Comments on the “Economics of Local Digital Audiovisual and Interactive Services”, a paper for Ofcom and the DCMS by Spectrum Strategy

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1.1 Introduction and Summary

Ofcom’s 2004-5 review of Public service Broadcasting (PSB) identified local TV as a potentially important element of the future PSB mix. However, the economic viability of local services was not established at the time and Ofcom undertook to carry out further research on the prospects for local digital content services. As part of this work it (together with the Department for Culture Media and Sport (DCMS)) commissioned Spectrum Strategy to assess the economics of delivering local digital services. The paper produced by Spectrum Strategy, ‘The Economics of Delivering Local Digital Audio-visual and Interactive Services’ (which we refer to as Spectrum (2005)) provided input to an Ofcom consultation titled ‘Digital Local’.[1]

Spectrum (2005) determines whether a local digital TV service is viable based on a snapshot of financial performance at year 3 after switchover i.e. 2015, though generally market data for 2005 is used in Spectrum’s model. Spectrum finds that services delivered to urban areas and to smaller communities are not profitable. Only local digital TV services serving large metropolitan areas are found to be viable, though Spectrum suggests that more favourable outcomes might be achieved if a network-affiliate model was adopted in which numerous local TV stations shared costs and jointly marketed their airtime.

This note assesses the modelling undertaken by Spectrum (2005), in the light of more recent market evidence and research, with a view to drawing conclusions on the likely viability of digital local TV services. We provide a brief overview of the Spectrum (2005) paper and then assess the key modelling assumptions. Our analysis focuses on Spectrum (2005)’s core scenarios, which all assume some original production whenever the service is broadcast. We do not consider that a broadcast channel with only user generated content would be viable, as such content would be highly unattractive relative to competing TV channels.

Our main finding is that Spectrum’s conclusions are overly optimistic. Local digital TV is likely to be unprofitable in all areas including large metropolitan areas. The reasons for this are as follows

- In 2015 TV will be operating in a much more competitive market. It is already facing erosion of viewing and revenues mainly due to the impact of the Internet. These trends will continue as broadband penetration and consumption of on-demand media grow. Local TV will also face

[1] http://www.ofcom.org.uk/tv/psb_review/digital_local/

competition for audiences and revenues from local and niche audio-visual services launched over broadband and from mobile TV.

- The TV market itself is becoming more competitive in the context of the growth in multi-channel viewing, and the resulting fragmentation of audience share between channels.

- Ofcom has found " viewers are interested in local TV content but quality of content is key".[2] Spectrum's assumed programme spend for local TV is very low at around £1,000/hour or less (compared with say £27,000/hour for regional programmes on PSBs). This means there would not be the budget to pay for quality talent (the consequence would be poor or inexperienced presenters) and production (meaning a relatively poor 'look and feel' of the programming) among other areas. By 2015 content on a number of distribution platforms (e.g. cable, satellite, DTT, DVDs and games) will be in high definition (HD), which will further reduce the attractiveness of low cost local digital TV.

- The 3% audience share assumption for local digital TV used by Spectrum is optimistic even for today's market. This share is more than many much better funded channels currently achieve (e.g. ITV2, Sky One, BBC3 and BBC4). A share well below 1% would seem much more realistic.

- An audience share of 1% or less would mean that the local TV services modelled by Spectrum would all be highly unprofitable, even in metropolitan areas, as revenues would fall by two thirds and there would be little offsetting reduction in costs. To make matters worse lower audience shares are generally associated with lower achievable advertising rates further reducing the revenue earning capacity of local digital TV.

The finding that local digital TV appears to have poor financial prospects should not come as a surprise. This reflects the actual performance of local TV in the UK. In addition, we note that Ofcom is now concerned that even the relatively well funded commercial public service broadcasters will not be able sustain regional and local news services in future.[3]

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[2] Digital Dividend Review Local TV Stakeholder Event, September 2007

[3] New News, Future News; the challenges for television news after Digital Switchover, Ofcom, June 2007 http://www.ofcom.org.uk/research/tv/reports/newnews/

1.2 Spectrum (2005) finds local digital TV is unprofitable outside metropolitan areas

Spectrum (2005) undertakes economic modelling of a number of local digital audio-visual scenarios where the scenarios vary according to the size of the population served, the type of content distributed, the duration of broadcasts and the delivery platform used (DTT, cable, satellite, TV over DSL and/or broadband). It is assumed that services commence operation in 2013.[4] Profitability is assessed with reference to a snapshot of the EBITDA at year 3 (i.e. in 2015) and the business is said to be sustainable if it has a positive EBITDA at that time.

Spectrum (2005) reports financial results for eight core scenarios (see Table 1 for a summary). The results indicate that the prospects for commercial local digital TV are not good. The hypothetical local digital TV provider is found to be profitable in only two of the eight scenarios (i.e. scenarios VIII and XII) modelled, though in one further scenario (XVI) small losses are incurred. The common feature of these 'profitable' scenarios is that they all involve delivering services to large metropolitan areas (where the potential audience is 1-2.5m people). An assessment by Arqiva suggests that there are at most five metropolitan TV markets in the UK that could fit this definition – Greater London, West Midlands urban area, Greater Manchester, West Yorkshire urban area and Greater Glasgow. Spectrum (2005) also finds that digital terrestrial television (DTT) is central to the delivery of a profitable digital local TV service in metropolitan areas. [5]

Table 1: Summary of Spectrum Findings for Core Scenarios

Scenario	Platform	Reach	Content	Profitable in year 3?
I	Broadband	Micro (20k)	User generated 4 hours/day	No
VI	Broadband, DTT	Dispersed (20-100k)	Min local news 8 hours/day	No
VII	Broadband, DTT, cable	Urban (100-750k)	Min local news 8 hours/day	No
VIII	Broadband, DTT, cable, satellite	Metro (1-2.5m)	Min local news 8 hours/day	Yes
XI	Broadband, DTT, cable	Urban (100-750k)	Local news +acquired 18 hours/day	No
XII	Broadband, DTT, cable, satellite	Metro (1-2.5m)	Local news +acquired 18 hours/day	Yes
XV	Broadband, DTT, cable	Urban (100-750k)	Local news + originated 18 hours/day	No
XVI	Broadband, DTT, cable, satellite	Metro (1-2.5m)	Local news + originated 18 hours/day	No, but losses small

Note: profitable or nearly profitable scenarios are shaded in orange

[4] We have assumed that switchover is completed in accordance with current plans i.e. by the end of 2012.
[5] Section 1.1, Spectrum (2005)

These findings are perhaps not surprising given the chequered history of local TV in the UK. For example[6]

- Six TV, the local channel broadcast in Southampton and Oxford over analogue signals, has been in financial difficulty. It has been unable to attract significant advertising revenues. Six TV constitutes the TV division of the Milestone Group Plc (MLG.L), and sustained a loss of £96k from a turnover of £76k in 2006 (a margin of -126%). Six TV previously broadcast in Portsmouth but has ceased transmission.

- C9TV, which has a licence from Ofcom to broadcast in the North West of Northern Ireland, was found by Ofcom in March 2007 to be in serious breach of its licence for failing to broadcast sufficient levels of local content. C9TV has gradually replaced local programming with more commercially viable music video content.

- A number of high profile local TV channels that launched on cable (each with the backing of major media) have failed

    - Channel One (London and Bristol), which was wholly owned by DMGT and closed in 1998 after 4 years despite securing an agreement with the London cable companies to provide Channel One with guaranteed revenue and promotion of the channel to subscribers

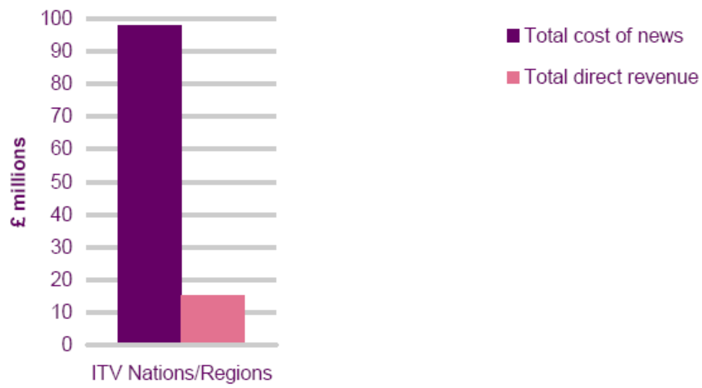
    - Channel One Liverpool Ltd, a joint venture between DMGT & the Trinity Group plc, which closed sometime after 2001 despite being supported by the *Liverpool Post and Echo*.

    - L!ve TV, owned by Mirror Group, closed in 1999.

The core of local TV services is local news. Recent research by Ofcom confirms the challenge of profitably providing regional and local news today.[7] As shown in the figure below provision of local news by ITV is not profitable. This is largely because unlike network programming the local programme costs are duplicated across all 15 regions, though the audience share for ITV's regional news has also fallen (from 25% in 2001 to 20% in 2006). Not surprisingly ITV has recently announced that it plans to cut back on its regional and local programming spend by around £40m.[8] Ofcom also concludes from its analysis of these data that new forms of public intervention will be required to secure the long term presence of regional and local news on commercial public service broadcasting.

[6] See also http://www.commedia.org.uk/about-community-media/community-television/history-of-community-television-in-the-uk/
[7] New news, Future News; the challenges for television news after Digital Switchover, Ofcom, June 2007 http://www.ofcom.org.uk/research/tv/reports/newnews/
[8] http://www.guardian.co.uk/media/2007/sep/12/ITV.citynews

Figure 4.7: Direct revenues and costs of ITV1 nations/regions news



Source: New News, Future News, Ofcom, June 2007

1.3 Spectrum (2005)'s conclusions are overly optimistic

While the prospects for local digital TV indicated by the Spectrum (2005) report are not good we consider there are strong grounds for thinking they are still are overly optimistic. Below we present evidence to support the view that the market will be more competitive than Spectrum assumes and Spectrum (2005)'s audience share and advertising revenue assumptions will not be fulfilled given the assumed programme budgets.

1.3.1 The market in 2015 will be much more challenging for local digital TV

The economic model presented by Spectrum is calibrated only for one year - 2015. The data used to calibrate the model is generally "current" 2005 data. The issue of whether data for 2005 is appropriate for modelling outcomes in 2015 is not considered by Spectrum. However, there are a number of trends in the TV market that mean that the context for local TV in 2015 will be very different from that in 2005.

- All households will be multi-channel households after switchover in 2012, meaning that local TV will face a far more competitive environment than it did in 2005 when it was broadcast in analogue format and was often competing for attention with only 4 or 5 other channels[9].
- TV viewing levels have fallen in recent years by around 3-4%, as has radio listening, while average Internet use has risen substantially (around 158%) since 2002[10] and use of mobile phones, with mobile Internet and advertising starting to take off, continues to increase. These changes are most pronounced in young people (aged 16-24) who spend 7 hours less per week watching TV than the general population. This age group is very attractive to advertisers because many purchasing habits are established at this time when a high proportion of income tends to be disposable. The growth in time-shifting through the use of PVRs means that it is

[9] Multi-channel penetration at Q1 2005 was 64.9% as compared with 81.7% in Q1 2007. Figure 2.58, The Communications Market 2007, Television, Ofcom, August 2007
[10] http://www.ofcom.org.uk/research/cm/cmr07/ccm/

also harder for advertisers to reach audiences. These factors are tending to make TV advertising less attractive than before. UK TV advertising revenues fell in nominal terms in 2006 and television's share of total advertising fell by 3.6% between 2000 and 2006 mainly as a result of gains made by Internet advertising.[11] These trends are expected to continue.[12]

- The advent of mobile TV (an expected new entrant to the UK market place as a result of the spectrum freed up from digital switchover or air traffic control spectrum (UHF Channel 36)), could have a negative impact on the viewing of traditional TV and advertising revenues. Given a mobile phone can be tracked to its locality at any point in time, it also begs the question whether a more credible route to market for local advertisers would be as part of a mobile TV package as opposed to a DTT model. So as you walk pass a street, you would receive an advert/text on your phone for the "specials" at the restaurant at the end of the street, etc. This would be in addition to growing use of Hypertag technology[13], where promotional messages, coupons etc are broadcast directly to mobile phones in the vicinity of a suitably-equipped billboard.

- HDTV seems likely to become a technology with widespread appeal, rather than a niche product. This assumption is based on the growing market evidence of the popularity of available HD services[14], rapid growth in the take-up of HD ready TV sets (see figures below),[15] high consumer awareness of the service and market research showing that consumers expect that they will be able to receive HD TV in future. [16] Low quality standard definition programming will look increasingly unattractive as consumption of HD content (TV, DVDs and games) grows. Evidence from households with HDTV is that SDTV channels are usually considered last when selecting channels[17].

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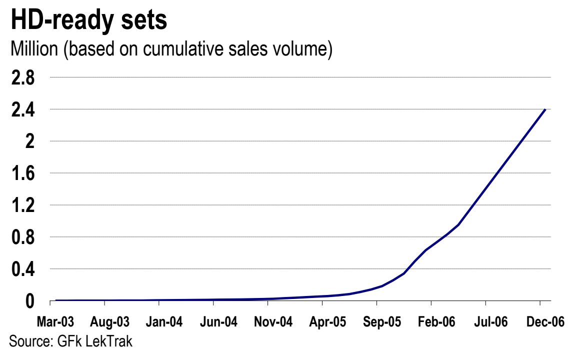
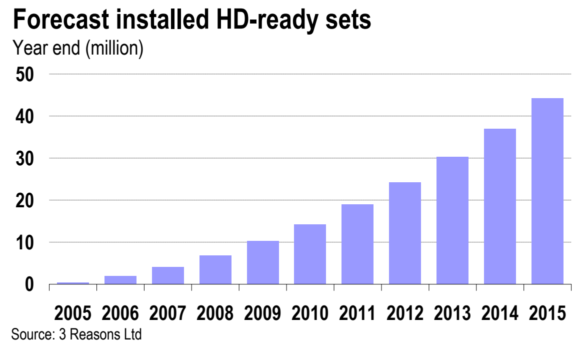
[11] Advertising Statistics Yearbooks
[12] Financial Review of Channel 4, Ofcom, 2007
http://www.ofcom.org.uk/tv/psb_review/c4review/lek/lek_full_report.pdf
[13] http://www.hypertag.com/
[14] By end September -2007 BSkyB had 358,000 HD subscribers – the fastest customer take-up of a new Sky product. Virgin has 150,000 HD subscribers. Communications Market 2007, Ofcom, http://www.ofcom.org.uk/research/cm/cmr07/
[15] Over five times as many HD-ready television sets (2,377,000) were sold in the year to December 2006, compared with 2005. GfK research; January 2007
[16] Research on public expectations of High Definition TV, BRMB for Digital UK, 23 February 2007
[17] Ofcom, Communications Market 2007





- Niche and local online video services are already emerging that could meet consumer demand for local video content and advertisers' requirements for advertising with measurable effects aimed at particular communities of interest. Examples include ITV local - a portal that launched as a trial in Brighton and Hastings in 2005 and following this success has now been rolled out to 11 UK regions, covering the whole of England and Wales- and services such as Brightcove, Narrowstep, Maven and Roo which have developed recently online, and offer the opportunity to present niche content to a wide audience. For example, Narrowstep offers over 180 channels in content areas such as field hockey, Land Rover cars, marine life, and equestrian sports.

By 2012 broadband penetration is forecast to be around 77% of UK households.[18] By 2015 it will be higher still. The move towards delivery of local content over broadband rather than other broadcast TV platforms therefore seems likely to continue because

- Internet advertising (unlike television) can work well at a local / niche level. Operators of broadband video services will be able to track audiences precisely, overcoming the problem for local television of relying on highly approximate audience estimates gathered from consumer research
- Internet advertising can be sold through internet advertising networks (e.g. DoubleClick, Aquantive, Right Media, Blue Lithium) enabling small niche / local services to capture share of the total internet advertising market
- Production costs for making advertising for local internet services are lower than for local television
- Programming costs could also be lower on broadband than television. Given the on-demand nature of viewing there will not be the need to fill a channel for 24 hours a day, but only to provide a selection of discrete programmes for viewers to choose from.

Finally, we note that Spectrum (2005)'s analysis does not explicitly take account of competitive reactions from the local newspaper and radio markets as the world around them goes digital.

[18]Source: European Internet Access Forecast, 2007-2012, Jupiter Research

All of these changes mean that local digital TV, with its relatively low cost output (see below), will find it increasingly difficult to attract audience and will face a much more competitive market for advertising revenues by 2015.

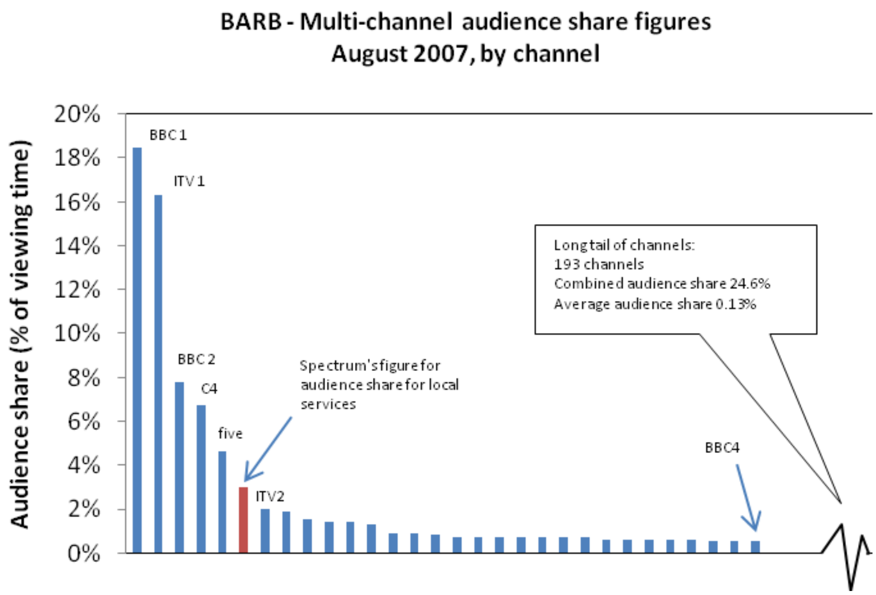
1.3.2 A 3% audience share assumption for local digital TV is too high

Spectrum (2005) assumes that in **all** scenarios local digital TV achieves an audience share of 3%. The basis for this assumption is unclear. Spectrum (p78) notes that two local TV channels (Channel m[19] and Channel 9) report peak viewing shares in excess of 3%, but also comment (p14) that the BARB audience system (which is used by the BBC and all commercial channels of any significance) is not used to measure audiences for such local TV operators. The source of the 3% share assumption is therefore highly questionable.

Evidence that the 3% audience share assumption is likely to be too high comes from an examination of the audience share data collected by BARB. A 3% audience share for a local TV channel would place it (in any given region) between five (4.6% share in August 2007) and ITV2 (2.0% audience share in August 2007) – see the figure below. In our view, such a high audience share is not credible given the low assumed programming spend of the local TV service. To put it in perspective, Five spent £107m on first-run original programming alone[20] (i.e. excluding its spend on acquisitions and repeats) in 2006 to achieve a 4.6% share (in any given region) where as Spectrum's local digital TV operator is assumed to spend at most £2m to achieve a 3% audience share. If this was credible we would see TV channels adopting this model.

[19] Channel m enjoys scarce analogue spectrum / limited competition, unlike any future local TV services that would compete with 30-40+ channels, and Channel m further benefits from synergies with the *Manchester Evening News* and *Stockport Times*, both owned by parent company *Guardian Media Group*.

[20] Ofcom, Communications Market 2007

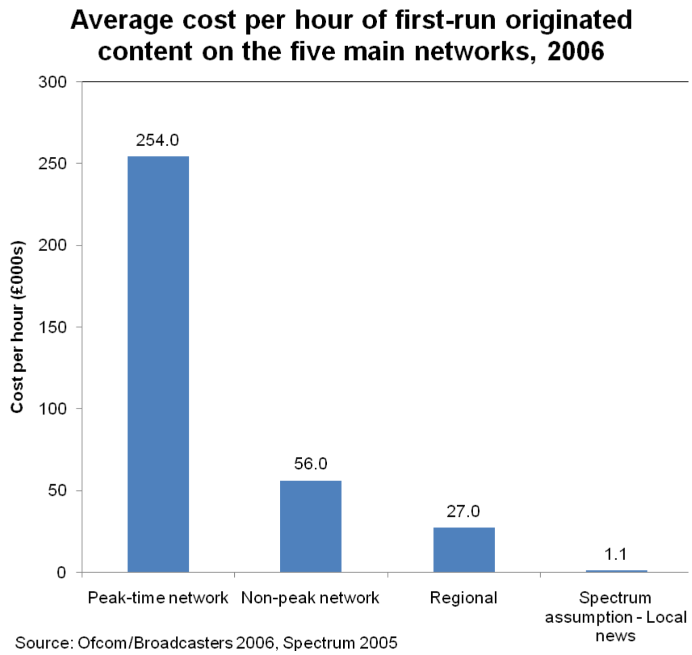


There is a growing 'long tail' of channels with an audience share of less than 0.5%, that have an average audience share of 0.13%. These tend to be thematic channels that fill their schedules with acquired international programming. Though the cost of this programming is relatively low (enabling these channels to be viable) the quality is high as the high original production costs are shared across many markets. Therefore, in our view it will be challenging for the local TV channels to reach even audience share levels of 0.5% or less.

Now it might be argued that local TV has special appeal that mean it is able to attract audiences despite its relatively low hourly programme spend (see figure below). However Ofcom has found that "audience research confirms viewers are interested in local TV content but quality of content is key".[21] With programme spend around £1,000/hour programme quality will not be high; by contrast BBC spending on news and weather was on average £25,900 per hour for 2006/7[22]. At £1,000/hour there would not be the budget to pay for quality talent (the consequence would be poor or inexperienced presenters) and production (meaning a relatively poor 'look and feel' of the programming) among other areas. It is highly unlikely that this type of programming would attract sizeable audiences. Even smaller audiences would be expected for scenarios with user generated content.

[21] Digital Dividend Review Local TV Stakeholder Event, September 2007

[22] This is the average for national and regional news and weather. Table 15, p73, BBC Annual Report and Accounts 2006/7.



In conclusion we consider that current market information would suggest that local digital TV channels would be highly unlikely to achieve an audience share in excess of 1%. Even lower audience share figures seem likely in 2015 when the TV market will be much more competitive. To make matters worse lower audience shares are generally associated with lower achievable advertising rates further reducing the revenue earning capacity of the channel. Even if local digital TV was to achieve a 1% audience share it would be ***highly unprofitable in all the scenarios*** Spectrum (2005) models, for revenues would fall by two thirds and only sales and marketing costs would fall.