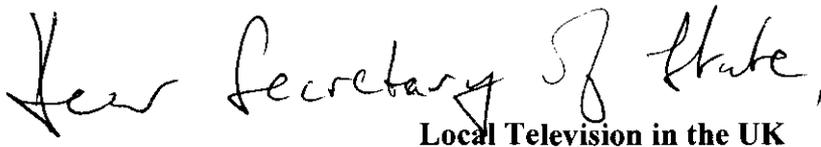


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Rt. Hon. Jeremy Hunt M.P.,
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9th December, 2010


Local Television in the UK

I last wrote to you in relation to this matter on 24th September. My letter took the form of an Interim Report, describing the findings and emerging thoughts of the Steering Group and outlining some of the further work to be done. The Steering Group has now completed its investigations and, accordingly, I am pleased to submit to you the Final Report.

The Report contains an Executive Summary and so I do not wish, in this letter, to duplicate that. However, I should like to summarise some key points, which culminate in the view that, in the long term, local TV can be commercially viable, as and when IPTV gains sufficient market penetration; and that, in the short to medium term, commercial viability of local TV delivered by DTT is achievable, as long as the minimum conditions set out in the Final Report are met and the assumptions set out in the summary of this letter prove to be valid.

The Long Term

I referred, in the Interim Report, to distribution of television services by IPTV, whose prospects have improved since my last letter, with Ofcom's decision not to investigate the proposed launch of YouView in 2011 and the Government's announced plan to roll out super-fast broadband to every community in the UK by 2015. The Steering Group has discussed this technology with various parties and, although it may take some length of time to achieve worthwhile market penetration, we are encouraged by the very widely held belief that it will do so (and, indeed, could overtake DTT as the principal means of television delivery in the U.K.) and that it will lend itself naturally to local TV. This is so because when the Government's broadband ambitions are achieved, it will be possible to deliver local TV services to even the most sparsely populated areas at considerably lower cost than over DTT - in fact, as the Interim Report explained, it is almost certainly uneconomic to deliver local TV services over DTT to these areas at all. Moreover, IPTV will facilitate the delivery of far more localised television than could ever be envisaged over DTT and, because of its 'non-linear' nature (in other words, viewers can access the content they want, when they want it) and the ability of viewers to participate (for example, by interactive 'blogs' or by up-loading video clips), it is likely to encourage real involvement at local community level - we regard this as wholly consistent with the perceived social benefits of local TV, about which there is widespread agreement.

As it happens, we believe that IPTV can also be of great benefit to existing local or regional media businesses, many of which are facing the challenge of significant structural change in their business models. As noted in the Interim Report, we believe that the facility of IPTV to combine text, video, web links and consumer interactivity holds out the prospect of a different and healthier business model. To seize the opportunity, we believe that existing operators will need to think of themselves no longer as newspaper or radio or television businesses, but rather as providers of news, entertainment and other content, delivered to their customers when they want it and in whatever form they want it. Of course, your stated intention to relax cross-media ownership rules will be an important step in this direction.

So, for these reasons, even though the precise shape of the new landscape described above may take years to evolve, the Steering Group is optimistic that local TV may be commercially viable in the long term, as part of a broad multi-layered, multi-platform local proposition.

The Short to Medium Term

This then leaves us needing to address the commercial viability of local TV in the more near-term future which, given the comments about IPTV, we regard as being a transitional period and during which, as stipulated by you, delivery must be, at least principally, by DTT. Many of the preliminary thoughts set out in the Interim Report have, following further deliberation, now become firm conclusions. These (and in many instances I repeat word-for-word the relevant parts of the Interim Report), together with subsequent conclusions, include the following:

- local television in sparsely populated areas cannot be commercially viable on DTT, because of the twin pressures of significant transmission costs and weak advertiser demand for dispersed audiences;
- even in densely populated urban areas, the economics of a TV business funded mainly by local advertising will still be challenging, given the steady structural decline in local and regional advertising expenditure, caused partly by the continuing rise of the internet and partly by the fact that High Streets are increasingly populated by national chains;
- additional revenue sources will therefore be necessary. The Interim Report pointed to the possibility of locally generated news content being sold to other broadcasters and we are therefore pleased to see that the BBC has agreed to spend up to £5 million per annum for three years on purchasing content from local TV services. Beyond this, we believe there is scope to generate a certain amount of national advertising revenue, but success in this may well depend on having a sales agent with the necessary skills and experience and with presence of some scale in the market already; on having geographic coverage that is as close to fully national as possible; and on the local TV services working together. I refer to each of these below;
- new technology should allow for much reduced costs without necessarily resulting in a reduction in production quality. However, in general, great care must be taken to ensure that the understandable drive for ever lower costs does not result in impaired quality of content: we profoundly believe that inferior quality will be fatal. In this connection, we believe that any requirement on the

part of the BBC for there to be a minimum quality threshold as part of its agreement to purchase locally generated content would be a positively good thing;

- the task of building and maintaining an audience should not be underestimated: although research points to consumer demand for local content, it is substantially for news or news-type programming, implying that maintaining audiences at viable levels for lengthy periods will be challenging, to say the least; but symmetrically, on the supply side filling an entire schedule may well be equally challenging. It therefore serves us well to think not of local TV channels, but of local TV services; and
- to help to meet those challenges local TV services will have to co-operate with one another to form a national 'backbone'. The purpose of this backbone will be to provide programming to augment the schedules of the local TV services; to eliminate duplication of local TV services' costs wherever possible, by sharing; to promote the generic concept of local TV services; and, crucially, to maximise national advertising revenues, either by means of an in-house sales team or, perhaps more desirably, in conjunction with a sales agent, as noted above. We continue to believe that having a single channel number which is common to all local TV services and which is in a prominent position on the EPG will be very important.

Ownership

I should comment on ownership structures. At the level of the individual local TV services, we believe that some involvement on the part of existing media operators would be beneficial, because of their established news gathering capabilities, their market knowledge and audience relationships and also because of the opportunities for cross-promotion. We hope that these existing operators will perceive that the benefits of their involvement would not accrue solely to the local TV services – we hope they will regard this as an important part of the reshaping of the media landscape, as described earlier in this letter. As to the level of any participation on their part, we do not have any objection to their having more than 50%, but we recommend that room should be left in the ownership structure for local enterprises and also for a cross-shareholding from the national backbone referred to earlier.

This latter point takes me to the ownership of the national backbone itself: we believe it is important that the local TV services should be encouraged to own, collectively, at least 51%, but we would not object to a third party (or parties) having an equity involvement up to 49%. Whether or not third parties will wish to participate will depend on the nature of the national backbone – if, for example, it has no responsibility for selling national advertising, then it will be little more than a service provider (rather like the old ITV Network Centre) with no obvious scope for a return on investment; conversely, if the advertising sales were not contracted out to a sales agent, it is possible that a third party may see it as an investment opportunity, with advertising sales being an area where value could be added. We do not think there should be any objection to an existing broadcaster being the owner of up to 49% of this entity, opening up the possibility of a model where national advertising sales are not contracted out to an agent, but handled in-house with the help of a large minority shareholder with relevant skills and experience.

Taken together, these suggested ownership structures of the local services and of the national backbone are designed to provide stability for local TV services (we have considered other structures, described in the main report, but we are concerned that, in some instances, the national backbone might take on a life of its own and seek to abandon the local services it is designed to support).

DTT Delivery Options

We have spent a considerable amount of time exploring technical delivery options, with valuable help from Ofcom. At a simplified level, some of the issues are easy to grasp: the opportunity cost of awarding 800 mhz or 600 mhz spectrum to local TV services would be enormous, so that this option can be ruled out straight away. But the comparison between, for example, Geographic Interleaved spectrum (GI) and, say, spectrum on a commercial multiplex is more complex: GI is less expensive and lends itself quite well to localisation, but it does not provide a full national footprint and is not available in major conurbations such as Bristol. The Steering Group does not feel competent to evaluate all the technical aspects of this important matter, so we recommend that you discuss the options with Ofcom. The final decision should take into account cost; ability to localise; and total coverage achieved (because the extent of national coverage will have a bearing on the amount of national advertising revenue that can be obtained).

The Nations and Regions

In the Interim Report, I mentioned it will be vital to take account of the particular requirements of the Nations and the Regions. By its very nature, local TV should be designed to cater for these specific requirements and it must not become just another London-centric medium. For this reason, the programming provided by the national backbone must be capable of being varied for different parts of the country – this should be perfectly possible, as we do not envisage much (if any) live programming from the national backbone but, rather, a 'library' of content from which individual operators can choose and which can be played out when they wish.

The main report discusses Northern Ireland, Scotland and Wales in more detail, but I should make reference here to what may be viable from a commercial standpoint: during the transitional period until IPTV has adequate market penetration, we are doubtful that more than about ten or twelve local TV services, based on urban areas, will be sustainable throughout the UK, given the requirement for delivery to be over DTT, and we have run our financial models on this basis. However, this does not mean that we are being prescriptive in saying that the number of local TV services should be limited to ten or twelve or, for that matter, that the conurbations that benefit from having a service should be chosen by rank order of size – this would mean that Wales and Northern Ireland might have no service at all. The process of awarding local TV licences is very important in this regard: whatever mechanic is selected for the award of local licences, we recommend that it should afford a high weighting to robust and sustainable business plans. This could mean that the number of licences awarded exceeds our expectations and could also mean that licences are awarded for some of the smaller conurbations.

Profitability

We have examined illustrative Profit & Loss models, using both revenue and cost inputs provided by credible industry sources and which we consider to be sound. The financial analysis suggests that the costs of the ten services and the National backbone combined

would be of the order of £25m per annum. We think it highly improbable that local TV could be profitable if it depended on local advertising revenue alone. However, we believe that there should be scope for some national advertising revenues, given a network founded on ten or so major conurbations – we believe that to have confidence in the possibility of profitability, it will be important to place a national advertising sales contract with a third party, with a minimum level of £15m per annum of revenue guaranteed (and a relatively attractive commission level probably being necessary to compensate for the guarantee). It is possible that such a third party may wish to be a shareholder in the national backbone in order to have some reasonable say in the conduct of that operation and, as indicated above, we would have no objection to that.

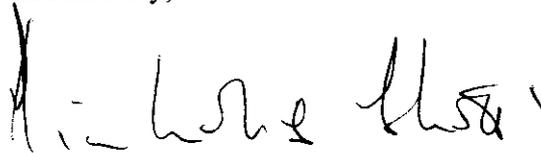
This would leave a gap of £10m per annum. Whilst we think it would be worth exploring further the scope for the local TV sector collectively to be sponsored, we are not optimistic that much in the way of this form of revenue will be forthcoming. On the other hand, the BBC's commitment to acquire locally generated news content for up to £5m per annum for three years clearly makes a material contribution to closing this gap. In addition, we have some confidence that local advertising revenues could exceed £5m per annum, especially if the local services were helped in this endeavour by the involvement of existing media operators, as suggested earlier. In time, this could eliminate the loss and perhaps even lead to acceptable levels of profit.

Summary

Your original brief to me was to describe the conditions necessary for local TV in the UK to be commercially viable. In the long term, the Steering Group is optimistic that IPTV will help to sustain local TV, within the context of a re-shaped and more vibrant local and regional media sector. For the short to medium term, the Final Report sets out the minimum conditions that we believe would be required for local TV to be commercially viable, within the context of your stipulation that it should be delivered principally by DTT. If these conditions are met (including importantly the £15m per annum of underwriting of national advertising sales), and £5m per annum of local revenues can be achieved as discussed above, then we can see that commercial viability is achievable, at least in the medium term while a £5m per annum commercial agreement with the BBC can be relied upon until 2016/17.

Finally, I should like to repeat my sincere thanks and profound appreciation for the enormous contributions made by Baroness Kingsmill, Claire Enders, Richard Eyre and Brian Linden in their roles as members of the Steering Group. Their wisdom, support and commitment of time have been invaluable to me and I am more grateful to them than I can say.

Yours sincerely,



Nicholas Shott