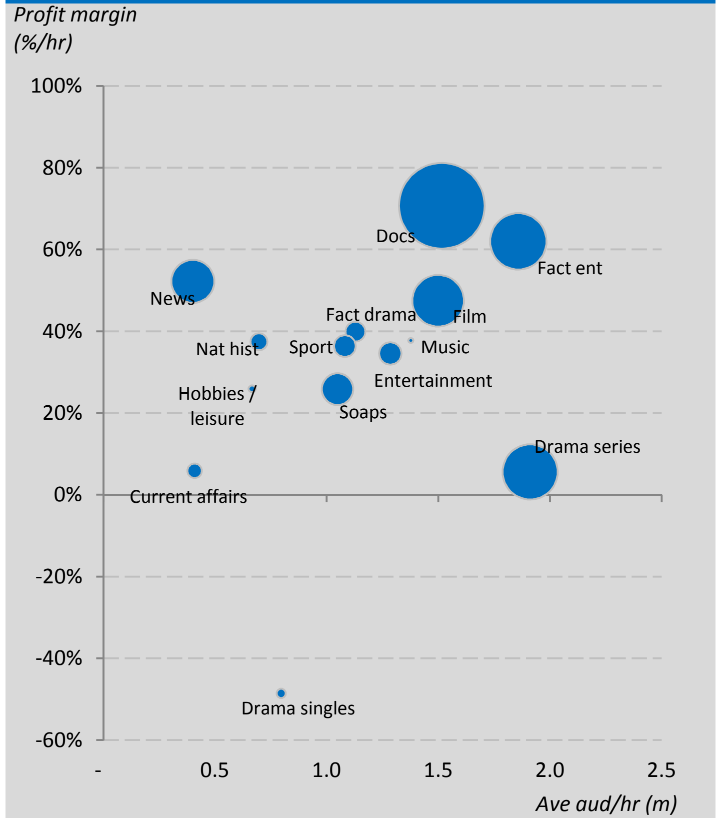
ITV gross profit margin vs audience size, by genre (peak hours 2013, m, %)



Channel 4 gross profit margin vs audience size, by genre (peak hours 2013, m, %)



Channel 5 gross profit margin vs audience size, by genre (peak hours 2013, m, %)



- Across all the commercial PSBs, those genres that secure larger audiences typically secure a higher profit margin – although this reflects a range of contrasting dynamics among individual genres and channels:
  - ITV soaps leverage significant brand value and loyalty to secure mass-market audiences on a regular basis. Similarly, ITV is able to promote drama brands and secure valuable talent on a cost-effective basis given relatively long runs
  - Factual entertainment across Channel 4 and Channel 5 is relatively cheap to produce (and often re-purpose) and secures significant audiences on a regular basis – the same is true across multiple sub-genres within documentaries

Source: Mediatique model. Size of bubble corresponds to each genre's share of broadcast hours

As market trends evolve, and the penetration of PVRs and on-demand devices increase, ROI profiles will shift further, particularly for those genres whose consumption is already biased towards non-live viewing

- Current outcomes confirm that each broadcaster and genre has a unique viewing/ROI profile, including its share of time-shifted and on-demand viewing. As audience behaviours increasingly favour non-linear viewing over time, some genres that are currently commercially attractive will become less so over time

- Those genres that are most reliant on live viewing are potentially challenged as the share of total TV viewing that is scheduled declines; by contrast, those viewers that are more likely to be watched on a non-linear basis are able to monetise viewing in on-demand windows, although are at risk from any chance in market practice that does not allow time-shifted (and potentially ad-skipped) inventory to be monetised

- The consideration of non-linear impacts/opportunities will become part of the content appraisal process – potentially favouring those genres that are more immune to changes in audience behaviour, and leading to a further withdrawal from marginal genres

- Broadcasters may be incentivised to rely on proven formats or programme brands that have established track records of generating positive ROI – this may also favour repeats, re-commissions or a shift towards lower-cost genres. Broadcasters may also seek to maximise revenues in secondary windows by focusing on genres with international appeal, with a potentially damaging impact on UK distinctiveness and innovation

- Market developments are likely to place pressure on overall content budgets at the PSBs as a decline in live viewing may reduce overall advertising budgets invested in linear TV. However, all PSBs will continue to consider broader strategic objectives when considering investment decisions, particularly if future trends are evolutionary rather than revolutionary

- As a result, all PSBs are likely to continue to invest in quality, creativity and diversity, and to optimise their engagement with audiences across as many windows/platforms/genres as possible

Our analysis suggests that market evolution may place further financial pressures on key PSB genres across all broadcasters – although some genres are able to leverage new opportunities on-demand to secure positive ROI

Genre	Position within future PSB compact by 2020*	
Arts & religious	▪ Economics are further challenged by market transition, with limited ability to derive compensating revenues in on-demand windows. Small audiences unable to offset production costs ▪ Likely to be further marginalised at ITV and Channel 5 in particular	At risk
Children's	▪ High repeatability and potential in on-demand windows sustains profitability for Channel 5 ▪ BBC to remain the benchmark for children's	Stable (at low levels)
Current affairs	▪ Bias towards live viewing makes economics more challenging for current affairs, with no compensating revenues in on-demand windows. Likely to remain important to ITV and Channel 4 strategies (and brand) but potentially only sustained by tier 2 regulation at Channel 5	Challenged
Documentaries	▪ Highly profitable for all broadcasters over time – with balanced engagement across live and on-demand windows allowing optimisation of revenue	Stable
Drama – series/ singles	▪ Still profitable for ITV, with potential to secure revenue across both live and on-demand windows ▪ Challenged for Channel 4 and Channel 5, but no significant change from 2014 as drama continues to perform well in on-demand windows (but thus outcomes are sensitive to underlying metrics in these windows)	Stable
Drama – soaps	▪ Still highly profitable for ITV, with potential to secure revenue across both live and on-demand windows ▪ Positive for Channel 4, challenged at Channel 5, but no significant change from 2014	Stable
Entertainment	▪ Likely to sustain reach and secure viewing share, talent associations and secondary revenues – and hence set to remain a cornerstone of schedules ▪ Future economics are neutral, as VOD revenues offset some decline in live ROI	Stable

*Source: Mediatique model. * 2020 position is based on Mediatique's modelling*

Genre analysis contd...

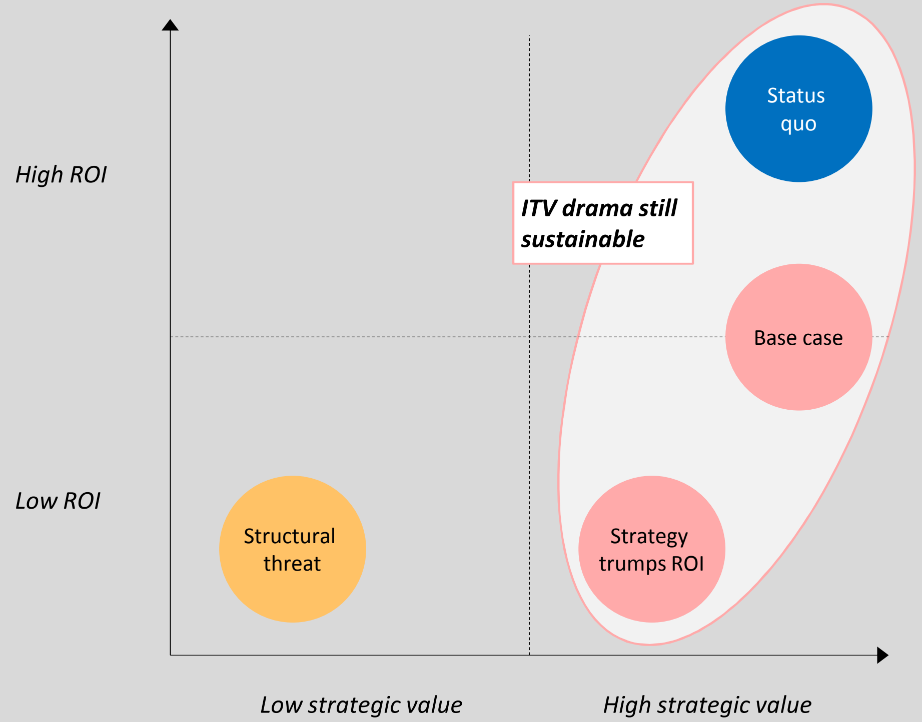
Genre	Position within future PSB compact by 2020*	
Factual entertainment	▪ Factual entertainment will continue to benefit from favourable economics (low production costs, large audiences) and can monetise on-demand consumption ▪ Likely to remain crucial to Channel 4 and Channel 5 profitability	Stable
Films	▪ Historically sourced via acquisition, and therefore highly substitutable by on-demand players (e.g., Netflix, Amazon) over time ▪ Relatively high margin for ITV and Channel 5 as long as acquisition costs remain low	Stable
Music	▪ Likely to morph increasingly to entertainment (e.g., live shows, best of programmes) ▪ Very limited scope for classical music outside the BBC	Challenged
Natural history	▪ Current bias towards live viewing likely to be sustained, with resultant impact on revenue/ROI ▪ Some blurring of definition (with factual entertainment/docs) likely over time, including sustained relationships with talent/celebrities and co-productions. “Pure” natural history benchmarks likely to be set by the BBC	Stable
News	▪ News likely to remain a cornerstone of live schedules, but likely to face declines in scheduled viewing ▪ Limited ability to derive compensation from VOD viewing, but still crucial to broadcaster strategies and channel brands. Regional news at ITV likely to face significant pressures in light of fixed cost burden	Challenged
Sitcoms (UK)	▪ Challenging economics across all the PSBs, but some upside from ability to secure on-demand revenues ▪ Likely to remain limited in scale, but driven by creativity and talent association	Challenged
Sport	▪ Rooted in live audiences, and thus limited upside from on-demand viewing ▪ Becomes financially challenged for all broadcasters, but likely to remain critical to ITV brand (particularly relating to international or premium sport) – Channel 5 likely to focus on cheap marginal genres (boxing) or highlights	Stable

*Source: Mediatique model. * 2020 position is based on Mediatique’s modelling*

We suggest that drama is likely to remain a cornerstone of ITV's schedule over time, even if ROI economics become more challenged as a result of more aggressive shifts in industry dynamics...

- Drama poses a particular issue for ITV as it currently delivers significant audiences and positive ROI, but represents the most time-shifted of all genres and is thus potentially the most at risk in terms of future dynamics
- Indeed, changes in consumer behaviour towards more non-linear viewing are set to reduce the ROI associated with drama, with potential implications for its sustainability within the ITV schedule
- However, it remains the case that drama contributes significant strategic value to ITV in the form of brand health, audience delivery and talent association
- We found a consistent view among ITV stakeholders that it would continue to schedule drama (across all sub-genre categories) even if economics became more challenged in order to maintain a benchmark against the BBC and Channel 4 – both of whom would continue to commission drama as part of their PSB remits
- Only a more radical acceleration of changes in consumer behaviour and technological enablement would result in a material shift away from drama for ITV

Future dynamics for ITV drama



Drama continues to secure high strategic value and ROI for ITV on our base-case view of the future, in spite of an increasing shift towards non-linear consumption
It is possible to envisage a more aggressive decline in ROI for drama – were, for example, there to be a collapse in VOD CPT rates or a more aggressive shift towards time-shifted viewing. In this scenario, drama is still likely to contribute more broadly to ITV's strategic health, however
Only in a situation of radical disruption would there potentially be a fall in both financial and strategic value – characterised, for example, by a shift in audience preferences away from drama (in all viewing windows) towards other genres or other forms of engagement

It is possible to envisage future scenarios that could fundamentally threaten the sustainability of PSB funding...

- An evolutionary forecast of future developments does not necessarily place fundamental challenges on the sustainability of PSB, not least as commercial broadcasters are able to adjust to market developments over time and to seize the opportunity to optimise commercial return across an increasing number of windows
- However, we have identified the key determinants of a more extreme case – as set out opposite. These conditions could fundamentally alter the business strategies of PSB funding across all commercial organisations, resulting in challenging economics and major changes in content investment decisions
- Any market outcome under these conditions would likely result in a withdrawal from PSB by ITV and Channel 5, and may leave Channel 4 as the sole commercial PSB – and even then with significant financial challenges in meeting its remit

Conditions for a collapse in the sustainability of PSB content

Further systematic **decline and fragmentation in linear viewing** placing at risk the universal reach of PSBs and their ability to secure mass-market audiences

Change in audience tastes away from PSB channels and PSB content – perhaps towards new entrants or more niche content aggregators

Inflationary pressures on the cost of production in key genres (e.g., competition for talent, format inflation), or changes in terms of trade that favour independent producers at the expense of returns retained by broadcasters

Change in market practice so that broadcasters are fully penalised for time-shifted/ad-skipped inventory – placing at risk (or removing entirely) any return from time-shifted viewing *(see overleaf)*

Deflationary advertising environment for TV – resulting in a decline in linear CPTs (in line with falling live viewing) and commoditisation of VOD CPTs (e.g., via automated trading)

By way of illustration, we have sensitised the 2020 profitability calculations on the basis that all time-shifted viewing is not monetised – with consequential implications on genres that are more prone to time-shifting...

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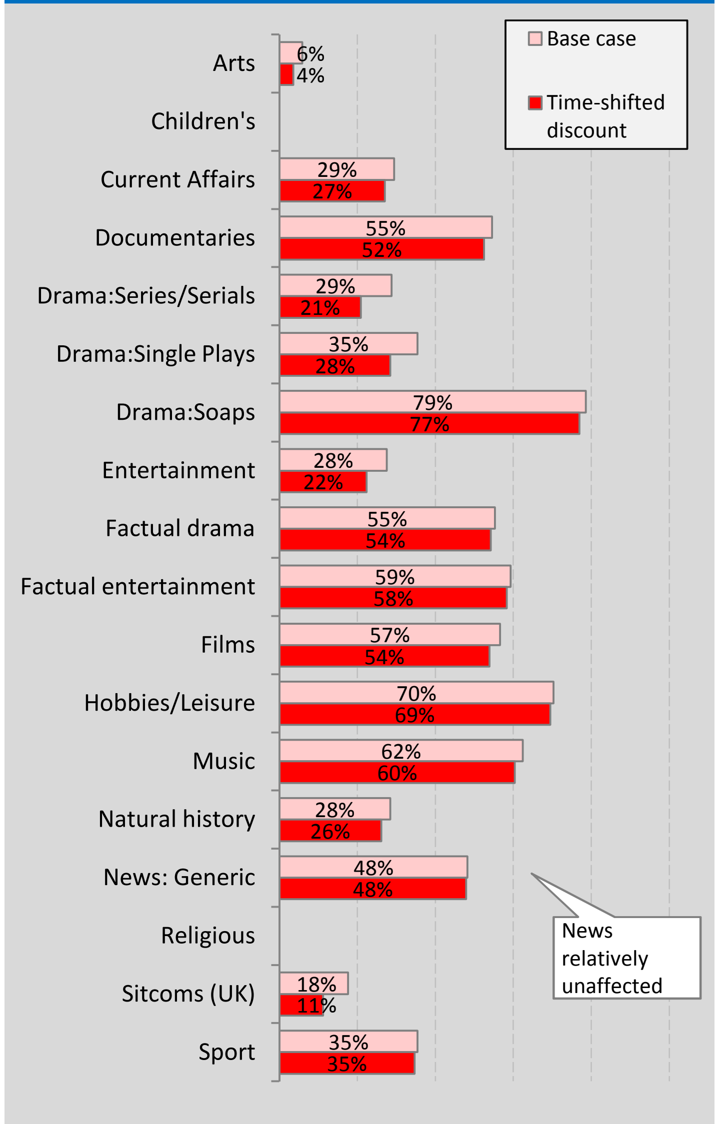
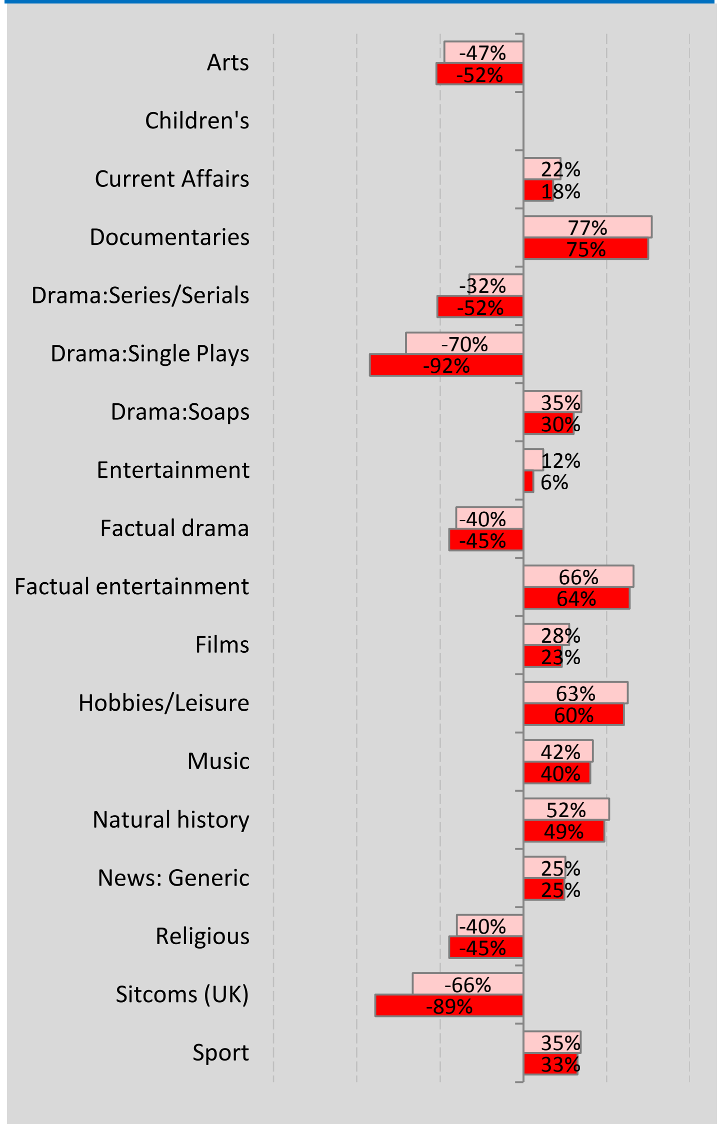
Base case shows 2020 profit margins based on current market practice, where time-shifted ads that are not fast-forwarded are monetised in line with live ads. Time-shifted discount shows profit margins where any ads that time-shifted are not monetised – hence those genres with a higher propensity towards time-shifted viewing are more likely to see profit margins fall in this scenario

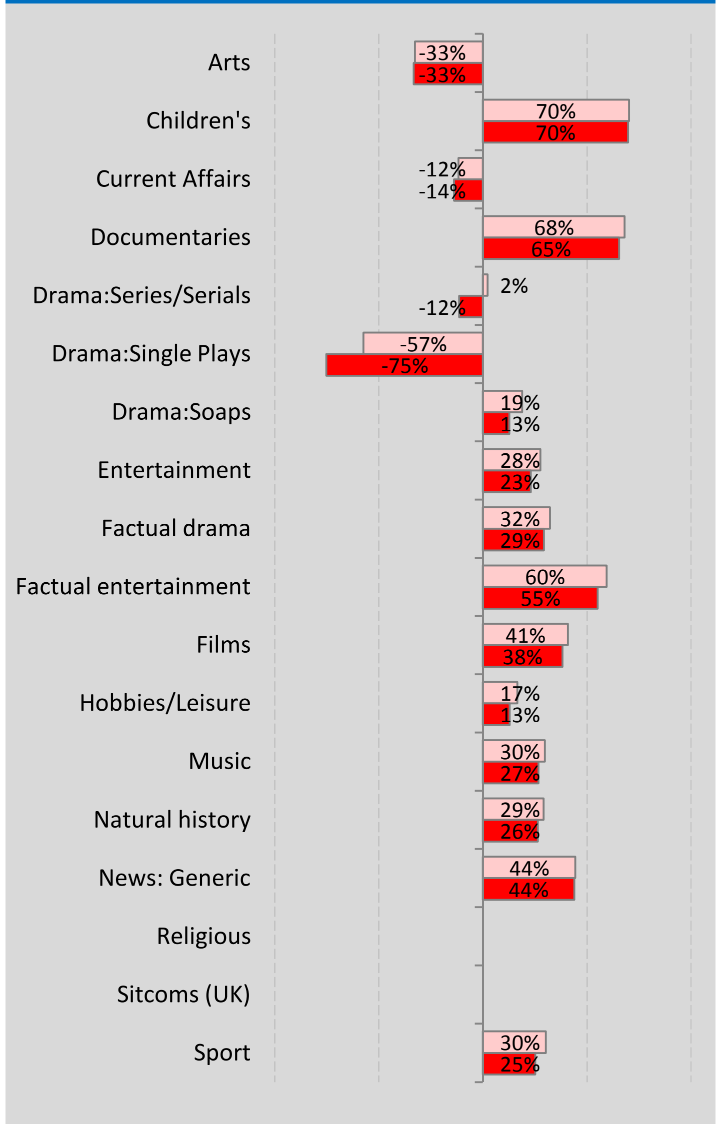
ITV gross profit margin contribution, by genre (peak hours 2020, %)



Channel 4 gross profit margin contribution, by genre (peak hours 2020, %)



Channel 5 gross profit margin contribution, by genre (peak hours 2020, %)



Source: Mediatique model. Genres with no written % indicate absence of programmes from that channel's schedule

All figures show gross profit/loss margin

Our view is that the conditions required to result in *fundamental* challenges to the sustainability of PSB genres are unlikely to materialise over the medium term...

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Condition required	Mediatique view
Further fragmentation of linear viewing	▪ The PSBs have maintained their position within the linear environment following digital switchover, and they continue to invest in quality content and to optimise their distribution to retain this. The greater threat remains fragmentation from emerging digital opportunities; however, the PSBs have extended their brands and content investment into the digital arena in order to retain audience traction
Change in audience tastes away from PSB channels	▪ The PSBs have retained near-universal reach, and continue to secure more than 70% of all viewing share across linear viewing; they also retain similar levels of engagement in non-linear consumption. These outcomes reflect the continuing primacy of PSB content within consumer preferences and exist despite the significant – and growing – opportunities to source content elsewhere
Change in market practice placing monetisation of time-shifted viewing at risk	▪ Market practice already precludes the sale of commercial inventory that is ad-skipped, but allows broadcasters to monetise time-shifted viewing if watched without being fast-forwarded. This seems likely to continue as broadcasters and advertisers are similarly incentivised to reach audiences that are engaged whether on a live basis or on a basis enabled by changes in technology
Deflationary advertising environment for TV	▪ TV remains a crucial medium for advertisers, particularly for brand advertising which is ideally suited to video display. TV has remained relatively resilient against new forms of digital advertising, and the commercial PSBs are presenting advertisers with holistic opportunities to advertise across linear and non-linear audiences, thereby supporting marketing investment in TV despite shifting viewing behaviours
Inflationary pressures in the cost of production	▪ The PSBs face competition for talent and ideas from other broadcasters (e.g., Sky) and increasingly from new entrants (e.g., Netflix, Amazon) which will inevitably lead to some upward pricing pressure. The PSBs' relative scale allows them to withstand some of this pressure, and indeed to offset inflation (e.g., investment in production technology, leverage of prior relationships with talent, ownership of formats/production resources)

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Mediatique is working with Ofcom to analyse the determinants of content investment at the public service broadcasters, and to develop a framework to illustrate the potential pressures on PSB genres...

- Ofcom is undertaking a review of public service broadcasting (PSB) covering the period 2008 to 2013, and identifying current developments which may have an impact on PSB provision in the future
- There have been significant developments in the media sector since the last PSB review, including the completion of digital switchover, growth in the take-up of connected devices and changes in consumer behaviour towards non-linear viewing
- These changes have exacerbated the fragmentation of viewing to PSB channels and have potentially wider implications for the sustainability of PSB content over time
- In light of this context, Ofcom is examining the current determinants of investment in PSB content and seeking to better understand how these might change in the future
- Mediatique is working with Ofcom to examine how content investment decisions are made, and how recent changes in technology and audience behaviour are affecting these decisions
- ...specifically we have tested whether any particular genres are under increasing threat as a result of growth in time-shifting, ad-skipping and other future developments

Areas of analysis

How are media developments affecting the economics of investment in content genres?

- **What currently determines content investment decisions at the PSBs?**
- **What return on investment do the commercial PSBs make in each PSB genres?**
- **How might content investment decisions evolve in the future?**

Important information

Scope of our work	▪ Mediatique was engaged by Ofcom to examine the dynamics of content investment decisions among the commercial PSBs in the UK. We sought to identify the processes by which the PSBs make investment decisions and the influences on each broadcaster's mix of genres ▪ One of the ultimate determinants of content investment is business performance, and the commercial PSBs' primary business model of advertising remains subject to cyclical trends. An analysis of these cyclical trends is outside the scope of our analysis, and we have focused instead on structural factors ▪ We have also analysed decision making at the BBC and Sky, as these provide useful benchmarks for analysing the commercial PSBs – and the content strategies of the BBC and Sky are themselves important influences on content investment at the commercial PSBs ▪ Our analysis has been informed by a range of interviews with senior executives, controllers and strategists at the PSBs and Sky. We have also analysed a range of viewing and expenditure data from Ofcom publications, stakeholder interviews and internal sources, which form the cornerstone of our findings on ROI ▪ The quantitative analysis contained has been informed by input data and is therefore unlikely to be absolutely accurate, although we are confident that model outputs are within acceptable error parameters for the purposes of drawing conclusions based on them
About Mediatique	▪ Mediatique is a strategic advisory and research firm specialising in the communications industries in the UK and internationally Mediatique provides bespoke advice and market intelligence to companies across three main areas: strategy consulting, commercial due diligence and independent research ▪ The firm has worked for major UK, US and European media companies, and has particular experience in broadcasting, content developments, commercial strategies and public policy
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As a brief overview of market context for this analysis, the TV sector has changed significantly since Ofcom's last PSB review...

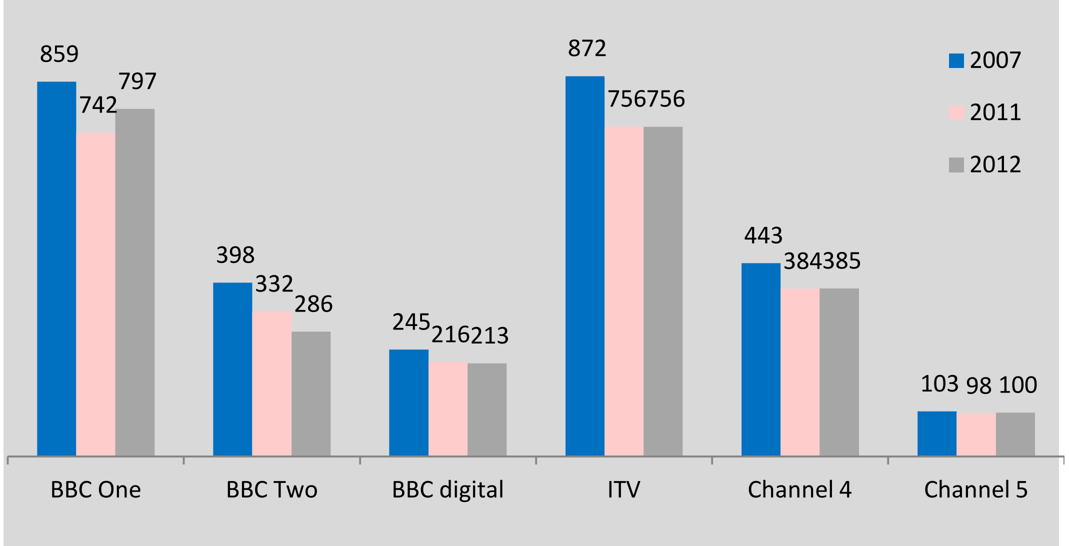
The changing market context since 2008

Changes to technology and market dynamics are creating new routes to market for broadcasters/channels	▪ The switch-off of analogue TV signals, increasing broadband penetration, faster network speeds, extended broadband network coverage and the proliferation of connectable/connected devices are enabling content owners to pursue new routes to market – content aggregators are no longer reliant solely on broadcast technology to distribute their channels and programmes ▪ Business models are evolving in recognition of changes in technology, with the advent of triple-play offerings from pay-TV operators (bundling telephony, broadband and TV), aggressive promotion of both PVRs and hybrid IP-DTT/IP-DSAT propositions and "authentication" services allowing consumers to access content on devices and at times of their choosing ("anywhere, anytime") ▪ In addition to the launch of the PSB players (iPlayer, ITV Player, 4OD, Demand 5), the market has also seen a number of SVOD services launched, including Netflix, Amazon Instant, and Now TV (some of which are now commissioning original content)
Viewer behaviour is increasingly embracing video consumption on a non-linear basis – including on non-TV platforms/devices	▪ Enabled by technology and connectivity, viewers are increasingly shifting their behaviour away from linear channels watched on the TV set towards new devices, consumed on an anytime-anywhere basis – younger audiences in particular are challenging the traditional paradigm of linear channel delivery; while the amount of TV content watched other than on the TV set is still small, it is increasing, as is the amount of content viewed on TV sets at times other than originally broadcast ▪ This presents a challenge to the PSBs in seeking to retain audience engagement – both to evolve their services in line with changes in audience behaviour and expectations (across all demographics) and to continue to provide PSB services to those who are unable or unwilling to evolve at the pace of the market average ▪ Despite these changes, the popularity of original PSB content (first run) continues to be marked – e.g., the amount of linear content consumed and the share of non-linear that is of the same programmes that are popular in broadcast schedules (see overleaf)
The commercial PSBs have seen changes in their competitive cohort since 2008	▪ The recessionary environment of recent years has created a challenging environment for advertising and forms the background for cost cutting at the PSBs. Indeed, the BBC has seen the licence fee frozen with implications for content expenditure over time ▪ However, Sky (and other multi-channel operators) have increased commitment to original content investment, even as the PSBs generally reduced original content budgets on mainstream channels between 2008 and 2013 ▪ In addition, new entrants are beginning themselves to invest in original content, following a period typified by pure aggregation; for example, Netflix, Amazon and Google have all made (or plan to make) original programming – typically focussed on building/retaining subscriber relationships ▪ Following recessionary pressures on costs in 2009-10 tariffs for TV content are moving back up, fuelled by new entrant demand and bolstered by consolidation of external supply – this is more of an issue for Channel 4 than for ITV, which has its own content business

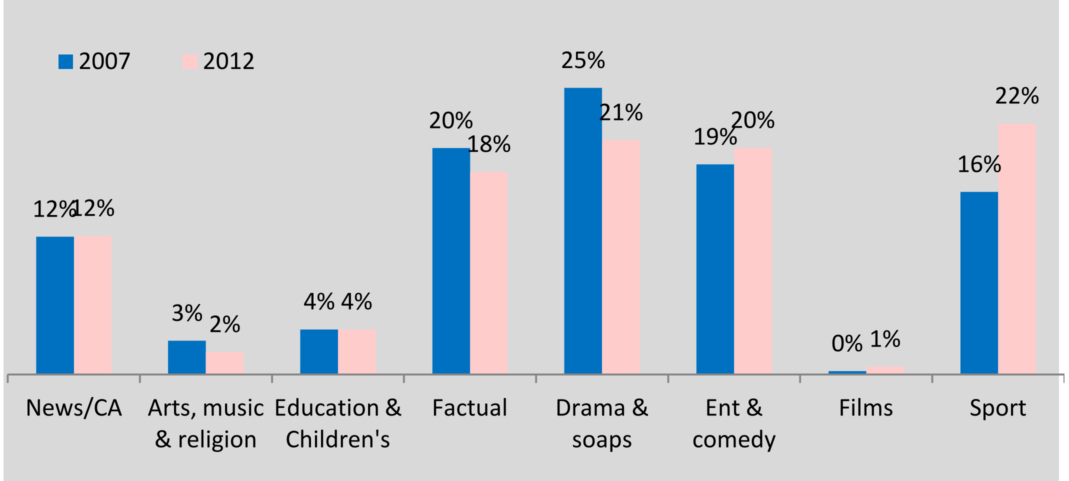
Alongside and as a result of changes in market dynamics, the period 2008-2013 has seen significant developments in the strategies of the PSBs...

- The PSBs have evolved their strategies over the recent period in light of market changes, in particular pressures on funding and further viewing fragmentation – firstly to other linear channels post-DSO and more recently to new entrants in the online/non-linear space
- Cuts to content budgets were made in response to challenging economics in 2007-2009, however, these have been reversed in recent years and content investment for nearly all the main channels is stabilising. This has affected the share of expenditure that certain genres secure, although the PSBs still produce across a range of genres
- All the PSBs now operate a branded portfolio of channels focused on key genres or targeted at specific demographics; all commercial PSBs also operate +1 channels which allow the aggregation of commercial impacts across both channels with marginal increases in content costs
- The PSBs all operate on-demand players online and on TV platforms, allowing viewers to catch-up on programmes they have missed and to access archive material on a range of devices
- The PSBs continue to sustain near-universal reach among UK households and can exert influence on consumer behaviour, particularly by encouraging the use of their own on-demand services or platforms. This is particularly the case for the BBC and ITV and they continue to strike a balance between enabling viewers to access content on their own terms and maintaining valuable audiences in the linear window across their portfolios of channels

First-run content expenditure by broadcaster, core channel (peak hrs, £m)



Share of first-run content expenditure, PSB core channels (peak hrs, %,)



Source: Ofcom expertise, Mediatique estimates

These changes since 2008 are reflected in the underlying economics of particular genres and the ways in which broadcasters assess the financial performance of those genres...

- Of the major market changes since 2008, the intersection of technology (typified by greater enablement in homes of VOD and time-shifting) and consumer behaviour (more frequent non-linear engagement, particularly among younger demographics) has generated the most obvious and potentially the most significant long-term trends:

  - In 2008, 97% of all TV viewing was scheduled; by the end of 2013, this had dropped to 88%
  - Amplifying this change have been the final stages of digital transition, ending in 2012 when all homes were fully digital, with half taking a pay TV service of some description

- The result for the PSBs has been an erosion in viewing share – albeit this has been mitigated by growth in the share of their portfolio channels

- It remains very complex to identify how programmes will perform and therefore how broadcasters should allocate expenditure; all broadcasters use a range of tools, including average slot performance, read-across from similar programmes broadcast in the past and the degree to which programmes generate ancillary revenues

- Inevitably, however, generally lower average audiences for live viewing has had an impact on ROI outcomes since 2008, certainly for mass market programmes which have been affected by audience fragmentation and content cost inflation. This also reflects an underlying reliance on linear advertising as a key revenue stream, rooted in the BARB currency which tracks absolute viewing and impact outcomes and does not fully support a broader assessment of audience engagement

- There is little evidence yet that advertisers are penalising broadcasters for “lost” impacts through ad skipping in particular: the net impact of non-linear viewing has been relatively modest in the years between 2008 and 2013, and airtime trading deals effectively “see through” the non-linear impact – through a combination of BARB accounting of Day 1-7 non-skipped ads, recognition that most PVR viewing to date can be seen as incremental rather than cannibalistic, and the continued high premium placed on even declining mass market audiences

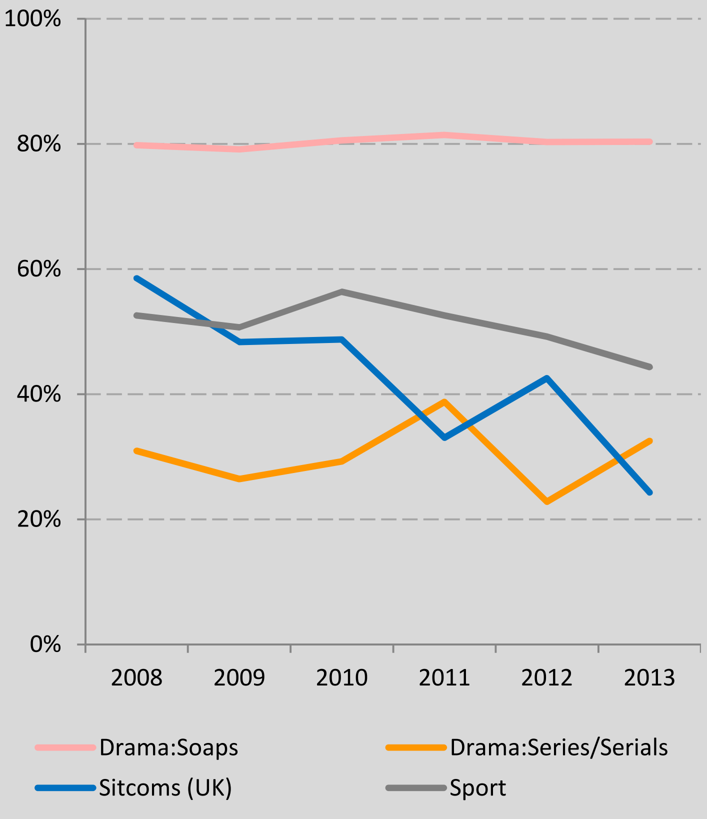
- However, the ROI approaches in place at the major broadcasters are beginning to reflect fundamental viewing trends

- For example, investment in drama and acquisitions of US series, which are more likely to be viewed than other content on a deferred basis, are showing lower returns in recent years; this has indubitably had an effect on investment decisions, leading to a decline in total share of budgets allocated to high cost lower margin genres, particularly original drama – as we illustrate overleaf

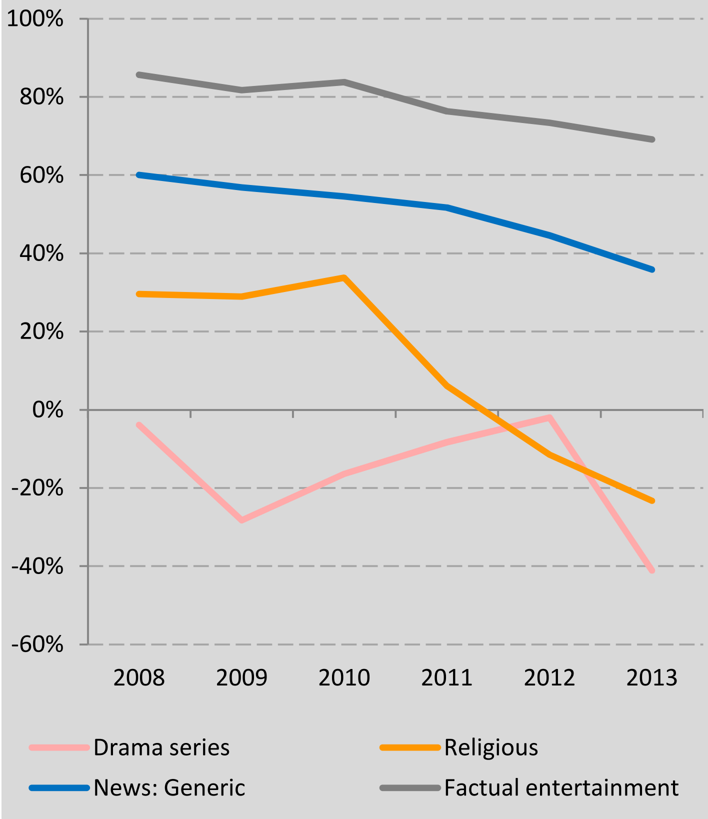
Key genres have experienced mixed profit margin outcomes since 2008, in part a reflection of underlying channel performance, but also structural issues at particular public service genres including arts and religious...

Figures show gross profit/loss margin

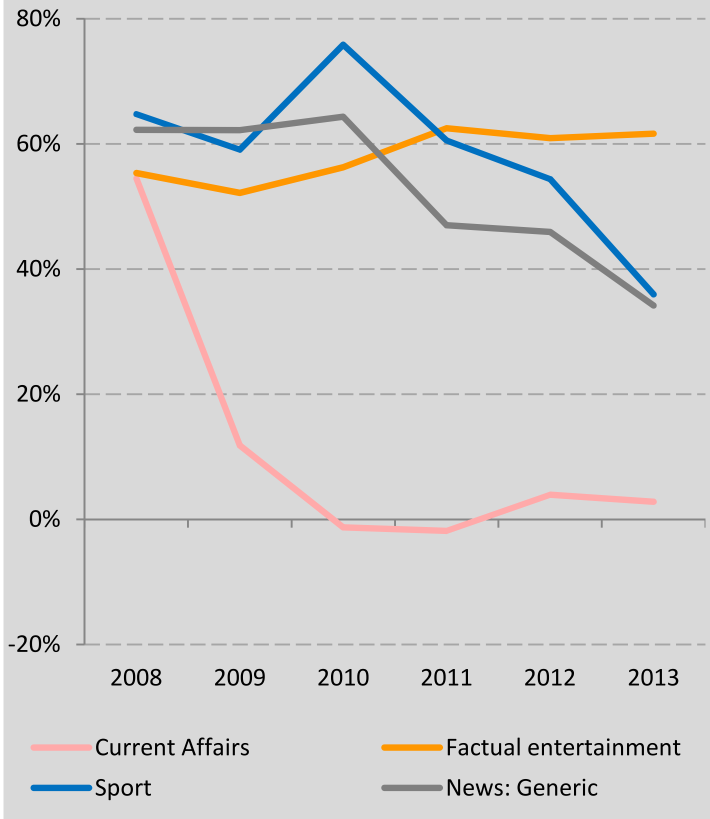
ITV gross profit margin, selected genres (peak hours, 2008-13, %)



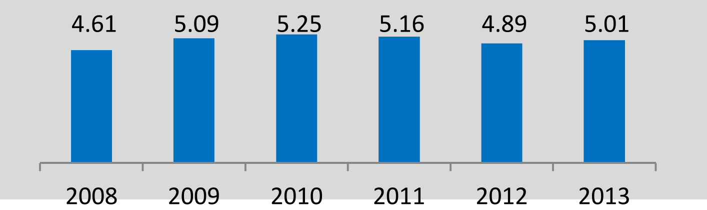
Channel 4 gross profit margin, selected genres (peak hours, 2008-13, %)



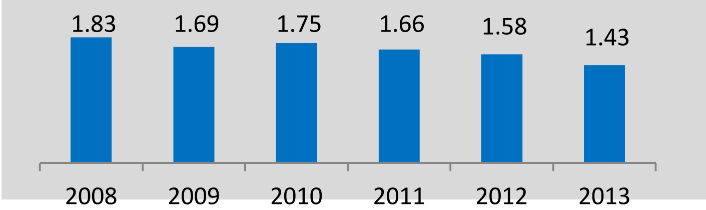
Channel 5 gross profit margin, selected genres (peak hours, 2008-13, %)



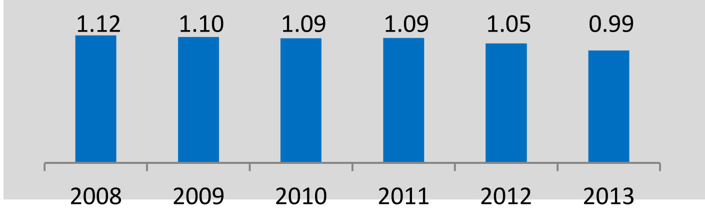
ITV average first-run audience (peak hrs, 2008-13, m)



Channel 4 average first-run audience (peak hrs, 2008-13, m)



Channel 5 average first-run audience (peak hrs, 2008-13, m)

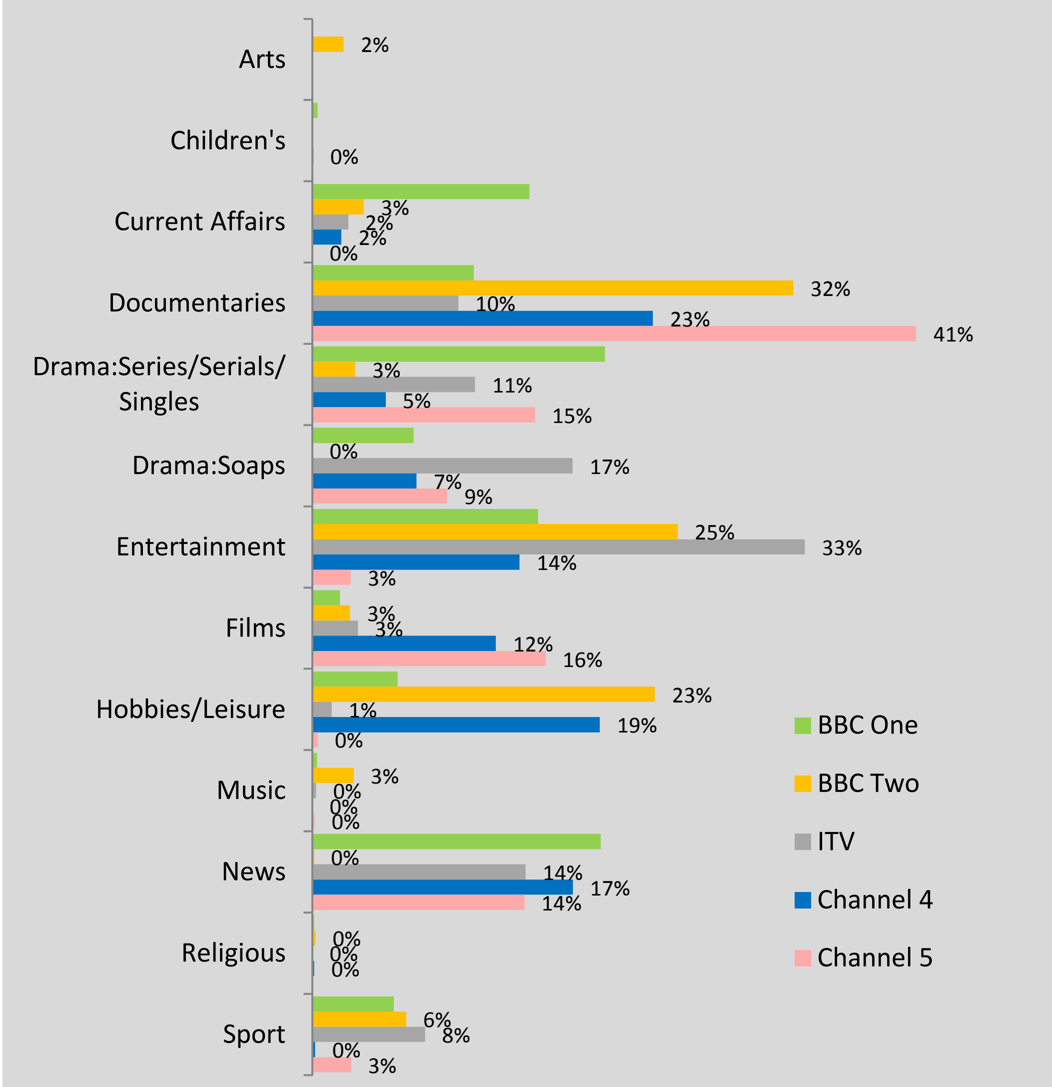


 Source: Ofcom expertise, Mediatique model

The PSBs – collectively and individually – invest in a range of genres, even though the decision to do so may not ostensibly be commercially optimal

- The PSB channels – the BBC, ITV, Channel 4 and Channel 5 – are generalist channels with universal availability and the (broad) goal of appealing to as wide an audience as possible
- As a result, these channels invest in and broadcast a range of genres, enabling them to secure audiences across multiple demographics and tastes
- Such an outcome may not ostensibly appear to be optimal, however, as some genres will not secure audiences of scale or value compared to others
- Following a purely economics based approach to considering content investment, the commercial PSBs might judge investment/commissioning decisions on the relative return on investment (ROI) for particular genres – namely, those genres which deliver the highest ROI would secure the biggest investment
- The same approach could be applied to the BBC, where those genres that maximise the BBC's reach (and "impact") would, in a purely economic framework, secure the highest investment
- In practice, however, ROI calculations are essentially a framework for analysing decision making at the PSBs; broadcasters ultimately make investment decisions on the balance of number of financial, commercial, strategic and more practical factors – as we outline in this section

Share of broadcast hours, by channel/genre (peak hours, 2013)



Source: Ofcom expertise, Mediatique model
Documentaries include factual entertainment, natural history, factual drama and human interest

The PSBs are required to account for policy prescriptions in determining the balance of their output – notably in relation to obligations on news and current affairs...

- The PSBs all have unique characteristics and objectives, sustained by their corporate status and their remit and obligations
- The PSB regime is enacted in primary legislation through the Communications Act 2003 requiring all PSBs to include programmes which cover many subjects and, taken together, maintain a high general standard and serve the needs and interests of many different audiences
- Investment in certain genres is sustained by the current regulatory compact which imposes obligations on the PSBs to provide programming from key genres. Increasingly, however, the PSB compact emphasises the characteristics of content (e.g., regional, original) rather than specific genres
- The PSB channels combine public policy requirements with commercial and strategic considerations to determine the mix of content outcomes for their channels
- We found that all the commercial PSBs believed that a broad genre mix had commercial benefits, as a broad and deep portfolio of programmes/genres sustained near-universal reach and was a key selling point to advertisers

Strategic and policy goals across the PSBs

- Ofcom prescribes quotas relating to original production (50-65%, depending on PSB), independent supply (25% of schedule) and out-of-London supply (10-35%, depending on PSB)
- The PSBs also have specific programming obligations and remits, set through a combination of primary legislation and Ofcom policy

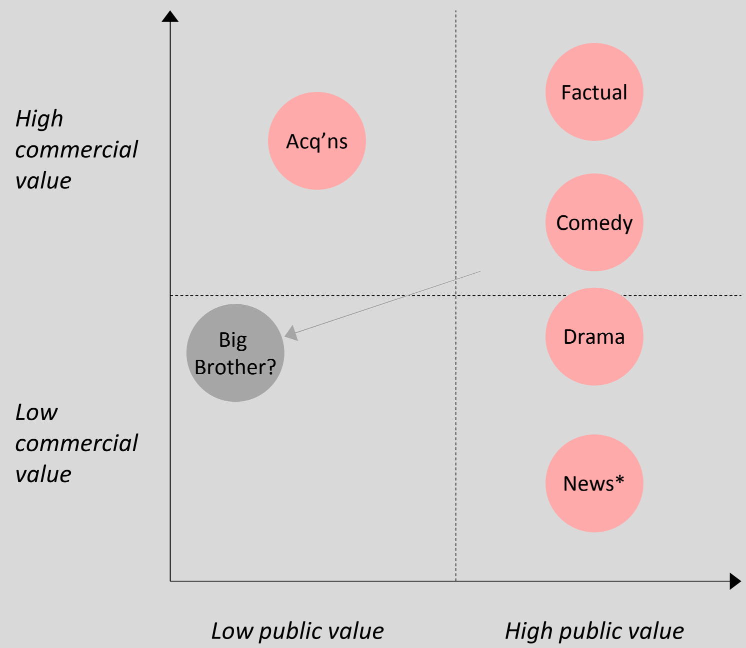
PSB	Remit and PSB requirements*
BBC	The BBC's remit is enshrined in six public purposes as set out in the Royal Charter and accompanying Agreement – these includes details of the BBC's obligations and its relationship to the BBC Trust and Ofcom
ITV	Remit requires provision of range of high quality and diverse programmes Obligations to provide national, international and regional news, current affairs and other programming
Channel 4	Remit to product high quality programmes that are characterised by innovation, experimentation, creativity, distinctiveness and that offer educational value and are reflective of cultural diversity Obligations to provide national and international news, current affairs and schools programmes
Channel 5	Remit requires provision of range of high quality and diverse programmes Obligations to provide national and international news, and current affairs

Source: Ofcom

The commercial PSBs face different remits and corporate objectives which can affect how decisions are made in relation to content investment...

- Our analysis confirmed that the PSBs' decisions on content investment are based on a balance of objectives and rationales
- In some cases these can be reconciled: Channel 4, for example, told us that they informally rank genres and programmes on the basis of their contribution to public value and to commercial value (see opposite) – some genres will straddle both, meeting Channel 4's remit while also generating large audiences
- Others may be limited in their commercial appeal but nevertheless meet other objectives – "public value" in the case of Channel 4, "brand health" in the case of ITV or reduced opportunity costs in the case of Channel 5
- Inevitably the profit motive has more influence at ITV and Channel 5 given their corporate status – ITV is a quoted company with multiple shareholders, Channel 5 now forms part of Viacom, whereas Channel 4 is publicly-owned organisation with a requirement to break-even
- ITV's decision-making process also differs from its commercial counterparts in light of its role as a producer of PSB content itself – in many areas it is incentivised to produce programmes where it has production strength and capability

A PS-commercial trade-off at Channel 4 *(illustrative)*



For Channel 4 the "public value" of a programme or genre reflects how it meets the broadcaster's remit – is it innovative, creative or reflective of cultural diversity, for example? This value is assessed on a regular basis – it is likely the case, for example, that C4's decision to axe Big Brother reflected a view that it no longer created public value for the channel

All PSBs consider delivering public value as part of their policy remit and thus an influencing factor in determining genre mix – although inevitably ITV and Channel 5 are likely to be influenced more by commercial value

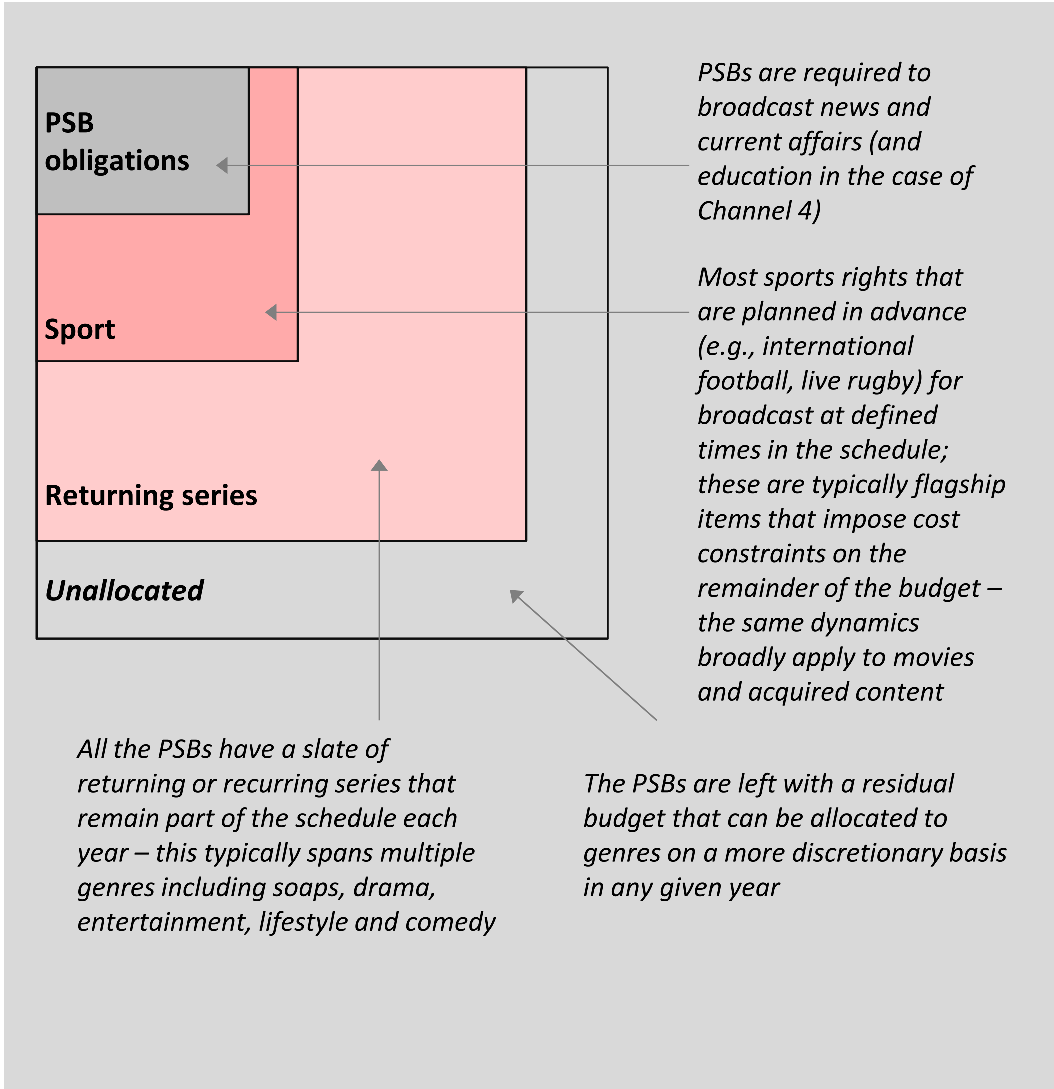
A framework such at this highlights the complexity of decision-making at the PSBs, and thus illustrates the limitations of relying wholly on ROI or commercial value as the basis of determining content investment. It also highlights the extent to which a channel's genre mix can be determined by decisions that are made on a programme-by-programme basis

** As we already reference, news (and other genres) are a special case – their direct allocated commercial value is limited, but retaining news in the schedule allows value to be transferred to other genres via the optimisation of advertising minutage*

The PSBs commit a proportion of their schedules to returning or recurring titles that can restrain the budget available to remaining genres...

- Outside the genre obligations imposed by PSB remits, the PSBs technically have total flexibility over their genre mix
- In practice, however, we found that the PSBs are typically committed to broadcasting a range of genres arising from successful rights acquisitions or from returning series in any given year. Indeed, primary sources confirmed that not re-commissioning a successful show (e.g., *Downton Abbey, The Hotel Inspector, The Inbetweeners*) was a significant risk to the predicted performance of the schedule and a risk to channel controllers personally
- These commitments impose budget constraints on the remainder of the schedule, and leave a residual budget/number of hours that can allocated to remaining genres
- By way of example, we were informed that 80% of ITV's schedule in 2014 were returning titles (including PSB obligations and acquisitions). We understand that only 20% of Channel 5's budget is unallocated to returning titles (including movies and acquisitions)

Determining expenditure by genre (share of hours/spend)



Source: Mediatique analysis

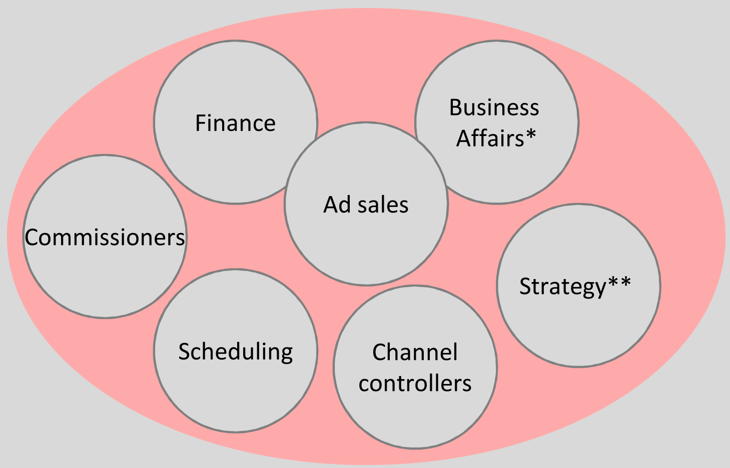
Across all the PSBs, discretionary decisions relating to the balance of genre investment are made by consultation with multiple internal stakeholders – including finance, strategy and creative teams...

- Our interviews with the PSBs confirmed that decision-making on content investment and genre mix is multi-layered at each organisation – a broad overview is illustrated opposite
- The PSBs have similar approaches to decision-making, albeit with differences to reflect the relative scale and complexity of each organisation:
  - All decisions are informed by broad corporate objectives that are set at the highest levels of management and these crucially determine the trade-off between public service/value and commercial objectives. This is rarely stated in absolute terms, however, but is intended to inform decision-making lower down the organisational chain
  - Broad objectives could be stated more formally as the outcome of strategic reviews at the PSBs, although the detail of these is not often publicly available – the one exception being the BBC which is typically required to consult (via the BBC Trust) on any content investment recommendations arising from strategic reviews
  - As a result, most decisions relating to the genre mix are determined discretely on the potential of individual programmes. A range of stakeholders are involved at all levels in determining the ultimate genre mix at all the PSBs – content budgets are set annually by senior management and discrete decisions on commissions and schedules are the result of numerous meetings/processes at all levels. Formal sign-off at committee stage is typically required
- All PSBs carry out periodic reviews of the genre mix, including the longevity of key returning/recurring series within the schedule

Elements of internal decision-making

Decision / process	Forum for decision making
Remit (where relevant) / PSB regime	Government, Ofcom
Corporate objectives	Board of directors / senior management
Budgets, strategy, divisional objectives	Executive board, finance committee(s)
Commissioning decisions	Management board(s) / controllers
Scheduling / production decisions	Channel controllers / departments

Stakeholders in determining content investment parameters



Multiple stakeholders, departments and committees are involved in agreeing broad (genre/channel strategies) and specific decisions (creative ideas, programmes)

...this includes a mix of weekly, monthly, quarterly and annual meetings and reviews

** Typically involved in agreeing terms and relationships with indies*
*** Larger PSBs have strategists attached to individual channels/genres, as well as general strategy teams*

Investment decisions are influenced by the potential of certain programmes – and genres – to optimise revenue across multiple windows and territories: this is typically the primary prism through which shows are assessed

- Financial performance is a crucial corporate objective for all the commercial PSBs – with ITV and Channel 5 seeking to maximise returns and Channel 4 seeking to break-even, all within the constraints of their wider policy remit

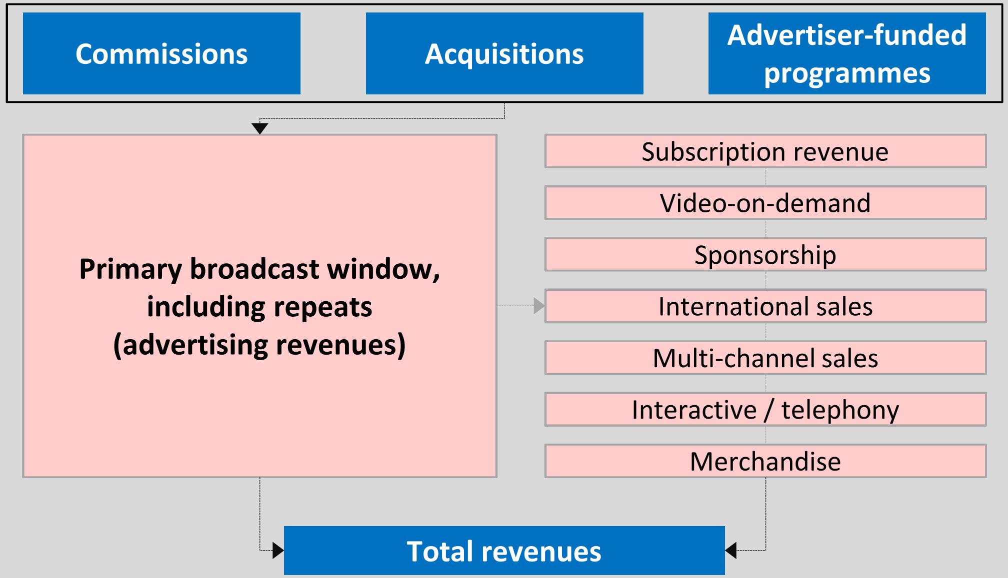
- Commercial considerations are increasingly complicated by the range of secondary revenues attainable by the PSBs (see opposite). The scope to secure secondary revenues varies substantially by genre, and the potential to generate revenues outside the primary broadcast window could tip the balance to produce a programme – this is particularly the case where primary revenues may not be sufficient to offset significant upfront production costs (e.g., drama)

- The scale of secondary revenues is in turn affected by the ownership profile of shows – upfront production costs are almost entirely borne by the PSBs, and they are far better placed to secure greater secondary value where they own the content rights outright (as opposed to the rights reverting to independent producers)

- ...all the commercial PSBs agreed that this was an increasingly important issue for the sustainability of public service content, and is of particular concern to C4 as it does not generally make its own content – although it recently elected to take strategic stakes in emerging indies

- All the PSBs confirmed that decisions were informed by internal forecasts and assessments of the audience and revenue potential of individual programmes – these were almost always informed by the performance of similar programmes and slots

The revenue life-cycle for PSB content



Determining the financial return of a programme or genre is increasingly complex, and different programmes are able to secure revenues across a range of windows and business models. The primary broadcast window remains the cornerstone of revenue generation for the PSB channels, but decision-making is increasingly influenced by opportunities in other windows:

- The ability of specific programmes to create incremental revenues in **secondary windows** was an increasing influence on commissioning decisions

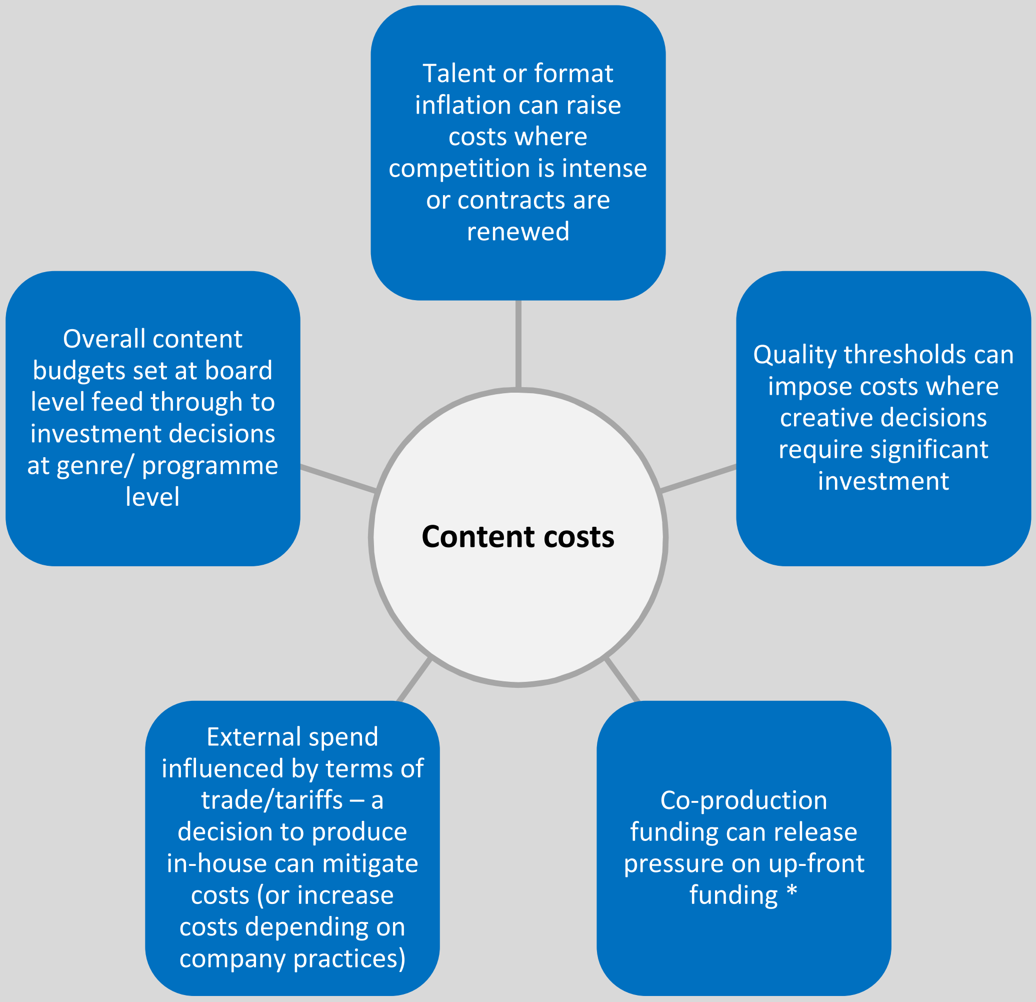
- The margins available in key secondary windows can vary depending on ultimate **ownership** – commissioned programmes typically see rights revert to independent producers where revenue shares dilute returns to the PSBs

Source: Mediatique model

The PSBs necessarily consider the relative cost of producing programmes when determining potential commercial return, which are subject to a range of internal and external influences...

- Production costs vary significantly among different genres and sub-genres, and profitability is necessarily a function of the relative cost burden imposed by commissioning or producing certain programmes
- Production costs at high-end ITV drama such as *Downton Abbey* cost in the region of £1m per hour; by contrast, Channel 4 documentaries cost in the region of £70,000-£110,000 per hour
- All the PSBs have published tariffs that set out the range of hourly costs for the major genres. These are indicative, however, and the PSBs can secure other terms via negotiation – and where programmes are produced internally by the PSBs
- We set out opposite the main influences on programme costs outside the core cost of sales associated with producing shows
- There is typically a balance to be struck between controlling costs (to ensure healthy ROI) and investing in quality/creativity (to ensure audience traction)
- Once certain programmes are established, the PSBs are able to share footage or leverage content brands to produce spin-off shows or repurposed shows at much reduced cost
- Recent technical innovations in production (e.g., tapeless production, high-definition improvements, cheaper kit) have reduced the costs of certain elements of production, and allowed channels to spend more on talent

Determinants of the cost of content



** We found that the commercial PSBs are increasingly receptive to advertiser-funded programming as this can secure tradable audiences and delivers high margins*

Source: Mediatique analysis

Alongside financial considerations, the PSBs incorporate a range of crucial practical factors in their investment decisions...

Practical determinants of investment decision-making		Examples
Desire to be a full-service broadcaster	▪ The PSB channels continue to focus on providing a broad portfolio of programmes across multiple genres in order to maximise reach, which remains an important metric for advertisers and shareholders ▪ This ambition also reflects a desire among the PSBs to maintain their status as a 'network' which offers a full-service of genres to cater for all tastes ▪ Such diversification also serves as a protection against changes in audience taste and allows broadcasters to experiment with new genres/sub-genres*	▪ ITV is likely to invest in national news irrespective of its formal PSB obligations, in the same way that the US networks run news as a loss-leader ▪ The diversity of schedules has allowed the PSBs to try new genres (e.g., scripted reality such as *TOWIE*) or to withdraw from others (e.g., telephone quizzes) without significant impact
Maintenance of "brand health"	▪ We found that the PSBs are often keen to commission content that may not maximise audiences, or may incur losses in the primary window, but nevertheless contribute to the creativity or diversity of the channel – this was referred to as maintaining "brand health" and is seen as a key selling tool to advertisers ▪ In these cases, creative considerations can trump financial/commercial factors	▪ Commissioners or producers may seek to increase expenditure on key programmes to ensure high production standards (e.g., *Downton Abbey, Titanic*) even if financial pressures are evident ▪ Such shows can extend reach and channel loyalty
Desire to secure/sustain relationships with talent	▪ The PSBs may seek to commission or re-commission content that is associated with talent (writers, directors, producers, actors) in order to form new working relationships or to sustain existing relationships ▪ These decisions may reflect commercial realities, with some talent necessarily attracting larger audiences and therefore justifying commercial payments, but in some cases may reflect a simple desire to benefit from creative association	▪ All channels have used talent associations to promote channel/programme brands (e.g., Ant & Dec on ITV, Jonathan Ross on ITV, Davina McCall on Channel 4, BBC relationship with Stephen Poliakoff)
One-off scheduling requirements	▪ Some PSBs are required to adjust their standard genre mix in order to account for short-term changes in the schedule – this typically arises in relation to large sporting events or election coverage (for example) which can influence the schedule, although these can be incorporated into long-run assumptions at the PSBs ▪ Some events that require TV coverage are less easy to predict, but can still influence the genre mix and sometimes necessitate changes in the remaining schedule – e.g., protracted news events (geographic tensions, war, natural disasters)	▪ The BBC's broadcasts of the Olympics every four years can significantly alter the genre mix in July and August – and subsequently across the year ▪ ...the same is true of other one-off or recurring events including Paralympics (Channel 4) and the World Cup (BBC and ITV) ▪ The BBC's one-off coverage of recent aviation disasters increased news coverage above the average over a 2-3 week period

** All broadcasters were aware that allowing an over-reliance on certain programmes or genres was a risky strategy. We were made aware of the US experience of ABC, which achieved initial success with* Who Wants to be a Millionaire *in 1999-2002, and subsequently filled the schedule with runs of the show, only to find that its initial impact and audiences were massively affected by over-exposure*

The system of airtime sales in the UK requires broadcasters to take a broader holistic view of their output decisions, and creates an incentive to ensure a wide mix of genres within the overall schedule...

Mediatique

- Identifying the financial return of a specific programme or genre at a PSB is essentially a theoretical exercise as the system or airtime sales in the UK is rooted in a channel's overall schedule such that programmes are generally not monetised separately*
- Advertisers commit a share of their overall budgets to individual sales houses, and will pay for the delivery of commercial impacts on the basis of each channel's station average price; this price is an average price across the entire schedule (a more detailed explanation is set out opposite)
- As a result, channels seek to maximise the delivery of commercial impacts across the schedule and this necessitates that the PSBs schedule programmes/genres that can maximise audiences at appropriate times across the entire schedule (e.g., entertainment on Saturday night, factual on weekday evenings)
- This allows the PSBs to incorporate a wide range of genres at certain points in the schedule without fundamentally compromising total delivery of commercial impacts. This ultimately ensures that programmes that secure significant audiences at low margin may be preferred to programmes with greater margins but small audiences
- ...indeed, maximising share in one year is a crucial bargaining tool to maintain or increase agencies' share of budgets (and CPT rates) in following years
- This also allows the PSBs to cross-subsidise certain genres whose audience traction may not be significant (e.g., news, children's), by maximising audiences in other genres – a practice also sanctioned by flexibility within the COSTA airtime rules (see opposite)

The determination of station average price (SAP)

- The PSBs trade on the basis of a negotiated discount to SAP which is an average price per impact across a channel's entire schedule for a given demographic

$$\frac{\text{Total revenues (all audiences)}}{\text{Total commercial impacts (ABC1s)}} = \text{Station average price (ABC1s)}$$

- This simple calculation reflects both demand and supply of audiences. If viewing (supply) increases, SAP falls; if revenue (demand) increases, SAP increases
- The SAP will vary month-to-month, depending on the ratings achieved by the broadcaster and the amount of revenue received by the sales house
- Agreements are made to establish the agency's discount (or premium) against the broadcaster's SAP, and are based on share deals. Agency buyers commit to spend a set percentage of their TV budgets with a sales house in return for a negotiated discount off SAP for the coming year: for example, a brand might agree to give the broadcaster 15% of its annual spend in return for a 10% discount off SAP

Flexibility in Ofcom's Code on the Scheduling & Amount of Advertising

- The COSTA rules state that the PSBs can run an average of 8 minutes of advertising per hour in peak (6pm-11pm) – subject to a maximum of 12 minutes per hour – for a total of 40 minutes
- This enables the PSBs to adjust their placement of ads within certain shows/genres to optimise returns – it can also lead to perverse outcomes on ROI for specific genres

Slot	18.30	19.00	19.30	20.00	20.30
Show	*Hollyoaks*	*Channel 4 News*		*Million Pound Drop*	
Ave aud	950,000	600,000		1.6m	

Ad minutes *Ad minutes*

Channel 4 News carries virtually no advertising, which allows C4 to place additional minutes in other peak-time slots and still meet its 8 minute average

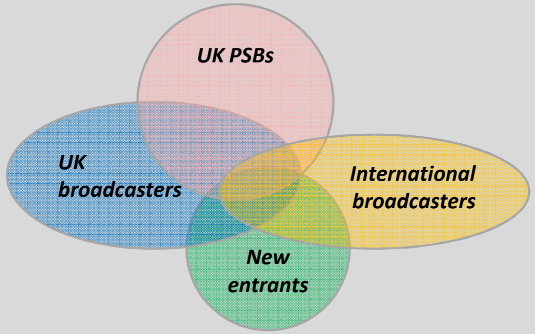
This effectively gives Channel 4 News a negative ROI, even though there is significant value in being able to transfer minutes elsewhere
This flexibility also reduces commercial pressure from the news genre to generate audiences

Source: Mediatique analysis
** There are some exceptions with a limited number of titles within the schedule sold as "specials" to key advertisers – these typically include flagship shows or events such as X-Factor or World Cup coverage*

Content investment decisions at one PSB (and increasingly at other players) can influence the scale and scope of investment in key genres at other PSBs...

- The PSBs operate within a broader television ecology in the UK, such that decision making is influenced by – and has an influence on – other players (see opposite)
- Our discussions with PSB providers confirmed that each of the PSBs maintain a watching brief on changes to the genre mix at rival PSBs and their strategic options are often intertwined:
  - We understand that ITV and BBC One both seek to "keep up" with each other in relation to their investments in drama and other key genres – any increase in expenditure at one broadcaster will likely act as a catalyst for investment changes at the other. This relationship reflects strategic decision making rather than tactical behaviour
  - The PSBs do not often come up against each other when commissioning programmes, although do compete each other in relation to talent and acquisitions. This is increasingly true of other broadcasters and new entrants – the BBC, in particular, is aware that its tariffs often struggle to keep up with cost inflation for certain content in particular genres
- The distinctiveness of each of the commercial PSBs means that they can retain a degree of autonomy in their investment decisions, however:
  - ITV is able to invest in high-end drama at levels unobtainable by the other commercial PSBs – with signature dramas (costing £800,000-£1m per hour) in excess of the tariffs of other commercial PSBs
  - Channel 4's distinct remit allows it to commission programmes that may not sit comfortably on the more commercial schedules of ITV or Channel 5

Spheres of influence in relation to UK PSBs



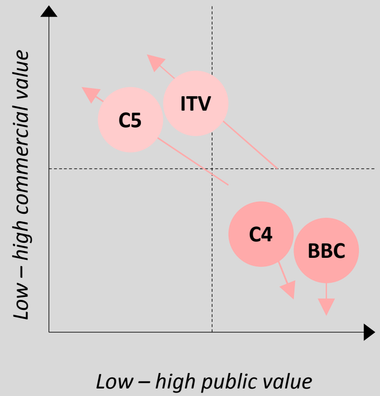
Specific influences included the content strategies of Sky, UKTV, NBC-U, Netflix. The ambitions of independent producers and talent were also influential

- We found that the scope and mix of programmes produced and acquired by the PSBs is influenced by multiple players, including those outside the PSB regime
- Recent moves by Sky into original drama and comedy, for example, has affected the pool of talent available on the PSBs
- Most of the PSBs saw recent investments in original drama by Netflix as a nascent influence on PSB as these are small and also not universally available and free-to-view

The overall PSB ecology...a zero sum game?

- A scenario in which ITV and Channel 5 became less committed to producing programmes of public value could alter the balance of public value programmes made by the BBC and Channel 4
- ...they may find themselves under pressure to meet market-wide PSB objectives as part of their distinctiveness remit
- This, however, may lead to a scenario where the BBC and Channel 4 are reduced to a "market failure" role – only producing programmes that others choose not (or are unable) to make
- Such a scenario seems unlikely in the near-term as ITV and Channel 5 both remain committed to retaining their PSB status

BBC/C4 required to fill PSB gaps left by others?



Source: Mediatique analysis

The impact of new technology and changes in consumer behaviour is only a marginal influence on investment decisions currently – although this is likely to increase over time as audiences become more enabled...

- Broadcasters are increasingly aware of the relationship between non-linear viewing –and thus the potential for ad-skipping and/or on-demand viewing – and revenue outcomes. They are also aware of differences in non-linear consumption among different genres – with drama and comedy being time-shifted on a more regular basis than other genres, for example

- The impact of these developments is accounted for differently at the PSBs at various stages of the decision-making process:
  - ITV and Channel 5 tend not to consider VOD or PVR impacts at the initial commissioning or creative stage but rather at later stages when commercial issues are considered
  - The BBC is more ambivalent about these developments – it still considers broadcast viewing as a cornerstone of its PSB remit but also considers multi-platform reach as an important policy goal
  - Channel 4 is mindful that its younger audiences are more regular non-linear consumers than the average – and this is accounted for specifically in its assessments of commercial value

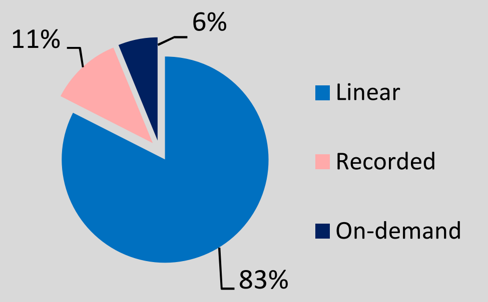
- All the PSBs confirmed that PVR and VOD impacts are part of the overall process of assessing content investment although, at this stage, are not a determining factor and have not thus far altered the genre mix in any way

- This partly reflects market practice around the sale of time-shifted inventory viewed within 7 days, which is consolidated by BARB within total viewing and monetisable if it generates commercial impacts (i.e., net of ads skipped)

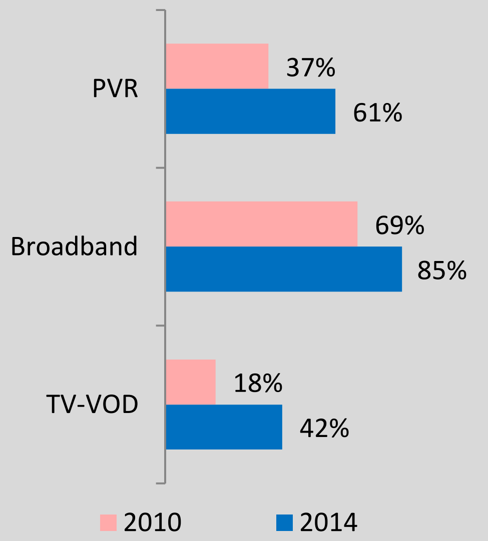
- Given that a significant amount of time-shifting viewing is incremental (PVR homes watch more TV overall) and not all ads are skipped, the impact to date has been limited – this may change over time

The impact of new technology on content investment

TV viewing hours, by type (2014, %)



Consumer enablement (% of UK households, 2010 vs 2014)



The increasing penetration of PVRs and on-demand capability is shifting the balance of viewing away from linear scheduled consumption

This has multiple implications for the economics of PSB delivery:

(a) Compromising the premium attached to the primary window – directly in the case of PVRs where this leads to ad-skipping
(b) Increasing the range of devices on which content can be consumed and creating opportunities for incremental secondary revenues (in catch-up or VOD windows)

The net revenue outcome across these dynamics will vary considerably by genre

All PSBs confirmed that these issues were likely to become more important over time in line with increasing consumer enablement – at some stage, their influence on content investment decisions will also become stronger

Source: Mediatique model

The impact of non-linear viewing on genre allocation forms a key part of our analysis in the final section of this report

Internal practices and the attitudes of management can significantly influence the practical outcome of investment decision-making...

Mediatique

Procedural determinants of investment decision-making

Management perspective / experience	▪ The structure of management processes and the personalities of specific directors/managers can strongly influence decision-making at the PSBs: – A management team focused on long-term outcomes may make different investment decisions to a team that is pursuing short/medium term-decisions, including the ability to take riskier commissioning decisions where evidence of commercial viability is not immediately clear – Some executives and commissioners may play safe in sticking to genres with a proven track record or for which the channel has a reputation and strong track record, characterised by a high level of re-commissions for example. We found that it was possible to build a reputation for quality in certain genres but this required time, risk capital and also managerial ambition – this was not always possible where budgets are squeezed or management is focused on genres that are more certain to perform – In genres where the revenue mix is shifting towards secondary windows, risk appetite plays an increasingly important role in content investment. We found this was the case particularly for original drama where high upfront costs were often not covered by primary revenues, but relied on executives being willing to risk capital to secure revenues in secondary windows (where rights ownership allows) ▪ Specific directors or channel controllers, including those with strong relationships with talent or with other executives, can influence decisions via their position on committees and within the wider media sector. By way of example, the recruitment of Peter Fincham (ex-BBC) and Kevin Lygo (ex-Channel 4) by ITV is likely to have strongly influenced the continuing commitment of ITV to high-end drama in spite of cost pressures
Internal practices / competence	▪ Investment decisions are, by necessity, made in advance of broadcast and thus commercial determinations are based on a broadcaster's expected return; as such, the practice of reconciling ROI outcomes with actual content investment decisions is ultimately a factor of a broadcaster's ability to forecast future audience and revenue outcomes – this places strong focus on research and analytical personnel at the PSBs ▪ We found that the PSBs have different working practices in place to determine and account for investment decisions – some PSBs were seen to be sophisticated and process-orientated in their assessments, and others were seen to be more creatively driven
Corporate ambitions / ownership	▪ Changes in corporate ownership and shareholdings can influence the investment decisions of the PSBs, although in practice this manifests itself through changes in corporate objectives which are set at board level ▪ Channel 5's acquisition by Northern & Shell heralded some changes in the content mix, including the purchase of the *Big Brother* format and the lessening of live sport (notably football). This may also be the case as a result of the recent acquisition of Channel 5 by Viacom – US network broadcasters have historically been weary of investing in public service broadcasters in Europe and it may be the case that Channel 5 shifts its strategy towards a greater reliance on US acquisitions (within the Viacom portfolio) or a further shift away from factual or current affairs programming in an attempt to increase commercial audiences – although Ofcom's Change of Control assessment ensured that obligations would be maintained and, in some cases, enhanced including through voluntary commitments ▪ There remains speculation in the financial press regarding the future ownership of ITV (driven in part by Liberty's recent emergence as a major shareholder) – as with Channel 5, any change in ownership may result in fundamental moves away from the current genre mix

Differences among corporate objectives at the commercial PSBs generate variations in their strategies and roles within the PSB arena...

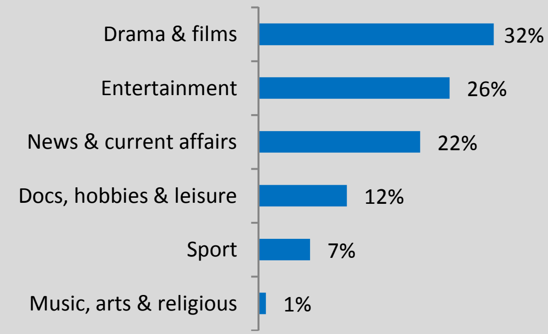
Source: Mediatique estimates, Ofcom expertise

Strategic positioning within the PSB regime

Share of first-run broadcast hours (2013, %)

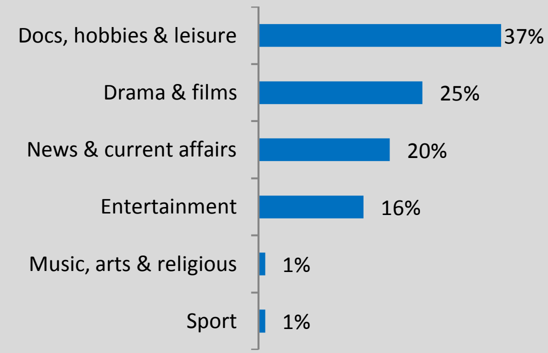
ITV

- The removal of prescriptive output obligations in arts, religion and music has seen ITV focus on drama and entertainment in its peak schedule, although it still retains a broad genre mix including news and documentaries
- ITV's strategic focus remains the delivery of mass-market audiences, and also seeks to retain universal reach (being part of "the national conversation") and to maintain parity with the BBC
- Such a strategy has resulted in a bias towards returning series and repurposing of existing programme/format brands. However, the business is seeking to optimise value across multiple windows and has invested in international distribution, ownership of production and has augmented the means by which audiences can be monetised (e.g., ITV Encore, ITV Player)



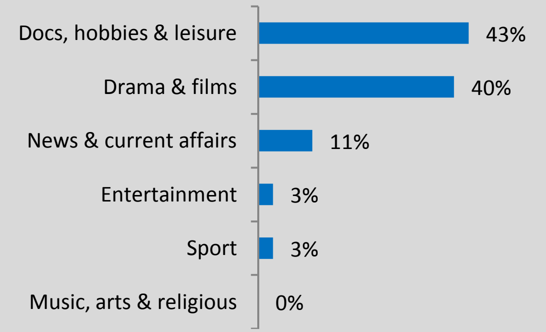
Channel 4

- Channel 4's PSB commitment is sustained by its remit and its peak-time output remains the most diversified of the commercial PSBs
- The channel is driven by commercial incentives, but is willing/able to commission programmes that do not necessarily maximise audiences and to run losses on key genres (notably drama, arts and religious)
- Recent weakness in core audience share has lead to pressure on margins across PSB genres, and programme budgets are set to decline marginally in 2014 to aid meeting a target of break even after two years of significant loss at operating level
- Of all the PSBs, Channel 4 has the most agnostic view of audience engagement across all its digital properties , although still secures a premium for delivery on core Channel 4
- The business remains focused on delivering 16-34 audiences, but values creativity, diversity and seriousness of output. It has been willing to use its core channel as a test-bed for format innovation



Channel 5

- Channel 5 is the most commercial of all the PSBs, reflecting its relative immaturity. As such, the channel has historically been more reliant on repeats, repurposed content, acquisitions and cheaper hourly content costs
- The channel has focused its commissioning on programmes that maximise audiences among its core demographic, and retains a reliance on Big Brother, acquired drama and films
- Nevertheless, the channel has carved out a niche is children's content and has recently invested further in innovative drama (including *Suspects*)



We summarise below how individual genres sit within this market context...

Mediatique

Strategic fit
Carried within the schedule
Strategically challenged

Genre	Strategic position	ITV	Channel 4	Channel 5
Arts	▪ A marginal genre with limited commercial appeal – evidenced by ITV's cancellation of *The South Bank Show* in recent years. More secure within Channel 4 as part of its remit ▪ Arts shows more regularly broadcast by the BBC and Sky (Sky Arts)			
Children's / education	▪ Children's production under pressure at ITV, and sidelined in CITV rather than the main channel, with an increasing emphasis on acquired. Channel 5 retains its *Milkshake* brand and this performs commercially, albeit partly driven by opportunity costs of broadcasting other genres in these slots ▪ Education on Channel 4 is sustained by specific PSB obligations	X		
Current affairs	▪ Part of the PSB compact for all commercial players and important strategically to sustain network status (and to be part of "the national conversation"). Recent successes at Channel 5 with its flagship *The Wright Stuff* and discussions around benefits			
Documentaries	▪ A cornerstone of the schedule for Channel 4 and Channel 5 across a range of topics and themes. Large variations in quality and scope on individual programmes, and cost economics/repeatability are favourable ▪ Factual entertainment (including reality) increasingly represented within documentary content			
Drama – single plays	▪ Strategically important for ITV (and Channel 4) to maintain creativity and parity with the BBC – some potential for secondary revenues in international markets (direct sales or format sales). Often part of seasonal promotion (e.g., over Christmas or Bank Holidays) ▪ Less appealing than drama series with a higher risk profile and lack of regularity in the schedule			
Drama – soaps / series	▪ A critical genre for ITV (including *Downton Abbey, Coronation Street, Emmerdale*) and responsible for securing the largest audiences on a systematic basis. The same dynamic applies to Channel 4's *Hollyoaks* and other series. Limited representation at Channel 5 in light of cost pressures, with reliance on acquired content			
Entertainment	▪ A crucial genre for all players, rooted in live shows, competitions, reality and talent search – typically includes flagship shows that sustain the schedule over time and secure large audiences across all demographics ▪ Strong bias towards live "shiny floor" shows, and lessening commitment to UK sitcoms			

We summarise below how individual genres sit within this market context...

Strategic fit
Carried within the schedule
Strategically challenged

Genre	Strategic position	ITV	Channel 4	Channel 5
Films	▪ A core genre for Channel 4 and part of broader commercial operations (FilmFour). Typically part of broader acquisition output deals for the commercial channels, with limited direct production (e.g., ITV's *The Queen*) ▪ Strategically important as part of the genre mix and brand health. Repeatability valued at Channel 5			
Hobbies / leisure	▪ A key part of the schedule for Channel 4, including lifestyle, cooking and property programmes with strong talent associations and healthy audience traction ▪ Less of a major genre for Channel 5, and even less so for ITV, and thus broadly carried within the schedule			
Music	▪ Historically important for Channel 4, although now rooted in 4Music rather than the core channel ▪ Limited representation on ITV and Channel 5, albeit carried within the schedule if appropriate. Recent blurring of distinctions between genres (music as documentary or entertainment) ▪ Classical music typically falls within arts and is almost entirely scheduled by the BBC now			
News – national/international	▪ Current levels and scheduling sustained by PSB obligations, and flexibility within COSTA guidelines ▪ A key content brand for ITV and Channel 4, and part of a desire to retain salience and brand health ▪ Concerns over counter-scheduling of news (BBC, ITV and Channel 5 between 6pm-7pm) and peak-time scheduling under pressure			
News – nations/regions	▪ Part of ITV's formal PSB obligations and rooted in ITV's former regional structure ▪ Lacking in the core strategic value of national/international news, although audience levels are not insignificant; however, high production costs and competition with the BBC reduce commercial incentives in this genre		X	X
Religious	▪ A marginal genre alongside arts, and unable to sustain audiences of scale across the schedule for the commercial channels ▪ Largely one-off events (e.g., Christmas or Easter services, funerals) or forming part of current affairs programmes, although more comfortable within Channel 4's remit on diversity and community			
Sport	▪ A cornerstone of the schedule for ITV in certain areas (international football); increasingly represented at Channel 4, albeit as part of their remit (Paralympics); recent withdrawal from top-flight football by Channel 5 in light of cost inflation (now largely focused on cricket highlights and boxing). ▪ Scheduling of sports typically reflective of timing of competitions (annually, 4-yearly etc) and can entail significant production costs in some areas (e.g., live commentary, presenters)			

Key findings from our analysis of decision making...

Key findings in this section

Decision making involves reconciliation of multiple objectives	▪ The decision to commission or produce a programme within a certain genre is subject to a financial assessment by all commercial PSBs. However, this picture is becoming more complicated with multiple components to investment economics and shifting audience behaviours altering the balance between live and non-linear viewing ▪ At present, a programme's ability to secure a positive margin contribution is a primary influence on decision making; however, all the PSBs recognise that a systematic focus on only broadcasting profitable genres would lead to a reduction in the overall diversity and attractiveness of the channel leading to declines in total reach and viewing share ▪ As a result, decision making is also strongly influenced by the potential contribution of a programme to the channel's policy remit*, its overall strategy and brand health and each organisation's corporate objectives (including financial motives and broader strategic interests relating to diversification, creativity and longevity). Programme-specific analyses were also complemented – or sometimes overruled – by a "gut feel" or "editorial feeling" that a particular show would work and would be successful commercially or creatively ▪ All investment decisions are ultimately made on the basis of balancing these objectives against budgetary constraints and commercial realities, including shifts in audience behaviour/taste and the strategies/schedules of rival broadcasters
An ROI framework still forms part of each channel's decision making	▪ Within this overall context, profitability is a crucial influence on content investment decisions even though it may not be the absolute determinant in all cases – and certainly decision-making is not programmatic. Nevertheless, an ROI determination remains a useful framework for all the PSBs when seeking to account for decisions, providing decision-makers with a comparable basis on which to layer on other considerations ▪ We set out in the next section our own framework for making ROI calculations with a view to highlighting how specific genres rate in relation to a ROI calculation

** We found a general view at the PSBs that their genre mix would not alter significantly in the absence of formal PSB genre prescriptions, with a few exceptions: some believed that Channel 5 would not produce live news in the event of reduced obligations, although would continue to produce children's (this provides a useful case study for illustrating the complexity of content investment decisions – ostensibly children's audiences are limited on Channel 5, but Milkshake represents a valuable brand for the channel while providing shows that are suitable for repeats; the channel would also need to consider the relative cost of broadcasting an alternative show in its place); some stated that ITV would continue to produce national news, but would likely change its broadcast timeslot towards the margins of peak*

Introduction

Decision making and genre allocation

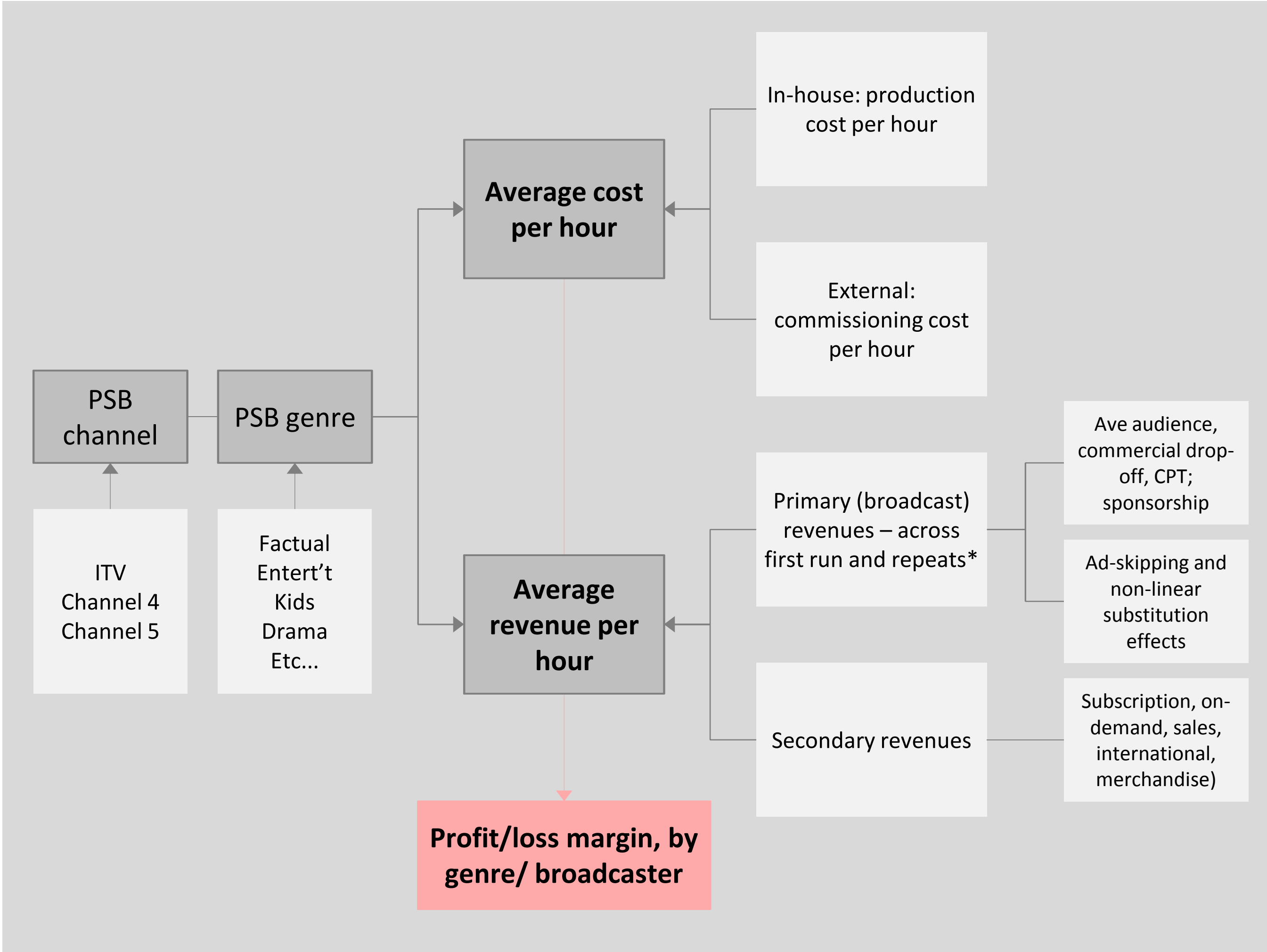
The relative profitability of genres

Future sustainability of PSB genres

We have developed a numerical framework to consider the return on investment across all commercial windows from different genres among the commercial PSBs...

- The determination of ROI for a commercial channel is becoming increasingly complex as the number and scale of revenue windows outside first-run primary window increases
- We have developed a framework to capture all components of value for programmes broadcast on the commercial PSB channels, as set out opposite
- This captures the core revenues generated from primary broadcast (including repeats, sponsorship and distribution on other linear channels) and ancillary revenues from on-demand distribution, merchandise and format/programme sales. These outcomes also account for the impact of PVR usage and ad-skipping
- This framework allows us to determine the current profit/loss margin for each channel and genre. By definition, these calculations exclude the costs of channel operation, distribution and other fixed costs. **This analysis is based on an annual sample of data and should be seen as indicative; we highlight a range of assumptions and caveats overleaf**

Mediatique framework to model gross profit/loss margins by genre



Source: Mediatique model
** Programmes can be repeated on the core channel later in the schedule (narrative repeats) or on portfolio channels (archive repeats)*

We have based our analysis on programme viewing data, combined with a number of commercial assumptions...

Key assumptions in our analysis

Parameters of our data set

- We analysed programmes broadcast across the PSB channels in 2013, in terms of broadcaster, genre, duration, viewing audience, viewing share and the proportion that was live/consolidated
- Programmes were analysed by broad genre category, and specific sub-genres
- The database comprised peak hours (i.e., 6pm-11pm) which contribute approximately 60% of all commercial impacts for the commercial PSBs. Viewing outcomes were consolidated to include live (as transmitted) and time-shifted viewing within 7 days of broadcast
- All metrics include the +1 channels of ITV, Channel 4 and Channel 5

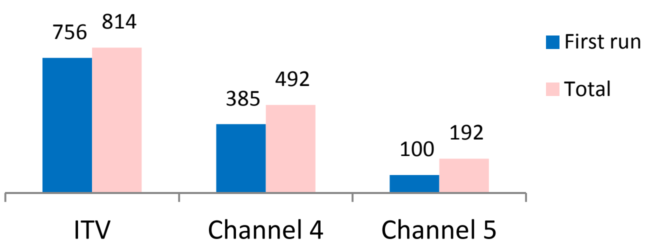
A calculation of average hourly revenues by genre

- We determined the core metric of average revenue per hour on the basis of viewing metrics sourced from the database. Audiences for each programme were adjusted for duration and stated as average audiences per hour
- We made a series of assumptions to determine revenues from first-run transmission and repeats on the core PSB channel, informed by our primary sources and our own understanding of the advertising and TV markets:
  - We applied commercial drop-off rates of roughly 20% to all genres to account for viewers missing commercial breaks during a show*
  - We assumed that each programme would carry 11 minutes of advertisements per hour (or 22 advertisements)
  - We used average CPT rates for ITV (£5.82), Channel 4 (£6.53) and Channel 5 (£5.01) which form the basis of monetising every commercial impact across the schedule – a 50% premium was applied to account for the proportion of returns secured during valuable peak-time slots
  - We applied different metrics to determine audiences and revenues for archive repeats on portfolio channels – these were all set at discounts to the core channels

Cost of content production/ commission

- There are significant variations in the hourly cost of content; while the PSBs publish standard hourly tariffs per genre, these can often form the basis of negotiation and are not necessarily indicative of actual hourly costs. ITV, as a producer-broadcaster, can spend more (or less) than commissioned programmes depending on the genre
- We spoke to a number of primary sources to confirm average hourly cost of production for each broadcaster and genre, and checked these against total expenditures at each channel

Total PSB expenditure (2012, £m)



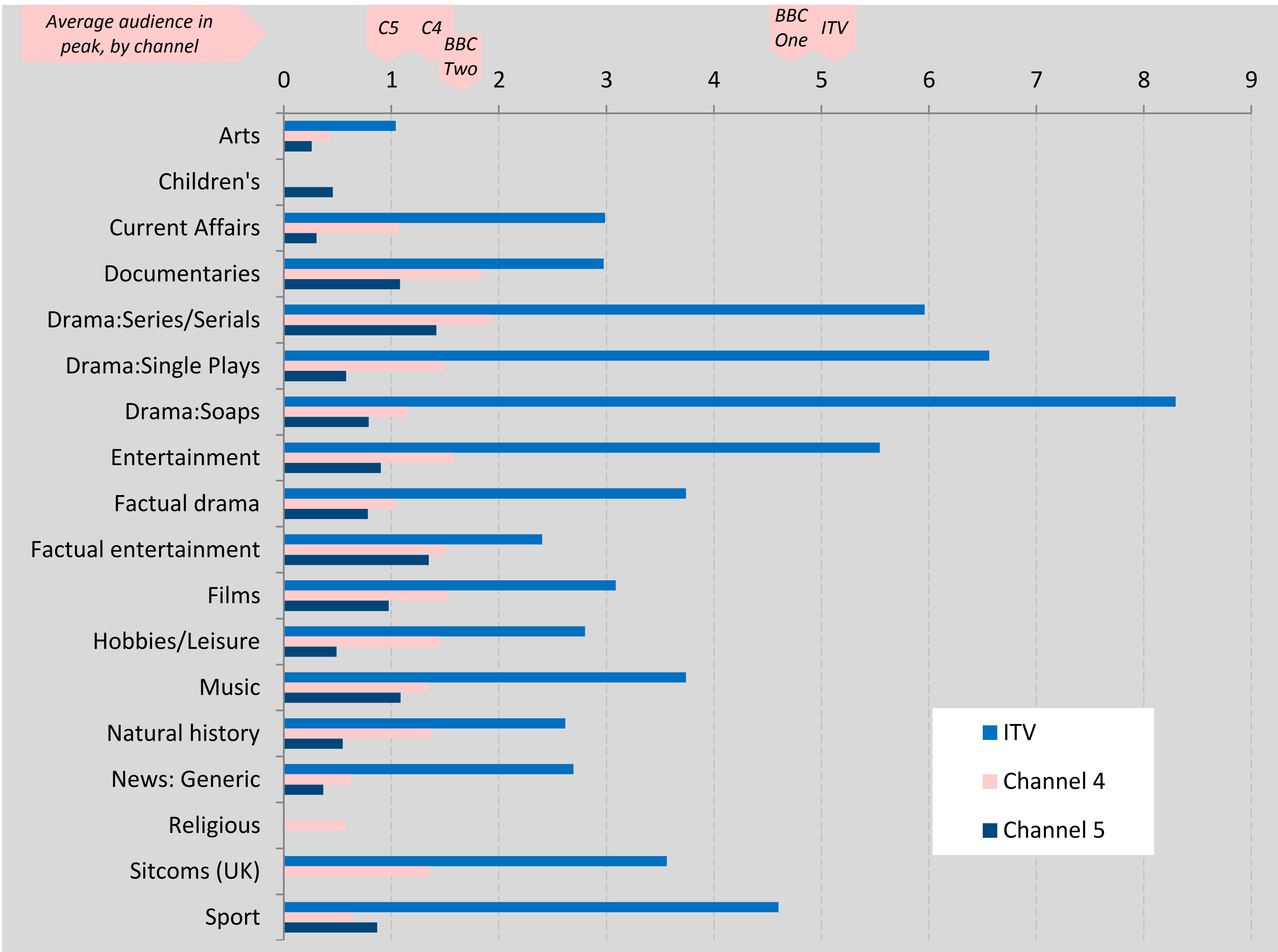
Source: Ofcom Public Service Broadcasting Annual Report 2013

** Commercial drop off accounts for a reduction in audiences that watch adverts during a commercial break compared with the total audience for the show itself (e.g., viewers that leave the room during a commercial break who return when the show resumes). This is based on primary research*

We determined the average audiences for first-run broadcasts on each genre on the PSB channels in peak in 2013...

- There are large variations in the audiences secured by particular genres on first-run transmission among the commercial PSBs
- With a peak-time average audience of 5.0m, ITV is the largest channel, followed by BBC One at 4.9m. BBC Two, Channel 4 and Channel 5 secure average audiences of 1.6m, 1.4m and 1.0m respectively
- On a genre basis, the best performing genres for the commercial channels (see opposite) are drama, documentaries, entertainment, films and sport

Average first-run audience per hour, by genre/channel (peak hours, millions, 2013*)

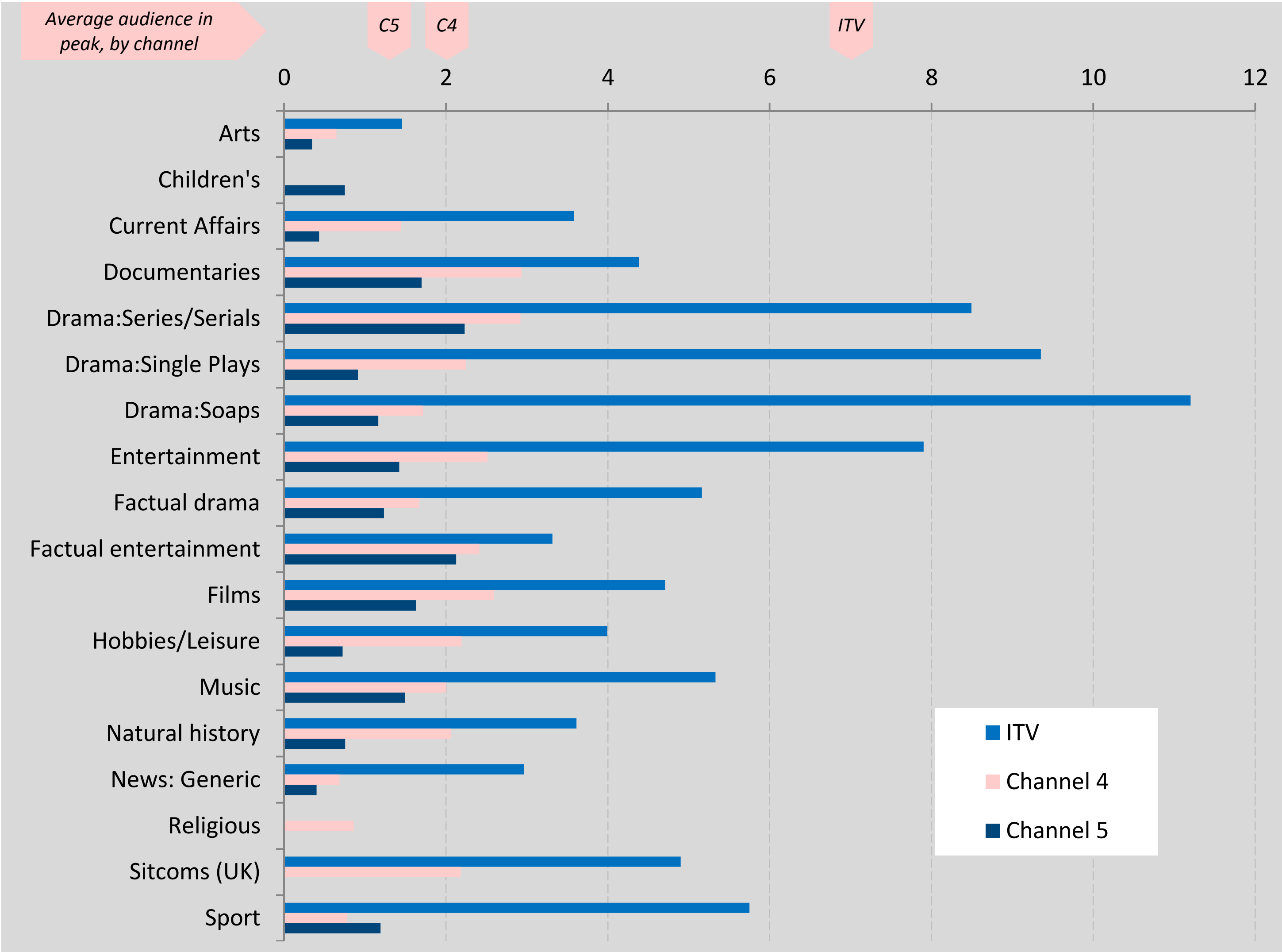


Source: Mediatique model
** Where the sample size is too small, we have used an average audience across 2009-13 in place of the 2013 figure. Includes consolidated viewing*
Blanks indicate that the relevant genre is not offered by the channel in peak

The PSB channels are able to repeat programmes on the core channel and on portfolio channels in order to secure greater audience figures and to monetise investment more efficiently...

- All PSBs repeat programmes on the core channel, allowing viewers without catch-up capability to access programmes they may have missed – this applies to most scripted genres, but is notably not applicable to news and some current affairs/sport
- The broadcasters also actively schedule programmes across their channel portfolios in order to optimise audiences and to widen distribution
- Informed by primary sources, we estimate that repeats on the core channel contribute between 20-30% of total audiences for the PSBs – these are monetised at the same average CPT as first-run programmes. We also estimate that repeats on portfolio channels secure audiences between 10-20% of first-run audiences (in key genres) – these audiences are sold at discounted CPTs
- Of all the PSBs, Channel 4 is most effective at securing incremental audiences, raising its average audience from 1.4m in first-run to 2.1m across all channels. ITV's total average audience is 7.1m and Channel 5 (with the greatest reliance on repeats on its core channel) at 1.4m

Total live average audience per hour, by genre/channel (peak hours, millions, 2013*)



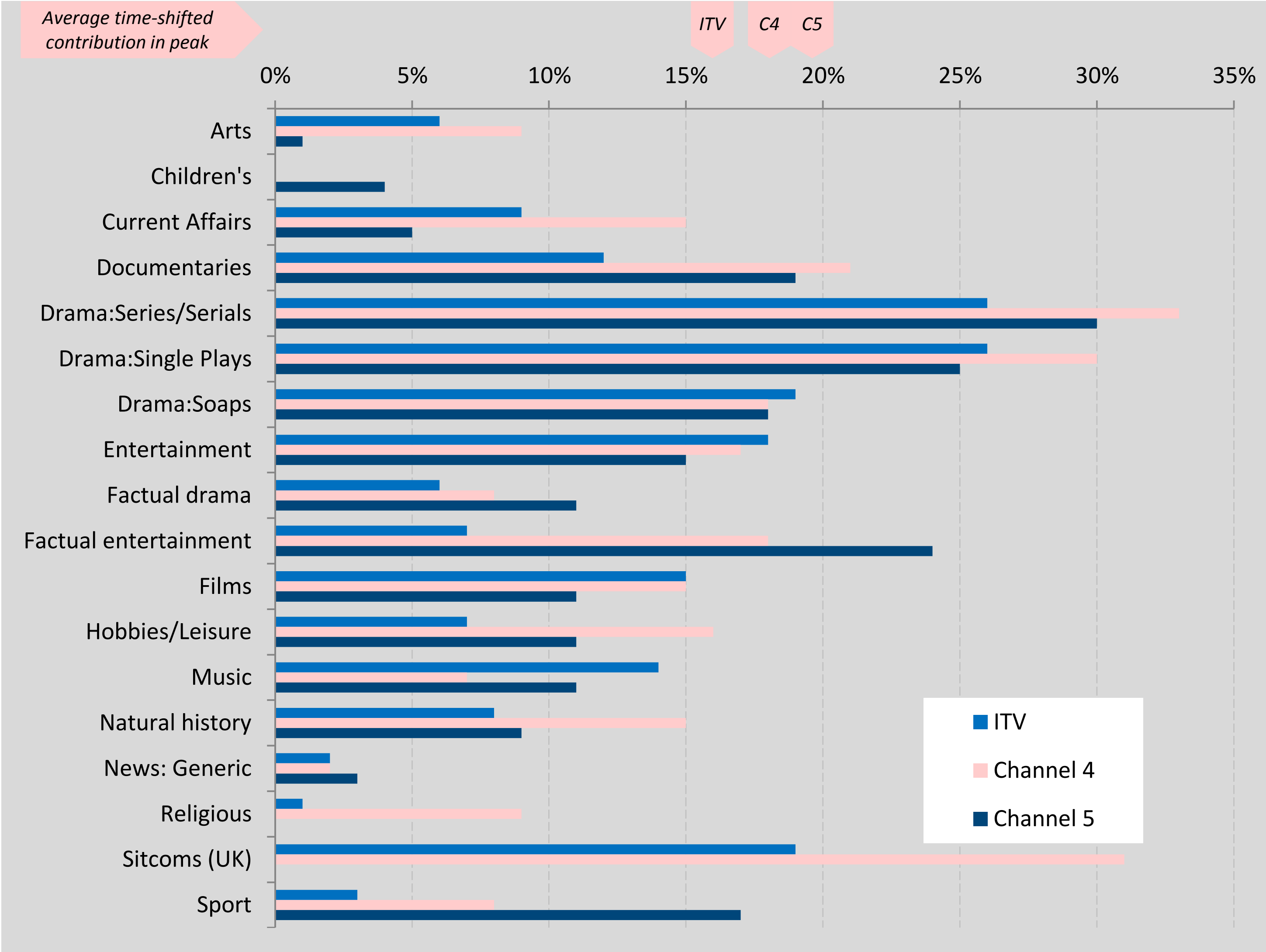
Source: Mediatique model

** Where the sample size is too small, we have used an average audience across 2009-13 in place of the 2013 figure. Includes consolidated viewing BBC portfolio channels not modelled and excluded from this analysis. Blanks indicate that the relevant genre is not offered by the channel in peak*

We also calculated what percentage of audiences were generated from live scheduled viewing, and what percentage was consolidated from time-shifted viewing after broadcast...

- Across all PSBs, 80-85% of peak-time viewing takes place on a live basis, with ITV at the top of this range (reflecting a schedule bias towards live and appointment-to-view programmes)
- There are wide variations among genres, however, with news, current affairs and ITV sport securing the highest live audiences. By contrast, drama and entertainment are the most time-shifted genres
- Households with PVRs typically watch more TV than the average, and time-shifted viewing that takes place within 7 days of the primary transmission is consolidated and forms part of the total audience achieved by each programme
- Among all time-shifted viewing, there remains a propensity for audiences to fast forward through commercial breaks – typically up to 70%** of advertisements viewed on a time-shifted basis are fast-forwarded, and thus not counted towards total commercial impacts
- This has significant implications for genre economics, as those genres that are more time-shifted (e.g., drama) can increase total viewing but incur an opportunity cost of foregone advertising revenue for every live hour that is substituted for a time-shifted hour

% first-run audiences viewed on a time-shifted basis, by genre/channel (peak hours, %, 2013*)



Source: Mediatique model

** Where the sample size is too small, we have used an average audience across 2009-13 in place of the 2013 figure. BBC portfolio channels not modelled and excluded from this analysis. Blanks indicate that the relevant genre is not offered by the channel in peak **Based on information shared by PSBs*

We calculated the contribution of secondary revenues to each commercial channel/genre, allowing the broadcasters to offset initial production or content costs

- We have focused on two categories of ancillary revenues: (1) the ability of channels to secure advertising revenues from on-demand viewing, and (2) the ability to secure secondary revenues from international sales of finished programmes, format licensing and merchandising
- Our key assumptions in calculating these revenues are set out opposite, and are based on information from primary sources and channel benchmarks
- The scale of these revenues varies by genre and programme, and we have assumed that there is very limited contribution from news, current affairs and religious programmes in either of these revenue streams

Assumptions relating to secondary revenues

On-demand revenues

- The ability of channels to secure audiences and revenues in on-demand windows is highly correlated to the affinity of certain genres/programmes to time-shifted viewing – hence, news programmes with a propensity for live viewing have limited appeal in on-demand windows
- We have modelled the overall scale of on-demand audiences for the commercial PSBs, and indexed the performance of each genre in light of this correlation
- We have assumed an average of 6 minutes of advertising inventory per on-demand hour; we further assumed sell-out rates of 60% with inventory monetised at CPTs of between £20-30
- We have also assumed that the PSBs incur a 50% payaway to rights holders for on-demand consumption

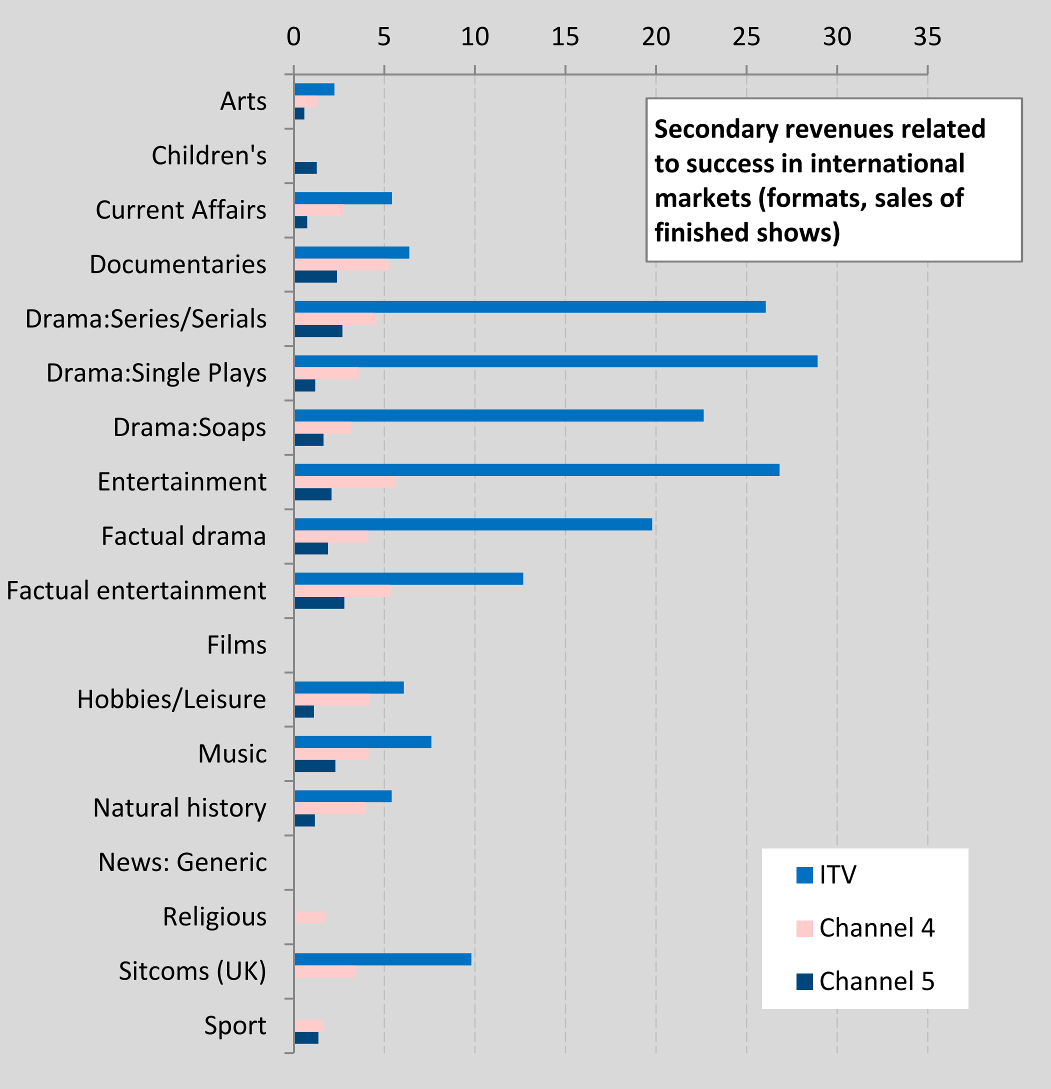
Other secondary revenues

- The commercial PSBs are able to secure revenues from a range of other secondary windows in certain genres, notably drama and entertainment – this is true of other genres too, although to a lesser extent
- We have not modelled these revenues on an individual or systematic basis as the potential for revenues differs from programme to programme
- We have instead assumed a range of contribution the broadcaster –from 0% to 5% of first-run revenues –secured from these windows, depending on the genre and channel
- ...notably, Channel 4 and Channel 5 have less exposure to secondary revenues than ITV given their publisher-broadcaster status
- We have checked these assumptions against specific channel/programme benchmarks and against top-down results from the commercial broadcaster

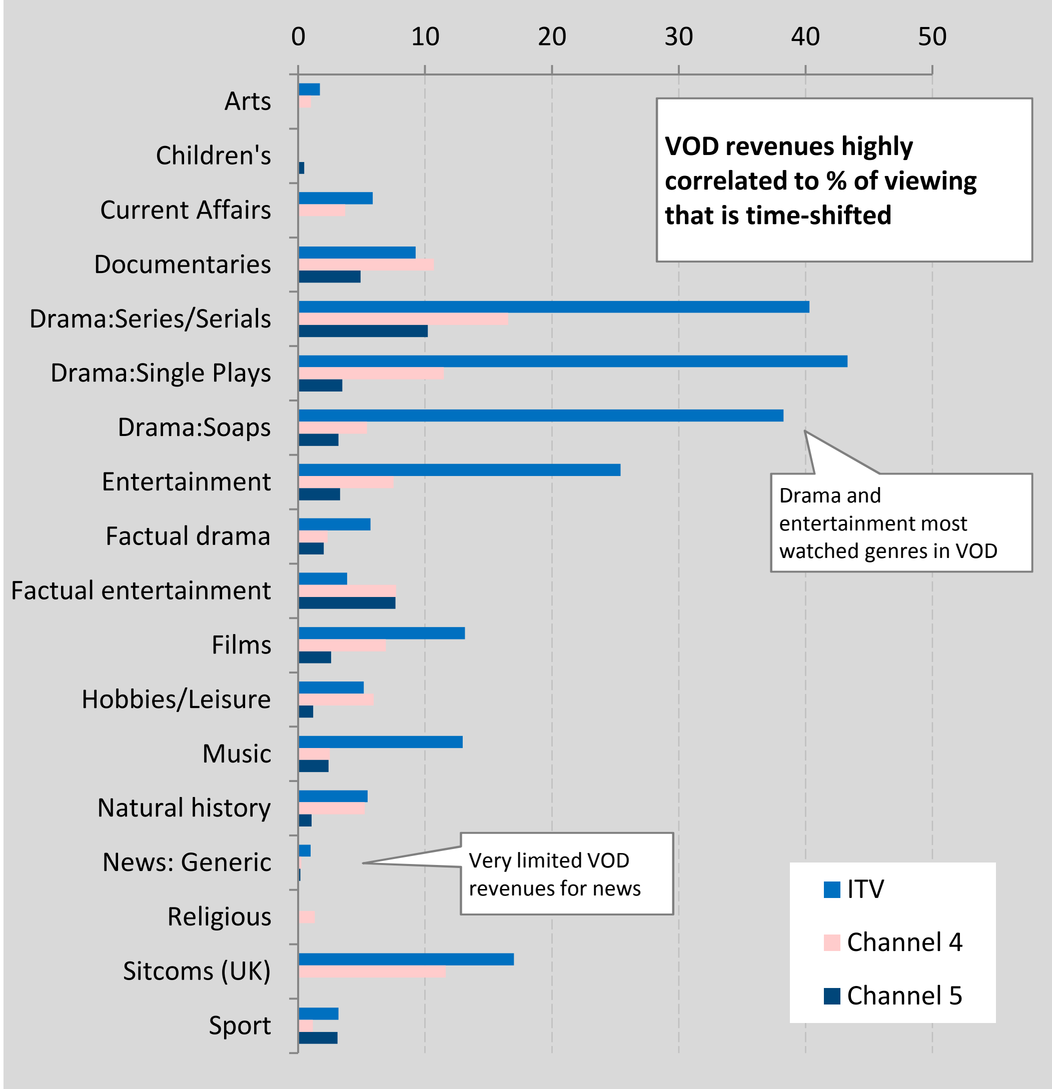
...these assumptions indicate that certain genres are able to secure incremental revenues from outside the primary broadcast window...

Mediatique

Secondary revenues per hour, by channel/genre (peak hrs, 2013, £000*)



On-demand revenues per hour, by channel/genre (peak hrs, 2013, £000)



Source: Mediatique model

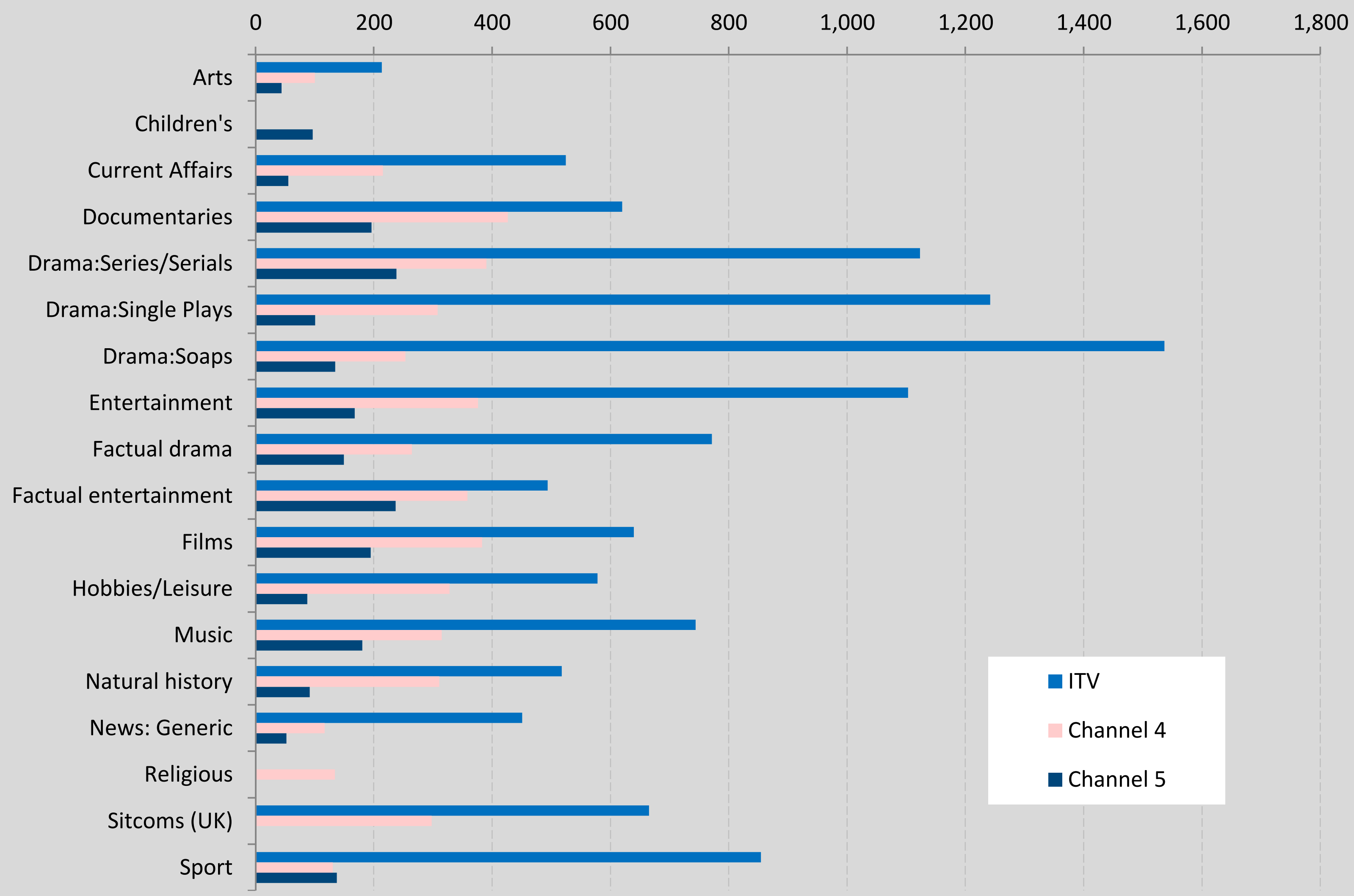
** Secondary revenues are stated after revenue shares with independent producers/rights owners*

Blanks indicate that the relevant genre is not offered by the channel in peak or no revenues are secured in these categories

On a total revenue per hour basis, the best performing genres vary by channel: ITV (soaps, drama, entertainment, sport), Channel 4 (drama, documentaries, films, entertainment), Channel 5 (drama, factual entertainment, documentaries, films)

Mediatique

Total average revenue per hour, by channel/genre (peak hrs, 2013, £000)



Total average revenue hour (across entire schedule):

- ITV: £991,000
- Channel 4: £314,000
- Channel 5: £166,000

- These outcomes reflect recent performance at the PSBs are therefore are only indicative of current/future outcomes
- In particular, Channel 4 has experienced some weakness in viewing share at its core channel (falling from 6.9% in 2010 to 6.2% in 2013*) which could reflect cyclical or scheduling weaknesses rather than underlying commercial outcomes

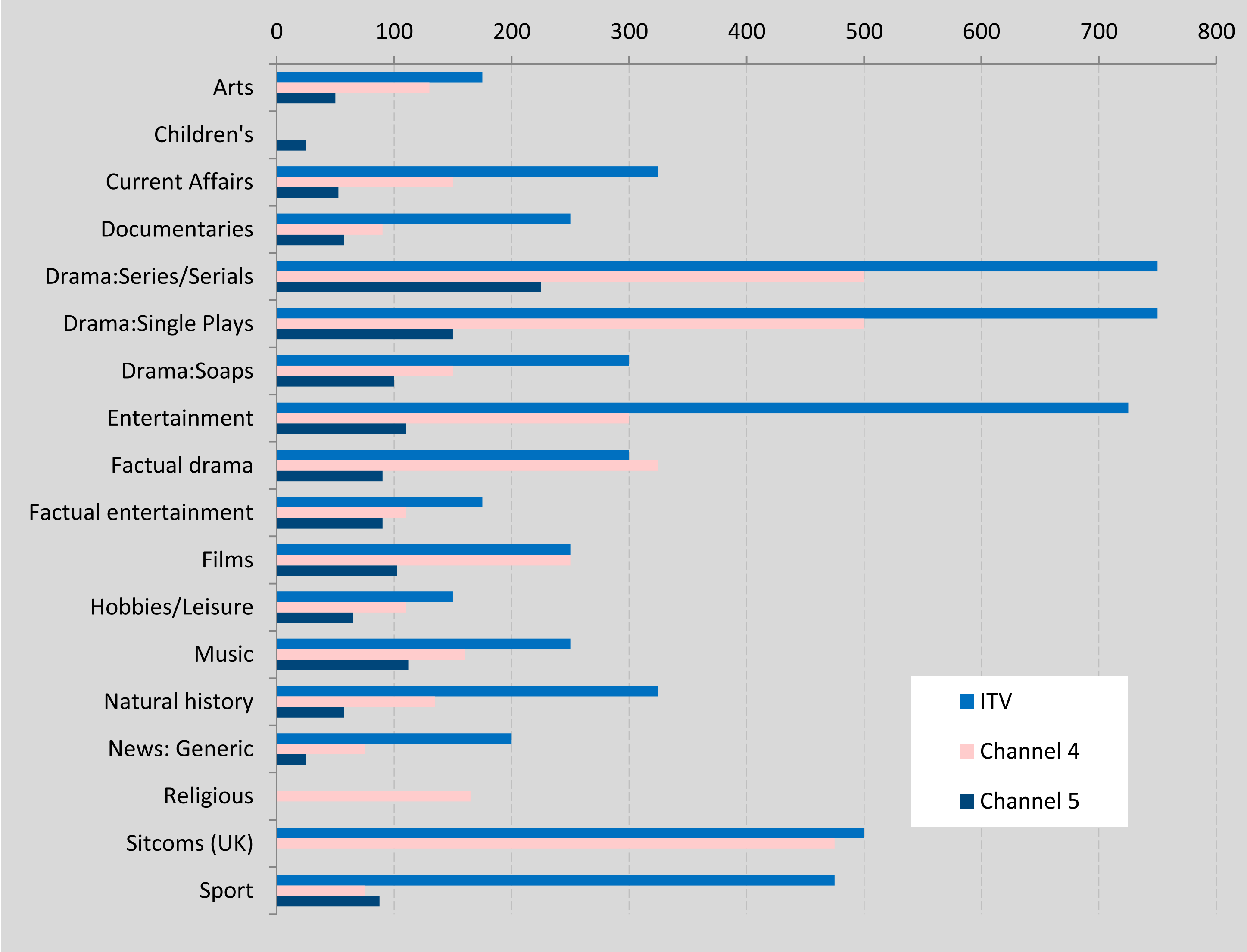
** Source: Ofcom Communications Report – includes Channel 4, Channel 4+1 and 4 Seven*

Source: Mediatique model. Blanks indicate that the relevant genre is not offered by the channel in peak.

We estimated an indicative average cost per hour for each drama, highlighting the relative expense of making certain genres (notably drama and entertainment – including sitcoms)

- Our estimates of the average hourly cost of content are informed by a combination of primary sources, top-down modelling (total expenditures, share of expenditure by genre, share of hours by genre) and a review of channel tariffs to the independent sector
  - An overview of our assumptions is illustrated opposite – in practice, there are wide variations in cost within genres (particularly in drama and entertainment) and our analysis is meant to capture average outcomes
  - These metrics indicate the total cost of producing an hour of content and do not reflect efficiencies (or inefficiencies) of producing in-house, nor the potential benefits of co-production funding or other commercial arrangements
- These costs also illustrate the relative cost burden on each channel, with average hourly costs at ITV roughly twice that of Channel 4 and 3-4 times that of Channel 5

Average production cost per hour, by channel/genre (peak hours, £000, estimate)

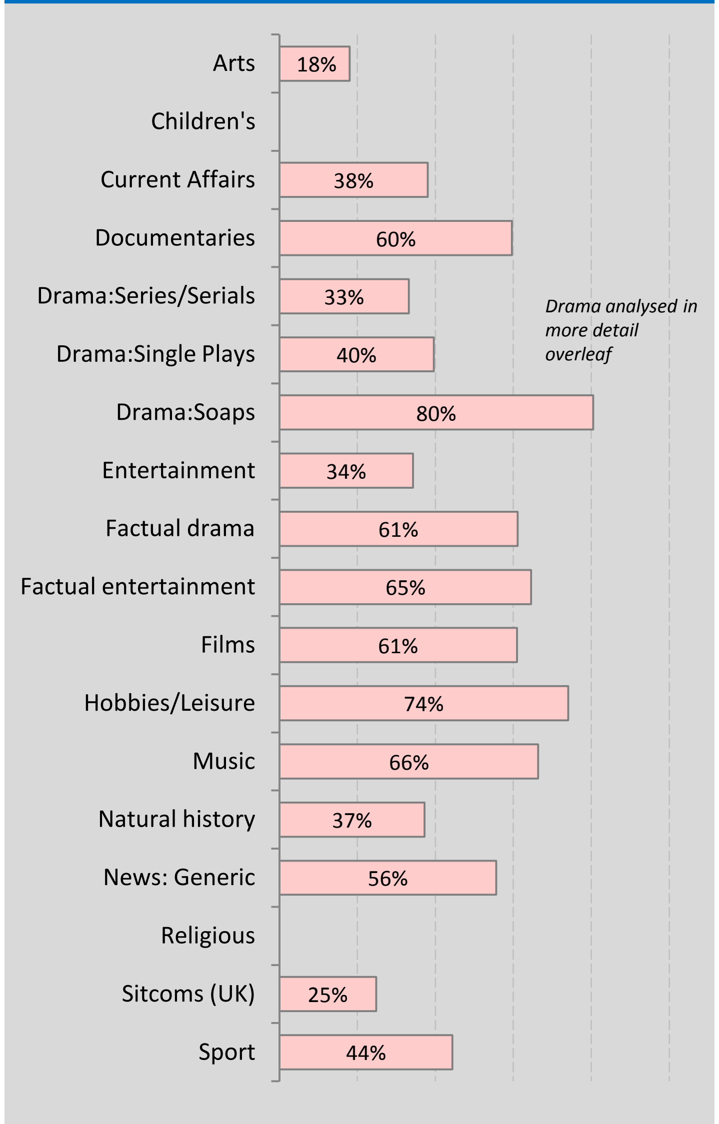


Source: Mediatique model
Blanks indicate that the relevant genre is not offered by the channel in peak

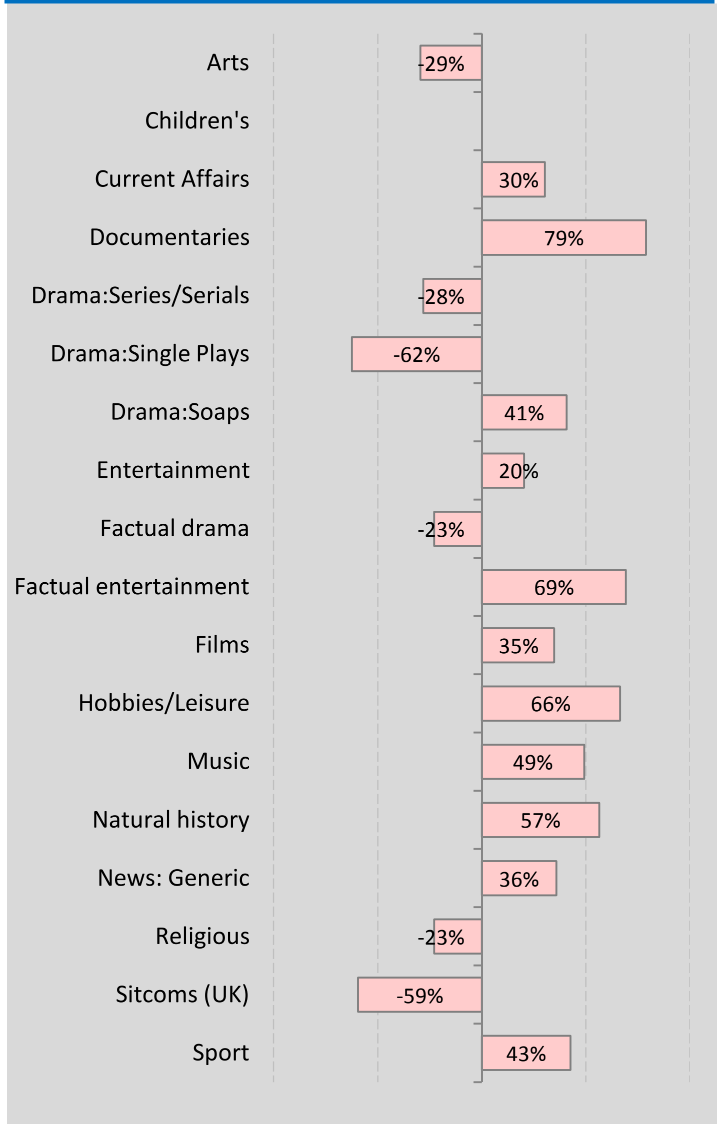
Each genre's commercial attractiveness varies among the three PSBs – notably, ITV is able to leverage its scale to offset higher production costs, whereas Channel 4's remit allows it to incur losses across a wider genre mix

All figures show gross profit/loss margin

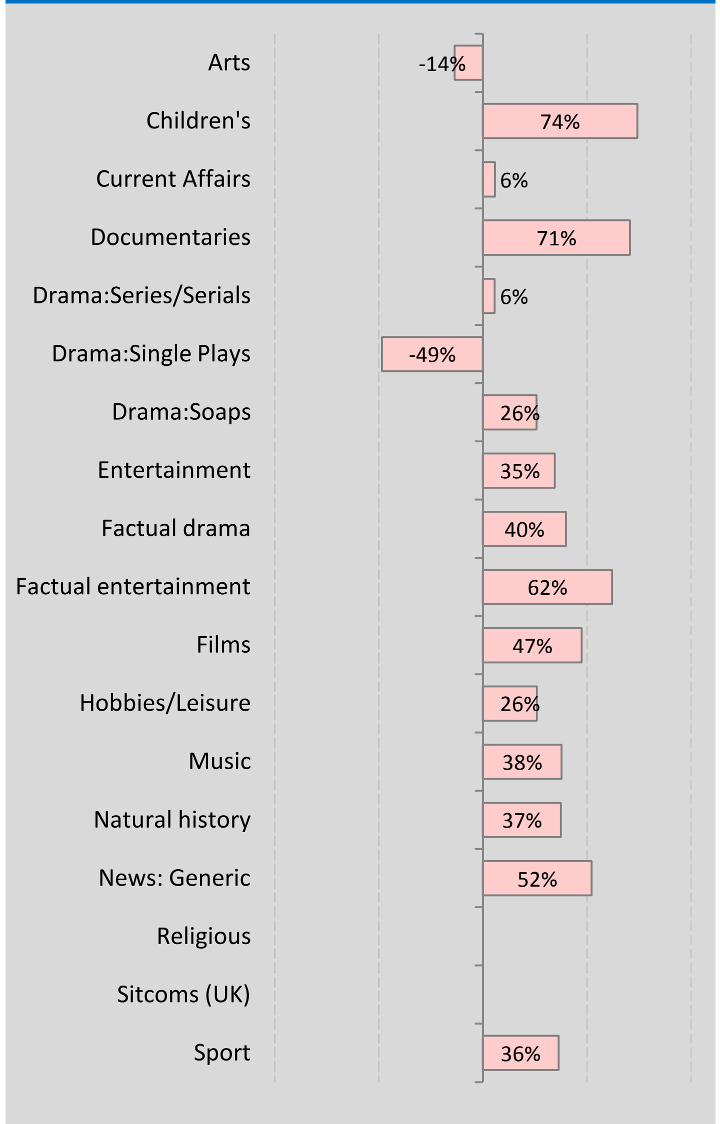
ITV gross profit margin contribution, by genre (peak hours 2013, %)



Channel 4 gross profit margin contribution, by genre (peak hours 2013, %)



Channel 5 gross profit margin contribution, by genre (peak hours 2013, %)

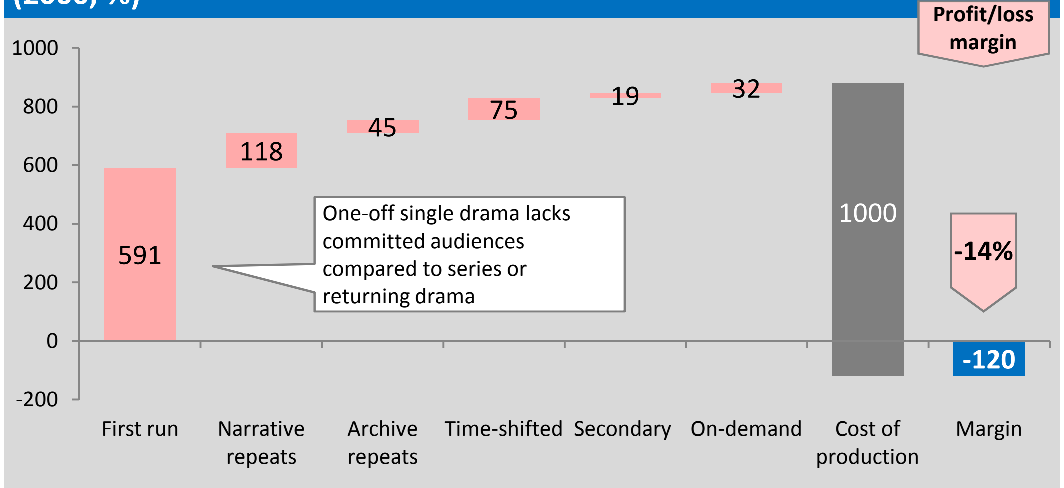


Source: Mediatique model. Genres with no written % indicate absence of programmes from that channel's schedule

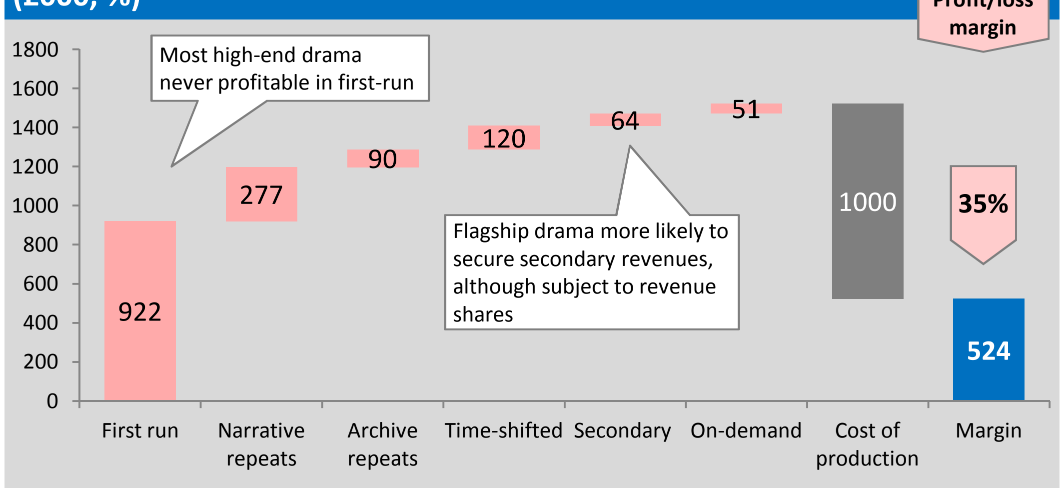
We have disaggregated results within ITV drama to illustrate the strategic benefit of producing high-end drama can offset challenging economics – this can hide significant variations among programmes, however...

- Variations in profitability can occur within sub-genres depending on the scale of investment undertaken and the quality of the end product
- At ITV in particular, a key distinction exists between high-end drama (e.g., *Downton Abbey, Broadchurch*) which can cost up to £1m per hour, and standard peak drama (e.g., *Midsomer Murders, Vera*) costing roughly £700,000 per hour. There are "signature" dramas in between (e.g., *Doc Martin, Mr Selfridge*) costing £800,000-£900,000 per hour
- Audience figures typically reflect the scale of investment here, including the role of high-profile talent and marketing within high-end category. As a result, high-end drama regularly secures audiences of 9-10m from first-run transmission, with average drama securing audiences of 5-6m in first-run. One-off drama also secures 5-6m, but typically incurs more significant costs as fixed costs are amortised across a single run, as opposed to a series of programmes
- The economics of all drama categories therefore differ, and we estimate (on average) that high-end drama trails standard drama in margin outcomes – see opposite. This largely reflects the costs required to produce such shows – it also confirms anecdotal evidence that high-end drama from previous decades (e.g., *Brideshead Revisited*) were loss-making, but were crucial to the schedule
- The continuing role of high-end drama within the schedule is explained by the strategic factors we highlighted in the first section – namely, the delivery of mass-market audiences, ensuring quality, associations with talent and the contribution to channel health/appeal
- This analysis is strongly <u>indicative</u>, however; for example, certain shows are able to secure significant secondary revenues from programme sales and are highly profitable, above the average

Gross profit margin contribution: ITV one-off drama, peak hours 2013 (£000, %)



Gross profit margin contribution: ITV high-end drama, peak hours 2013 (£000, %)

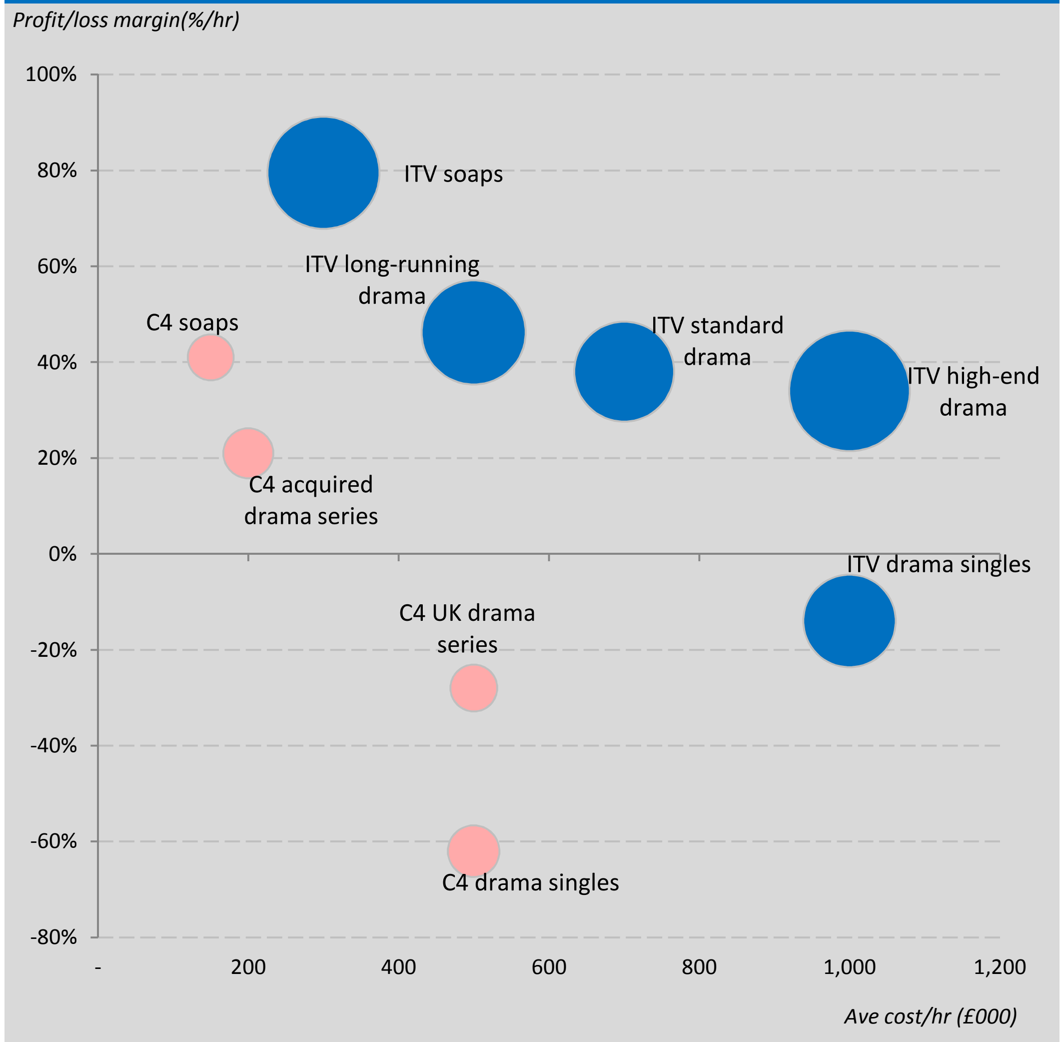


Source: Mediatique model
Analysis refers to ITV metrics in 2013 only. Consolidated viewing set at 73% live for average drama and 71% live for high-end drama

There is a wider disparity in economic returns among more specific sub-genres within drama – across both ITV and Channel 4...

- We have extended our analysis of drama investment to assess differences in economics among all drama categories for ITV and Channel 4
- There are clear cost differences among drama categories, with soaps and long-running drama serials typically at the lower end – and able to amortise fixed production costs more effectively over longer runs. High-end drama and single dramas lie at the other end, generating significant production costs
- Historically Channel 4 has relied on securing acquired drama series (at a typical cost per hour of £100k-£300k) to generate positive economic returns and allow cross-subsidy of more expensive UK drama. Channel 4 has faced strong competition from rival broadcasters in recent years, notably from Sky and Channel 5, and seen costs trend upwards – thus putting pressure on the relative profit margin from acquired series
- As an illustration of the relative scale and the different corporate objectives of the two broadcasters, Channel 4 drama typically secures lower margins across the board compared to ITV

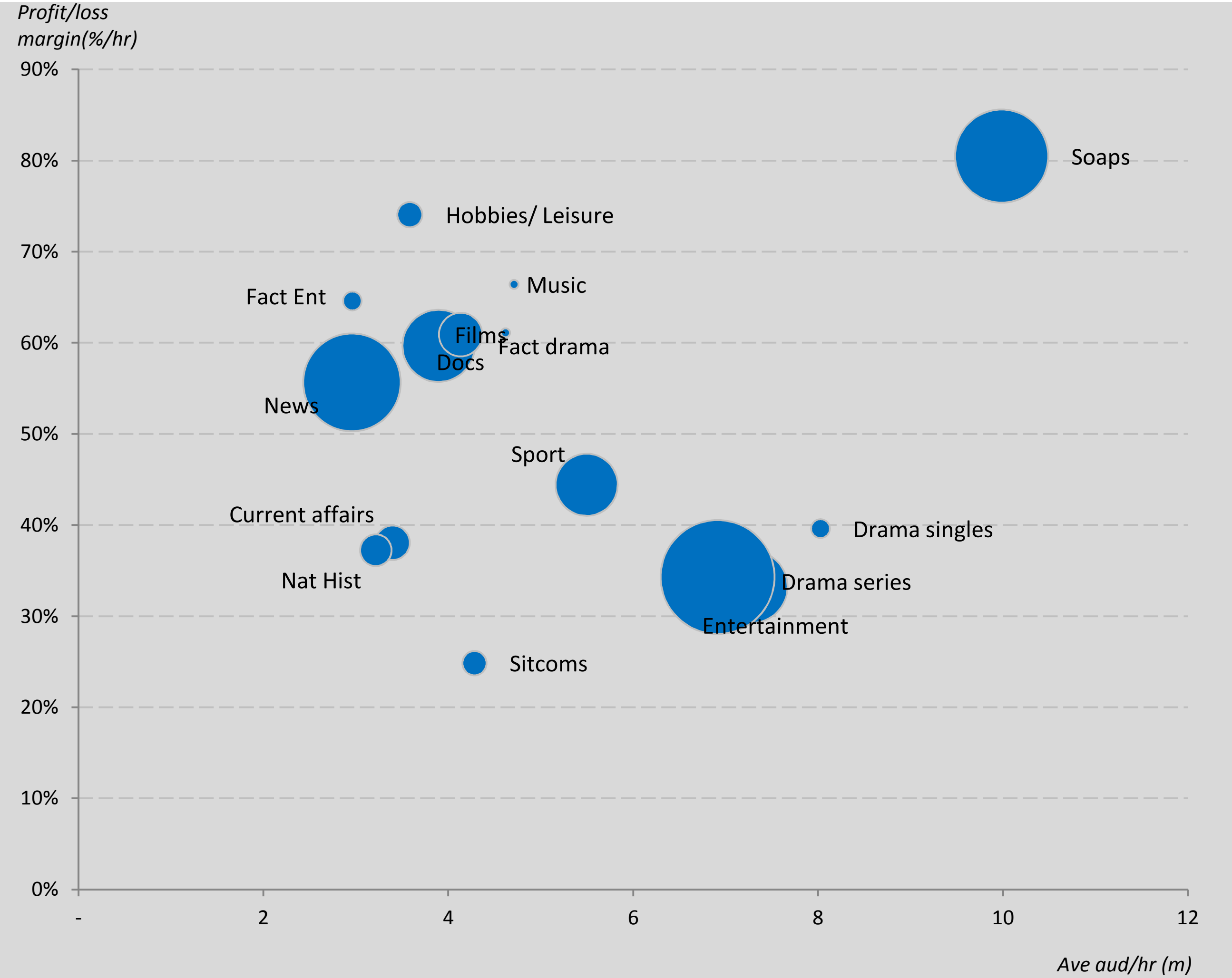
Gross profit margin vs cost/hour, ITV and Channel 4 drama: peak hours, 2013* (% £000)



Source: Mediatique model
Size of bubble corresponds to average audience per hour
** ITV drama singles based on average audience between 2010-2012 given small sample size in 2012*

ITV's commercial focus is evidenced by its reliance on profitable genres that secure higher audiences – however, even genres that secure smaller audiences can still secure some positive contribution to ITV's margins...

ITV gross profit margin vs average audience, by genre, 2013 peak hours (%, m)

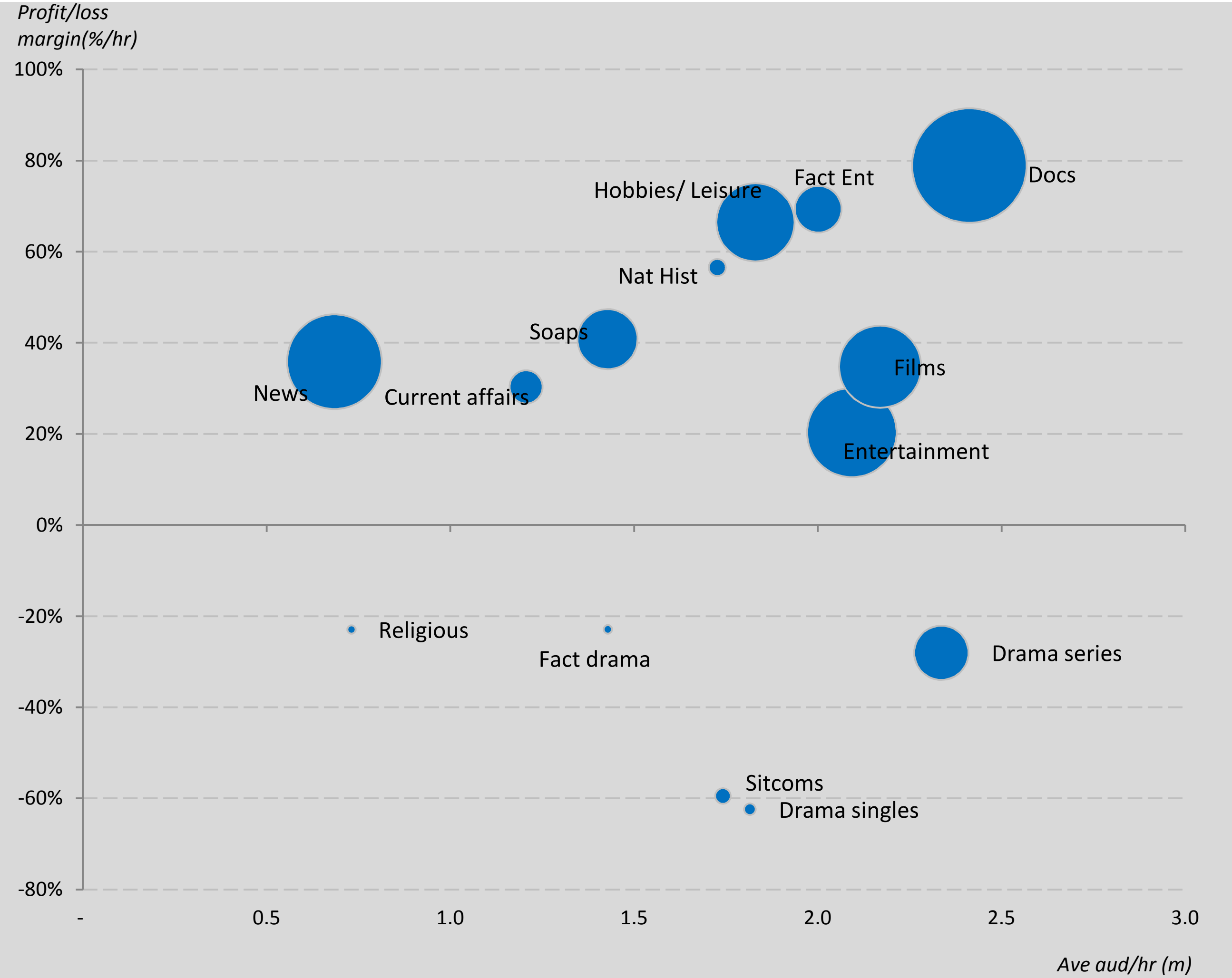


- For ITV, there is some correlation between the scale of audiences secured by each genre, its profitability and its share of broadcast hours
- In particular, ITV soaps leverage significant brand value and loyalty to secure mass-market audiences on a regular basis. As such, the best-performing shows such as soaps continue to secure a material share of ITV's viewing
- Similarly, ITV is able to promote drama brands and secure valuable talent which translates into significant audiences, enabling ITV to offset much of the cost burden associated with production

Source: Mediatique model
Size of bubble corresponds to each genre's share of broadcast hours

Channel 4 has a broader genre mix, with a lesser reliance on profitability and large audiences as a determinant of its schedule...

Channel 4 gross profit margin vs average audience, by genre, 2013 peak hours (%, m)

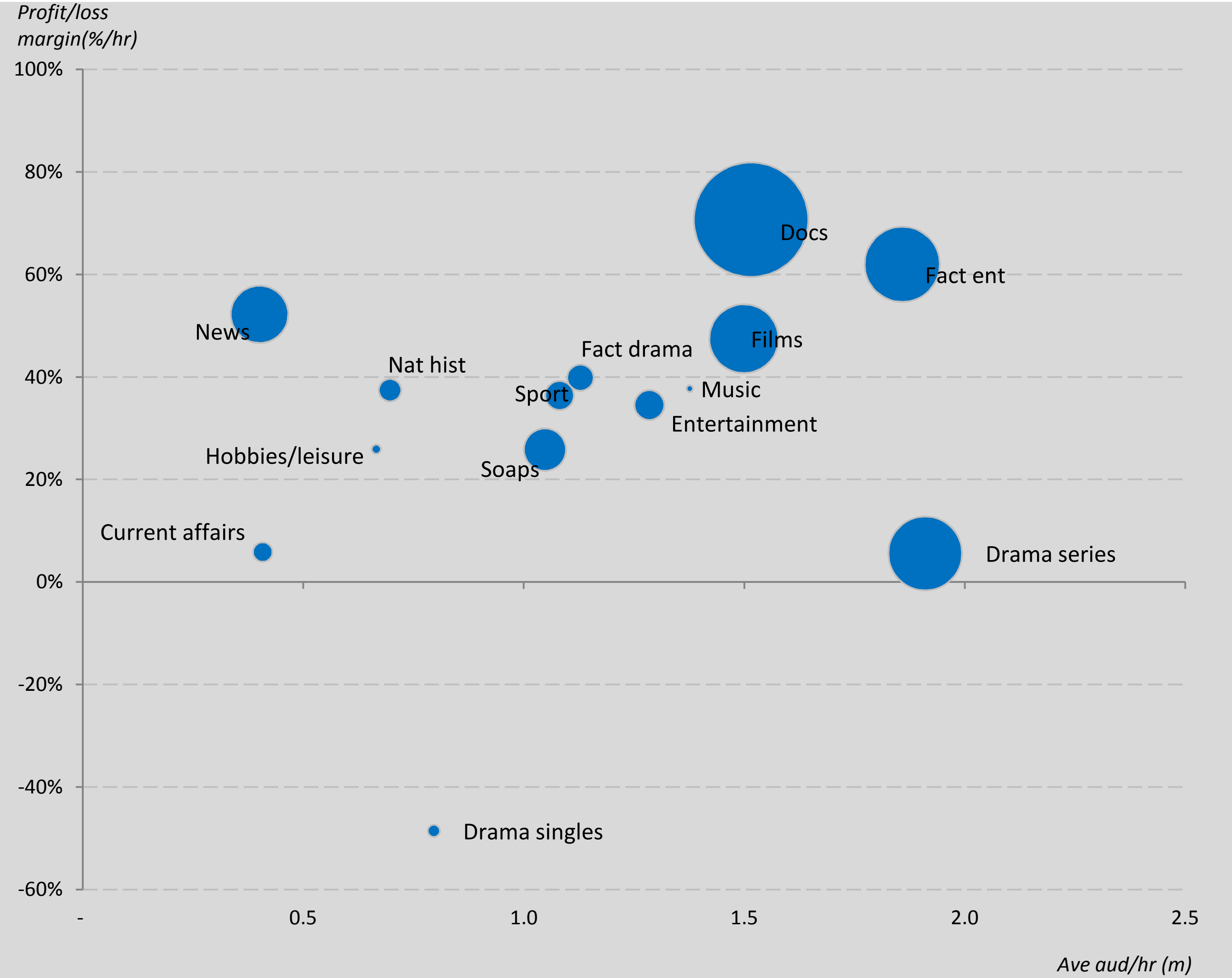


- Channel 4 demonstrates some correlation between size of audience and profitability – however, the relationship between scheduled hours and profitability is more nuanced in light of Channel 4's more balanced corporate objectives
- We can categorise genres into three distinct groups, all of which contribute to the balance of commercial-public service objectives for Channel 4:
  - High audience, high profitability genres including documentaries and factual entertainment
  - Low audience, but efficient and profitable genres including news, music and current affairs
  - Low audience and loss making genres such as religion and arts which nevertheless contribute to Channel 4's PSB remit
- As a result, Channel 4's distribution of broadcast hours is spread more evenly across all genres

Source: Mediatique model
Size of bubble corresponds to each genre's share of broadcast hours

Channel 5 has a tighter focus for its strategy – and schedule – on genres that secure higher audiences and returns...

Channel 5 gross profit margin vs average audience, by genre, 2013 peak hours (%, m)



- As with the other PSBs, those genres that secure larger audiences typically secure a higher profit margin – although this reflects a range of contrasting dynamics among individual genres and channels:
- Factual entertainment remains a profitable genre for Channel 5, being relatively cheap to produce (and often re-purpose) and secures significant audiences on a regular basis
- It is instructive that those genres with lower margins are increasingly less represented in Channel 5's schedule as it seeks to focus on profitability when making commissioning and scheduling decisions

Source: Mediatique model
Size of bubble corresponds to each genre's share of broadcast hours

We have illustrated the relative commercial attractiveness of the main genres across all commercial PSBs, confirming that certain genres with strong PSB credentials (arts, religious) are fundamentally challenged...

- The outcomes of our analysis allow us to categorise specific genres in relation to their relative ROI. However, as we assessed in the first part of this report, an ROI ranking is not the determining factor for a genre's sustainability
- As a result, we have considered each genre's ROI alongside its strategic value and its position within the current strategies of the commercial PSBs – *this analysis is indicative and outcomes vary considerably by programme and by broadcaster*
- This categorisation confirms that broadcasters are able to secure strategic value from producing in certain genres even where they are ostensibly not commercially attractive

Current categorisation of genres within the commercial PSB compact

Typically high audience, high production standards or very strong PSB credentials

	High strategic value	Carried within schedule	Low strategic value
Highly profitable	Drama (soaps) Factual entertainment		
Profitable / marginally profitable	Documentaries National news† Sport (premium) Drama (series*) Drama (singles*) Entertainment* Factual drama	Children's (acquired) Film (acquired) Hobbies/leisure Music‡ Natural history Current affairs	
Unprofitable / marginally unprofitable	Sitcoms	Film (UK) Sport (other)	Arts Religious
Highly unprofitable			Regional news[π] Children's (UK)

Least commercially attractive

Source: Mediatique model
** Drama profitability driven by ITV, more challenging economics for Channel 4 and Channel 5*
† National news is not profitable for Channel on a standalone basis but allows C4 to further monetise other genres via flexibility with in COSTA
‡ Does not relate to classical music; economics of PSB music clouded by blurring distinctions in this genre (music as entertainment)
[π] ROI not analysed separately – based on primary research

Key findings from our analysis of return on investment...

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Key findings in this section

Genres vary in their commercial attractiveness

- Our analysis illustrates that there is a wide disparity in profitability and commercial attractiveness among genre and broadcaster. A number of genres remain commercially attractive, including drama, factual entertainment and entertainment. Other genres, including those with very strong PSB attributes, are commercially challenged and increasingly unattractive for the commercial PSBs – including arts, religious and current affairs
- It is instructive that the removal of output prescriptions on arts, religious and music programming has resulted in their marginalisation or removal from the schedules of the commercial PSBs in recent years

Commercial attractiveness can be offset by broader strategic contributions

- The commercial attractiveness of certain genres can be complemented or offset by the broader strategic objectives we analysed in the first part of this report – all the PSBs see a strategic merit in retaining diversity of genre within their schedules and are not minded to focus too narrowly on only the best performing genres
- The PSBs are incentivised to maximise audiences across their schedule and genres that secure large audiences can offset concerns over profitability by maximising reach and share – both of which are crucial to retaining commercial salience among advertisers and agencies
- Equally, while there remains some correlation between audience size and profitability, more marginal genres that are less represented in the schedule are able to produce some positive financial contribution to overall channel outcomes, and can also serve to attract a broader range of audience groups and cater to varying tastes

Commercial attractiveness is likely to vary over time

- Current outcomes confirm that each broadcaster and genre has a unique viewing/ROI profile, including its share of time-shifted and on-demand viewing. As market trends evolve, and the penetration of PVRs and on-demand devices increase, these profiles will shift further, particularly for those genres whose consumption is already biased towards non-live viewing
- These changes in profile illustrate how the profitability, commercial attractiveness and ultimately the sustainability of each genre might vary over time
- In particular, there may be implications for certain genres depending on future trends, which we cover in the concluding section of this report

Introduction

Decision making and genre allocation

The relative profitability of genres

Future sustainability of PSB genres

We have extended our analysis to chart the impact of PVR penetration and on-demand capability on PSB genres...

- In tracking the future evolution of investment decisions, we have identified the key drivers of change in market outcomes – as set out opposite
- The extent to which these will influence content investment outcomes will depend on the view we take on market evolution over time: a scenario where linear viewing continues to secure the lion's share of all TV viewing may lead to a different market outcome (in terms of content investment and decision making) compared to one where non-linear viewing becomes the norm
- Our analysis is focused on the impact of technological enablement on viewing behaviours and content investment decisions – as a result, we have assumed a steady-state outcome whereby changes in the competitive landscape and public policy are not material
- We have posited a base-case outcome of non-linear enablement (see overleaf) which allows us to track the impact of PVR and on-demand usage on the ROI metrics by channel/genre – this serves to highlight which genres are likely to be most challenged in the future

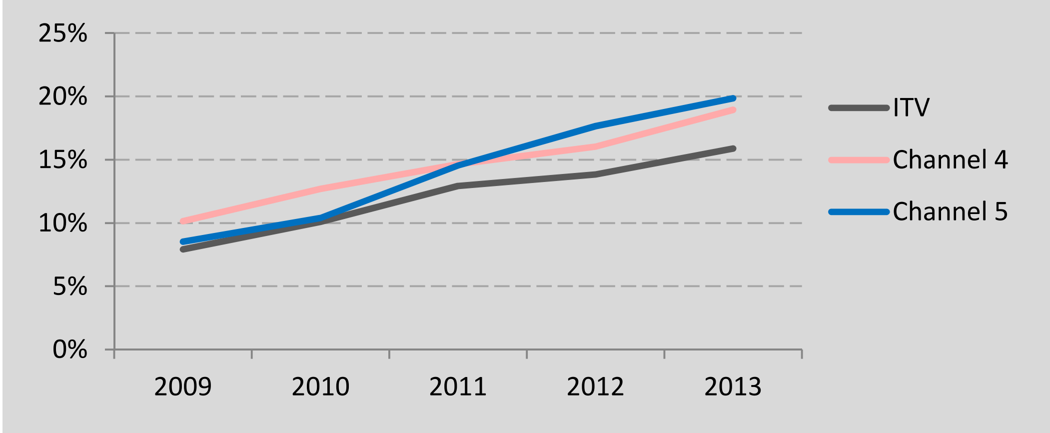
Future drivers of change in PSB content investment

Technology – and consumer behaviour *Focus of this analysis*	▪ Technology innovation, increases in connectivity and penetration of devices may enable further substitution/ avoidance of broadcast schedules ▪ This will affect – and potentially compound –changes in consumer behaviour...in turn influencing the relative demand (and hence ROI) for content and genres/sub-genres
Competitive dynamics	▪ Changes in the competitive landscape – including the role of the BBC, the success of new entrants and shifts in corporate ownership – will determine the scale of return achievable to key broadcasters in key genres
Working practices	▪ Supply-side working practices and decision making will influence scope/nature of investment decisions at broadcasters ▪ Demand-side working practices will determine the ways in which content investment is monetised (including the longevity of buying practices across the entire schedule vs discrete monetisation)
Public policy	▪ Changes to regulation and public policy will determine the obligations on key broadcasters to maintain investment in certain genres, and influence the appetite for existing (or new) PSB players to accept the terms of any PSB compact

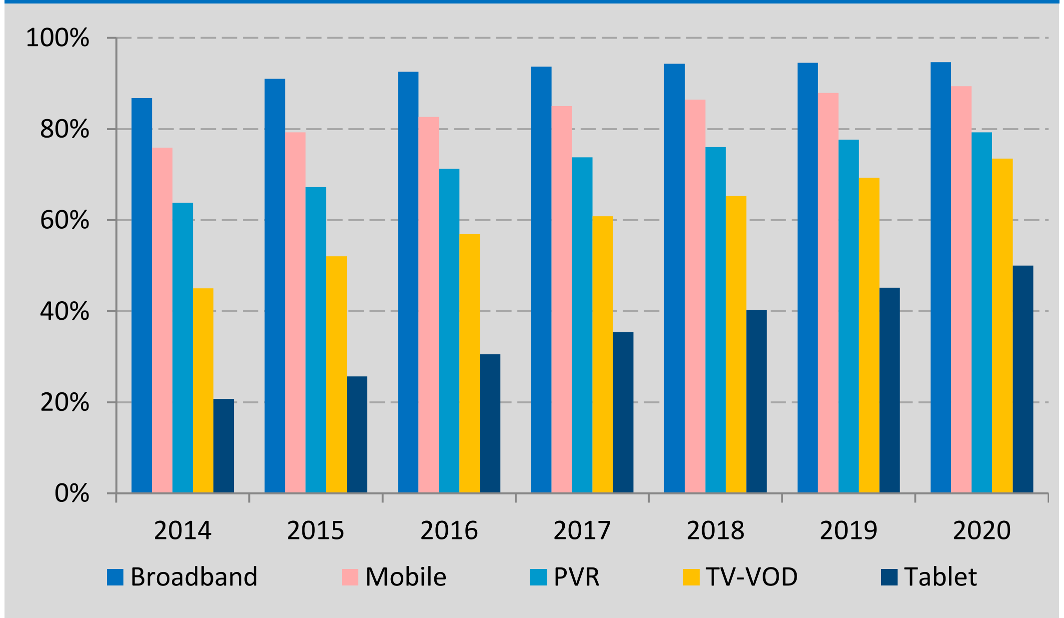
Our analysis is rooted in forecasts of increasing consumer enablement by 2020 – with more than 70% of UK households having access to a PVR and on-demand...

- Viewers are embracing new opportunities to view content on a time- and place-shifted basis. Increasingly wide distribution of content in on-demand windows is also conditioning expectations of content availability, as viewers increasingly expect content to be easily and readily available on all connected devices following initial broadcast
- Consumption outcomes across the range of release windows are increasingly inter-related, notably with the initial broadcast window driving consumption trends in multiple subsequent windows
- The PSB channels have all launched on-demand players to distribute their TV content directly to internet and platform users (e.g., iPlayer, ITV Player, 4OD) on multiple devices including PCs, consoles, tablets, connected TVs, smartphones
- ...in addition, platform operators, TV manufacturers, new content aggregators and players from affiliated markets are all targeting the VOD market, while content owners (including independent production companies and studios) are seeking direct consumer access
- We have forecast growth in the penetration of devices and functionality that allow consumers to watch content on a non-linear basis, as set out opposite

Share of total viewing that is time-shifted, by channel (%)



Penetration of devices/functionality (% households*)



Source: Mediatique model

** Mobile and tablet penetration stated as % of individuals*

We have modelled an evolutionary view of consumer behaviour, forecasting that live viewing will account for 70% of all TV viewing hours by 2020...

The impact of consumer behaviour on content investment

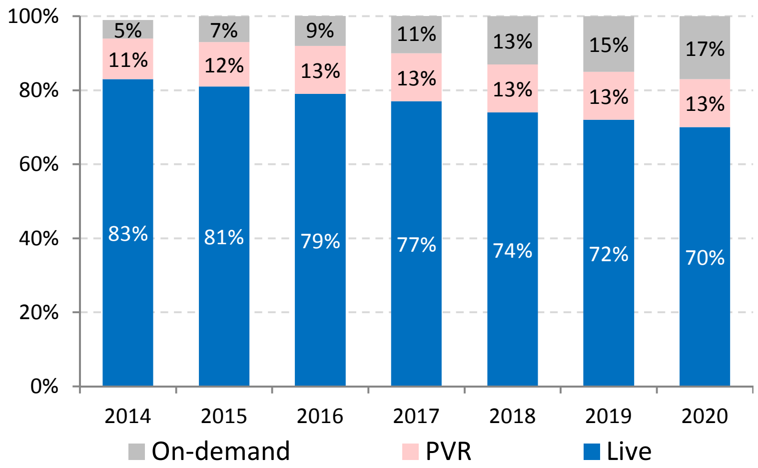
Genres are affected differentially by enablement

- Current viewing outcomes illustrate that established patterns of behaviour already exist in relation to certain genres: news and sport are almost entirely watched live, whereas drama and entertainment are the most time-shifted of all genres – this suggests that existing behaviours can be used as the basis to forecast how newly enabled homes might watch different genres over time
  - Evidence suggests that between 15-20% of viewing in a PVR-enabled home is time-shifted, resulting in an average of roughly 11% across all homes (i.e., enabled and non-enabled). BARB data confirms that behaviours *within* a PVR home have not changed materially over time, in spite of recent growth in PVR penetration
  - As a result, we forecast that the contribution of PVR viewing to total TV viewing will increase in line with penetration rather than exogenous changes in behaviour
- It also confirms why the commercial PSBs are potentially concerned by the impact of increasing PVR penetration on the economics of those genres that contribute most to viewing outcomes (i.e., drama and entertainment) – with roughly 70% of ads watched on a time-shifted basis being skipped

Market dynamics are likely to evolve – rather than revolutionise – over time

- Growth in on-demand viewing is likely to be the key change in TV viewing hours by 2020, notably as TV sets become connected and audiences are able to select from on-demand libraries via their TV or set-top box. This will enable the easier substitution of on-demand viewing for live consumption, but also presents the PSBs will opportunities to monetise on-demand viewing via advertising or the payment of carriage fees from platform operators
- The combination of increased time-shifting and on-demand viewing will result in a decline in the share of viewing that is secured by first-run/repeats viewing
- For as long as live viewing remains the lion's share of TV viewing, we maintain that the commercial PSB channels will be able to secure a premium for delivering mass-market audiences – indeed, even by 2020, we think it likely that ITV will remain the only place through which advertisers will be able to reach audiences of multiple millions

Share of TV viewing hours (%, 2014-20)

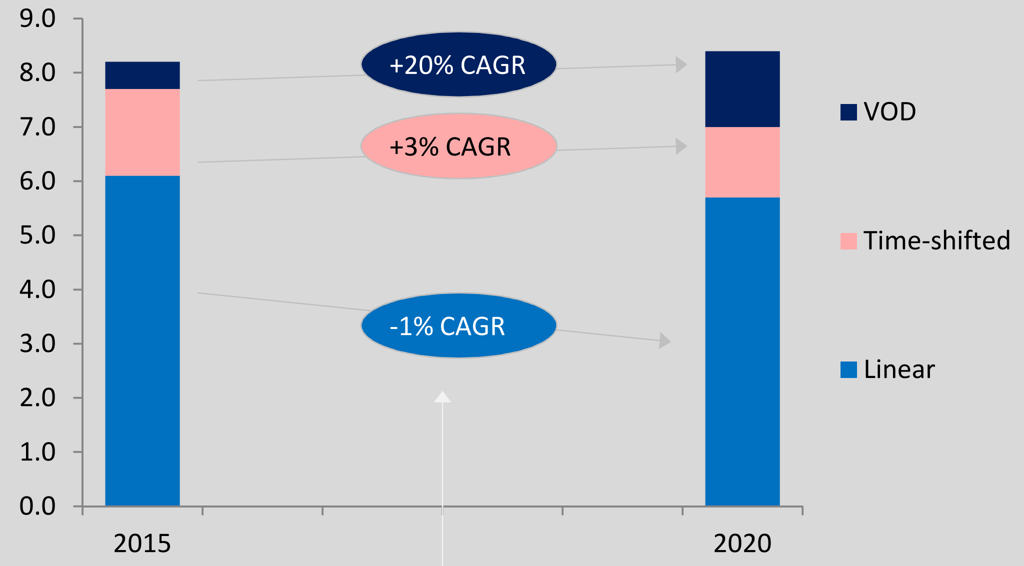


Source: Mediatique model
On-demand viewing hours determined across all enabled devices (including TVs, computers and mobile devices)

We have forecast the viewing profile – across live, time-shifted and on-demand – of each genre on each broadcaster over the model period...

- We extended our ROI model for the period 2014-2020 in order to examine the impact of increasing consumer enablement on the ROI of each channel and genre
- Based on the current viewing/ROI profile of each channel/genre, we applied the same market growth rate for each category of viewing hours to forecast the change in viewing/ROI profile by 2020 (see opposite)
- ...on this basis, all genres will see a decline in their first-run audiences and growth in their on-demand viewing by 2020
- By way of illustration, in 2014 live viewing accounts for 69% of ITV drama audiences and 98% of ITV News audiences; by 2020, these will fall to 46% and 74% respectively (in line with market trends)
- In order to isolate the impact of new media enablement on ROI, we have held the pricing/inventory metrics for first-run and repeats revenues constant over the period – in practice, there could be a change in linear CPT rates either upwards (to reflect the reducing supply of commercial impacts) or downwards (to reflect the reducing engagement of audiences and hence advertising budgets)

Changes in average audiences, by viewing type (aud/hr, m) *illustrative*



Different starting position for each genre

Growth rates based on market change in share of viewing hours for each viewing category (see previous page)

Different 2020 position for each genre

Source: Mediatique model

The decline in linear viewing is gradual, allowing broadcasters to adapt to market changes at an evolutionary pace – this is particularly germane for broadcasters where lead-times in commissioning and production can tie-in decision making over multiple years

Genres that are currently profitable may face margin erosion as market dynamics present new challenges to the PSB regime: ultimately, these outcomes will reflect the balance of shifting dynamics across all variables

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Changes to market variables over time

Key dynamics

Linear viewing declines as a percentage of total viewing

This decline in first-run viewing hours lessens the revenue potential from the main contributor of audiences/value (absent inflation in CPTs as a result of reduced supply)

PVR penetration and ad-skipping reach near-universal levels

An increase in time-shifted viewing (at the partial expense of live viewing) – and subsequent ad-skipping – imposes foregone revenues on viewing and lessens ROI

On-demand consumption increases in scale

This growth in VOD viewing reduces the scale of live audiences, but secures some compensating revenue from the sale of on-demand inventory

As such, revenues placed at risk by ad-skipping can be offset by the opportunity to derive on-demand revenues (particularly where CPT rates can be sustained and PSB VOD players retain salience online and on TV platforms)

Changes to the competitive cohort of the PSBs are likely to impose increases in production costs across key genres

We have applied an inflation-linked increase in content costs at 1.5% per year over the model period, allowing us to determine the ROI for each genre over time

Impact on genres

All genres affected by decline in live audiences – but those genres with bias towards live (e.g., news) more sensitive to changes in monetisation/ market practice

Those genres with greater propensity for time-shifted viewing (e.g., drama) more at risk from substitution effects of ad-skipping

Those genres with limited on-demand viewing (e.g., news, sport) unable to benefit from compensating VOD revenue

All genres sensitive to changes in cost – those genres with larger audiences or part of series/returns are better able to sustain cost changes

Our analysis suggests that market evolution may place further financial pressure on arts, current affairs and comedy at ITV, although drama is relatively protected by ITV’s ability to secure on-demand revenues...

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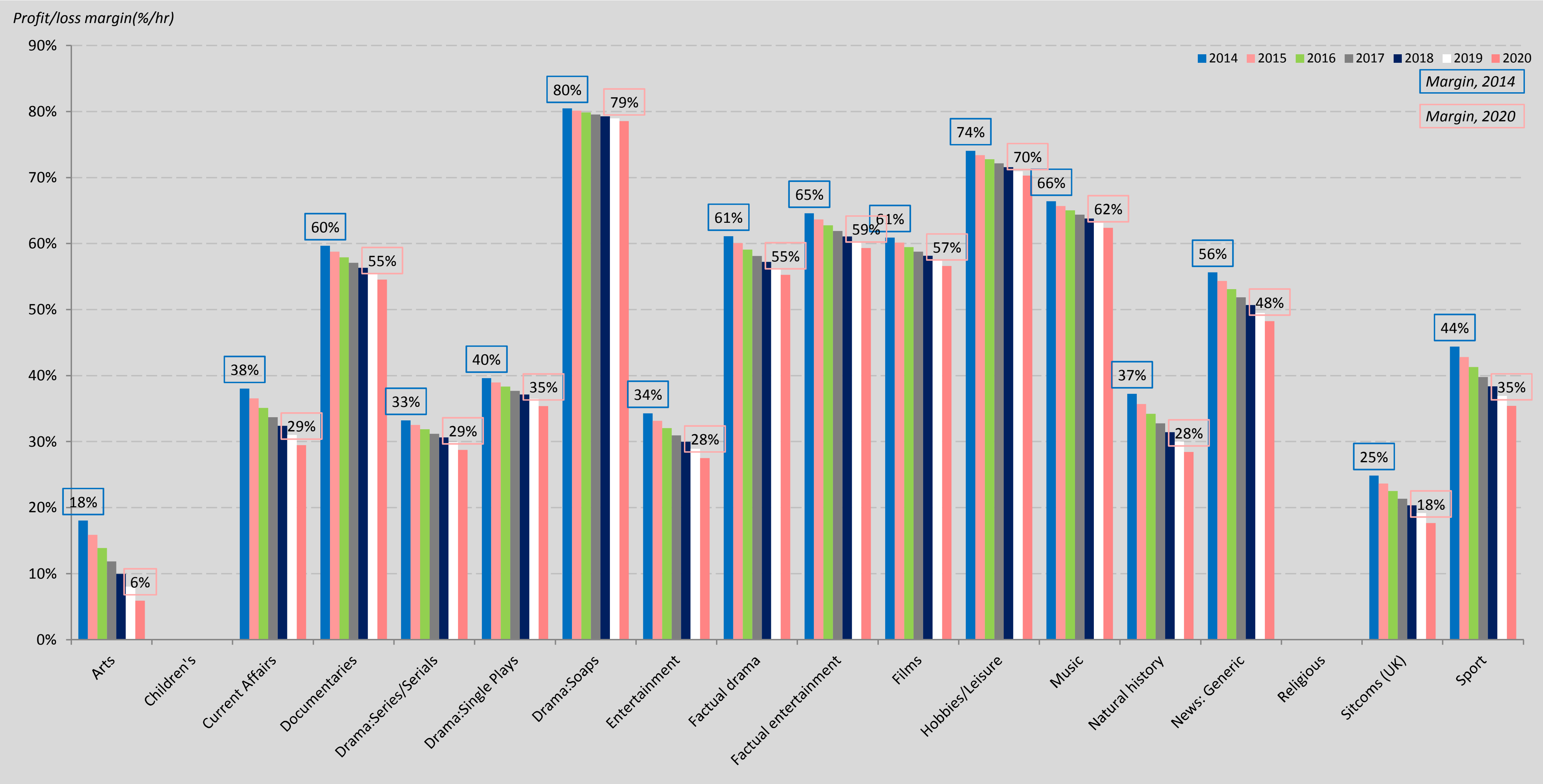
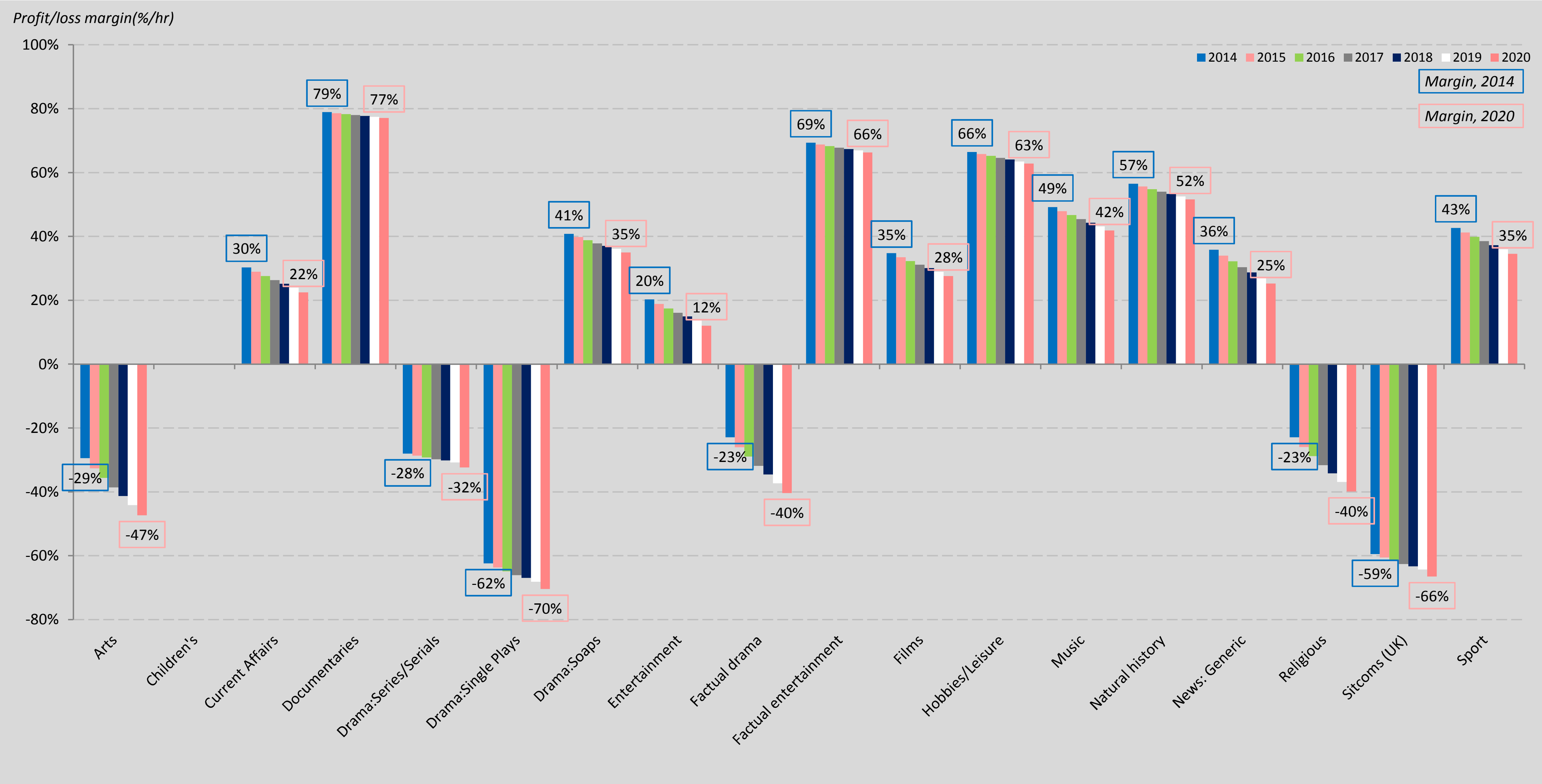
ITV gross profit margin, by genre, 2013-2020 peak hours (%, m)



Source: Mediatique model

Channel 4's contribution from arts, religion and comedy may be further reduced over time, although its returns from documentaries/factual will remain consistently strong...

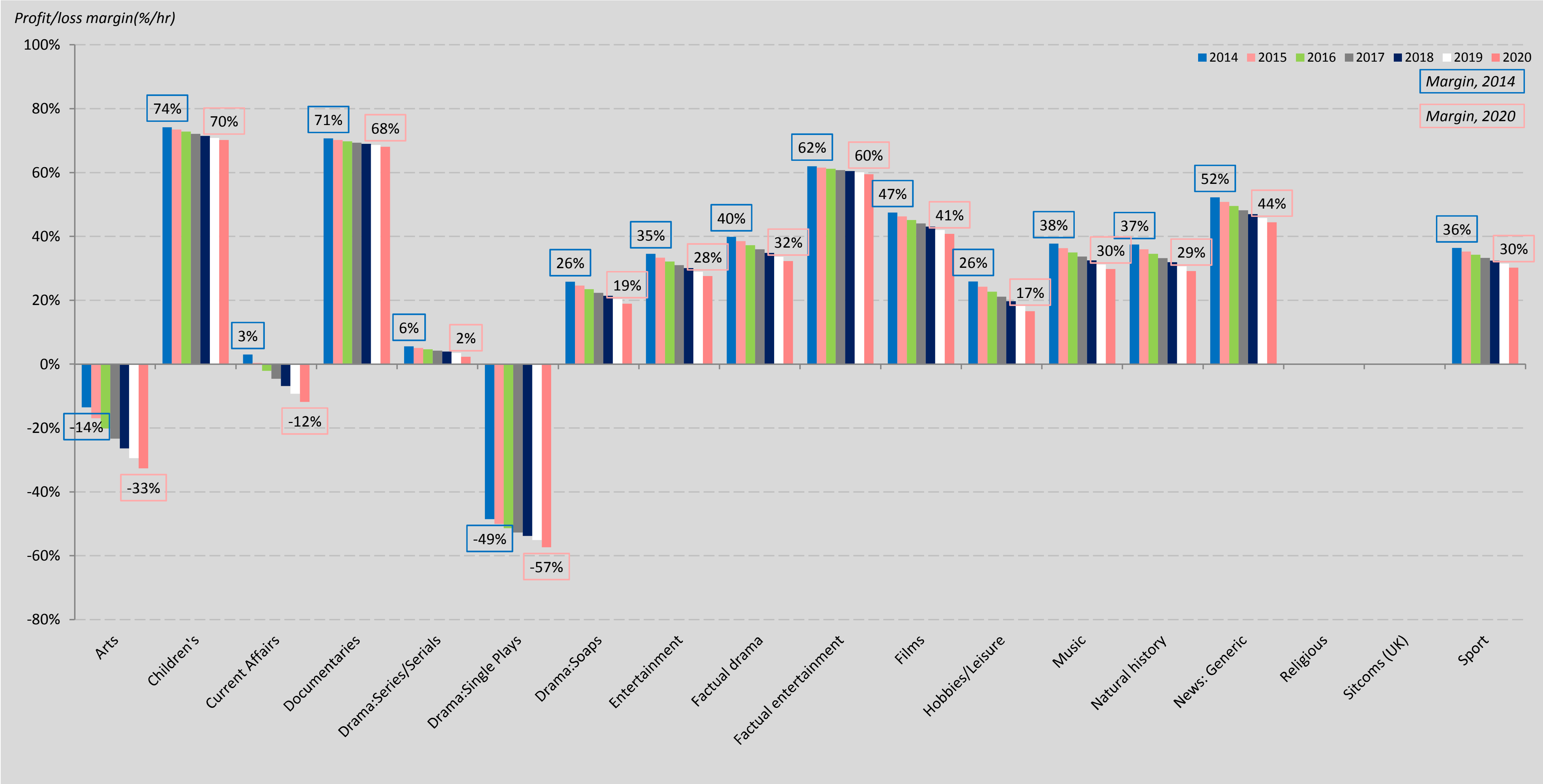
Channel 4 gross profit margin, by genre, 2013-2020 peak hours (%, m)



Source: Mediatique model

Channel 5 will also see further challenges to the economics underpinning arts and current affairs; by contrast, factual entertainment and documentaries will be able to accrue compensating value in on-demand windows...

Channel 5 gross profit margin, by genre, 2013-2020 peak hours (%, m)



Source: Mediatique model

Our analysis suggests that market evolution may place further financial pressures on key PSB genres across all broadcasters – although some genres are able to leverage new opportunities on-demand to secure positive ROI

Genre	Position within future PSB compact by 2020	
Arts & religious	▪ Economics are further challenged by market transition, with limited ability to derive compensating revenues in on-demand windows. Small audiences unable to offset production costs ▪ Likely to be further marginalised within ITV and Channel 5 in particular	At risk
Children's	▪ High repeatability and potential in on-demand windows sustains profitability for Channel 5 ▪ BBC to remain the benchmark for children's	Stable (at low levels)
Current affairs	▪ Bias towards live viewing makes economics more challenging for current affairs, with no compensating revenues in on-demand windows. Likely to remain important to ITV and Channel 4 strategies (and brand) but potentially only sustained by tier 2 regulation at Channel 5	Challenged
Documentaries	▪ Highly profitable for all broadcasters over time – with balanced engagement across live and on-demand windows allowing optimisation of revenue	Stable
Drama – series/ singles	▪ Still profitable for ITV, with potential to secure revenue across both live and on-demand windows ▪ Challenged for Channel 4 and Channel 5, but no significant change from 2014 as drama continues to perform well in on-demand windows (but thus outcomes are sensitive to underlying metrics in these windows)	Stable
Drama – soaps	▪ Still highly profitable for ITV, with potential to secure revenue across both live and on-demand windows ▪ Positive for Channel 4, challenged at Channel 5, but no significant change from 2014	Stable
Entertainment	▪ Likely to sustain reach and secure viewing share, talent associations and secondary revenues – and hence set to remain a cornerstone of schedules ▪ Future economics are neutral, as VOD revenues offset some decline in live ROI	Stable

Source: Mediatique model

Genre	Position within future PSB compact by 2020	
Factual entertainment	▪ Factual entertainment will continue to benefit from favourable economics (low production costs, large audiences) and can monetise on-demand consumption ▪ Likely to remain crucial to Channel 4 and Channel 5 profitability	Stable
Films	▪ Historically sourced via acquisition, and therefore highly substitutable by on-demand players (e.g., Netflix, Amazon) over time ▪ Relatively high margin for ITV and Channel 5 as long as acquisition costs remain low	Stable
Music	▪ Likely to morph increasingly to entertainment (e.g., live shows, best of programmes) ▪ Very limited scope for classical music outside the BBC	Challenged
Natural history	▪ Current bias towards live viewing likely to be sustained, with resultant impact on revenue/ROI ▪ Some blurring of definition (with factual entertainment/docs) likely over time, including sustained relationships with talent/celebrities and co-productions. "Pure" natural history benchmarks likely to be set by the BBC	Stable
News	▪ News likely to remain a cornerstone of live schedules, but likely to face declines in scheduled viewing ▪ Limited ability to derive compensation from VOD viewing, but still crucial to broadcaster strategies and channel brands. Regional news at ITV likely to face significant pressures in light of fixed costs burden	Challenged
Sitcoms (UK)	▪ Challenging economics across all the PSBs, but some upside from ability to secure on-demand revenues ▪ Likely to remain limited in scale, but driven by creativity and talent association	Challenged
Sport	▪ Rooted in live audiences, and thus limited upside from on-demand viewing ▪ Becomes financially challenged for all broadcasters, but likely to remain critical to ITV brand (particularly relating to international or premium sport) – Channel 5 likely to focus on cheap marginal genres (boxing) or highlights	Stable

Source: Mediatique model

We suggest that drama is likely to remain a cornerstone of ITV's schedule over time, even if ROI economics become more challenged as a result of more aggressive shifts in industry dynamics...

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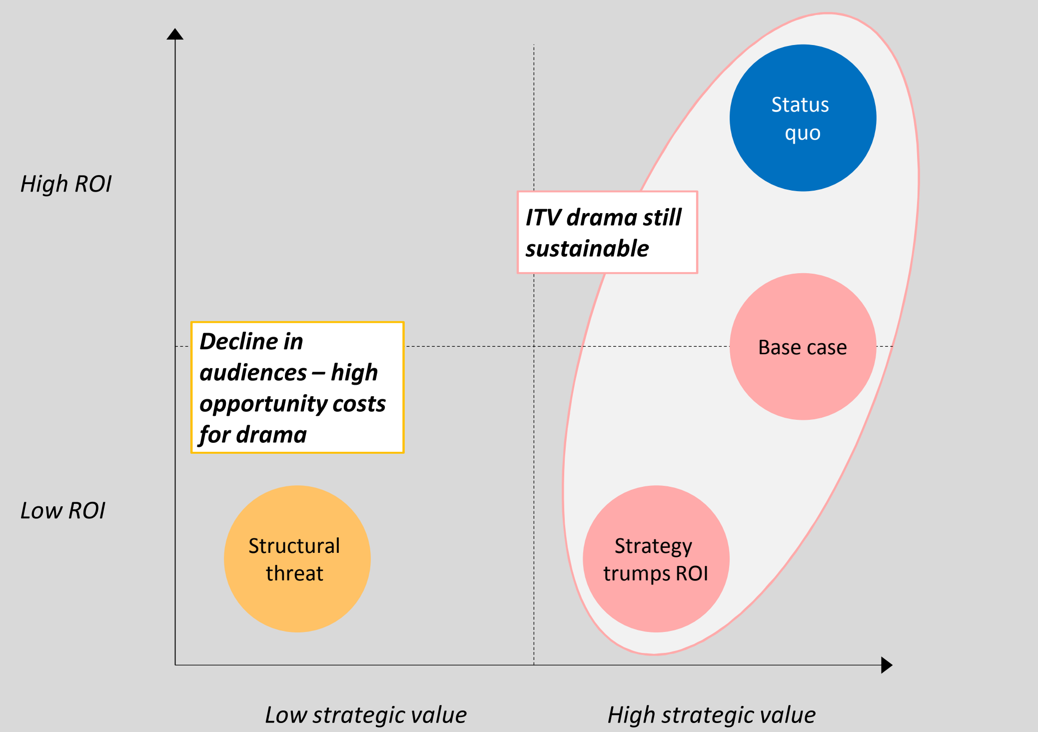
- Drama poses a particular issue for ITV as it currently delivers significant audiences and positive ROI, but represents the most time-shifted of all genres and is thus potentially the most at risk in terms of future dynamics
- Indeed, changes in consumer behaviour towards more non-linear viewing are set to reduce the ROI associated with drama, with potential implications for its sustainability within the ITV schedule – it is unlikely that these changes will push drama into negative ROI; however, a material decline in ROI might increase the opportunity costs of scheduling drama against other better performing genres (including factual entertainment, entertainment)
- In spite of the potential for higher opportunity costs, it remains the case that drama contributes significant strategic value to ITV in the form of brand health, audience delivery and talent association
- We found a consistent view among ITV stakeholders that it would continue to schedule drama (across all sub-genre categories) even if economics became more challenged in order to maintain a benchmark against the BBC and Channel 4 – both of whom would continue to commission drama as part of their PSB remits
- Only a more radical acceleration of changes in consumer behaviour and technological enablement would result in a material shift away from drama for ITV

Future dynamics for ITV drama

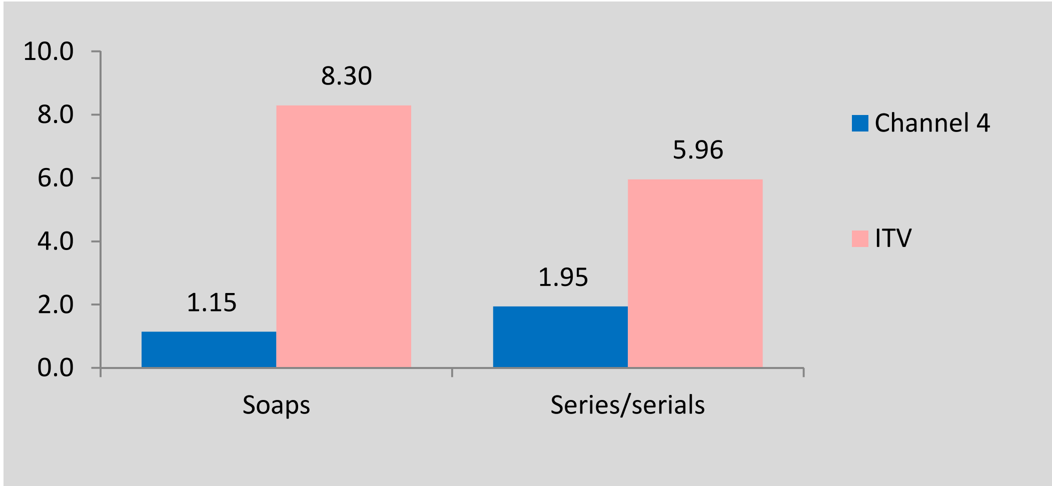


Drama continues to secure high strategic value and ROI for ITV on our base-case view of the future, in spite of an increasing shift towards non-linear consumption
It is possible to envisage a more aggressive decline in ROI for drama – were, for example, there to be a collapse in VOD CPT rates or a more aggressive shift towards time-shifted viewing. In this scenario, drama is still likely to contribute more broadly to ITV's strategic health, however
Only in a situation of radical disruption would there potentially be a fall in both financial and strategic value – characterised, for example, by a shift in audience preferences away from drama (in all viewing windows) towards other genres or other forms of engagement

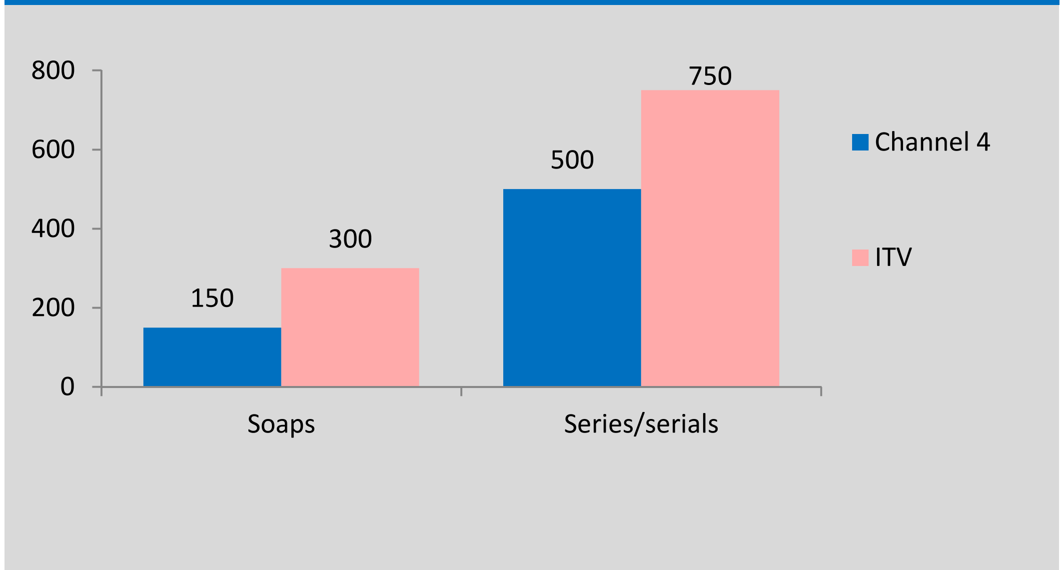
Channel 4's commitment to drama is more challenged, as the underlying economics force Channel 4 to rely more on strategic value to justify commissioning drama...

- Drama (outside soaps) remains loss-making at Channel 4, largely as the costs of making drama at Channel 4 are not sufficiently different from ITV to offset the relative outperformance of ITV in audience terms
- ...the average drama audience at ITV is close to 6m, compared to 2m at Channel 4, whereas the cost differential to produce quality UK drama is more modest – as a reflection of the relative burden of fixed costs and talent in producing drama
- Drama continues to represent a significant share of content at Channel 4 (albeit not as significant as ITV), and remains critical to Channel 4's remit, its channel brand and its contribution to public service
- As such, Channel 4's commitment to drama is sustained more by strategic contribution than financial contribution compared to ITV. This may become more true over time, as changes to the market environment worsen (rather than strengthen) the burden of drama on Channel 4
- Channel 4's ability to produce drama is sustained by the performance of other genres, whose contribution is required to cross-subsidise loss-making dramas. Our forecasts assume that Channel 4 can continue to secure positive contributions from a range of genres (including documentaries, factual entertainment and hobbies/leisure); however, a more conservative outcome among these genres may limit the channel's ability to sustain its cross-subsidy model

Average aud/hr, drama by channel (2013, m)



Average cost/hr, drama by channel (2013, £000)



Source: Mediatique model

Key findings from our analysis of future dynamics...

Mediatique

Key findings in this section

Market evolution may challenge the economics of certain genres	▪ As audience behaviours increasingly favour non-linear viewing over time, some genres that are currently commercially attractive will become less so over time – Those genres that are most reliant on live viewing are potentially challenged as the share of total TV viewing that is scheduled declines*, therefore increasing the proportion of viewing that is time-shifted and hence reducing the number of commercial impacts that are delivered per hour of viewing – By contrast, viewing that is non-linear can be monetised in on-demand windows ▪ These trends reflect the scope and pace of change, however – and our base-case view implies that a deterioration in ROI for certain genres will occur gradually over the model period
Decision making at the PSBs may alter as a result	▪ The consideration of non-linear impacts/opportunities will become part of the content appraisal process – potentially favouring those genres that are more immune to changes in audience behaviour, and leading to a further withdrawal from marginal genres ▪ Broadcasters may be incentivised to rely on proven formats or programme brands that have established track records of generating positive ROI – this may also favour repeats, re-commissions or a shift towards lower-cost genres. Broadcasters may also seek to maximise revenues in secondary windows by focusing on genres with international appeal , with a potentially damaging impact on UK distinctiveness and innovation ▪ The PSBs are likely to face increasing competition from new entrants, including niche players, that may aggregate and distribute content on new connected platforms without the high costs of distribution associated with legacy broadcast networks
Genre diversity is likely to be maintained as a strategic goal	▪ Market developments are likely to place pressure on overall content budgets at the PSBs as a decline in live viewing may reduce overall advertising budgets invested in linear TV*. However, all PSBs will continue to consider broader strategic objectives when considering investment decisions, particularly in an evolutionary view of the future ▪ As a result, all PSBs are likely to continue to invest in quality, creativity and diversity, and to optimise their engagement with audiences across as many windows/platforms/genres as possible

** It is also possible that online fragmentation and a decline in linear viewing will increase the scarcity value of mass-market audiences secured by the PSBs within the broader TV market – with genres suited to live viewing (sport, news, live shows) placed at a premium over time*

It is possible to envisage future scenarios that could fundamentally threaten the sustainability of PSB funding...

Mediatique

- An evolutionary forecast of future developments does not necessarily represent fundamental challenges for the sustainability of PSB, not least as commercial broadcasters are able to adjust to market developments over time and to seize the opportunity to optimise commercial return across an increasing number of windows
- However, we have identified the key determinants of a more extreme case – as set out opposite. These conditions could fundamentally alter the business strategies of PSB funding across all commercial organisations, resulting in challenging economics and major changes in content investment decisions
- Any market outcome under these conditions would likely result in a withdrawal from PSB funding by ITV and Channel 5, and may leave Channel 4 at the sole commercial PSB – and even then with significant financial challenges in meeting its remit
- Any change to the dynamics of content supply (further consolidation, more US studio involvement in UK content production), even if it leads to higher cost inflation, may not be wholly negative for ITV (as a major content producer) but may still jeopardise certain PSB genres even at ITV and certainly at Channel 4

Conditions for a collapse in the sustainability of PSB content

Further systematic **decline and fragmentation in linear viewing** placing at risk the universal reach of PSBs and their ability to secure mass-market audiences

Change in audience tastes away from PSB channels and PSB content – perhaps towards new entrants or more niche content aggregators

Inflationary pressures on the cost of production in key genres (e.g., competition for talent, format inflation), or changes in terms of trade that favour independent producers at the expense of returns retained by broadcasters *(see page 74)*

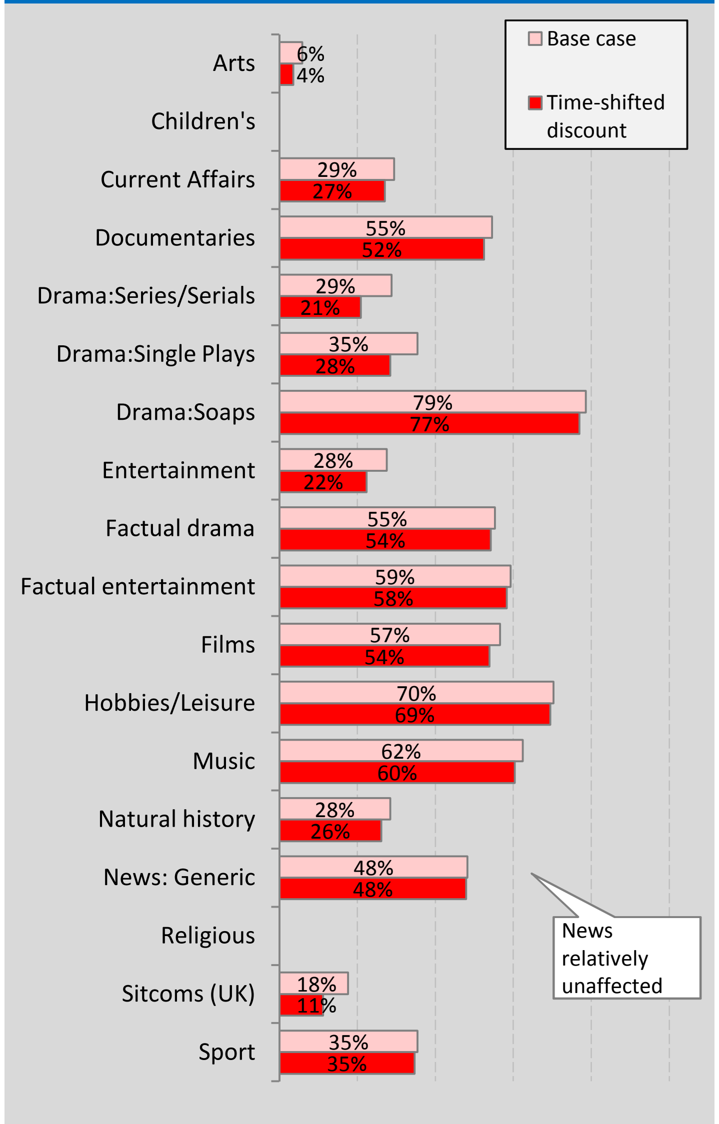
Change in market practice so that broadcasters are fully penalised for time-shifted/ad-skipped inventory – placing at risk (or removing entirely) any return from time-shifted viewing *(see overleaf)*

Deflationary advertising environment for TV – resulting in a decline in linear CPTs (in line with falling live viewing) and commoditisation of VOD CPTs (e.g., via automated trading)

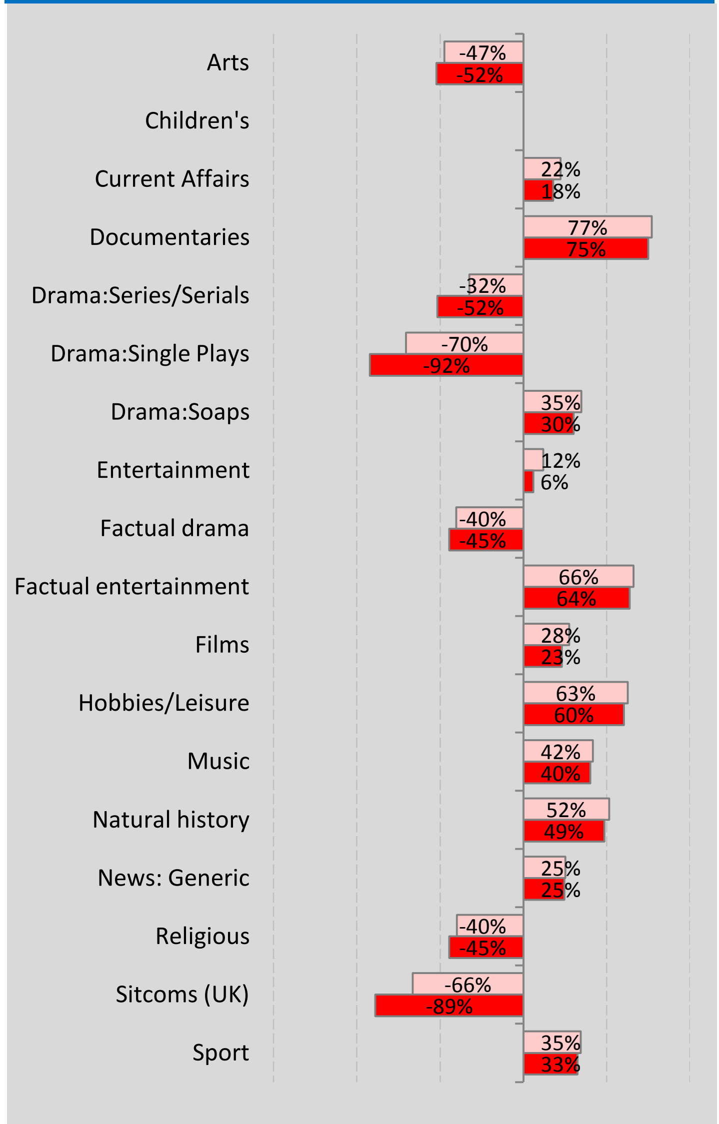
By way of illustration, we have sensitised the 2020 profitability calculations on the basis that all time-shifted viewing is not monetised – with consequential implications on genres that are more prone to time-shifting...

Base case shows 2020 profit margins based on current market practice, where time-shifted ads that are not fast-forwarded are monetised in line with live ads. Time-shifted discount shows profit margins where any ads that time-shifted are not monetised – hence those genres with a higher propensity towards time-shifted viewing are more likely to see profit margins fall in this scenario

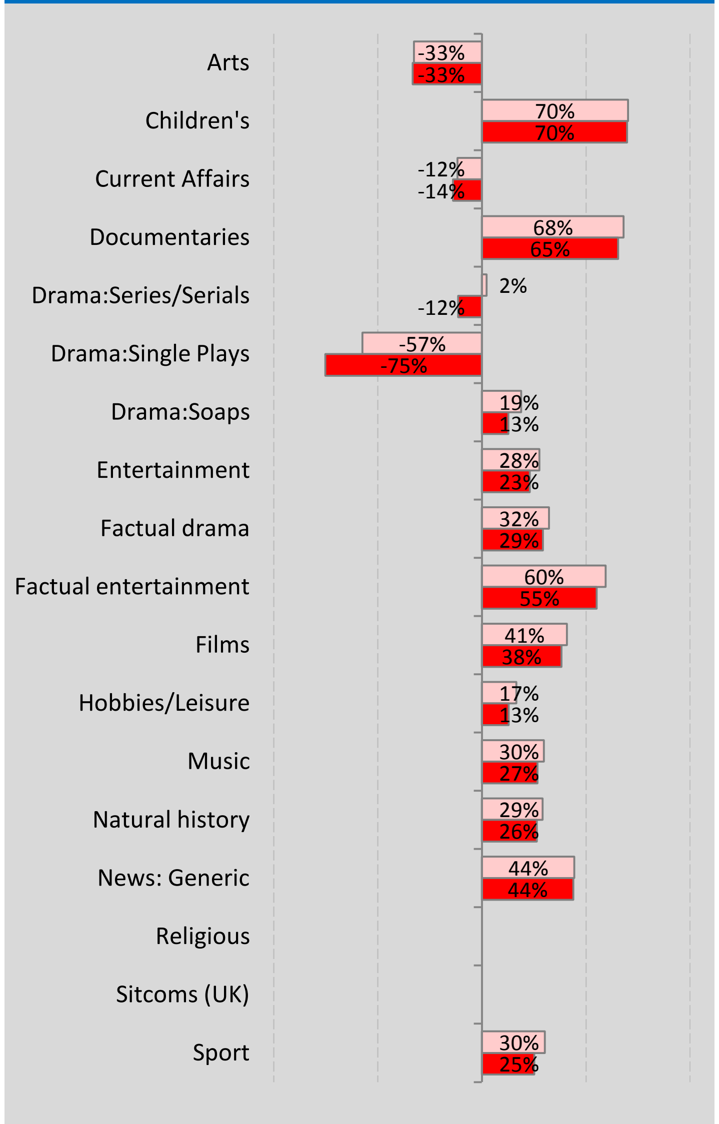
ITV gross profit margin contribution, by genre (peak hours 2020, %)



Channel 4 gross profit margin contribution, by genre (peak hours 2020, %)



Channel 5 gross profit margin contribution, by genre (peak hours 2020, %)



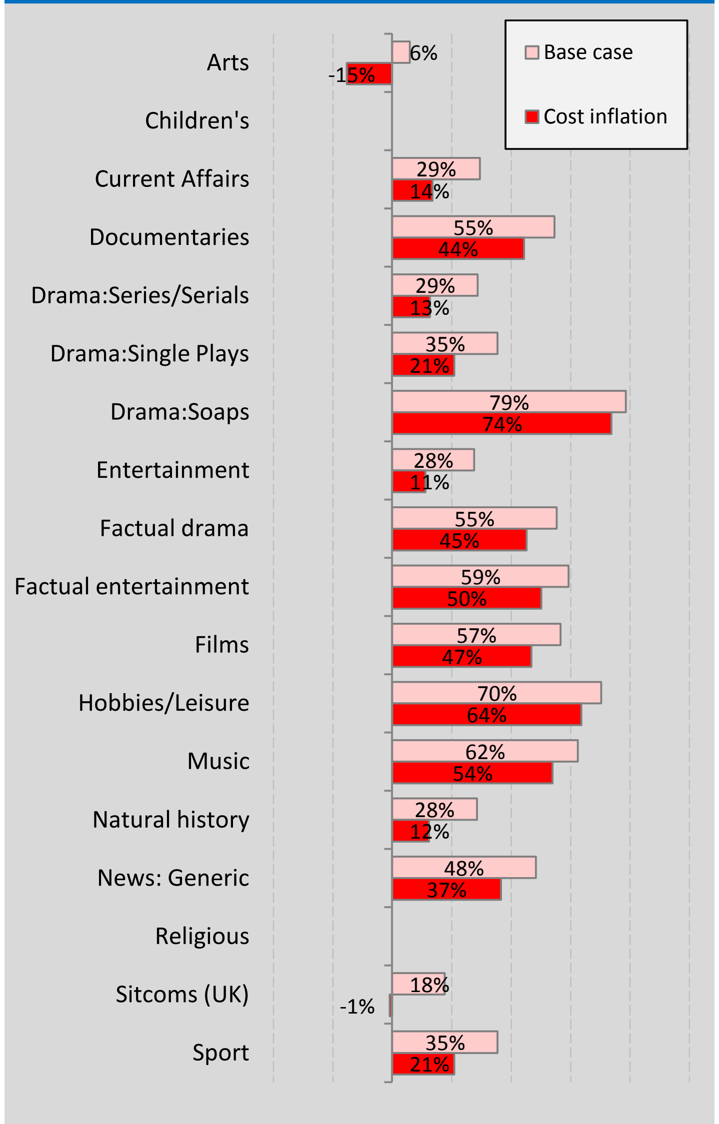
Source: Mediatique model. Genres with no written % indicate absence of programmes from that channel's schedule

All figures show gross profit/loss margin

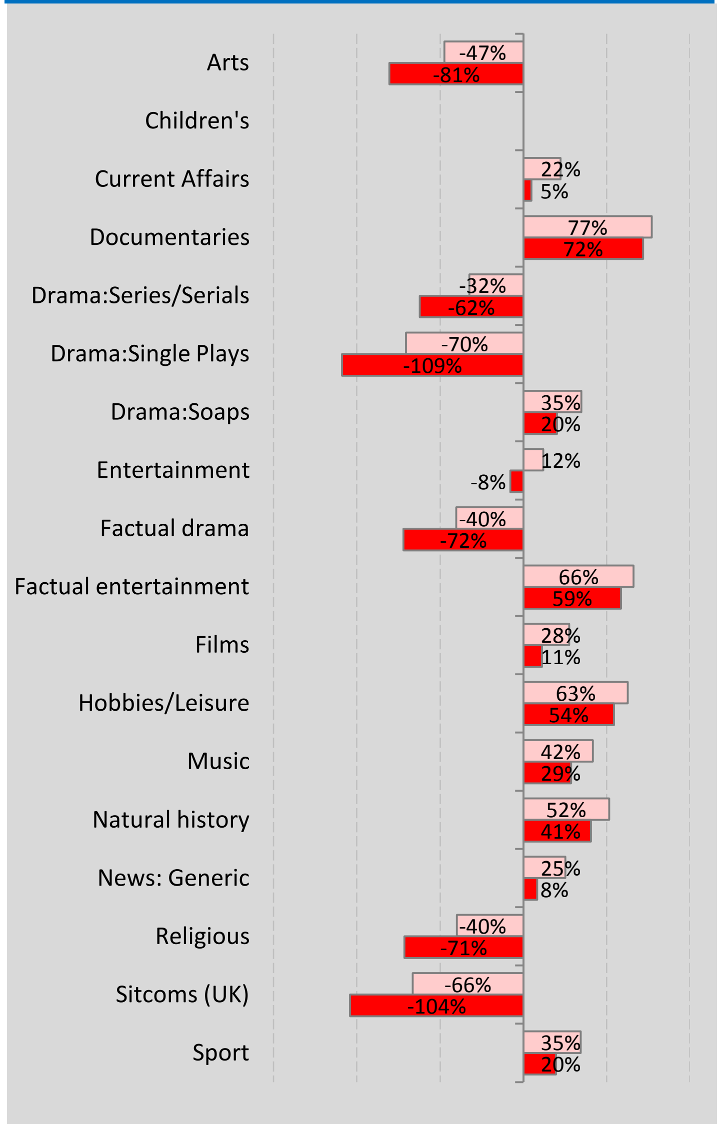
We have also sensitised the 2020 profitability calculations by genre on the basis of a higher inflationary outcome in the cost of production across all genres...

Base case shows 2020 profit margins where content costs are assumed to increase by 1.5% per year. Cost inflation shows profit margins where content costs increase by 5% a year, in line with a n inflationary environment for content production and talent

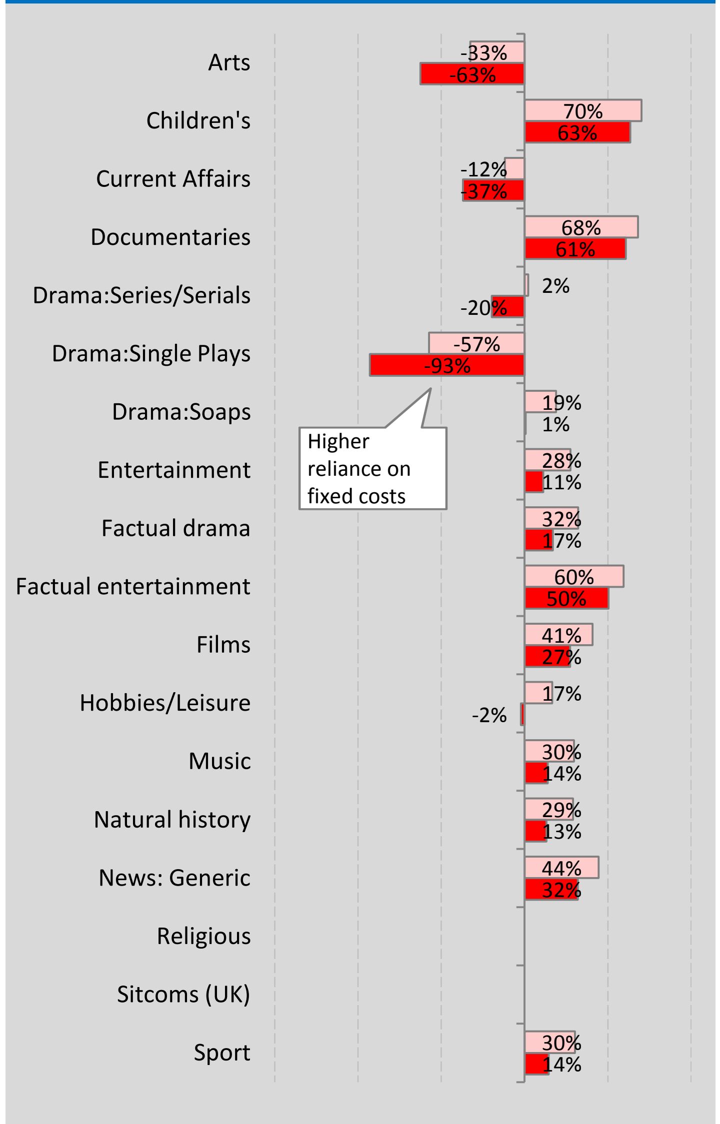
ITV gross profit margin contribution, by genre (peak hours 2020, %)



Channel 4 gross profit margin contribution, by genre (peak hours 2020, %)



Channel 5 gross profit margin contribution, by genre (peak hours 2020, %)



Source: Mediatique model. Genres with no written % indicate absence of programmes from that channel's schedule

All figures show gross profit/loss margin

Our view is that the conditions required to result in *fundamental* challenges to the sustainability of PSB genres are unlikely to materialise over the medium term...

Condition required	Mediatique view
Further fragmentation of linear viewing	▪ The PSBs have maintained their position within the linear environment following digital switchover, and they continue to invest in quality content and to optimise their distribution to retain this ▪ The greater threat remains fragmentation from emerging digital opportunities; however, the PSBs have extended their brands and content investment into the digital arena in order to retain audience traction
Change in audience tastes away from PSB channels	▪ The PSBs have retained near-universal reach, and continue to secure more than 70% of all viewing share across linear viewing; they also retain similar levels of engagement in non-linear consumption ▪ These outcomes reflect the continuing primacy of PSB content within consumer preferences and exist despite the significant – and growing – opportunities to source content elsewhere
Change in market practice placing monetisation of time-shifted viewing at risk	▪ Market practice already precludes the sale of commercial inventory that is ad-skipped, but allows broadcasters to monetise time-shifted viewing if watched without being fast-forwarded ▪ This seems likely to continue as broadcasters and advertisers are similarly incentivised to reach audiences that are engaged whether on a live basis or on a basis enabled by changes in technology
Deflationary advertising environment for TV	▪ TV remains a crucial medium for advertisers, particularly for brand advertising which is ideally suited to video display. TV has remained relatively resilient against new forms of digital advertising, and the commercial PSBs are presenting advertisers with holistic opportunities to advertise across linear and non-linear audiences, thereby supporting marketing investment in TV despite shifting viewing behaviours
Inflationary pressures in the cost of production	▪ The PSBs face competition for talent and ideas from other broadcasters (e.g., Sky) and increasingly from new entrants (e.g., Netflix, Amazon) which will inevitably lead to some upward pricing pressure ▪ The PSBs' relative scale allows them to withstand some of this pressure, and indeed to offset inflation (e.g., investment in production technology, leverage of prior relationships with talent, ownership of formats/production resources)

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