The Communications Market

Interim report, February 2006

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1: Key facts

Radio

- Cumulative sales of DAB digital radio sets passed 2 million at the end of Q3 2005, with industry bodies suggesting that heavy Christmas sales had boosted that total to 2.7 million by the end of the year
- Commercial radio's share of listening continued to lag behind the BBC in Q3 2005 (537 million hours of listening, vs. the BBC's 611 million), with preliminary Q4 figures suggesting that this trend continued to the end of the year
- The number of community radio licences awarded by Ofcom tripled over 2005 to 62, and further awards in 2006 have brought the total to 84
- A survey by RAJAR showed that the share of all listening via digital platforms increased to 10.5% over August/September 2005, from 5.9% over the same period a year earlier
- Almost one in five 15 to 24 year olds said in the same RAJAR survey that they were likely to buy a DAB digital radio in the next six months – the highest of any age group
- Satisfaction with UK radio is high; according to Ofcom's latest consumer survey, 86% were satisfied with radio choice and 93% were satisfied with content

Telecoms

- Based on data supplied to Ofcom by operators, retail revenues from all telecoms services in the 12 months to 30 September 2005 were £37.2 billion – over 6% higher than in the previous year
- In the year to 30 September 2005, fixed-line revenues fell to £10.3 billion – down by 9% compared with the previous 12 months – while revenues from mobile communications grew by 16% to £13.6 billion
- By the end of September 2005, Ofcom's data showed that 57% of the country's 15.5 million internet connections were over broadband, and latest figures show that by December 2005 there were almost 9.8 million broadband connections across the UK
- The number of local loop unbundled (LLU) lines grew from fewer than 50,000 in Q1 2005 to over 200,000 by the end of the year, and according to the Office of the Telecommunications Adjudicator this total had increased to 250,000 by February 2006
- At the end of September 2005, Ofcom's research showed that there were 62.5 million mobile subscriptions – a figure that is higher than the total UK population. Further consumer research by Ofcom showed that around 80% of UK adults (some 40 million) use mobile services, suggesting that a significant number of people now have two or more mobile subscriptions
- Mobile virtual network operators (MVNOs), which offer retail mobile services by leasing network capacity from operators, now account for over 5.5 million subscriptions in the UK

Television

- By the end of September 2005, 66% of UK households (16.5 million) had digital television
- Over the six months to 30 September 2005, the number of Freeview-only households grew by 14% (716,000 new households), to a total of 5.8 million homes
- Over the same period, pay-TV digital satellite households increased by 123,000 (2% growth, to a total of 7.5 million), free-to-view satellite households grew by 100,000, and digital cable households grew by 101,000
- The reach of multichannel TV grew to 60.1% in December 2005 (with audience share growing to 30.8%). In contrast, year-on-year reach of the terrestrial channels continued to fall, with ITV1 experiencing the greatest single-channel decline (from 78.7% to 74.8%) during 2005
- The BBC continued to take the biggest broadcaster share in multichannel homes, with a 30.8% share for all BBC channels in December 2005, compared with 22.6% for the ITV channels and 9.8% for all Sky channels
- By the end of Q2 2005, satellite channels exceeded Channel 4 in revenues from advertising – satellite net advertising revenues for Q3 2005, at £177 million, stood second behind only ITV (£373 million)

2: Introduction

This report is one of a series of regular updates to Ofcom's annual Communications Market reports, the latest of which was published in August 2005. This issue mainly covers data from Q2 and Q3 2005, with market development updates covering the period from June 2005 to February 2006.

The Communications Market supports Ofcom's objective to provide best-in-class research to which stakeholders have regular access. It aims to give a comprehensive picture of the radio, telecommunications and television sectors, with a round-up of recent developments and the latest available data on:

- Industry size, structure and financing;
- Availability, penetration and use of products and services; and
- Consumer attitudes and behaviour.

In addition, we take a closer look at some emerging themes in each sector:

- Radio sector finance;
- Mobile Virtual Network operators (MVNOs); and
- The cable sector.

Note that the information set out in this report does not represent any proposal or conclusion by Ofcom in respect of the current or future definition of markets and/or the assessment of licence applications or significant market power for the purposes of the Communications Act 2003, the Competition Act 1998 or other relevant legislation.

Ofcom welcomes comment on the content and style of the Communications Market to help inform future publications. Suggestions and queries should be sent to: market.intelligence@ofcom.org.uk.

3: Executive summary

3.1: Radio

The radio industry underwent a period of internal consolidation over the second half of 2005, following a period of widespread merger and acquisition (M&A) activity. A number of the larger radio groups including GCap and Chrysalis announced strategic changes. Some of these, for example GCap's decision to divest a number of stations, are likely to lead to further M&A activity. However, a number of new initiatives will alter the way that the companies do business (for example the Virgin radio station launches and GCap's change in advertising policy). The effect of these internal changes on the industry as a whole will become clearer over time.

New ways of consuming radio – particularly digital radio – continue to become more popular. A survey by RAJAR showed that the share of radio listening via digital platforms increased to 10.5% in August and September 2005, up from 5.9% a year earlier. Organisations are responding to this change in listening habits: recent months have seen both radio operators and other companies (usually print media) launch podcasts (radio programmes for downloading either to a PC or a portable music player), while new products such as the Sky Gnome are being introduced to make digital radio listening easier over multiple platforms.

In October 2005, Ofcom published 'Phase 2 of Radio – Preparing for the Future', its review of radio in the UK, and in December 2005, Ofcom published a statement on the allocation of spectrum in VHF Band III, Sub-band 3. These two documents laid out a number of decisions on the future of analogue and digital radio. They also set out Ofcom's overall strategic framework for radio and its public purposes, and localness guidelines. Ofcom has also continued to issue commercial and community radio licences – community radio has received a particular boost, with the number of community licences awarded tripling in the second half of 2005.

Despite difficult market conditions, revenue per listener and revenue per listener hour in commercial radio both rose slightly over the past five years (by 5% and 8% respectively). Over the same period, the revenue split between stations of different styles has changed significantly, with chart-led mainstream stations' share of revenue falling from 55% of all commercial revenue in Q3 2000 to 42% in Q3 2005. Perhaps surprisingly, the stations that have the highest revenue per listener tend to be those that cover smaller populations. London stations have the lowest average revenue per listener, despite the fact that these stations tend to generate the highest total revenues.

3.2: Telecoms

The second half of 2005 saw a number of major mergers and acquisitions in the telecoms industry. In January 2006 Spain's Telefonica acquired mobile network operator O2, in a deal worth around £17.7 billion; in October 2005, cable operators Ntl and Telewest announced an agreed merger; also in October 2005, BSkyB announced a recommended bid for LLU (local loop unbundling) operator Easynet for £211 million; and in August 2005, Cable & Wireless issued an agreed bid of £780 million for corporate telecoms operator Energis. The Ntl/Telewest and BSkyB/Easynet transactions are particularly noteworthy, since both are seen as important precursors of widescale deployment of TV over broadband.

In a further piece of potential corporate activity, in January 2006 Ntl announced a revised bid for mobile operator Virgin Mobile. If the deal goes through, the combined group, which would probably operate under the Virgin brand name, would be the UK's first company to offer quadruple-play services spanning cable TV, fixed-line telephones, mobile and internet.

The second half of 2005 also saw the introduction of live streaming TV over 3G by most of the UK's network operators, and a number of trials of TV to mobile devices using technologies other than 3G. In September 2005, mobile operator O2 began a trial of mobile TV in the Oxford area using DVB-H technology, in conjunction with TV broadcaster Arqiva, and in mid 2005, BT and Virgin Mobile teamed up to trial the BT Movio mobile TV service, using existing DAB technology and network. The next 12 months are likely to see some important industry decisions being made over standards adoption, with a key consideration being the availability of appropriate electromagnetic spectrum.

BT's new local access business unit, Openreach, came into being on 11 January 2006; its creation was a key outcome of BT's acceptance of undertakings in lieu of a reference under the Enterprise Act. In addition, Ofcom confirmed in December that after two years of development the Wholesale Line Rental (WLR) product offered by BT now meets a series of agreed criteria, subject to certain further improvements committed to by BT. Ofcom has therefore relaxed price controls on BT's retail services, and has also set charge ceilings which result in a cut in certain WLR charges.

Retail revenues from telecoms services in the 12 months to September 2005 were £37.2 billion – £2.2bn more than year to September 2004. Mobile revenues accounted for £13.6 billion of this total, a 16% rise year-on-year, while revenues from fixed telecoms fell by 9% over the same period. By December 2005 there were almost 9.8 million broadband connections to UK homes and businesses, with the number of broadband connections comprising 57% of all internet connections in September 2005.

3.3: Television

The media mergers and acquisitions outlined above also had a major impact on the TV sector. Ntl's bid for Virgin Mobile and BSkyB's acquisition of Easynet mark major strategic moves to enable operators to offer customers a range of television, broadband and fixed-line telephony services, known as 'triple-play' – or 'quad-play' with the inclusion of mobile services. The long awaited Ntl/Telewest merger is intended to build significant scale in the cable sector creating a combined entity with over 5 million subscribers.

The trend in convergence continued across the broadcasting sector: BT announced that its broadband-delivered IPTV service will be launched in late 2006; AOL has gone live with its video service, Hi-Q; and the terrestrial broadcasters have launched broadband TV services. Most notably, the BBC has stated that it intends to make 'Catch Up' programming (recently-aired shows) and its archives available online, and ITV launched its broadband 'ITV Local' service in two south coast cities.

By the end of Q3 2005, digital television penetration reached 66% of households (16.5 million) across the UK, according to Ofcom estimates. Over the six months to 30 September 2005, over one million new households gained access to digital TV programming, of which the Freeview platform accounted for 716,000 (equating to 14% growth in the total number of Freeview-only households to a new total of 5.8

million). Over the same period, pay-TV digital satellite households increased by 123,000 (2% growth, to a total of 7.5 million), free-to-view satellite households grew by 100,000 to 545,000, and digital cable households grew by 101,000 to 2.6 million.

ITV and Channel 4 each took a 20% stake in Freeview in October, and Five acquired an undisclosed stake in Top Up TV in November. In addition, ITV and the BBC announced a joint plan in September to launch a free digital satellite service in the first half of 2006 which will be largely aimed at the 27% of UK households who are currently unable to receive subscription-free digital services through Freeview.

The BBC published its case for a new licence fee settlement in October. In order to deliver the future vision set out in the Government's March 2005 Green Paper, the BBC said that it would need to spend an additional £5.5 billion over the first seven years of the next Charter period, from 2007/08 to 2013/14, necessitating an increase in the licence fee, from RPI plus 1.5% currently to RPI plus 2.3% per year. The BBC said that the new money would be spent on producing high-quality locally-relevant content, and on new digital services and infrastructure.

Television advertising revenues peaked in late 2004 at £926m and then declined in each quarter during 2005, reaching £789m in Q3. Satellite channels were the only channels to show growth during this period, but in Q3 they too began to decline and ended the year at £177m.

This growth is underpinned by a long-term trend that has seen multichannel reach grow to 60.1% in December 2005 and audience share grow to 30.8%. In contrast, year-on-year reach of the terrestrial channels continued to fall. ITV1 experienced the greatest drop, with reach in December 2005 dropping to 74.8% compared to 78.7% in December 2004.

4: Radio market developments

4.1: Radio groups refocus and reposition

Over the past six months, a number of larger UK radio groups have announced changes in strategy.

GCap Media announced a new business strategy to 'reverse the decline in GCap's audiences…and to restore growth in listeners revenues and profits' in November 2005. The key elements of this were to:

- reinforce the market position of its core analogue stations, focusing in the first instance on Capital FM;
- reshape its brands and stations into a complementary portfolio addressing the most commercially attractive markets; and
- grow the revenue generated directly from listeners

In September 2005, Chrysalis Group announced its intention to dispose of 'its loss making and non-core books division'. It also announced that it would minimise its exposure to recorded music and in effect focus the music division on publishing and distribution. In November 2005 Chrysalis confirmed that it had signed a conditional sale and purchase agreement for the disposal of the books division for £12.5m. Chrysalis said that the disposal was the final stage in realising the strategy of focusing on radio and music and reducing exposure to non-core operating activities.

Virgin Radio has expanded the range and availability of its radio offerings. It launched Virgin Radio Xtreme on 5 September 2005 on Sky and online as well as on DAB in London; the service is aimed at 16 to 34 year old audience. In November, Virgin Radio Classic Rock and Virgin Radio Xtreme launched on Telewest. In addition, Virgin Radio has announced its intention to launch further services.

In January 2006 The Guardian reported that Guardian Media Group was to carry out a strategic review of its non-national newspaper assets. This will also consider the future of its radio assets.

The changes in the radio industry are not confined to the commercial sector. BBC World Service announced in October 2005 that it would close 10 language services as part of a reprioritisation that will see the launch of an Arabic language television news and information service for the Middle East. The 10 language services broadcast in Bulgarian, Croatian, Czech, Greek, Hungarian, Kazakh, Polish, Slovak, Slovene and Thai will cease by March 2006.

4.2: Further changes in station ownership signalled

In August 2005 Guardian Media Group (GMG) increased its shareholding in Reading 107 FM from 37.8% to a controlling stake of 60.3%. This would have been GMG's sixth licence and the first non-regional, or London, station that GMG would control. However, in December 2005 Reading 107 FM changed control again, this time from GMG to Madejski Communications Limited.

In September 2005 control of the licence for FM 107 The Edge changed to Perth FM Ltd. The station was relaunched as L107 in November 2005. L107 covers the North Lanarkshire area and provides a 'locally-oriented mix of local news, information and entertainment combined with an adult mix of melodic current and classic hits.'

The announcement by GCap in November that it is planning to dispose of nine analogue stations[1] signals further changes in ownership over coming months.

4.3: Ofcom announces decisions on the future of radio

In October 2005 Ofcom published 'Phase 2 of Radio – Preparing for the Future', its review of radio in the UK. The document contained Ofcom's position on certain proposals from 'Phase 1 of Radio – Preparing for the Future'. The document included Ofcom's overall strategic framework for radio, the public purposes of radio and Ofcom's final localness guidelines. In addition the document contained a question for consultation on the proposed procedure and considerations for dealing with requests for format changes for analogue commercial local radio stations. This consultation closed on 11 January 2006. The 11 non-confidential responses have been published on the Ofcom website[2].

At the same time a consultation was published on the licensing policy for spectrum in VHF Band III, Sub-band 3 (i.e. the radio frequency range 209.2 to 217.5 MHz). In December 2005, Ofcom published its final statement. Ofcom's decision, subject to the outcome of the Regional Radio Conference on international spectrum usage and the vacating of the spectrum by existing users, was to allocate four blocks of spectrum in VHF Band III, sub-band 3 to DAB digital radio services: one for a further national commercial radio multiplex and three to provide further local radio multiplexes, with the primary objective of extending the coverage of local digital radio services to those areas of the UK that are currently not served. Ofcom concluded that all of these multiplex licences should be awarded under the Broadcasting Act 1996. Ofcom also published a document, 'The Future Licensing of DAB Digital Radio', which set out for consultation the proposed licensing process, the way that Ofcom proposes to apply the statutory criteria, the proposed local areas to be licensed and the proposed timetable for advertising local and national licences.

4.4: Podcasting takes off

During 2005, increasing numbers of radio stations have been offering all, or part, of their programmes as podcasts. Podcasting is a way for digital audio files to be published on the internet, which can then be downloaded onto computers and transferred to portable digital audio players. In November, Capital Radio (or 95.8 Capital FM as it was then) began to offer segments of some shows, combined with additional material, as podcasts. Capital joined stations such as BBC Radio 4 and Virgin Radio, which already provide some of their content as podcasts. Towards the end of 2005, Chrysalis launched a subscription-funded podcast service for shows on LBC 97.3 including full-length downloads of most programmes, additional content only available to subscribers as well as a number of free, 15 minute long, 'best-of' podcasts.

Podcasts are now increasingly available through organisations that have not been traditionally associated with radio. In November The Daily Telegraph launched a daily

[1] Specifically, MFM and The Buzz, Coast FM, Champion FM, Gemini FM/Plymouth Sound, Orchard FM, Lantern FM and South Hams
[2] http://www.ofcom.org.uk/consult/condocs/radio_reviewp2/responses/?a=87101

podcast offering three articles from the day's newspaper. Also in November the New Scientist started a nine week pilot of podcasts that included news and interviews. Following the podcasting of parts of their Xfm show earlier in 2005, Ricky Gervais, Steve Merchant and Karl Pilkington began providing a weekly podcast for the Guardian website in December 2005. This type of programming may increase as use of RSS (Really Simple Syndication) tools make it increasingly easy for users to generate content and distribute it as podcasts.

4.5: DRM trial underway in London

National Grid Wireless (formerly Crown Castle) started a technical trial of Digital Radio Mondiale (DRM) inside the M25 at the end of October 2005. DRM technology was developed primarily as a digital standard for the short-wave, long-wave and medium wave bands. It offers an improvement in sound quality and signal robustness over analogue AM services.

The stated objectives of the National Grid Wireless trial were to gain practical knowledge of different DRM transmission modes in a large urban environment and to compare DRM with AM, DAB and FM. The trial, carried out in partnership with Virgin Radio, talkSPORT, Kiss 100, BBC World Service and the RIZ Transmitter Company, ended in January 2006.

4.6: Illegal broadcasters in London targeted

At the end of October 2005 Ofcom carried out an operation to take off air illegal broadcasters operating in Greater London. This led to the seizure of 53 illegal radio transmitters and the disabling of 17 transmitters and aerials. In addition, 43 land line and mobile telephone numbers linked to illegal broadcasting operations were gathered for further investigation and nine letters of warning were sent to night clubs that had advertised events on illegal radio stations.

Four days into the operation 44 illegal broadcasters had gone off air and Ofcom's unmanned monitoring station in London recorded a 57% drop in the number of illegal broadcasts being made.

5: The radio industry

5.1: Further Ofcom commercial radio licence awards

Since the August 2005 Communications Market update, Ofcom has awarded eight new commercial radio licences. September saw three licences awarded for Torbay, Swindon and Solent, with Barrow-in-Furness awarded in October. Most recently, Ofcom awarded the new FM licences for Swansea and Northampton in November, Ipswich in December and Warwick in January this year.

A full list of licence awards made by Ofcom has made is in Figure 1 below.

Figure 1: New FM licence awards

Date of award	Area	Station name	Ownership
December 2004	Blackburn	The Bee	Two Boroughs Radio Ltd (32.5%) (a 100% subsidiary of The Local Radio Company), The Radio Business Ltd (32.5%), and 8 individuals
December 2004	Edinburgh	Talk 107	The Wireless Group plc
January 2005	Ashford	KM-FM Ashford	Kent Messenger Ltd (67%), Barretts Ltd (10%), Hobbs Parker Partnership (7.5%)
February 2005	Kidderminster	107.2 The Wyre	MNA Broadcasting Limited (wholly owned by Midlands News Association Ltd)
March 2005	Cornwall	Atlantic FM	Atlantic Broadcasting Ltd (Tindle Radio Holdings 47%, Camel Media 47%)
March 2005	Belfast	U105	Ulster Television plc
April 2005	Durham	Durham FM	The Local Radio Company
May 2005	Banbury	The Bear	CN Group
June 2005	Manchester	Xfm	GCap Media plc
June 2005	Norwich	Crown FM	Tindle Radio Holdings (Provincial Radio Ltd) and Town and Country Broadcasting
June 2005	Ballymena	Seven Towers FM	Alpha Newspaper Group and Irish News Ltd
September 2005	Torbay	Palm FM	London Media Company Ltd and Palm Radio Ltd
September 2005	Swindon	Now FM (Ridgeway Radio Ltd)	The Local Radio Company plc
September 2005	Solent	Original 106 FM Ltd	CanWest Global Communications Corp
October 2005	Barrow-in-Furness	Abbey FM (Barrow Broadcasting Company Limited)	The Radio Business Ltd, The Local Radio Company Ltd, CN Group Ltd
November 2005	Swansea	Swansea Bay	Town and Country Broadcasting

Date of award	Area	Station name	Ownership
		Radio Limited	Ltd, Haven FM (Pembrokeshire) Ltd
November 2005	Northallerton	Mowbray Radio Limited (BTN FM).	The Local Radio Company (TLRC)
December 2005	Ipswich	Town FM	Tindle
January 2006	Warwick	2DayFM	CN Group
February 2006	Shrewsbury	Shrewsbury FM	MNA Broadcasting Ltd (90%), a wholly owned subsidiary of Midlands News Association Limited

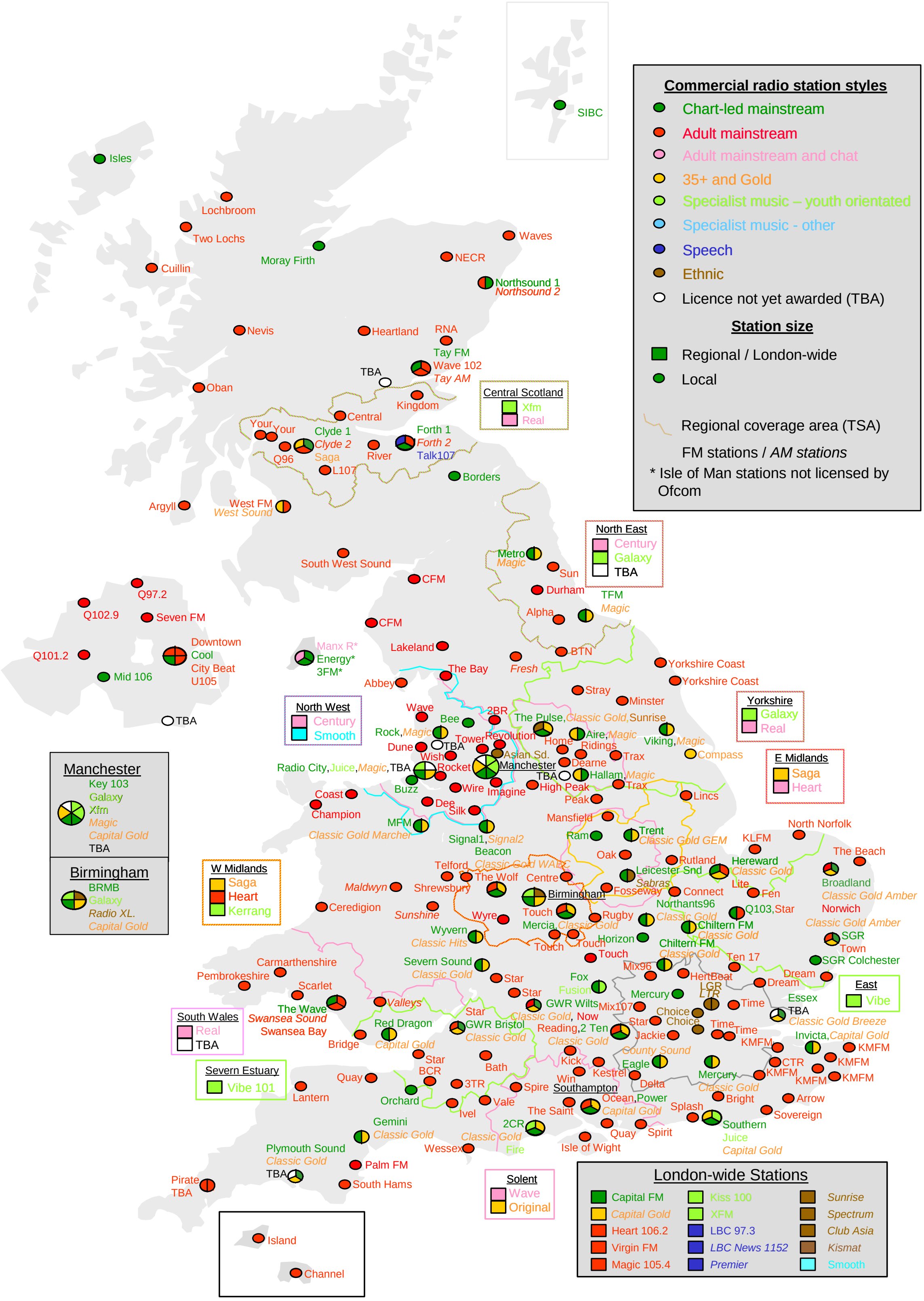
Source: Ofcom

Statements setting out the key determining factors for the award of licences are available on the Ofcom website[3]. Eight of the stations have already commenced broadcasting (those in Edinburgh, Blackburn, Ashford, Kidderminster, Belfast, Durham, Banbury and Ballymena), with further launches planned in the coming months. All new licensees are expected to begin broadcasting at the earliest opportunity, and must do so no later than two years from the award date.

Following these licence awards the commercial radio landscape in the UK was as shown in Figure 2.

[3] http://www.ofcom.org.uk/radio/ifi/rl/commer/ar/lapr/awards/

Figure 2: Listener choice – analogue commercial local radio



Source: Ofcom

In addition to licence awards made in the autumn and winter, applications are currently being considered for the following licences, Plymouth, North East England and Southend-on-Sea. Full details of each application are available on the Ofcom website[4].
Although there are few commercial FM frequencies remaining, Ofcom expects to allocate around 30 licences over the next few years. The latest timetable is shown in Figure 3.

Figure 3: Timetable for the advertisement of new FM licences

Advertised / due to be advertised	Larger licence area	Smaller licence area
February 2006		Andover Exeter
March	Bristol	Oxford / S Oxfordshire
April	Liverpool	
May		Perth
June		Preston / Leyland / Chorley
July	Manchester	Aberdeen

Source: Ofcom

5.2: 84 community radio licences now awarded

Community radio licensing took a major step forward in 2005; between September and December 2005, 42 more community radio stations were awarded five-year licences, bringing the total number awarded to 62 – three times the previous total. A further 22 licences were awarded in January and February 2006, bringing the total to 84. The balance of the 194 applications will be dealt with by the Ofcom Radio Licensing Committee over the coming months. As can be seen in the map in Figure 8, community radio stations are now available in a number of UK cities, in all of the nations and in many communities across the English regions.

In December 2005, Ofcom's Radio Licensing Committee made seven licence awards to the applicants in Figure 4.

Figure 4: Community radio licences awarded in December 2005

Station	Area	Comment
West Hull Community Radio	West Hull	This group will serve the geographically based community in West Hull.
Radio Reverb	East and Central Brighton	The station will serve the East and Central Brighton areas, focusing on the needs of various under-served areas and groups.
Colchester Garrison FM	Colchester	The station will serve soldiers, their families and other Ministry of Defence personnel.
Spirit of Plymouth	Plymouth	This station is seeking to serve the Christian community in the City of Plymouth.
Desi Radio	Southall, West London	The station will serve the Panjabi community in West London.

[4] http://www.ofcom.org.uk/radio/ifi/rl/commer/ar/lapr/ifmapps/?a=87101

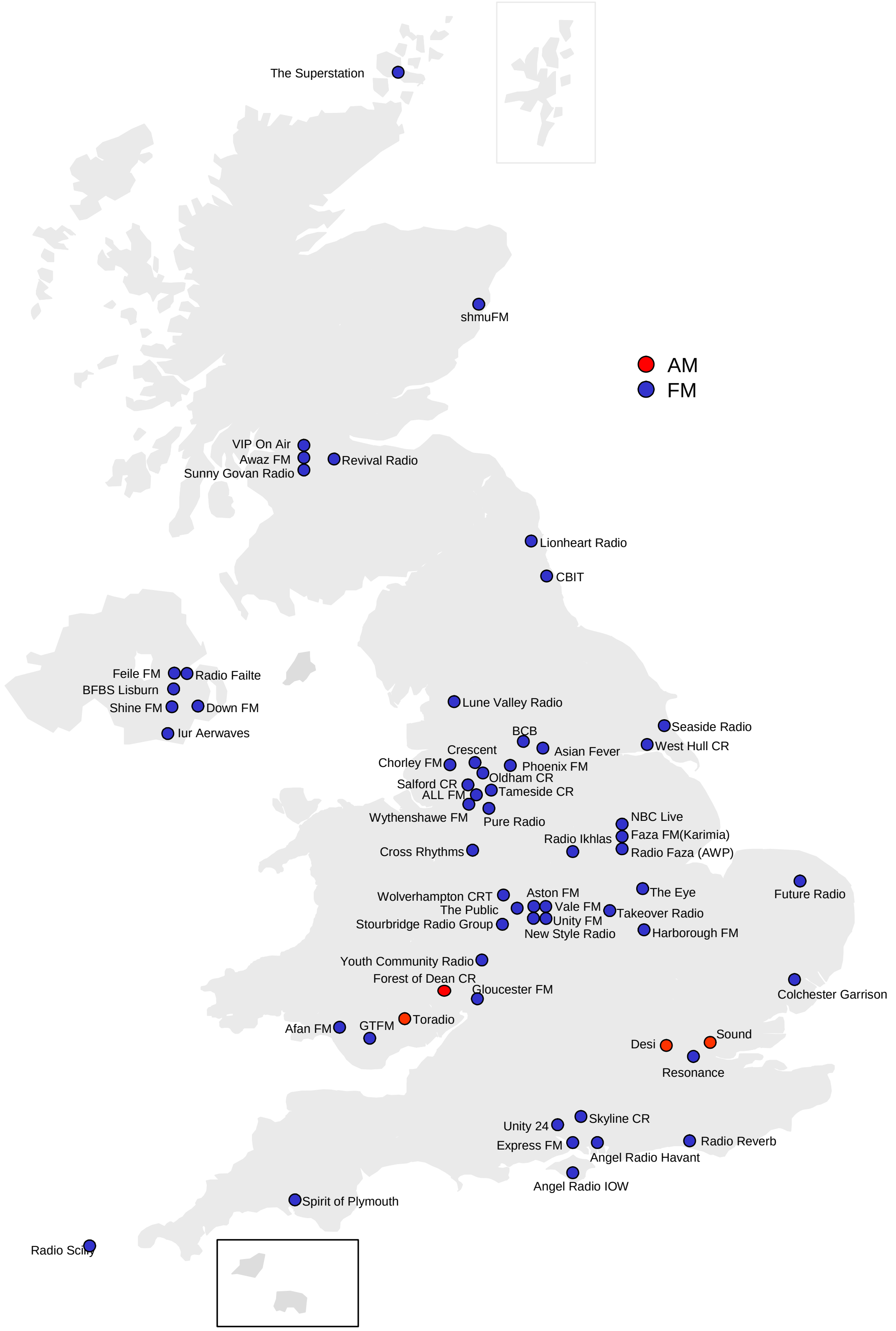
Station	Area	Comment
Sound Radio	Hackney, East London	The station will serve a range of communities within the London Borough of Hackney.

Source: Ofcom

The first five of the above stations: West Hull Community Radio, Radio Reverb, Colchester Garrison FM, Spirit of Plymouth, and Resonance FM, will broadcast on FM. The last two services, Desi Radio and Sound Radio will broadcast on AM. All will be licensed for a five-year period.

The locations of the 62 community radio stations currently operating around the UK are shown in Figure 5.

Figure 5: Community radio licences awarded



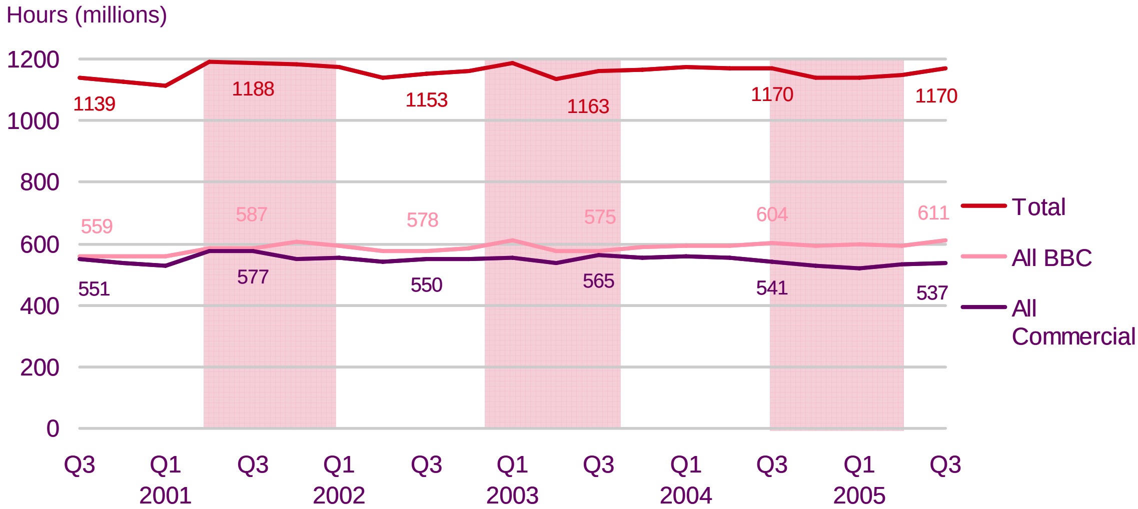
Source: Ofcom, December 2005

6: The radio listener

6.1: Total listening up, but commercial listening falling

Total radio listening showed a slight increase during the third quarter of 2005, although remained the same as a year previously. Listening to the BBC stations increased against Q3 2004, up by 1.2% (7m hours) by Q3 2005, meanwhile total commercial listening saw a drop of 0.7% (4m hours) on Q3 last year (Figure 6).

Figure 6: Total listening

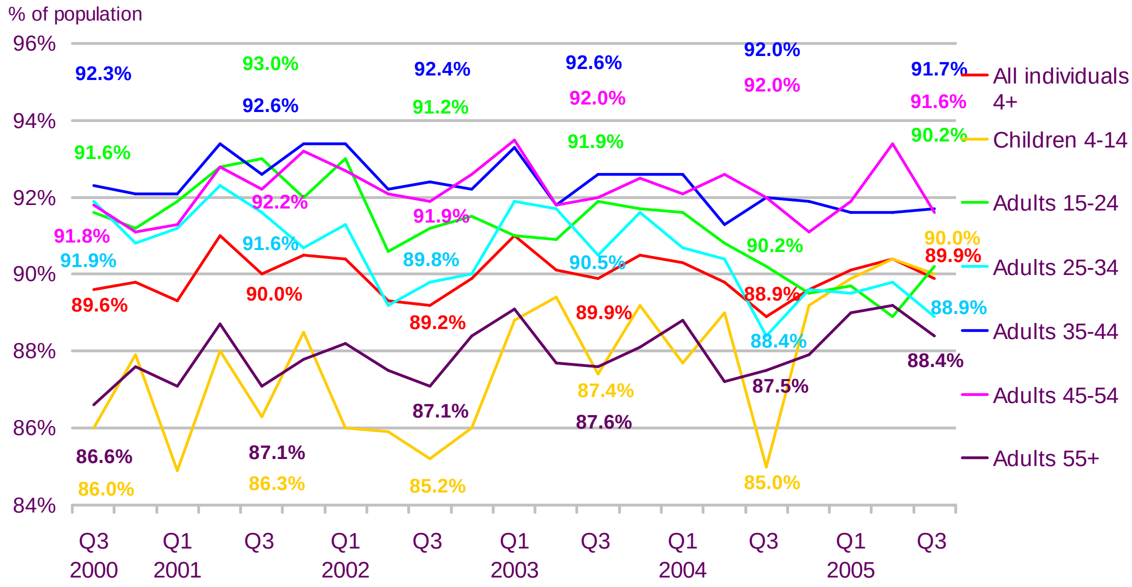


Source: RAJAR, all listeners

Taking a longer view, total radio listening has risen by 2.7%, or 31m hours, over the last five years. During this time, BBC listening grew by 9.3% (52m hours), while commercial listening fell by 2.5% (14m hours). The first three quarters of 2005 saw a lower number of commercial listening hours than at any point over the last five years.

RAJAR figures suggest that nine out of ten individuals listened to at least some radio every week (see Figure 7). This is broadly consistent with the results of Ofcom's Residential Tracker Survey (see Figure 11). This level of reach has stayed roughly constant over time.

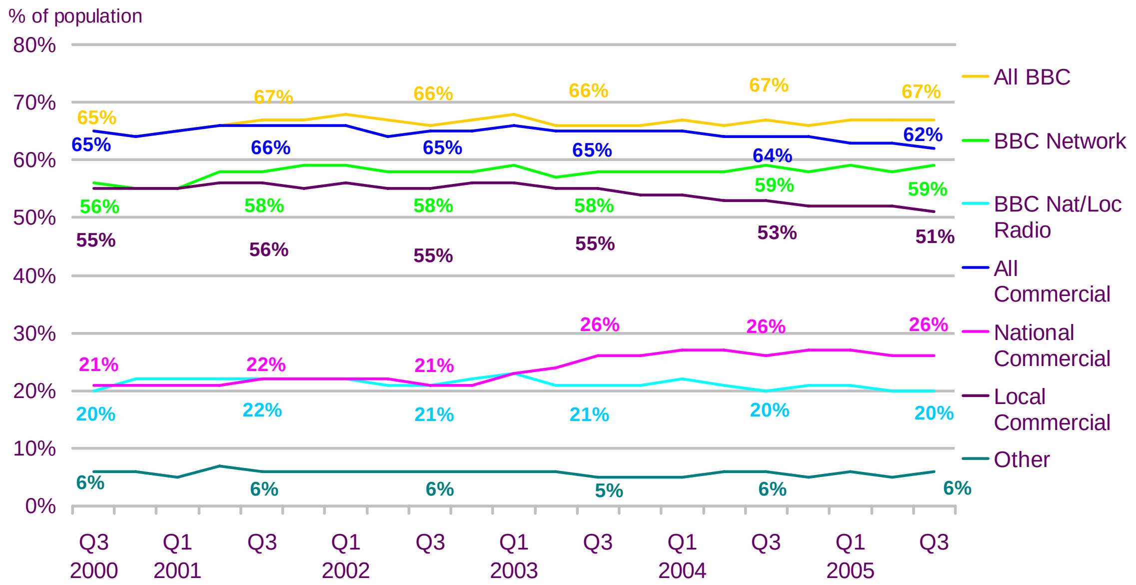
Figure 7: Reach of radio by demographic



Source: Rajar

Radio has a high reach across all ages. In general reach is lower among children than other age groups, but showed signs of change over the year to September 2005, with reach of 4 to14 year olds rising 5 percentage points. However, over the past five years radio reach amongst young (15 -24) adults has declined from 93% in Q3 2001 to 90% in Q3 2005. At around 92%, radio reach tends to be highest amongst 35 to 54 year old listeners.

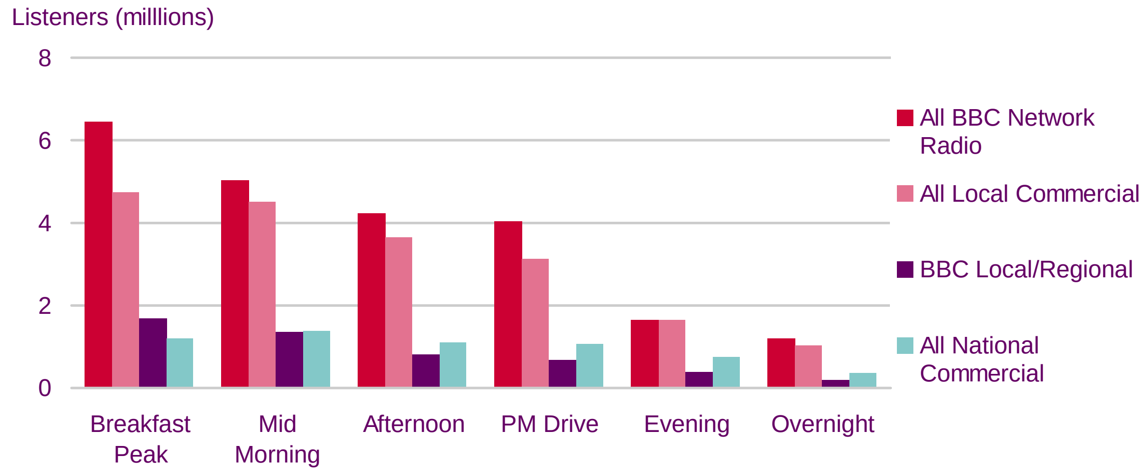
Figure 8: Reach of radio by sector



Source: RAJAR

Total radio reach stayed broadly similar over the course of 2005 as it has for the past five years. However, commercial radio has shown signs of a falling trend, down 3 percentage points over the period. This has been driven by the decline in local commercial reach, from 55% to 51%, more than off-setting the 5 percentage point rise from national commercial. For the BBC, Network Radio has performed strongly, up 3 percentage points since Q3 2000.

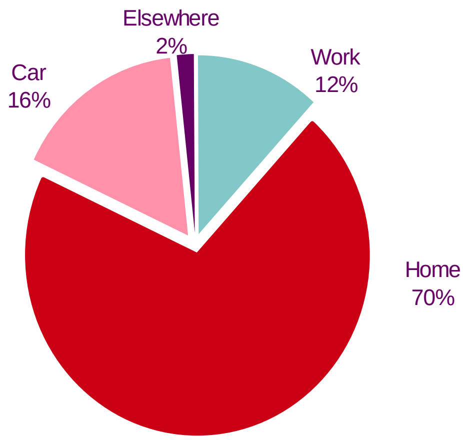
Figure 9: When people listen



Source: RAJAR Q3 2005, all listeners

The pattern of listening over the course of a day stayed broadly stable during 2005. The success of the breakfast show is still the key to the success of a station, although the national commercial stations buck this trend, actually adding listeners during mid morning. 2005 saw changes in breakfast show presenters at a number of the larger stations, with Christian O'Connell moving from Xfm to Virgin Radio, and Danny Baker, Jono Coleman, Jamie Theakston, David Prever and Lauren Laverne taking on new morning shows in the competitive London market. Listening tends to tail off during the rest of the day with a particular fall off at the end of the day, following 'drive-time' (Figure 9).

Figure 10: Where people listen

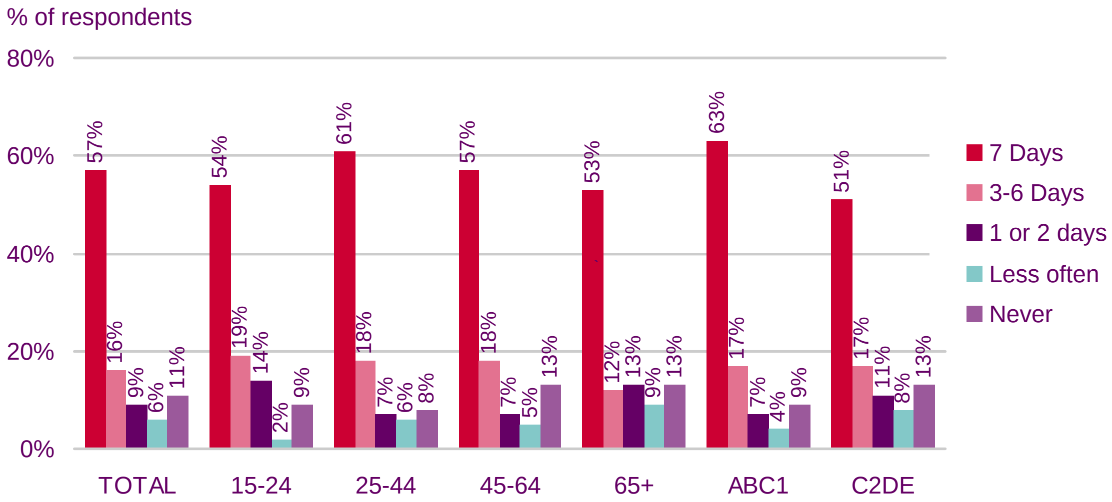


Source: RAJAR Q3 2005, all listeners

The location of listening to radio also broadly stayed the same over the course of 2005. Well over two thirds of listening (70%) continued to take place at home, followed by listening in the car (16%) and then at work (12%) (Figure 10). Once Podcasting, with its convenience and potential portability, takes off, it seems reasonable to expect listening to move away from the home. However, with penetration of portable music players (including MP3 players) at 27%, and with 20% saying that they use portable music players[5], it may be too early to judge any potential long term impact.

[5] Source: Ofcom Residential Tracker Survey, September 2005

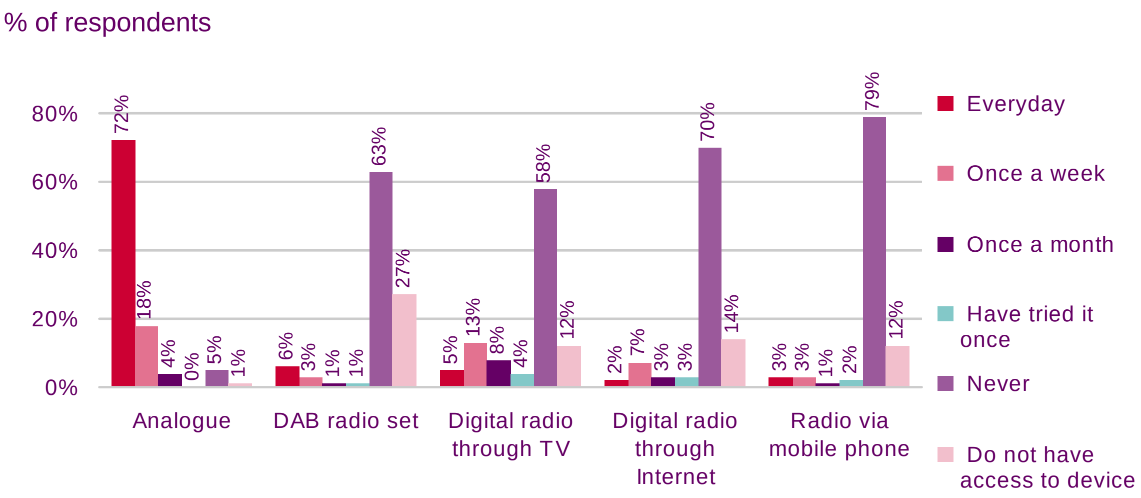
Figure 11: Frequency with which people say they listen to the radio each week



Source: Ofcom residential tracker survey July 2005

Radio is very much a part of listeners' everyday life, with 82% of the respondents to Ofcom's residential tracker survey saying that they listened to radio at least once a week, and over half (57%) listening every day (Figure 11). Listening seven days a week was more frequent among those in age groups 25-44 (61%) and 45-64 (57%). 63% of ABC1s also listened every day of the week, 12 percentage points higher than C2DEs.

Figure 12: How often if at all do you access the radio via…

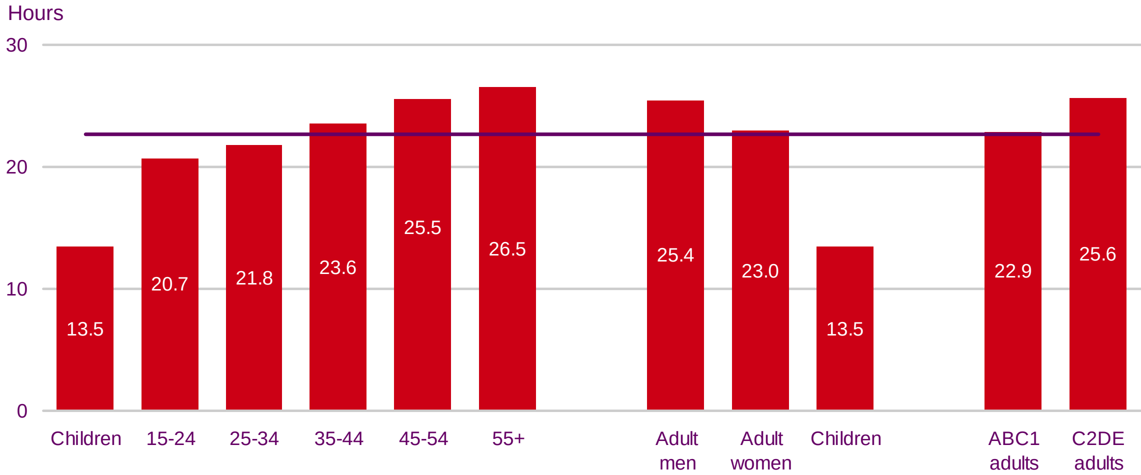


Source: Ofcom's Residential Tracker Service, July 2005

According to the residential tracker survey (Figure 12), by far the most popular device through which to access radio services was a traditional analogue radio set, with 72% using one every day and 90% at least once a week. However, other radio technologies are increasing in popularity, with the most prevalent being DAB sets;

6% use them every day compared to listening through the TV set (5%), via the internet (2%) and via a mobile handset (3%).

Figure 13: Demographic profile of overall listening



Source: RAJAR Q3 2005, all listeners

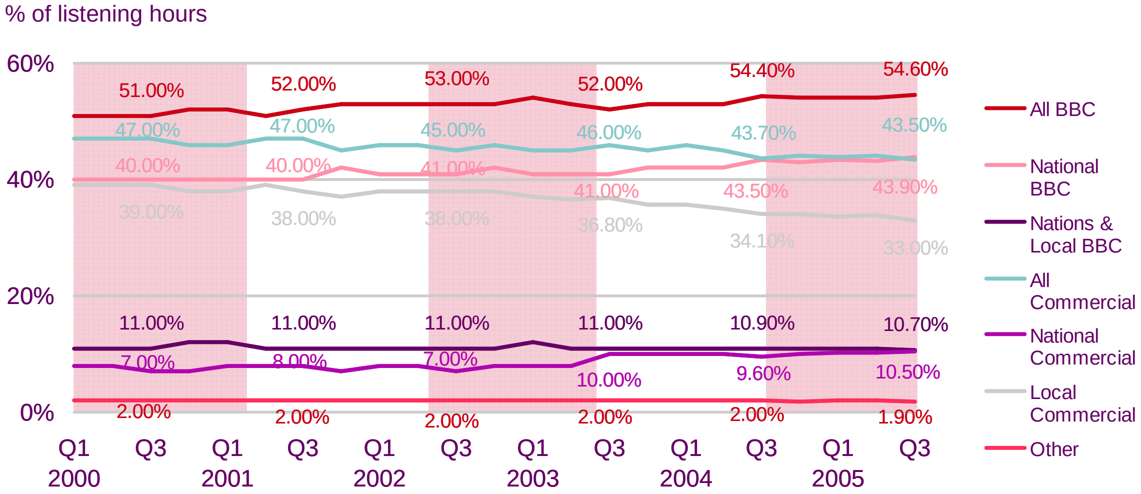
The profile of average weekly listening by different demographics remained broadly stable in 2005. Children (aged 4 to 14) listened to significantly less radio than other demographic groups, and average listening increased by age, peaking at 55 years and over. On average, men listened to the radio for over two hours longer per week than women, and adults in the C2DE social classes listened to more than two and a half hours more per week than ABC1 adults (Figure 13).

6.2: BBC Network listening exceeds commercial

Over the five years to September 2005, average listening to all radio remained broadly constant. However, over this period the BBC's share rose by just over three and a half percentage points, resulting in a 54.6% share by Q3 2005, while commercial radio listening fell by a similar amount to 43.5% (Figure 14).

Between 2000 and 2005, the national BBC radio stations' (Radio 1, 2, 3, 4 and 5 Live) share gained around four percentage points to 43.9%, overtaking all commercial radio (43.5%) in Q3 2004. National commercial radio, meanwhile, increased its share by three and a half percentage points since 2000 to 10.5% overall, while local commercial listening fell by six percentage points to 33%. The increase in listening to national commercial radio can partly be attributed to the introduction of several new national commercial digital stations over the past three years.

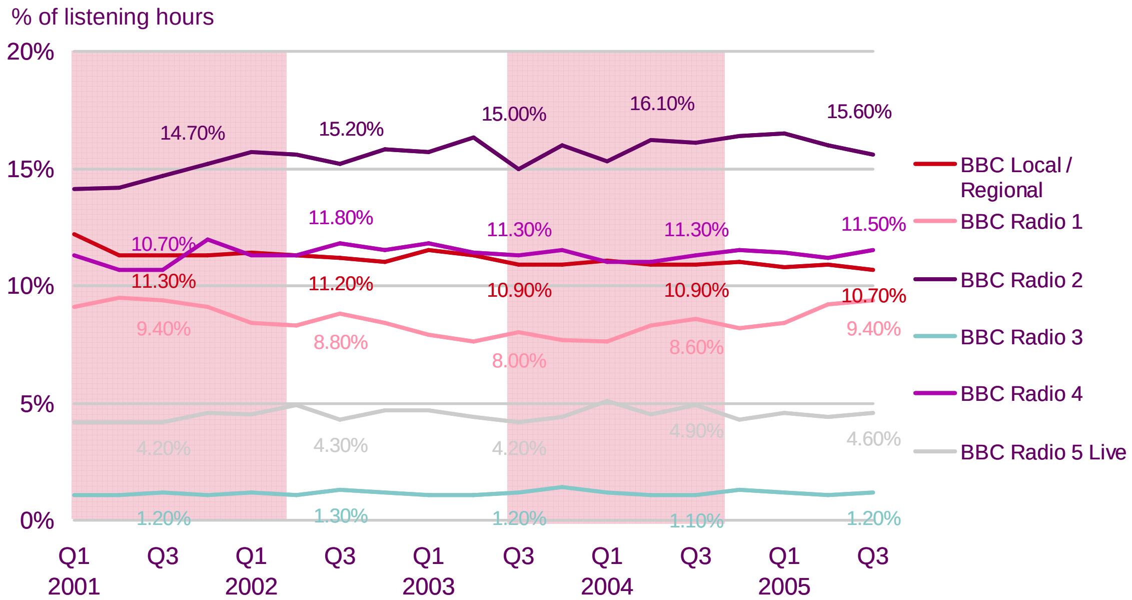
Figure 14: Share of listening hours by sector



Source: RAJAR

Within the BBC's total share of listening, Radio 1 increased its share by 0.8 percentage points year-on-year to 9.4% in Q3 2005 – its best performance since Q3 2001. Radio 4's share grew by 0.2% over the same period, and Radio 3 was up by 0.1%. By contrast, listening to Radio 2 fell by 0.5 percentage points (although it is still by a clear margin the most listened-to BBC station), while BBC local and regional stations lost 0.2% share, and Radio Five Live lost 0.3% share year-on-year (Figure 15).

Figure 15: Performance of BBC radio



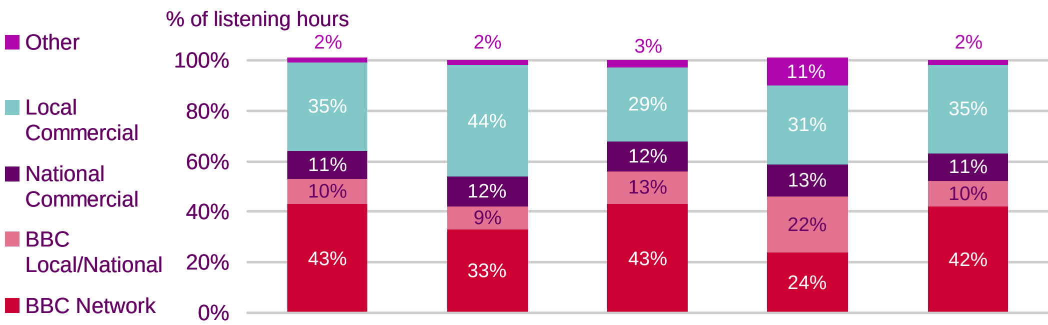
Source: RAJAR

6.3: Listening differences across the nations continue

There are different patterns of listening across the BBC networks in the nations of the UK. In Scotland, local commercial radio achieved a 44% share of listening hours in Q3 2005 – significantly higher than the UK average of 35% – whilst the BBC networks' share (33%) was correspondingly lower than the UK average of 42%. In Northern Ireland, low levels of listening to BBC network stations (24%) were offset by the above-average share of the BBC local/national station (Radio Ulster, at 22%). Listening to 'Other' stations was also much higher in Northern Ireland (11%) than in the other Nations (Figure 16).

Reach was broadly similar across the Nations, with Northern Ireland the highest at 92.4% and Scotland the lowest at 87.7%. During Q3 2005, average listening hours were highest in England (22.8 hours per week), and lowest in Wales (21.9 hours per week).

Figure 16: Share of listening hours by nation



	England	Scotland	Wales	Northern Ireland	UK TOTAL
Average weekly listening	22.8 hours	22.1 hours	21.9 hours	22.1 hours	22.7 hours
Reach	90.0%	87.7%	88.4%	92.4%	89.9%

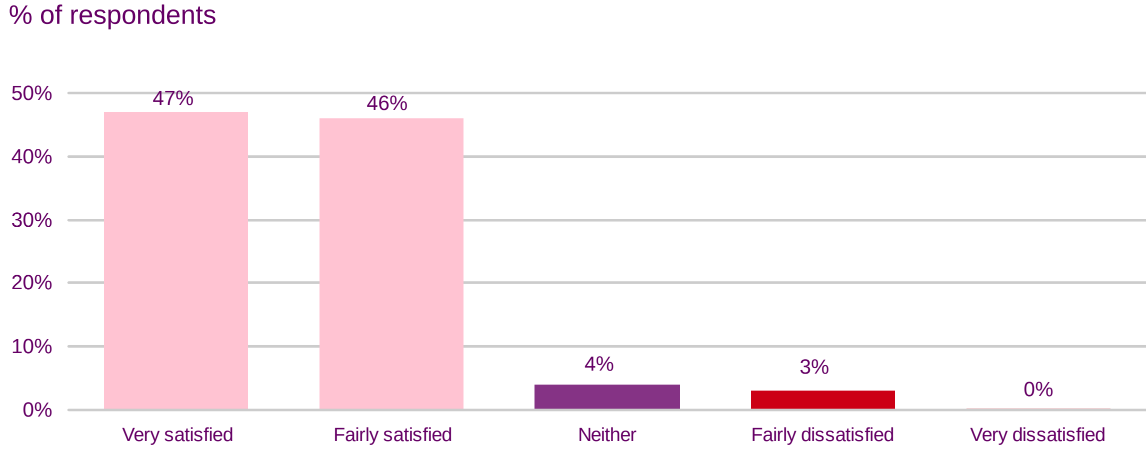
Source: RAJAR Q3 2005, all listeners

6.4: Consistently high satisfaction with radio listening

According to Ofcom's consumer research, UK radio listeners were almost all satisfied with what they heard on the radio (see Figure 17). This is consistent with recent Ofcom surveys that were carried out for the Radio Review[6]. Over 90% said that they were either very satisfied or fairly satisfied with radio content, with none reporting that they were very dissatisfied.

[6] See market research for Radio – Preparing for the future (http://www.ofcom.org.uk/consult/condocs/radio_review/radio_review2/appendixB.pdf and http://www.ofcom.org.uk/consult/condocs/radio_reviewp2/appendix_a.pdf)

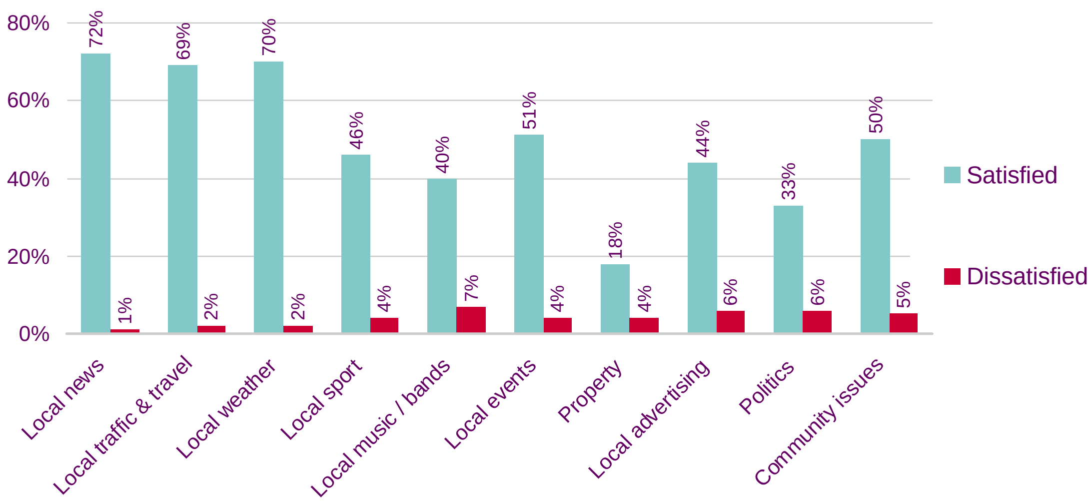
Figure 17: How satisfied are you with the content of what you listen to on the radio?



Source: Ofcom's Residential Tracker Survey, July 2005

Respondents were also asked how satisfied they were with the coverage of a variety of local issues and events on radio (Figure 18). In all cases, respondents had higher levels of satisfaction than dissatisfaction with local coverage. The most satisfactory local services (at around 70%) were local news, weather and traffic and travel. Around 50% of respondents were satisfied with the coverage of local events and community issues. The areas with the highest level of dissatisfaction were local music / bands (7%), local advertising (6%) and local politics (6%). However it is not clear whether these are all areas which listeners feel should be covered on local radio.

Figure 18: How satisfied are you with the coverage of the following local issues and events on the radio?

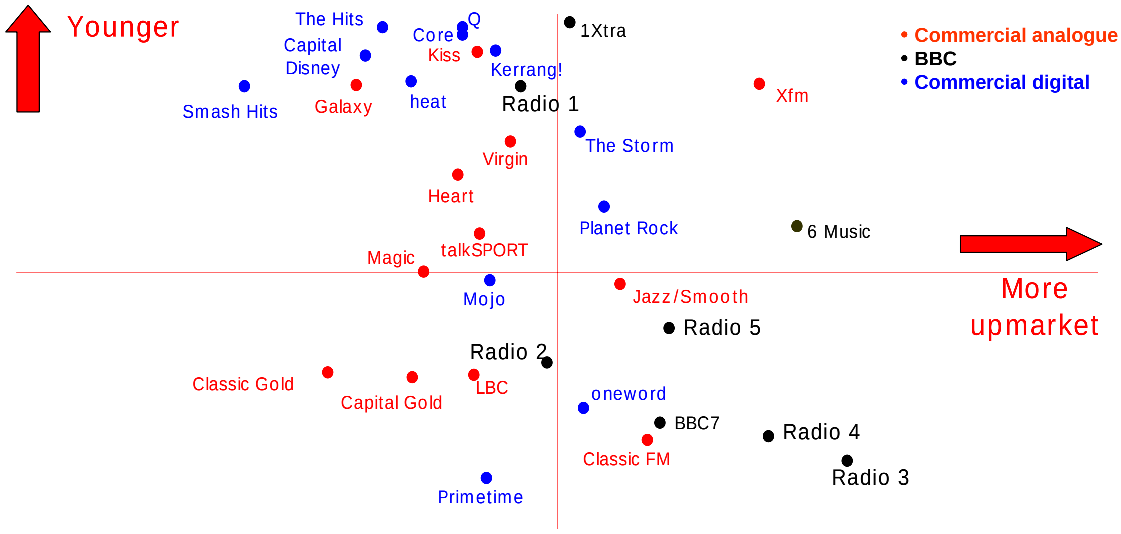


Note: Remaining % are 'Don't knows'
Source: Ofcom's Residential Tracker Survey, July 2005

6.5: Choice of radio stations cover all demographics

UK-wide analogue radio stations and brands provided services which were listened to across a wide range of demographics. BBC stations attracted a higher proportion of ABC1 and older listeners than commercial services, whilst both digital and analogue commercial brands attracted younger listeners (see Figure 19 below).

Figure 19: Positioning of national radio stations/brands

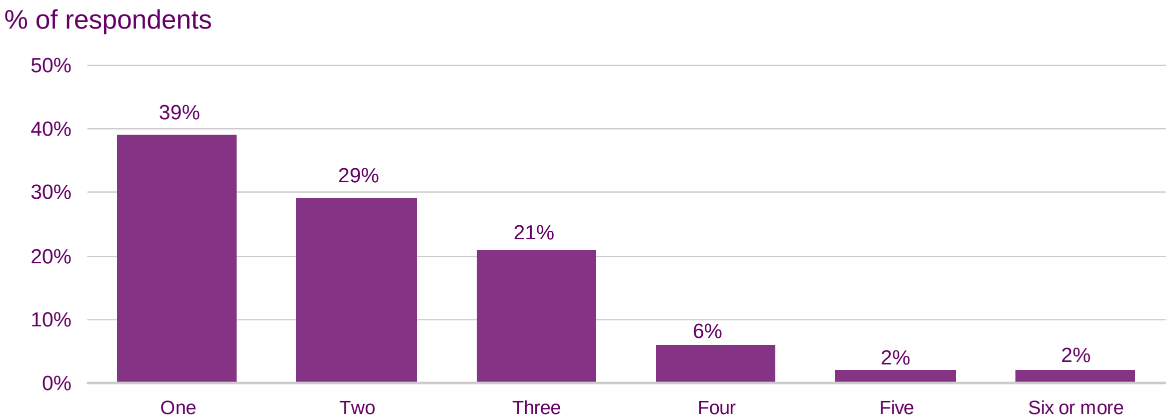


Gridlines mark UK population profile

Source: RAJAR Q3 2005/RAB
Note: Due to the relatively small audiences of some of the stations, their position from quarter to quarter may change significantly.

Ofcom's Residential Tracker Survey asked how many radio stations per week respondents listened to. Over a third (39%) were loyal to one station, whilst half selected from two to three stations (Figure 20).

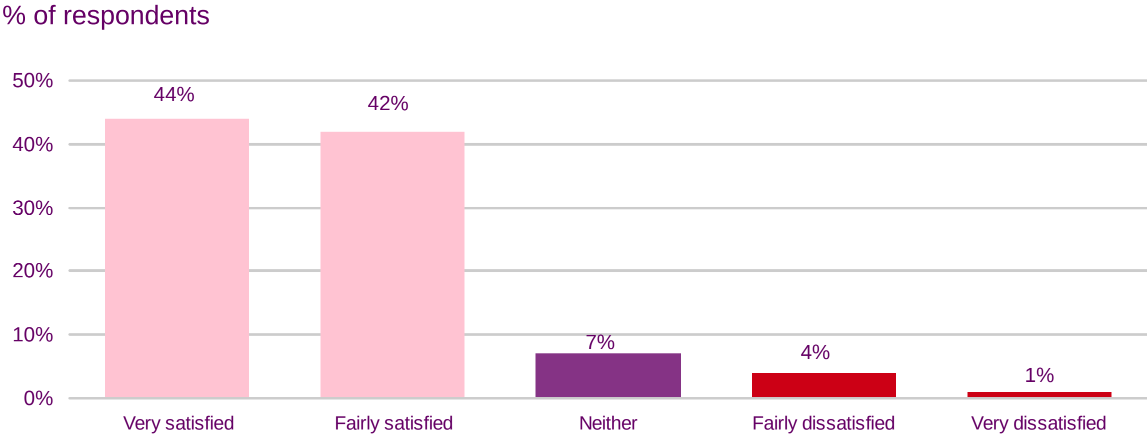
Figure 20: In an average week how many different radio stations do you choose to listen to?



Source: Ofcom Residential Tracker Survey, July 2005

Satisfaction with the choice of radio stations was reasonably high; overall, 86% of respondents were very or fairly satisfied with the choice of stations in their area. Only 5% were dissatisfied, with 1% of these very dissatisfied (Figure 21).

Figure 21: How satisfied are you with the choice of radio stations available in your area?

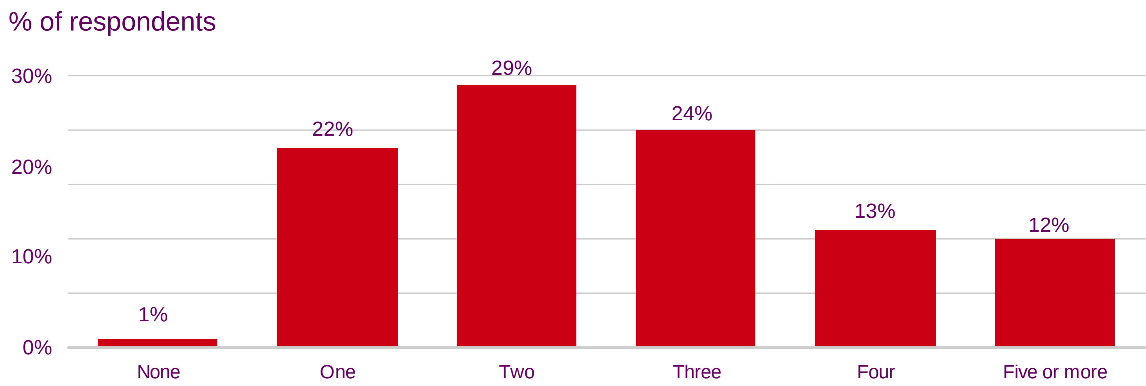


Source: Ofcom Residential Tracker Survey, July 2005

6.6: Rising digital radio penetration and listener choice

Radio is a ubiquitous medium, with approximately 99% of homes having at least one set in the house. Over three quarters (78%) of respondents owned two or more radio sets and around one in eight (12%) had five or more (Figure 22).

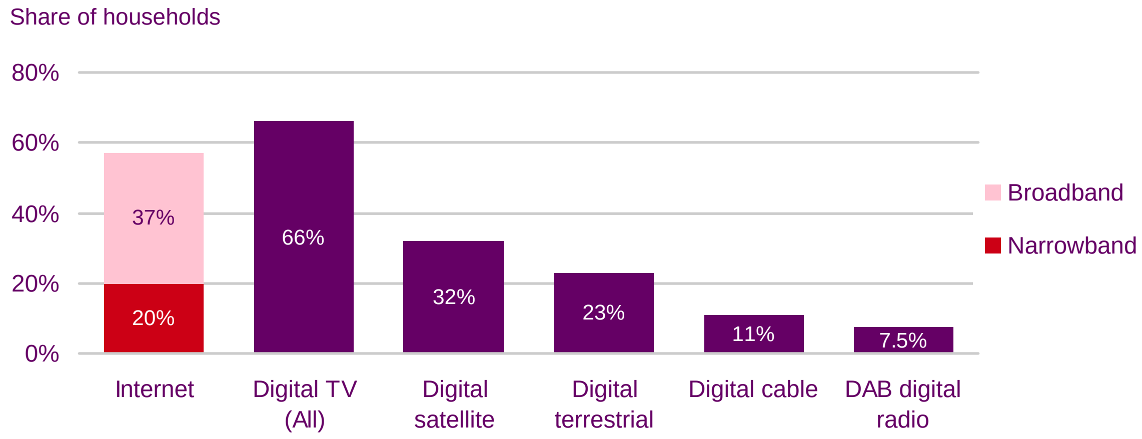
Figure 22: How many radio sets do you have in your household?



Source: Ofcom Residential Tracker Survey, July 2005
Note: Average ownership across all homes was 2.6 sets, in homes where there was at least one radio set it was 3.3 sets

Although digital radio is available over a number of platforms, only 32% of respondents to Ofcom's consumer research thought that they had access to digital radio. However, Figure 23 shows that by the end of September 2005, over two thirds of households had access to digital radio through digital TV alone.

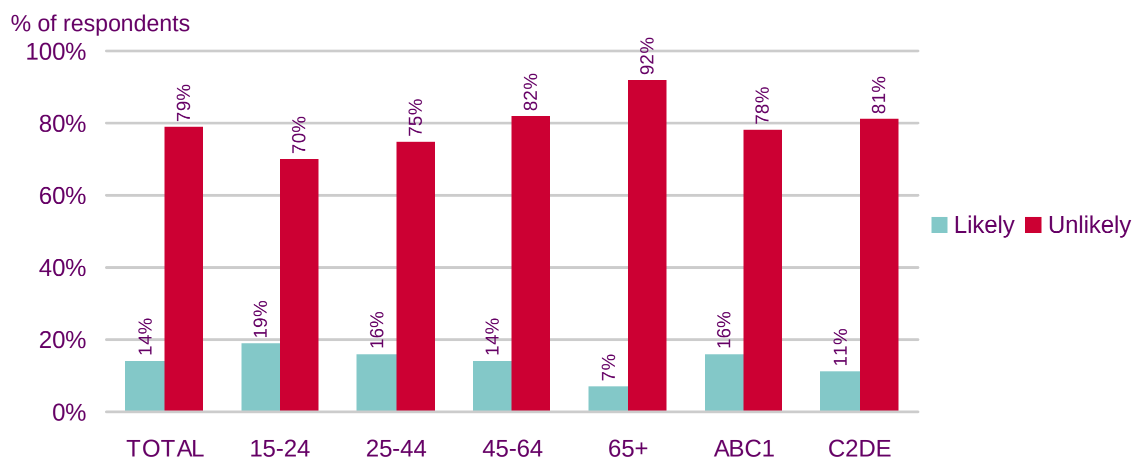
Figure 23: Penetration of equipment capable of receiving digital radio



Source: Ofcom, GfK, September 2005

Ofcom's research also asked respondents how likely they were to purchase a DAB radio (Figure 24). 14% of respondents said they were likely to buy one within six months. ABC1s were more likely to purchase (16%) than C2DEs (11%), whilst the younger 15-24 age group was the most likely group to purchase (19%). This suggests that the average age of DAB owners may fall over the coming years.

Figure 24: How likely are you to purchase a DAB digital radio in the next six months?



Source: Ofcom Residential Tracker Survey, July 2005
Note: Remaining % are 'Don't knows'

6.7: DAB take up continues to grow

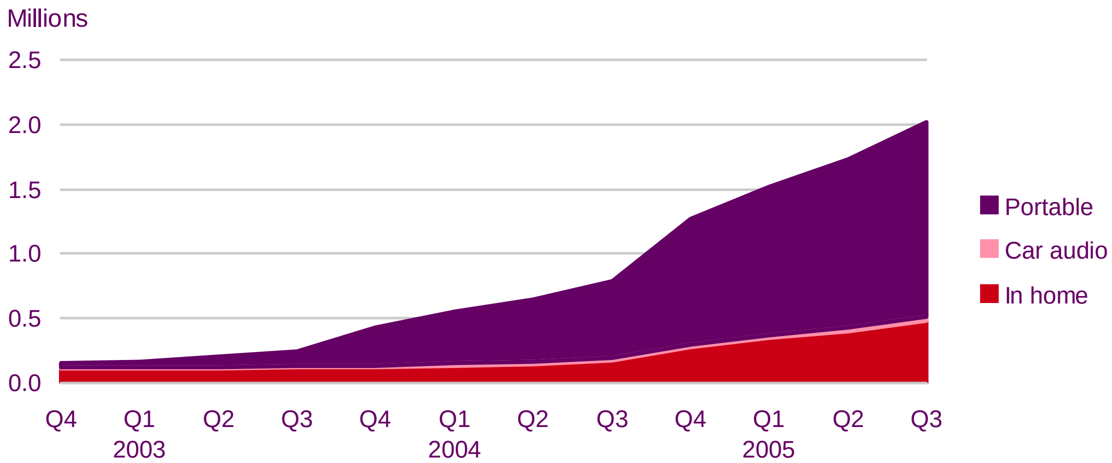
Total sales of DAB radio sets reached 2 million by the end of September 2005, up from 1.4 million at the end of January 2005 – equivalent to around 600,000 sales in eight months (Figure 25). By Q3 2005, 7.5% of homes had at least one DAB set.

According to the Digital Radio Development Bureau (DRDB), DAB digital radios accounted for 12% of all radios sold (and 45% of all portable 'kitchen' radios sold), during August and September 2005. For the year to September 2005, the DRDB reported that sales of DAB receivers reached £120m, or 17% of the total value of radio sales.

There were around 300,000 DAB sales during Q3 2005, double the amount for the corresponding quarter in 2004. In the latest Q4 figures, the DRDB reported that 2.7 million DAB sets had been sold by the end of 2005, boosted by a strong Christmas performance.

Amongst the different DAB set categories, DAB ‘portable’ accounted for around two thirds of the sales during Q3, with DAB ‘in-home’ (e.g. tuners, audio system, satellite receivers, set top boxes) making up the majority of the rest. DAB car radio sales remained comparatively small at around 2,500 (Figure 25).

Figure 25: Number of DAB digital radio sets sold[7]

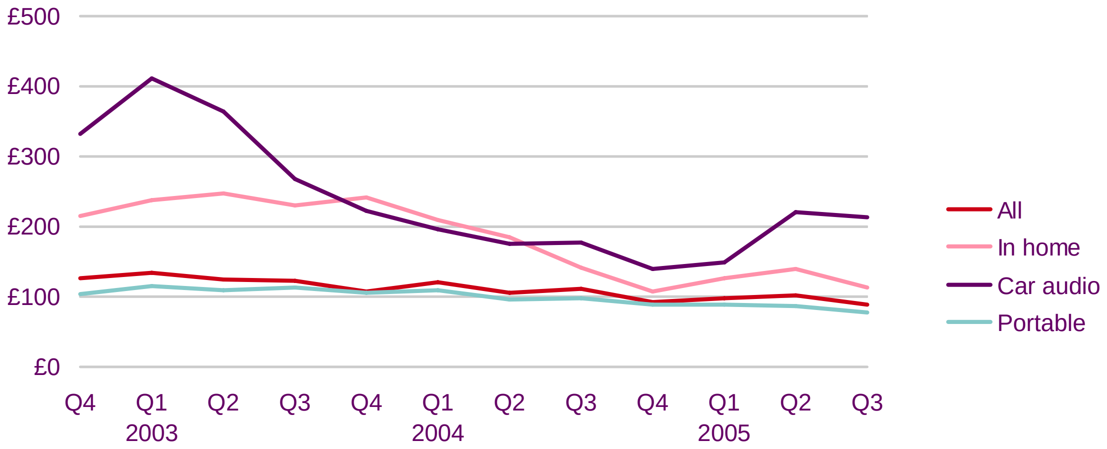


Source: DRDB / GfK Q3 2005

The average price of DAB digital radio sets continued to fall throughout 2005, to less than £90 by September 2005 – a decrease of £12 on the corresponding quarter in 2004, which itself was a £12 drop from Q3 2003 (Figure 26). The average price of ‘in home’ sets fell by £29, with ‘portable’ sets falling by £11 over the year. These reductions were offset by an increase of £36 in the price of in-car DAB sets.

[7] Car audio (e.g. integrated tuner, tuner component), in-home (e.g. tuners, audio system, satellite receiver (set top box)), portable (e.g. portable CD, transistor radio, radio cassette, personal stereo, MP3, clock radio)

Figure 26: Change in average price of DAB digital radio receivers

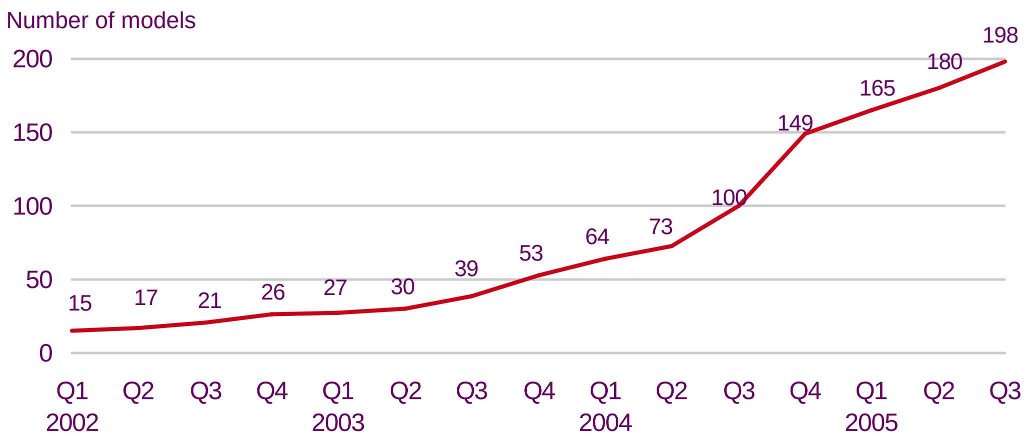


Source: GfK Q3 2005

Choice of DAB sets increased by 50%

According to the DRDB, by the end of September 2005 198 different types of DAB set were available for consumers to purchase, compared to 149 in January 2005, and only 15 at the start of 2002 (Figure 27). As with previous years, the choice of sets was expected to increase further over Christmas 2005.

Figure 27: Number of DAB models available in the UK



Source: DRDB

6.8: Alternative digital radio receivers emerging

As digital radio listening increases, new ways of accessing radio are emerging. Devices such as the Reciva that allow portable listening to internet radio stations have been available for a couple of years.

In October 2005, Sky launched the Sky Gnome, a portable wireless receiver that enables remote listening to Sky TV and radio channels within a typical range of 30 metres from the Sky set top box.

6.9: Listening to digital radio increases in importance

Over the last two years RAJAR has carried out listener research that can help to understand better how listeners are responding to – and using – digital radio.

According to RAJAR's platform study, listening via DAB grew by 165% between August/September 2004 and August/September 2005, whilst listening to digital radio via digital TV and the internet grew by 42% and 84% respectively. In the 2005 survey, an estimated 10.5% of all radio listening was via digital platforms (up from 5.9% in the corresponding period in 2004), and an estimated 5.5% of all radio listening was via DAB (up from 2.4%).

Platform	Share of listening August and September 2004	Share of listening August and September 2005
DAB	2.4%	5.5%
Digital TV	2.3%	2.9%
Internet	1.1%	1.8%
Unsure of platform	0.1%	0.3%
Total listening via digital platforms	**5.9%**	**10.5%**

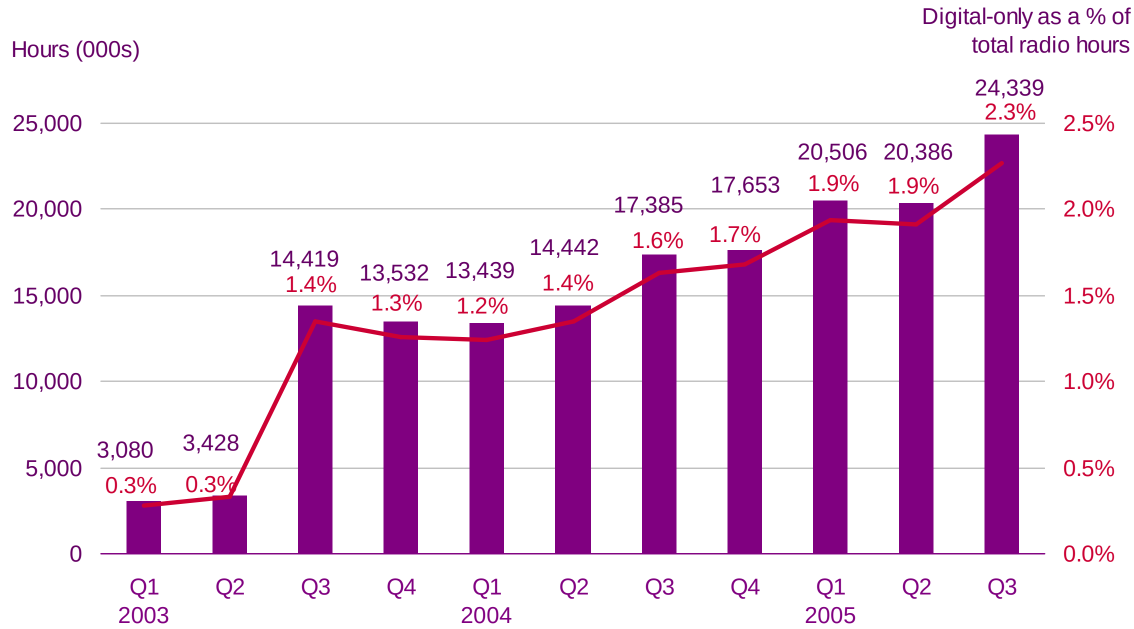
Source: RAJAR platform study

The research also showed that people with DAB radios listened longer per week on average (26.6 hours) than the average listener (24.1 hours).

To try to gauge a picture of digital radio listening over a longer period of time it is also possible to measure listening to stations that are only broadcast on digital platforms, or that are only available in a particular area on digital[8]. According to the Q3 2005 figures from RAJAR, 'digital-only' radio accounted for over 24 million hours during Q3 2005, equivalent to 2.3% of all radio hours for the quarter (Figure 28).

[8] For example on analogue, Kiss is only available in London, but it is available on digital throughout the UK on various platforms. Therefore the audience for Kiss outside London is likely to be digital (although there may be an element of listening to analogue stations just outside their official analogue area). This ignores the fact that many listeners in London may also be listening on digital. Similarly, it is not possible to say how much of the listening to existing analogue national stations, whether BBC or commercial, is being done via digital.

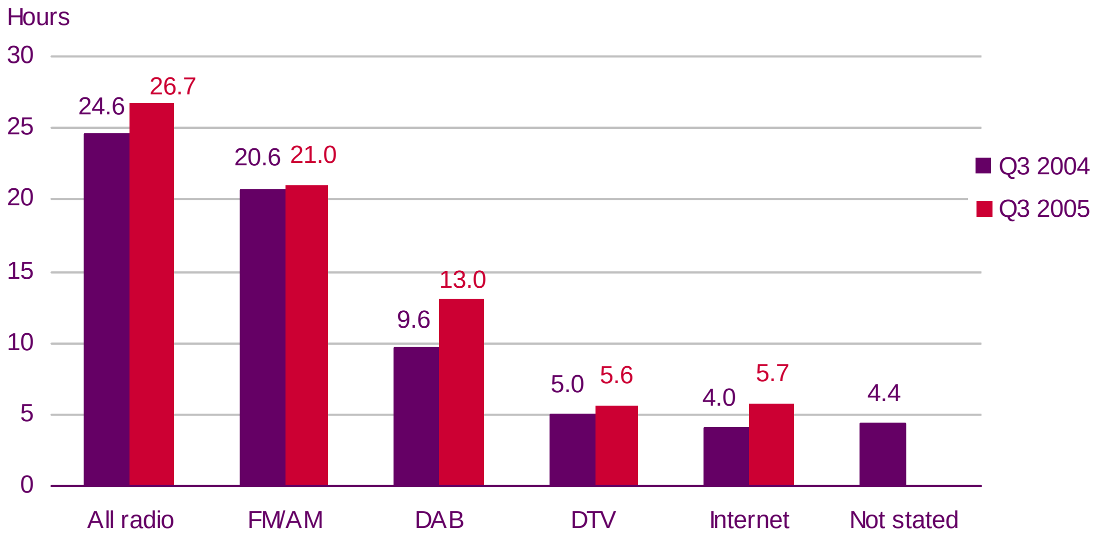
Figure 28: Digital-only listening



Source: RAJAR Q3 2005

DAB was the digital platform which commanded the most listening hours (averaging 13 hours per week in Q3 2005, up by 3.4 hours/week from Q3 2004) – however this was still less than two thirds of the average 21 hours spent listening to analogue platforms. Listening to digital radio over the internet also grew (up by 1.7 hours a week), and listening to radio via digital TV was up by 0.6 hours per week (Figure 29).

Figure 29: Average hours spent listening to each radio platform per week



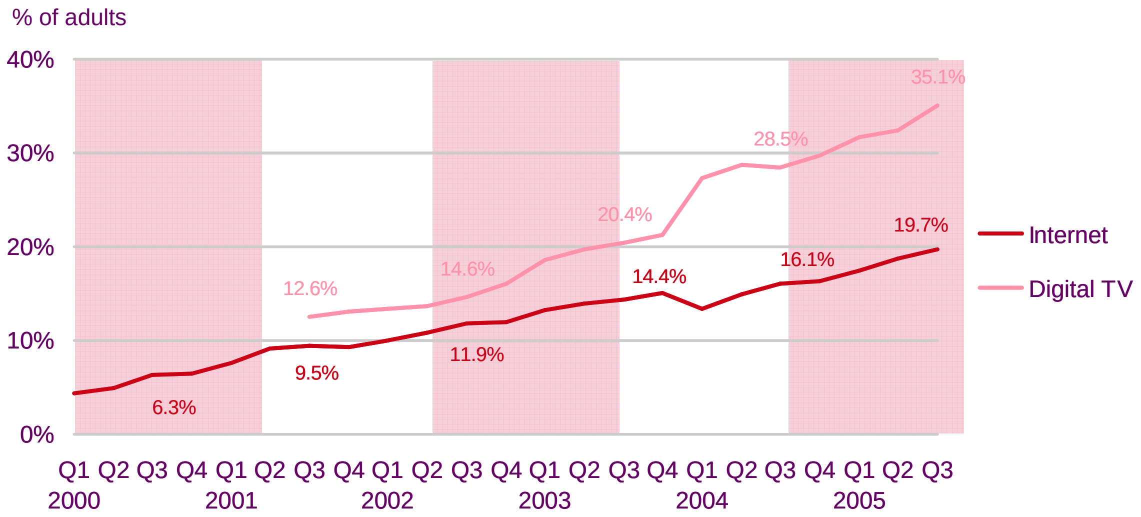
Source: RAJAR platform study

6.10: Over 35% of adults claim to have listened to radio via the television

In Q3 2005, according to RAJAR, over 35% of the adult population claimed to have listened, at some time, to radio via their TV set – this equates to over half of all digital TV viewers (Figure 30). Internet listening is also increasing, up to almost 20% of adults with the internet, partly as a result of product innovations.

These figures are broadly consistent with findings from Ofcom's consumer survey; respondents who had digital television were asked whether they had ever listened to the radio via their television: 30% claimed to have done so, with 5% saying they did so every day; 15% of those with internet access claimed that they used the internet for radio listening.

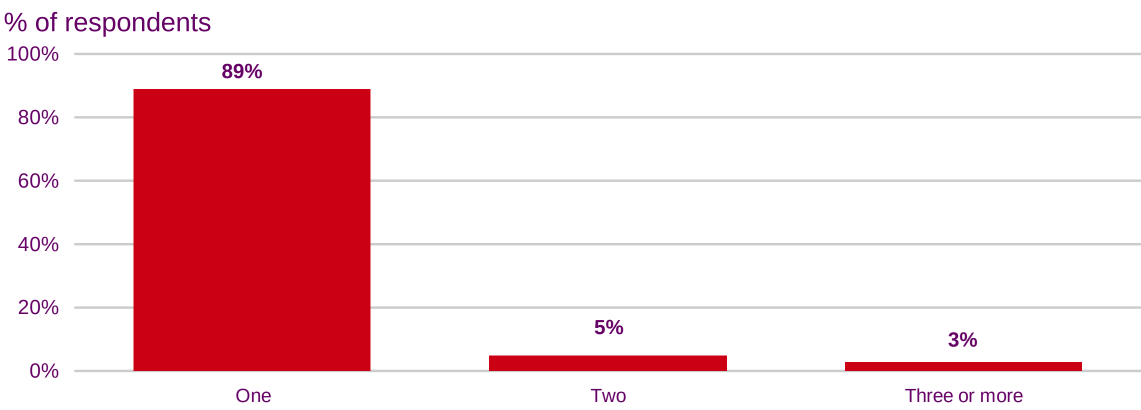
Figure 30: Proportion of adults who have ever listened to radio via television or the internet



Source: RAJAR

Respondents who owned a DAB radio were asked how many DAB sets they owned. The majority (approximately 89%) answered that they owned just one such set, but around 8% said they owned two or more (Figure 31). This in part reflects the early stage of DAB development compared to analogue radio.

Figure 31: How many DAB radio sets do you have in your household?



Source: Ofcom Residential Tracker Survey 2005

7: Theme – Focus on radio finance

7.1: Introduction

The financial performance of the UK radio industry over the last five years shows a mixed picture. Following consistent increases in radio's share of advertising in the late 1990s, recent years have seen it stabilise at around 4.5%[9]. The fortunes of the larger radio groups have been mixed, with some groups issuing profit warnings whilst others have shown growth in a relatively flat market. 'Traditional' advertising revenue is perceived to be declining, whilst digital and brand extensions are providing radio stations with new revenue opportunities.

This section will look at the different funding models for UK commercial radio and the financial performance of the industry[10] as a whole. It will then move on to look at how advertising, still the largest component of commercial radio revenue, is sold. It will conclude by analysing the importance of revenue per listener and per listener hour across different segments of the UK analogue radio market.

7.2: Commercial radio funding models are evolving

Historically, commercial radio stations earned revenue through selling advertising, classified as local or national: local advertising tends to be sold by the radio station directly to advertisers and tends to focus on organisations, products and services based in the local area; national advertising tends to be sold through media sales houses or advertising agencies and is more likely to involve national brands and co-ordinated campaigns across the UK. Although national advertising sales have fallen in recent years, they are still the single largest source of revenue for the UK commercial radio industry.

Following the rise of sponsorship and promotion in recent years, radio stations are now beginning to develop new business models to exploit technological developments in the sector. Revenue streams such as 'calls-to-action' (including text messaging or telephone calls) and downloads (for example the 'Hear It, Buy It, Burn It' service) are emerging, and could generate significant revenue in the future.

In addition to revenue models closely linked to radio programmes, a number of organisations are looking at the opportunities afforded by brand extensions. To date these have primarily involved non-radio brands extending over to radio stations. For example, Saga has a number of analogue and digital stations aimed at the same demographic as its other businesses, and Emap has launched a range of stations largely based around its stable of music magazines (Q, Mojo, Kerrang! etc). Emap's strategy has been largely digital-only (but with Kerrang! 105.2 FM launching in the West Midlands, not exclusively so). In some cases, radio stations have extended their brands into other areas: for example, Classic FM offers, among other things, a magazine, a credit card and a range of CDs and books, while Magic 105.4 brands a credit card, a wine shop and a DVD rental service.

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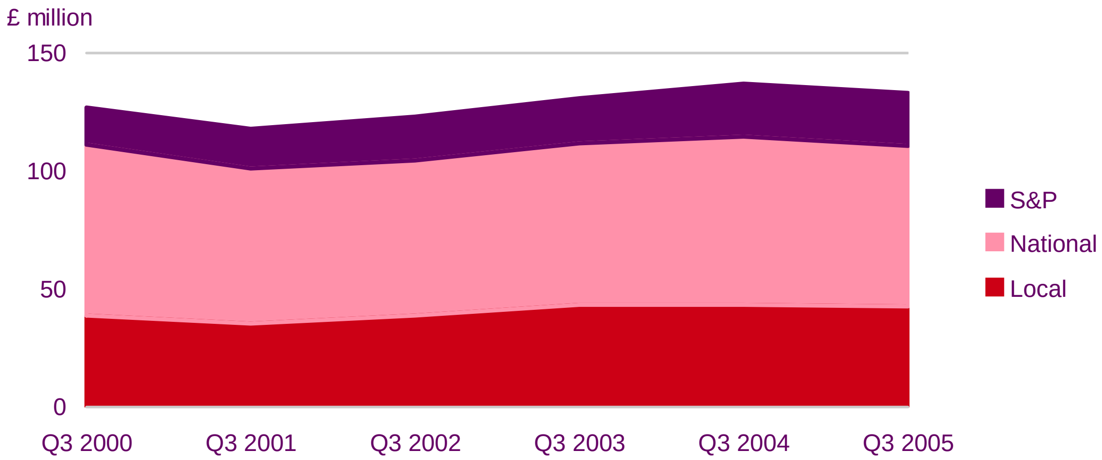
[9] 6.5% to 7% as measured by the Radio Advertising Bureau. The difference occurs due to different definitions of display advertising and radio revenue.
[10] Note: The finances of BBC radio were looked at in the August 2005 Communications Market Report (http://www.ofcom.org.uk/research/cm/aug05update/)

7.3: Market performance shows slow rise

Total Net Broadcasting Revenue (NBR)[11] rose by 5% in the five years between 2000 and 2005, to £133m in Q3 2005. Figure 32 shows that national advertising revenue is still the largest component of commercial radio revenue – however, it fell by 6% between 2000 and 2005, and consequently declined as a share of total NBR from 57% in Q3 2000 to 51% in Q3 2005. Sponsorship and promotion (S&P) rose by 39% over the five years, reaching £22m – 17% of total quarterly NBR – in Q3 2005. Local advertising revenue rose by 11% across the five year period to £43m (32% of NBR).

Figure 32: Total industry revenues[12]



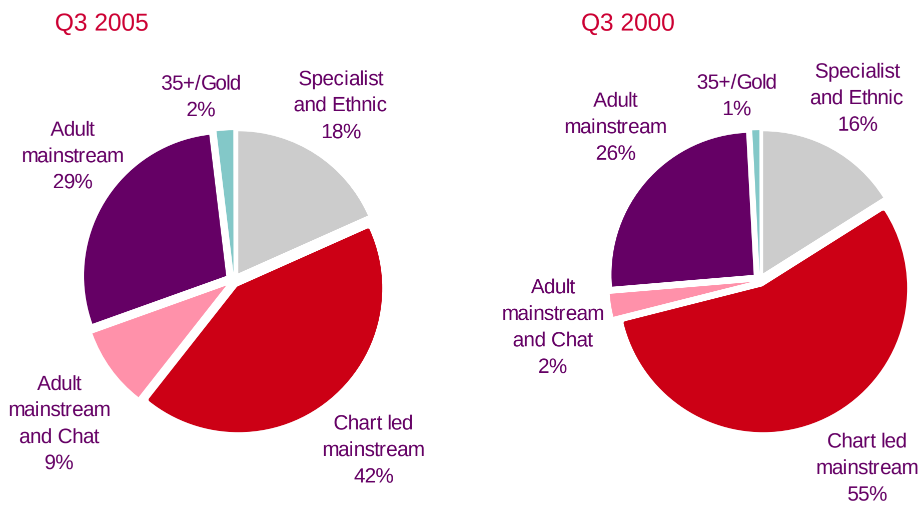
Source: Licensee data

In Q3 2005, 13% of stations had a NBR of greater than £1m. Between them these stations accounted for 63% of total commercial revenue. A further 11% of stations had quarterly revenues between £500,000 and £999,999, comprising 16% of total revenue. 13% of stations had revenues between £250,000 and £499,999; these stations made up 10% of total commercial revenue. The remaining 63% of stations accounted for the last 11% of revenues.

Seven groups owned all the stations with revenues of over £1m per quarter, and nine groups owned all the stations with quarterly revenues greater than £500,000. The revenues of these larger groups increased significantly over the five years to 2005. In Q3 2000 there were eight groups with a quarterly NBR of more than £1m. By Q3 2005 this had (adjusting for the effect of mergers) increased to 13 groups with revenues greater than £1m. Between the same two periods, the proportion of all commercial revenues accounted for by the five largest groups fell from 90% to 80%.

[11] NBR is calculated as gross advertising revenue less sales commission; advertising revenue includes all local, national and sponsorship revenue.
[12] This excludes additional revenue data provided to the RAB by some networked radio programmes.

Figure 33: Revenues by style



Source: Licensee data

The split of revenue between stations of different styles[13] changed significantly between 2000 and 2005 (Figure 33). Chart-led mainstream stations took well over half (55%) of all commercial radio revenues in Q3 2000. Five years later, their share of revenues had fallen to 42%, whilst all other styles had increased their share: in particular, Adult Mainstream and Chat stations increased from 2% to 9%.

7.4: How radio advertising is sold

Advertising airtime on radio is sold in two ways: either on a cost per thousand (CPT) basis, or as ‘spot’ advertising. CPT refers to the cost for each thousand listeners who hear a 30 second advertisement at a certain time (e.g. a cost for each thousand people that hear a 30 second advertisement during next Monday’s breakfast show). Stations also sell spot advertising which gives a total cost to a particular period of airtime (e.g. 30 seconds during next Monday’s breakfast show).

Sponsorship and promotion (S&P) are relatively new commercial activities. Sponsorship may take the form of ‘branding’ a weather or traffic report, and tends to involve a higher level of presenter participation than is the case for traditional advertising. As a result, sponsorship tends to build a stronger relationship with the audience, and is often used by large advertisers on a long-term basis for brand-building purposes. Typical sponsorship contracts last between 6 and 12 months. Promotions tend to be much shorter, typically lasting for a week or a weekend, and are more focused on immediate sales generation. S&P tends to be sold on the same basis as standard advertising, either on a CPT or spot basis. Therefore, in the remainder of this section, the term ‘advertising’ will include both traditional advertising and S&P.

[13] Styles are as defined in figure 2.35 of The Communications Market 2005 (http://www.ofcom.org.uk/research/cm/cm05/)

Pricing

Many radio groups or stations publish a form of 'ratecard' setting out list prices and reflecting differing levels of demand for particular stations and particular time periods. Although the structure of the ratecard varies across the industry, there are a number of common demand factors. These are:

- station or grouping of stations;
- season or month;
- day of week;
- time of day; and
- early or late booking.

The price for a slot on a station or grouping of stations will vary according to a number of factors, including the size of the audience (as tracked by RAJAR), the level of demand for advertising in the relevant catchment area, and the particular demographic that a station is targeting. Although the majority of advertising airtime is traded on the basis of 'all adults'[14], in practice the demographics of a particular station's audience can influence the price demanded for that station's advertising airtime. For example, a station that successfully targets a demographic which is highly valued by advertisers (e.g. 25-34s), will tend to command higher advertising prices than a station targeting all adults. Some radio groups will price each station individually, whereas others will group stations together and have a price for each station in that grouping, rather than for each individual station.

How radio advertising is purchased

There are two principal methods an advertiser can follow in order to purchase advertising:

- **'direct':** an advertiser approaches the sales team at each individual station separately. The industry typically refers to this type of purchase as 'local' advertising as it is the approach generally used by local advertisers that wish to advertise on one or a small number of specific local stations.

- '**indirect':** an advertiser employs the services of a media buying or advertising agency to manage its purchases of advertising on individual stations or clusters of stations, purchasing this airtime through a single point of sale[15] (the radio group's advertising sales house). This is called 'national advertising' by the industry, as it is the method typically used by large advertisers that wish to advertise their product generally to customers across large parts of the country.

Having determined the 'ratecard' value, in many instances the actual price paid will depend on negotiation. Advertisers that do not use an advertising agency or media buying agency tend to negotiate for themselves. However, those using the services of an advertising agency tend to use media buyers to negotiate on their behalf. Media buyers can negotiate for their clients together or individually depending on the deals that they can get.

Even where an advertiser is buying airtime on a large number of stations, the negotiation usually involves the agreement of a price on each individual station rather

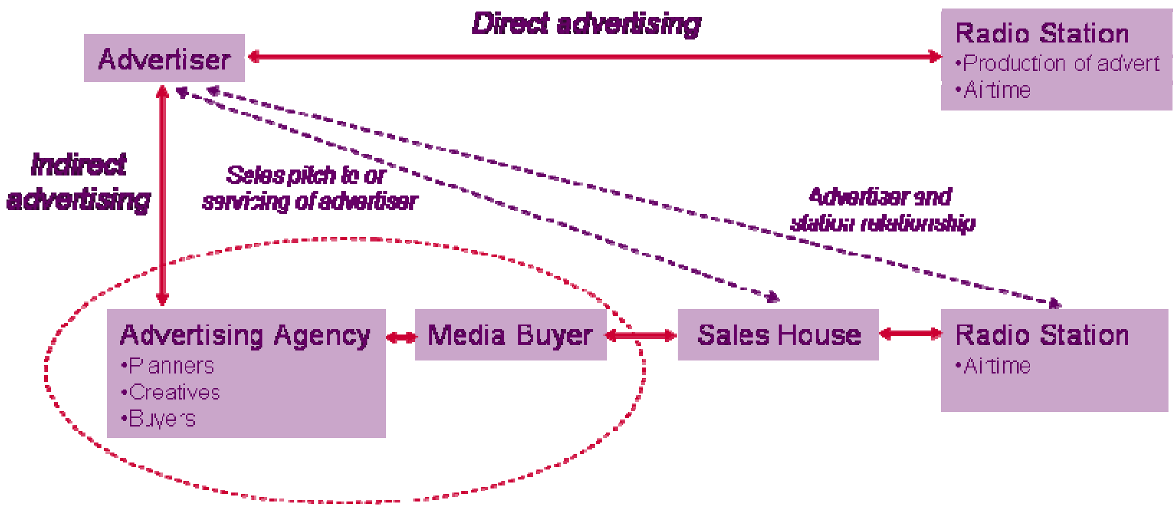
[14] Defined as individuals of 15 years old or older ('15+')
[15] Though it should be noted that the advertiser will still pay a different price for each individual station that it buys.

than an average price across the range of stations at which airtime is being bought.

Advertisers or media buyers usually have the option of contracting[16] with the sales house or the station for an extended period (typically for 6 or 12 months) in order to set a base price for airtime on individual stations over the contracted period. However, it is also possible to purchase airtime closer to the transmission date, usually for a single campaign. Local or direct advertisers tend to buy on a short term basis (i.e. they do not contract), whereas larger advertisers using agencies are much more likely to agree a longer term contract.

Figure 34 is a stylised representation of the process by which radio advertising is sold. The role of each element in the process is discussed in greater detail below.

Figure 34: Radio advertising sales



Source: Ofcom

The advertiser

The advertiser is the ultimate source of a radio station's income. Radio advertisers range in size from the large national advertisers that spend millions of pounds a year on radio advertising, to small local advertisers that may only spend tens of pounds per year. Advertisers determine their overall budget and how much of it they wish to spend on radio. For larger advertisers this decision is likely to be made jointly with the planners at an advertising agency.

The largest advertiser in UK Radio is the Central Office of Information, which is a government body that provides consultancy, procurement and project management for public information campaigns. In the year to November 2005 it spent £34.7m on radio advertising[17]. This was nearly four times the amount spent by Unilever, which had the second highest radio spend at £9.2m. Of the other large advertisers, Vodafone, Abbey and BT all spent more than £6m in the year to November 2005, whilst another 10 organisations spent more than £4m.

Smaller, more local advertisers tend to deal directly with their local radio station whereas national advertisers tend to work through agencies and radio sales houses.

[16] The term 'contracting' is not used in a legal sense, but rather denotes a long term commitment between the station or sales house and the agency or advertiser.
[17] Source: Radio Advertising Bureau / Nielsen Media Research

However, this does not hold true in all instances for national advertisers. In some cases, even though a large advertiser may use an agency, it may have a direct relationship with a radio group's sales house. For example, the sales house may pitch for business to an advertiser, which will then purchase airtime through an agency.

The advertising agency / media buyer

A full service advertising agency (or range of agencies) will try to ensure that all elements of a client's campaign are delivered. Strategic planners will offer advice as to how the client's objectives can be delivered. This may include advice as to the mix of advertising spend on different media. Creative staff design the actual advertisements while account executives liaise with the client and ensure that the advertisement is created and delivered to the media provider (e.g. the radio station, the television channel or the newspaper).

The optimal mix of advertising spend on different media is primarily determined by the type of message that is to be conveyed. Other factors in this decision process could include the different media available and the relative cost effectiveness of these media.

Media buyers purchase advertising space from media owners. Media buyers can either be part of the advertising agency or a separate company.

The largest buying agency in radio is Mindshare, which procured £45.3m worth of advertising in the year to November 2005. Media Com and Carat each bought more than £30m of advertising in the same period. In total, 11 media buying agencies bought more than £10m of radio advertising in the year to November 2005[18].

The sales house

A radio sales house is a single point of contact where a media buyer can buy airtime across a large number of stations. The media buyer may buy airtime on one or more of the stations represented by the sales house. This provides convenience and a level of sophistication for a media buyer, and allows an individual radio station to create more leverage than it might have if it sold advertising separately. Many groups have their own sales houses, for example Emap, GCap and Chrysalis. A number of these sales houses sell advertising space on behalf of third party stations in addition to their own stations, for example First Radio Sales is a subsidiary of The Local Radio Company Plc and Ulster Television Plc (owner of The Wireless Group), and is the national advertising sales agent for over 115 UK radio stations.

The radio station

A radio station can sell airtime on its own behalf, or its airtime can be sold from a central sales house (if a relationship exists either within the group or externally). As discussed above, smaller local advertisers are likely to demand spot advertising, and are more likely to deal directly with individual stations. Individual radio stations usually have their own sales staff and may also have their own in-house creative team. This provides the stations with flexibility and allows them to simplify the radio advertising process for smaller or less sophisticated advertisers, as they can offer them a complete radio advertising solution at one point of contact. Larger advertisers tend to buy on a CPT basis and usually purchase airtime through advertising

[18] Source: Radio Advertising Bureau / Nielsen Media Research

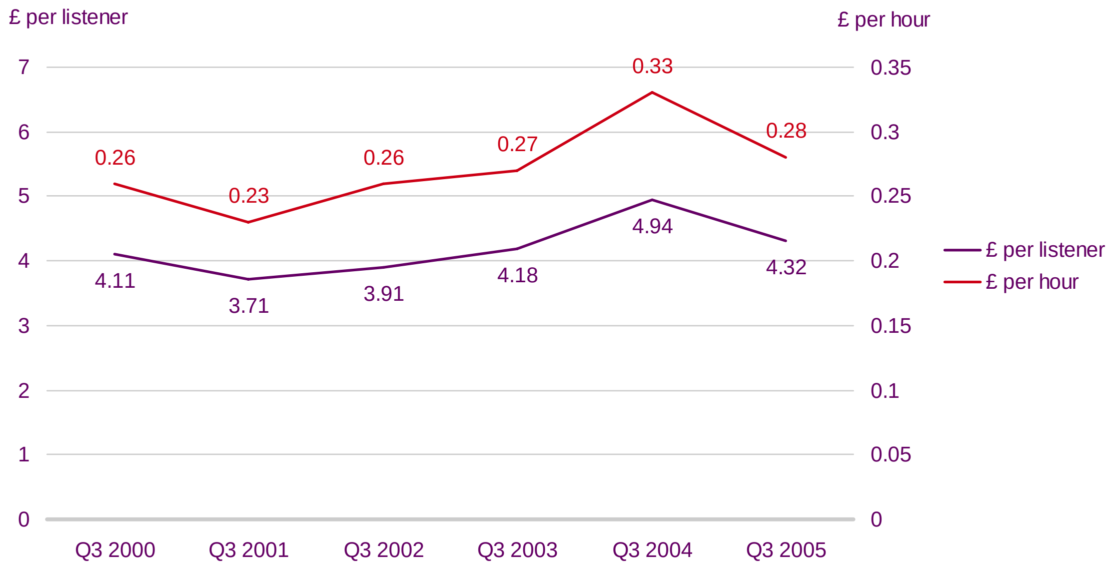
agencies and/or media buyers, and therefore have no direct relationship with the station.

7.5: Revenue per listener and per listener hour

Radio stations tend to have relatively fixed costs, so (all other things being equal) higher absolute revenues should translate to higher profits. However, those stations which cover a larger pool of potential listeners generally have higher revenues than those covering a smaller pool. In this case, direct comparison of total revenues is not particularly revealing. Therefore, for a better understanding of differences in finances across the radio industry it makes sense to look at revenue per listener and revenue per listener hour for different groupings of stations.

Using licensee and RAJAR figures, total revenue per listener in Q3 2005 was £4.32. This has fluctuated over the previous five years, but is up 5% from Q3 2000. Average revenue per hour (calculated as total NBR divided by total adult listening hours) in Q3 2005 was £0.28; again this has fluctuated, but rose by 8% over the five years to 2005 (Figure 35).

Figure 35: Average commercial radio revenue per listener and per listener hour



Source: Licensee and RAJAR data

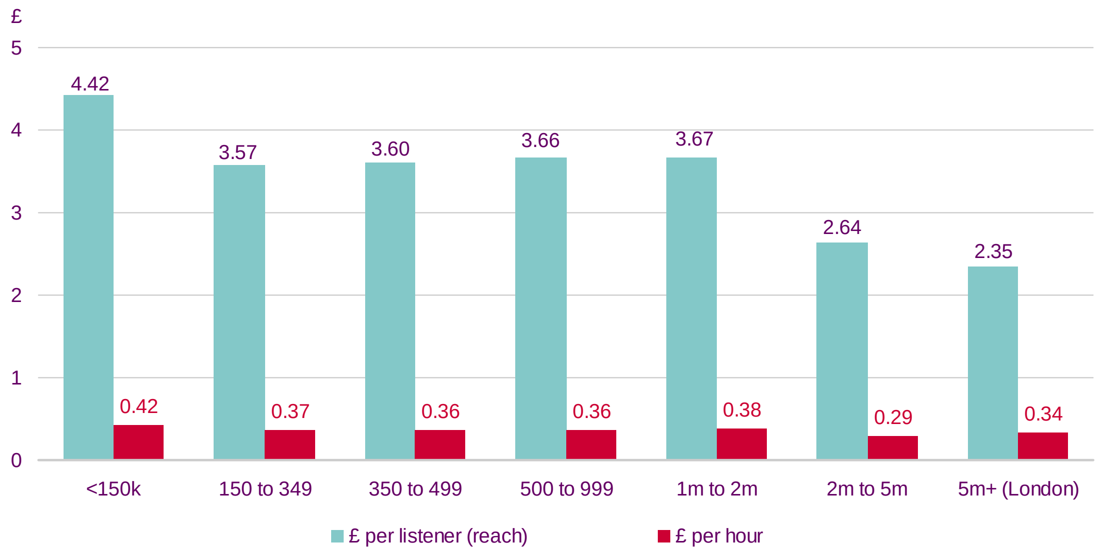
In Q3 2005 the average station revenue per listener (calculated as total NBR divided by adult reach) was £2.74. Three stations managed to generate revenue per listener greater than £10. At a group level, five groups had revenue per listener greater than £3.50, however none of these groups had stations that served the larger metropolitan areas; many of the stations in these groups served larger towns or parts of larger towns. This is borne out when looking at the revenue per hour. Only four radio groups had revenue per listener hour greater than £0.40, and all of these are among the five stations that have the highest revenue per listener.

However, the history of radio in the UK means a number of the groups that have stations in the larger metropolitan areas tend to have both an AM and FM stations in these areas. Because of this, around 1 in 10 stations sell advertising for their AM and

FM variants together[19]. Local AM stations tend to have a lower income per listener than FM stations.

Figure 36 shows that average revenue per listener and revenue per listener hour tend to be highest for stations with the lowest potential audience (as measured by total service area – TSA). Stations with a TSA of less than 150,000 potential listeners have an average revenue per listener 20% higher than stations with a TSA of between 1m and 2m (the group of stations with the next highest average revenue per listener).

Figure 36: Average revenue per listener / listener hour by local station TSA



Source: Licensee and RAJAR data, Q3 2005.
Note: This excludes the national analogue stations

Stations with TSAs between 150,000 and 1m have a broadly similar average revenue per listener and revenue per listener hour. Revenue per listener and per listener hour for stations in this range is significantly lower that that of the smallest stations. However, average revenue rises as the stations increase in size from TSAs of 150,000 to 1m.

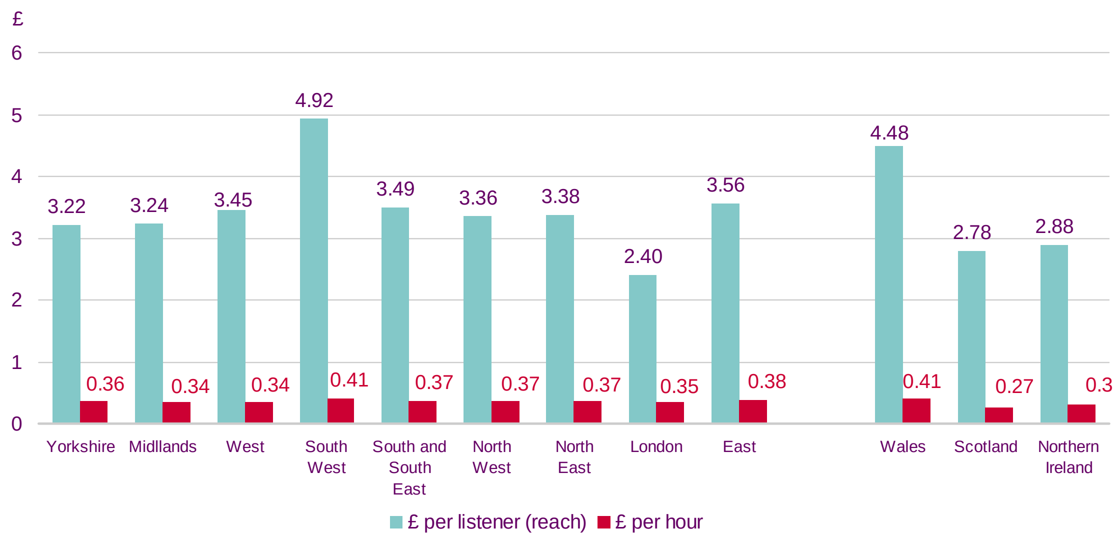
Stations with the lowest revenue per listener and revenue per listener hour tend to be those that have the highest potential audience (those stations with a TSA greater than 2m). Those stations with a TSA greater than that 5m (the London stations) have the lowest average revenue per listener, while those with a TSA of 2m to 5m have the lowest average revenue per listener hour.

There are a number of potential reasons for this. Only stations that cover London have a TSA greater than 5m. London has the greatest choice of listening in the UK (see Ofcom's October 2004 Communications Market Report[20]). The increased competition in the market may therefore lead to the revenue per listener being lower. On the other hand, smaller stations may be more effective at tapping into local advertising For instance, local advertisers (which may be less price- or results-

[19] In these instances where appropriate in the analysis the revenue is attributed to the FM station as it is likely to be the source of the majority of the revenue.
[20] This discussed further in Ofcom's October 2004 Communications Market Report (http://www.ofcom.org.uk/research/cm/qu_10_2004/)

sensitive than national advertisers) may not consider other alternatives such as television or outdoor advertising.

Figure 37: Average revenue per listener / listener hour by nation and regions data



Source: Licensee and RAJAR data, Q3 2005
Note: There are a number of stations that only cover part of London; therefore there is a difference between the London figures in this chart and the figures for stations with TSAs greater than 5m in the preceding chart.

There are also significant differences in revenues across the nations and regions. London has the lowest revenue per listener whereas the South West has the highest (Figure 37). However, the mix of urban, rural, regional and other stations in each of these regions varies, so strong conclusions cannot be drawn from this data.

7.6: What does the future hold?

Although UK commercial radio revenues and per listener revenues have stayed broadly flat over the past five years, this is set against the broader picture of falls in commercial radio's share of listening. A number of radio groups have taken specific steps to address the fall in listening and, if successful, these would be expected to ultimately translate into increased revenues and may lead to similar changes by operators of other radio stations.

Looking a little further forward, it seems likely that commercial radio will further reduce its reliance on traditional advertising revenue, although it will likely remain the most significant source of commercial radio revenue for some time. Sponsorship revenue is growing rapidly, and new sources of revenue such as subscription podcasts and brand extensions are emerging.

Looking to the longer term, as digital radio broadcasting increases it is likely that the additional opportunities provided by this new platform will be embraced by radio companies.

8: Telecoms market developments

8.1: Major mergers and acquisitions dominate the headlines

Telefonica acquires O2
In January 2006 Spain's Telefonica acquired UK mobile network operator O2, in a deal worth around £17.7 billion. The acquisition was cleared in early January by the European Commission, which had been concerned about potential distortions in international roaming charges. In return for the Commission's approval, Telefonica has undertaken to withdraw from its international cellular roaming alliance with Deutsche Telekom, France Telecom and Telecom Italia.

Telefonica announced its offer for O2 in October 2005, following months of speculation regarding potential suitors for the former mobile division of BT. There were strong rumours that Deutsche Telekom or KPN – or a consortium of the two – might have made counter-bids (KPN had already had a bid rejected by the O2 board in 2004); however, neither operator came back to the table, and neither was there any approach from private equity firms.

In acquiring O2, Telefonica has gained control of a UK nationwide 2G network and partial-coverage 3G network, together with almost 16 million directly-controlled UK customers (plus a further 1m through the Tesco Mobile MVNO joint venture). It also now controls O2's operations in Germany (9.8 million subscribers) and Ireland (1.6 million subs). In the year to March 2005, O2 generated revenues of £6.7 billion, EBITDA of £1.8 billion, and pre-tax profit of £309 million.

One of the more compelling reasons for O2 to accept the Telefonica offer was the geographic fit: there is no overlap between the two companies' operations, and Telefonica's strength in Spain and Latin America fits well with O2's northern European presence. Telefonica has a strong corporate fixed-line presence in Germany (Telefonica Deutschland), which it plans to merge into O2 with the aim of offering fixed-mobile convergence (FMC) services to business customers. Telefonica estimates that the deal will generate operating synergies of up to £200m per year by 2008, mainly as a result of economies of scale in marketing, head office functions, and purchasing.

Telefonica has stated that O2 will retain its brand, and will continue to be based in the UK, with a management board reporting to the Telefonica main board in Spain. O2's CEO Peter Erskine remains in charge (as Chairman and CEO), and also joins the main board of Telefonica. The acquisition of O2 means that all but one of the UK's mobile network operators are now owned by companies based outside the UK (Vodafone being the sole exception).

Ntl and Telewest merge
In October 2005, Ntl announced an agreed bid of around £3.4 billion for rival cable operator Telewest. The two companies subsequently restructured their merger deal before Christmas, so that Telewest is now legally taking over Ntl rather than the other way around. This was done because Telewest owns broadcaster Flextech, which in turn owns 50% of the TV channel group UKTV in a joint venture with the BBC. The terms of the UKTV joint venture gave the BBC the right to buy Flextech's 50% share in the event of a change of ownership of Flextech – this right would have been triggered had Ntl legally acquired Telewest.

A combined Ntl / Telewest would have around 5.1 million subscribers (compared to BSkyB's 8 million), of which over 2.2 million are broadband internet subscribers. The combined companies' cable networks currently pass around 12.6 million of the UK's 25.1 million homes.

The Office of Fair Trading cleared the deal to go ahead in December 2005, noting that there is no overlap in the two operators' cable networks and therefore no diminishing of consumer choice for access. The OFT also rejected concerns expressed about the potential competition issues arising from Telewest's ownership of Flextech, its programming arm.

The Ntl / Telewest merger is discussed at more length in the Television section of this report. From a telecoms perspective, the merger creates a powerful high-speed broadband and fixed-line operator with a network that reaches half the homes in the UK.

BSkyB buys Easynet
Also in October 2005, BSkyB announced a recommended bid for LLU (local loop unbundling) operator Easynet for £211 million. The transaction was cleared by the Office of Fair Trading in January 2006, and is expected to complete by the end of February 2006.

In buying Easynet, BSkyB has added a major UK distribution platform to its satellite network. Easynet will provide Sky with high-speed broadband access to around 6 million UK households through unbundled local exchanges – the operator has already unbundled 232 UK exchanges covering 4.4 million UK households, and has planned to unbundle up to a further 120 exchanges over 2006).

Sky believes that broadband offers a significant opportunity for it to evolve its business model, offering a potential source of both new customers and new revenues. Broadband connectivity will allow Sky to offer advanced interactive, targeted services and programming (for example, full on-demand operability and narrowcasting) – a facility that is difficult if not impossible to achieve over a satellite link, even with a telephone return path.

Sky also believes that a broadband strategy is essential for it to best compete in a rapidly converging landscape. The prospect of 'home hubs' and device convergence is coming ever closer as broadband speeds increase, devices become more intelligent and more unified, and home data storage becomes smaller and cheaper.

C&W acquires Energis
In August 2005, Cable & Wireless issued an agreed bid of £780 million for Energis. The OFT passed the bid in October 2005, having judged that the acquisition raised no significant competition issues, and the deal has now completed.

By acquiring Energis, C&W has cemented its position as the second operator in the UK business telephony and data services sector behind BT. Energis owned significant amounts of fibre network infrastructure, which, when combined with C&W's IP backbone network, creates a powerful facilities-based operator capable of delivering next-generation products and services.

C&W announced at the time of the bid that it needed to become a larger-scale operator in order to compete effectively in the UK communications market. Energis gives it a greatly-enhanced presence in the corporate and large business market, and is seen as the last major acquisition-related piece in the jigsaw for C&W's

corporate strategy following the purchase of LLU operator Bulldog last year. C&W announced in February 2006 that it was to separate into two distinct business units – UK and International. There is speculation that C&W UK may choose to focus exclusively on wholesale and corporate services – a strategy that would place question marks over the future of Bulldog.

The combined businesses are forecast to generate around £80 million in cost synergies within three years, mainly in the areas of inter-company trading, purchasing, marketing and customer support. In the year to March 2005, C&W's UK business had revenues of £1.6 billion, and Energis had revenues of £720 million.

Ntl announces intention to acquire Virgin Mobile
In addition to its merger with Telewest, Ntl also announced in January 2006 that it intended to acquire Virgin Mobile, the UK's leading mobile virtual network operator (MVNO) with over 4 million subscribers. The deal valued Virgin Mobile at £919 million, after major shareholder Richard Branson agreed to receive less per share than other minority investors.

This was Ntl's second approach for Virgin Mobile, after an earlier offer in December 2005 was rejected when Virgin Mobile's board and its minority shareholders had argued that the minorities should receive more. Both companies said a deal would be subject to several preconditions, including a successful brand licensing deal between Virgin Group and Ntl. It is likely, therefore, that the combined business would operate under the Virgin brand.

If the deal completes, the new company would be the first in the UK to offer quadruple-play services spanning cable TV, fixed-line telephones, mobile and Internet. This in turn could act as a driver for convergence of services and devices, particularly in the area of fixed/broadband/mobile convergence using voice over IP technology.

8.2: TV over mobile takes its first steps

Operators launch TV services over 3G
The second half of 2005 saw the introduction of live streaming TV over 3G by most of the UK's network operators:

- **Orange:** Its mobile TV service was the first to launch in the UK, in May 2005. Subscribers with 3G devices can access 16 channels, including live feeds from ITN, CNN and Bloomberg, and other channels such as Bravo, Fashion TV and Cartoon Network. The service costs £10 per month for up to 20 hours' viewing, and 50p per minute for any viewing above this amount.

- **Vodafone:** In November 2005, Vodafone Live! began offering its Sky Mobile service over 3G. The service comprises a mixture of live feeds from Sky News, Sky Sports News, CNN and Bloomberg, plus a variety of other channels including Discovery Channel, MTV, Nickleodeon and Sky Movies. Tariffs start at £5 per month per 'bundle' of programmes (Sky News, Sports and Factual Pack, and Sky Music & Entertainment Pack)

- **3:** Having been the first operator to introduce 3G services, 3 currently offers a subscription TV service, with a variety of pre-recorded channels to choose from including Sky Sports News bulletins, certain MTV shows, and a 24-hour music video channel. Prices start at £5 per month per 'genre' of programmes (sport, general). In addition, subscribers with certain Nokia handsets can access MobiTV (the same channel package as Orange offers), via a separate subscription.

- **O2** and **T-Mobile:** Neither operator has yet introduced live TV over 3G, although T-Mobile offers video traffic reports, and O2 offers a number of downloadable video clips via its i-mode service (although it has trialled the delivery of TV over DVB-H – see below).

O2 trials TV over DVB-H
In September 2005, mobile operator O2 began a trial of mobile TV using DVB-H technology, in conjunction with TV broadcaster Arqiva. DVB-H (Digital Video Broadcasting - Handheld) is a proprietary standard for transmitting TV signals to mobile devices, and was developed in part by Nokia. It has been adopted as the preferred standard by ETSI (European Telecommunications Standards Institute) and the EBU (European Broadcasting Union).

The trial took place in the Oxford area among 375 volunteers, using specially-developed Nokia devices. A wide variety of broadcast TV channels was provided, including all five free-to-air channels, CNN, Sky News and MTV. The trial is expected to last for six months, and interim findings were released in January 2006. They indicated that the trial viewers watched on average over three hours of mobile TV per week, with each viewing session lasting an average of 23 minutes. Perhaps surprisingly, 36% said they used the service most often when they were at home, and the most popular viewing times were before 9am, between 12pm and 2pm, and between 6pm and 8pm.

DVB-H is one of a number of technologies that could be used to transmit new media services (including TV and radio) to handheld and mobile devices. Other technologies include DMB, proprietary technologies such as MediaFLO, and development of 3G standards such as MBMS. The use of a technology such as DVB-H or DMB is potentially attractive as it would allow one-to-many broadcasting, which uses less capacity for these applications than existing 3G services. However, technologies like these will require new subscriber devices and new networks, as well as access to the radio spectrum, which is a scarce and valuable resource already heavily in demand.

Ofcom is currently taking forward work on releasing a variety of spectrum bands to the market that could be used for new applications such as these. This includes plans to auction spectrum at 1452-1492 MHz ('L-Band') in 2006-2007, and work on the Digital Dividend Review, which is considering options for use of the spectrum that will be released when the analogue TV signal is turned off in 2012. Ofcom announced terms of reference for the Digital Dividend Review in November 2005, and expects to publish a consultation document before the end of 2006.

BT and Virgin Mobile trial TV over DAB
In mid 2005, BT and Virgin mobile teamed up to trial the BT Movio (previously known as BT Lifetime) mobile TV service, using existing DAB technology and network. The trial was conducted among around 1,000 users in the London area, who were issued with devices capable of receiving DAB mobile TV as well as DAB radio. The DAB-IP standard used by BT for mobile TV broadcasting differs from DVB-H in that it uses a different technical standard (known as Eureka 147) and operates commercially in a different area of the radio spectrum.

The results of the trial showed that the mobile TV product was popular, with users watching an average of 66 minutes per week (interestingly, the same users listened to an average of 95 minutes of radio per week over the same device). This compares with reported viewing of around three hours per week in the O2 trial – a discrepancy that may in part be explained by the fact that the BT trial only offered three channels, compared with 16 channels in the O2 trial. As with the O2 trial, the most popular viewing times were early in the morning or in the early evening, and again a surprising amount of mobile TV viewing took place within the home.

BT believes that its Movio product will gain widespread market acceptance, since it can be commercially rolled out almost immediately, using space on the Digital One multiplex. In addition, the first commercially available handset – capable of receiving both mobile TV and DAB radio – is already being produced by HTC in Taiwan. However, a significant factor limiting the appeal of TV over DAB is the small number (5-8) of channels that can currently be provided, owing to spectrum constraints on the DAB multiplex.

8.3: Ofcom relaxes retail price controls on BT, but moves to reduce wholesale prices

In December 2005, Ofcom announced that it was going to relax the existing retail price controls over BT, in line with a commitment made in 2003 relating to the delivery of BT's Wholesale Line Rental (WLR) product.

Ofcom confirmed in December that after two years of development the WLR product offered by BT now meets a series of agreed product criteria, subject to certain further improvements committed to by BT. WLR is used by BT's competitors to offer customers a single bill for line rental as well as voice calls.

In reaching its conclusions, Ofcom assessed the WLR product against a series of requirements first agreed with telecoms companies in 2003 covering service standards, functionality and market impact.

Ofcom's analysis showed that the WLR product now meets almost all of these requirements. There are now nearly 2 million WLR lines in the market, and take-up continues to grow with more than 130,000 new orders every month. BT has given written commitments to resolve the small number of outstanding issues as part of system upgrades in April 2006.

Ofcom reduces BT wholesale prices to improve competitors' margins

In order to compete effectively, telecoms companies need a clear margin between the wholesale price they pay to rent a telephone line from BT, and the price that they charge their retail customers for line rental.

Increasing this margin will mean greater competition in the calls and line rental market, expanding consumer choice, and increasing value for consumers as more providers compete for their custom.

In January 2006, Ofcom set charge ceilings for certain WLR charges, which will result in a cut in WLR prices by 9% for residential WLR and by 8% for business WLR.

The margin will also be increased as a consequence of price changes previously announced by BT in June 2005. BT is raising its retail charges for line rental (including VAT) by 50 pence per calendar month, with effect from January 2006.

Openreach opens for business

BT's new local access business unit, Openreach, came into being on 11 January 2006 – ahead of schedule. The creation of Openreach was a key outcome of BT's acceptance of undertakings in lieu of a referral under the Enterprise Act. The WLR product previously offered by BT Wholesale is now offered to providers by Openreach, which employs 30,000 staff (around 25,000 of whom are engineers) and operates 22,000 vehicles. Openreach has a separate brand identity and livery to BT Group, with separate headquarters and management board.

Openreach's performance and compliance with the undertakings will be monitored by the Equality of Access Board (EAB) – an independent compliance board which will have extensive powers to request information from Openreach and other parts of BT Group, and which will publish its findings regularly. In addition, Ofcom will closely monitor industry outcomes in order to gauge not only BT's compliance with the letter and spirit of the undertakings, but also whether the regulatory approach itself has had the desired effects for citizens and consumers.

As part of BT Group's Undertakings, Openreach is committed to delivering further improvements on the WLR product by mid-2007. These developments will give BT's competitors access to a WLR product which is exactly equivalent to the product available to BT's retail businesses.

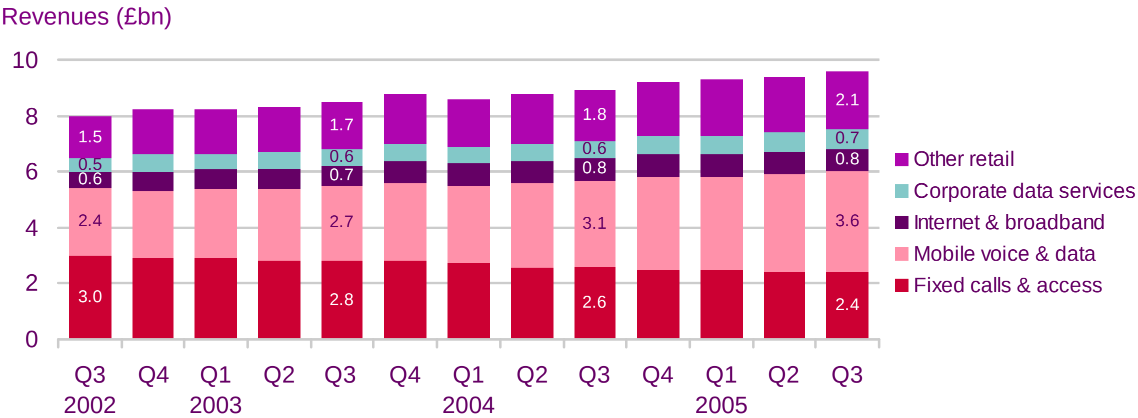
9: The telecoms industry

9.1: Revenues grow in all areas except fixed voice

Overall retail telecoms service revenues in the three months to September were £9.6bn, 4% higher than six months previously and 6% higher than the corresponding period a year ago. Retail revenues in the 12 months to September 2005 were £37.2 billion, £2.2bn more than in the previous year.

Figure 38 shows the breakdown of revenues from each of the main categories of telecoms service. Growth was largest in the mobile sector, where revenues increased by 9% in the six months to September 2005. Fixed voice revenues on the other hand fell by 5% over the same period. Internet revenues remained relatively steady with growth of only 2% between Q1 and Q3 2005, as increased broadband take-up was countered by falling prices.

Figure 38: Revenue from main telecoms services

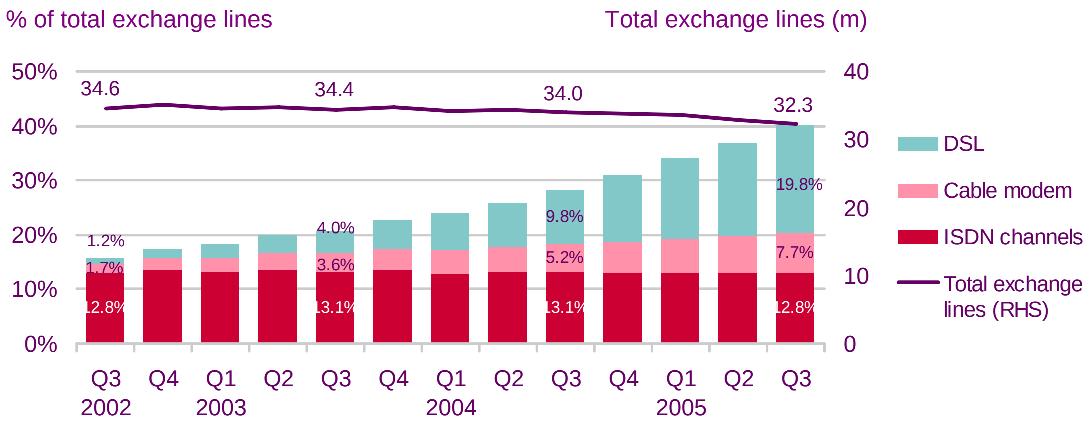


Source: Ofcom / operators

9.2: Fixed voice revenues continue to fall as competition grows

The total number of fixed exchange lines in the UK continues to decline, reflecting growth in mobile-only homes and a fall in the number of second lines for dial-up internet access (Figure 39). Overall, the total number of broadband enabled lines was 27% of all exchange lines at the end of September 2005 compared to 15% a year earlier. Including ISDN, over 40% of fixed exchange lines can now be said to provide a quality of service superior to basic PSTN.

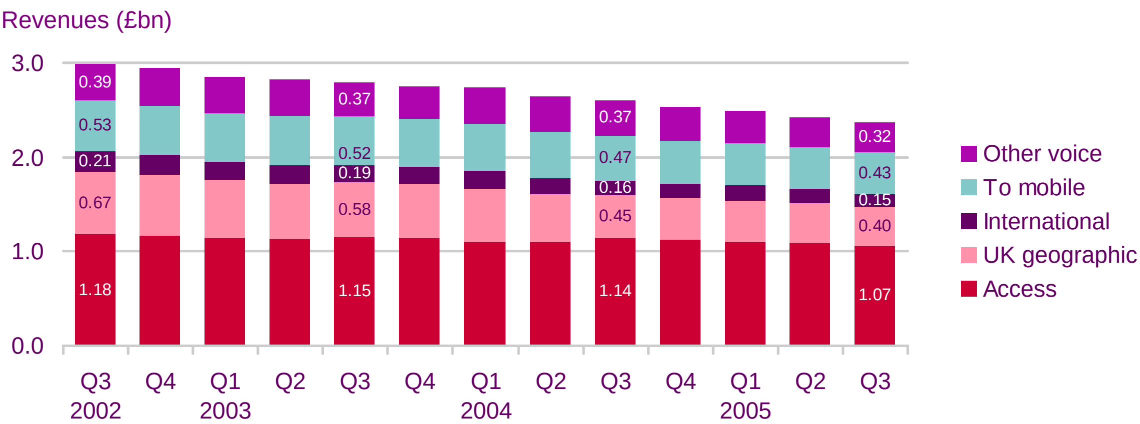
Figure 39: Fixed telecoms lines



Source: Ofcom / operators

A downward trend in voice call volumes, combined with price reductions, contributed towards falling fixed access and call revenues. Overall fixed voice revenues fell by 5% in the six months to September 2005 and were down 9% on a year previously (Figure 40). Of the major call types, revenues from UK geographic calls were hardest hit, down 9% year-on-year. Revenues from fixed to mobile calls were down 10% year-on-year, reflecting to some extent regulatory action on mobile termination rates. Total residential calls and access revenues fell by 7% year-on-year while business figures were down 13%. Full details are provided in the telecoms data appendices.

Figure 40: Fixed voice telecoms revenues



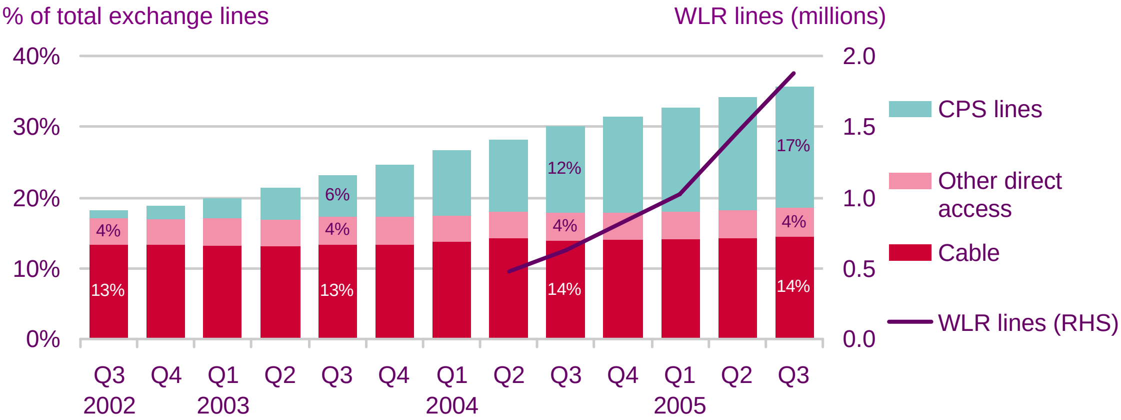
Source: Ofcom / operators

Note: 'Other voice' includes all other calls made from a fixed line except dial-up internet e.g. calls to directory enquiries, premium rate services and other special local and national rate calls

9.3: Competition increasing as CPS take-up continues to grow

At the end of September 2005 there were 5.6 million carrier pre-selection (CPS) lines, representing over a fifth of all BT exchange lines. Carrier pre-selection enables customers to automatically make and receive calls using an alternative operator's service over their BT line, without having to dial prefixes or use specialist end-user equipment. Together with existing direct access competition, around 36% of lines now use voice services from non-BT providers (Figure 41). At September 2005 there were over 1.8 million lines serviced by other operators using BT's wholesale line rental (WLR) product.

Figure 41: Lines taking non-BT services

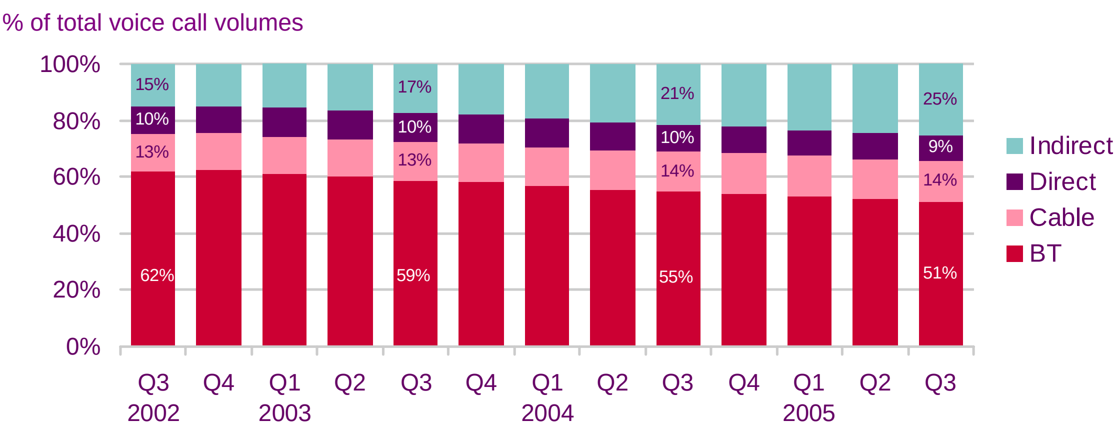


Source: Ofcom / operators

9.4: BT's share of fixed-line volumes falls further

Continued growth in competition resulted in further reduction in BT's share of call volumes over 2005 (Figure 42). Its share of total fixed voice volumes (defined as UK geographic calls, international calls, and calls to mobiles) fell from 53.1% to 51.3% in the six months to September 2005, and is four percentage points lower than a year ago. Total indirect access volumes on the other hand represented 25% of all call volumes, an increase of four percentage points on a year previously.

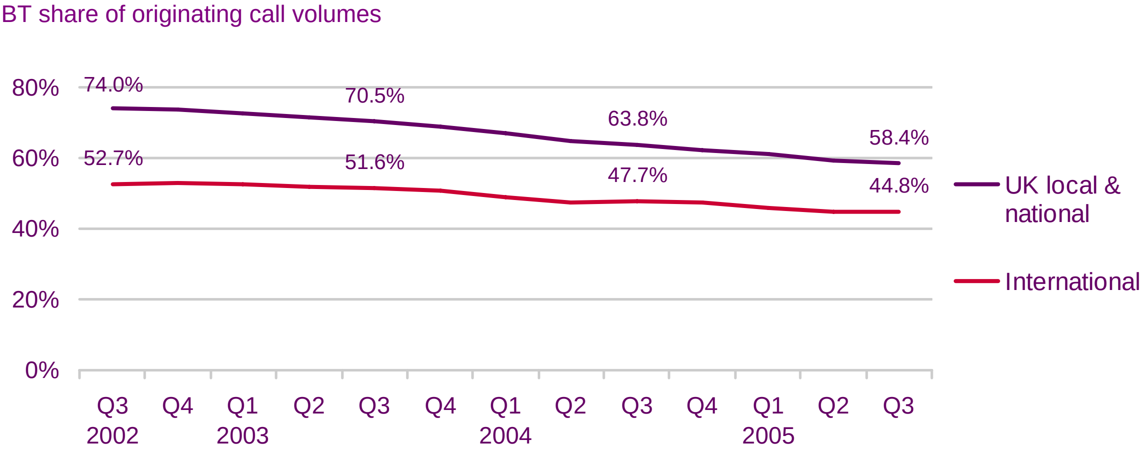
Figure 42: Fixed call volume market share



Source: Ofcom / operators

BT's share of residential UK geographic voice call volumes continued to decline and stood at 58% in Q3 2005 (Figure 43). The company lost nearly 3% of market share to smaller fixed voice service providers over the six months, while the combined share of BT's largest competitors, Ntl and Telewest, stayed unchanged at around 19%.

Figure 43: BT share of residential voice calls

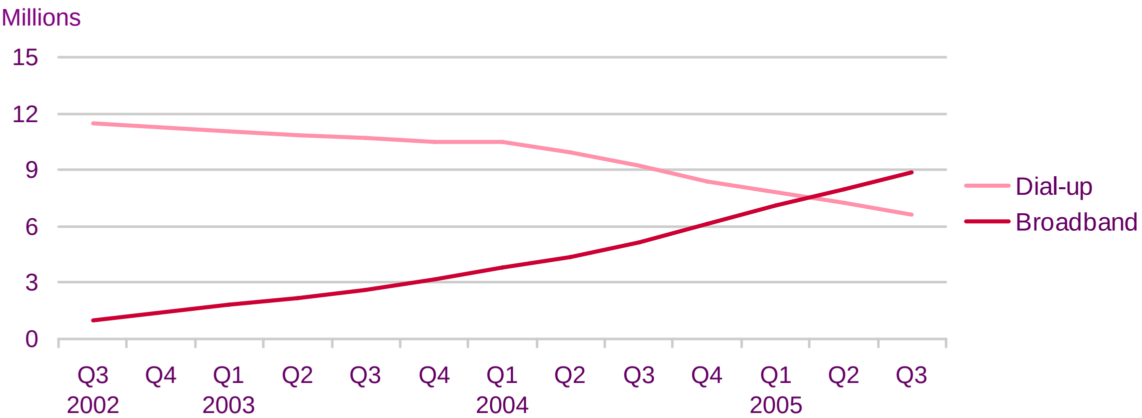


Source: Ofcom / operators

9.5: Broadband growth drives internet connections

Provisional figures show that there were 9.792 million UK broadband connections by the end of December 2005. Although broadband growth has slowed, Ofcom estimates that there were 15.5 million internet connections in the UK at the end of September 2005 (Figure 44). The number of dial-up internet connections continued to fall, as dial-up users switched to broadband services. Often there is little price differential between unmetered and dial-up services, and in some cases broadband tariffs are cheaper than unmetered packages.

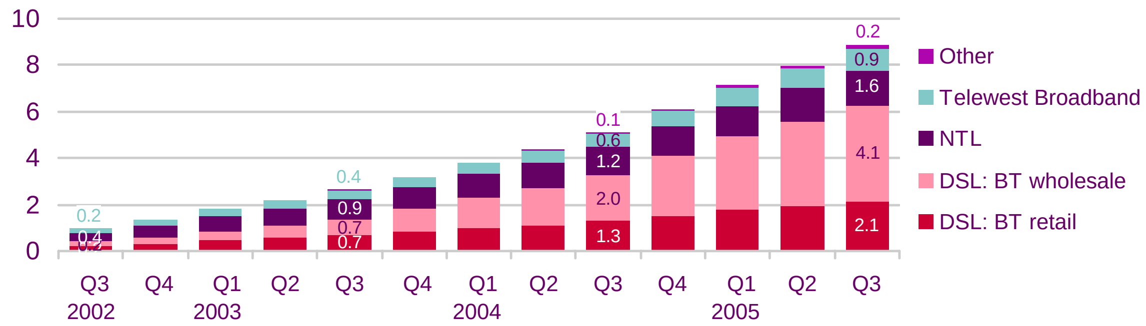
Figure 44: UK internet connections by type



Source: Ofcom / operators

Ofcom's own survey estimates show that the proportion of homes with internet access was 58% in November 2005, up from 56% in June. Broadband accounted for 57% of all internet connections in the UK as of Q3 2005, with 6.4 million DSL connections and nearly two and a half million cable modem connections in the UK (Figure 45 and Figure 46).

Figure 45: UK broadband internet connections by platform



Source: Ofcom / operators

Figure 46: UK broadband internet connections

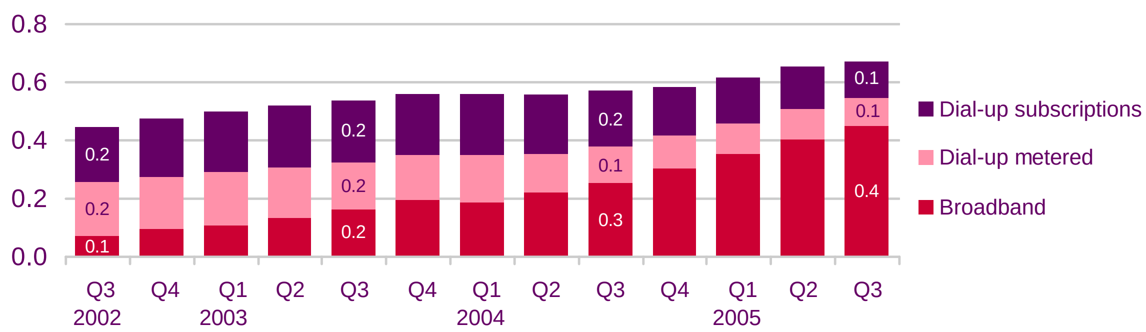
000s

	Sep 04	Dec 04	Mar 05	Jun 05	Sep 05
BT retail	1,283	1,491	1,752	1,940	2,110
BT wholesale	2,011	2,616	3,180	3,658	4,119
Other DSL: LLU & Kingston	42	53	71	105	163
Ntl	1,174	1,247	1,327	1,409	1,550
Telewest BB	607	703	792	858	925
Other: Satellite & FWA	9	9	9	9	9
Total	**5,126**	**6,119**	**7,131**	**7,979**	**8,876**

Source: Ofcom / operators

The continued migration of dial-up internet customers to broadband services has also helped swell internet service provision revenues, although this has been offset to some extent by the competitive price environment. Overall, broadband revenues reached £450 million in the three months to September 2005, some 77% higher than the same period a year ago (Figure 47). Broadband now accounts for over two thirds of ISP revenues.

Figure 47: Estimated dial-up and broadband internet service provision revenues

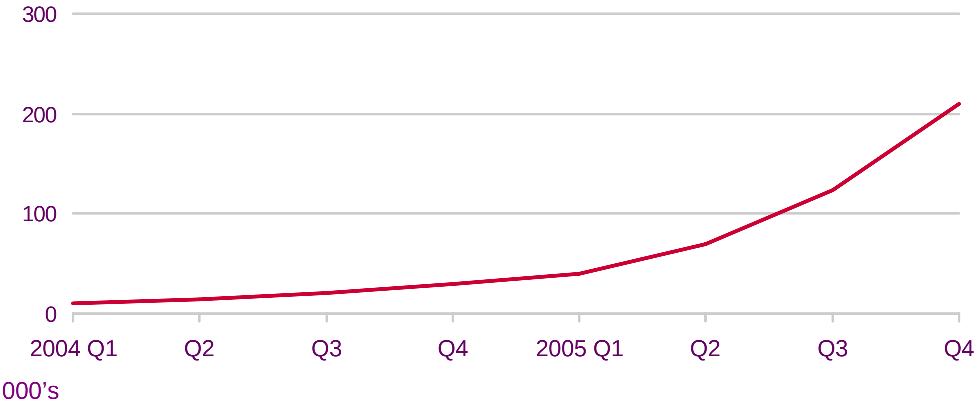


Source: Ofcom / operators
Note: dial-up metered revenue figure is based on revenue paid to the telecom provider, not the element retained by ISP

9.6: LLU price cuts have stimulated take-up

Recent wholesale price cuts for access to BT's copper loops, as well as on-going work on BT's wholesale systems and processes, have stimulated take-up of local loop unbundling (LLU) amongst ISPs (Figure 48). Many internet service providers have recently started to use unbundled lines to connect their customers rather than use BT's wholesale DSL products. Use of LLU allows BT's competitors to differentiate their products and prices from BT's, and therefore offers the greatest opportunity for innovation. Wanadoo is offering its unbundled customers speeds of up to 8Mbit/s compared to BT's fastest 2Mbit/s speed, and other ISPs such as Be Un Limited are offering speeds of up to 24Mbit/s using ADSL2+ technology.

Figure 48: Unbundled local loops

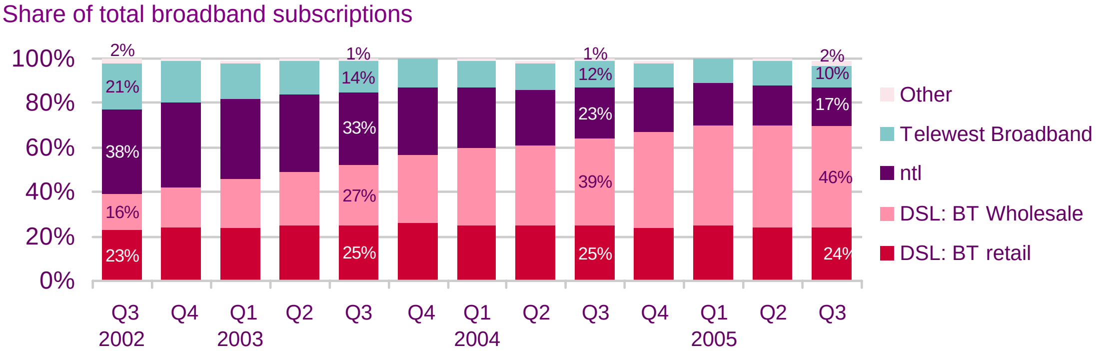


Source: BT / Office of the Telecoms Adjudicator

9.7: BT's wholesale DSL product continues market leadership

In the broadband market, there has been little change in wholesale market structure over the last few periods, although there has been an upturn in the number of services provided over unbundled local loops. BT's wholesale DSL service (supplied to both BT Retail and to other ISPs) continues to account for 70% of the broadband market. At the retail level, BTs market share has been stable at around 24% while the share of the two cable companies has been slowly eroding. Alternative ISPs, using BT's wholesale DSL product, have now managed to gain over 45% of the retail broadband market. Wholesale market share figures, based on operator returns, are summarised in Figure 49.

Figure 49: Broadband wholesale market share



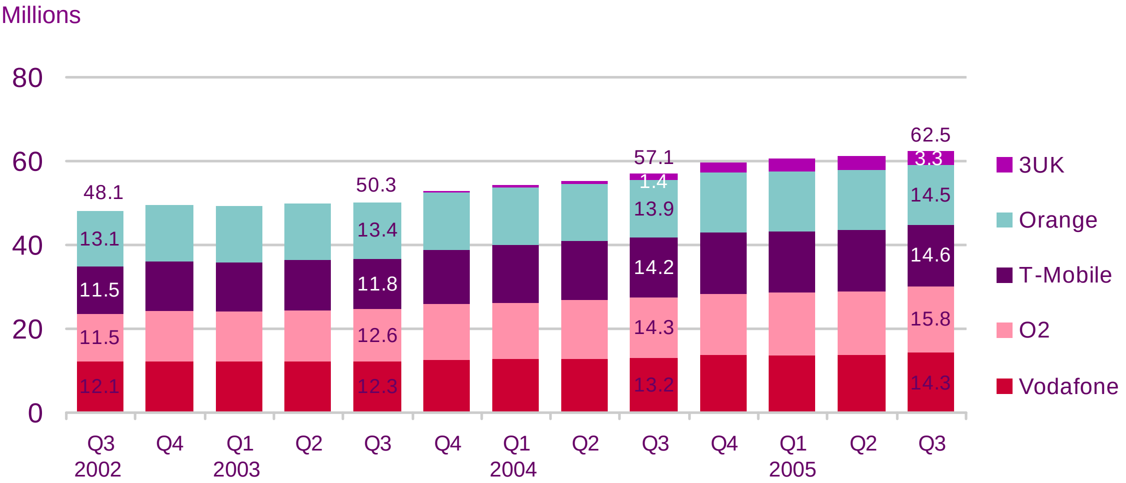
Source: Ofcom / operators

9.8: UK mobile subscription numbers continue to grow

The total number of reported active mobile subscriptions continues to rise, despite this number being greater than the UK population. This is due to the fact that reported subscription numbers relate to devices / SIM cards, and not individual customers; an increasing number of individuals have more than one mobile SIM – for example, one in their mobile phone and another in a BlackBerry or other mobile data device.

Ofcom figures show that there were 62.5 million UK mobile subscriptions at the end of September 2005, 9% higher than a year earlier. The numbers of reported active subscriptions for each of the four largest networks are still reasonably close, although it should be noted that the figures for T-Mobile include 4.2 million Virgin Mobile subscriptions and O2's figures include around 750 thousand Tesco Mobile subscriptions (Figure 50). In addition to the four largest networks, 3 had over 3.3 million subscriptions in Q3 2005.

Figure 50: Mobile active subscriptions by network



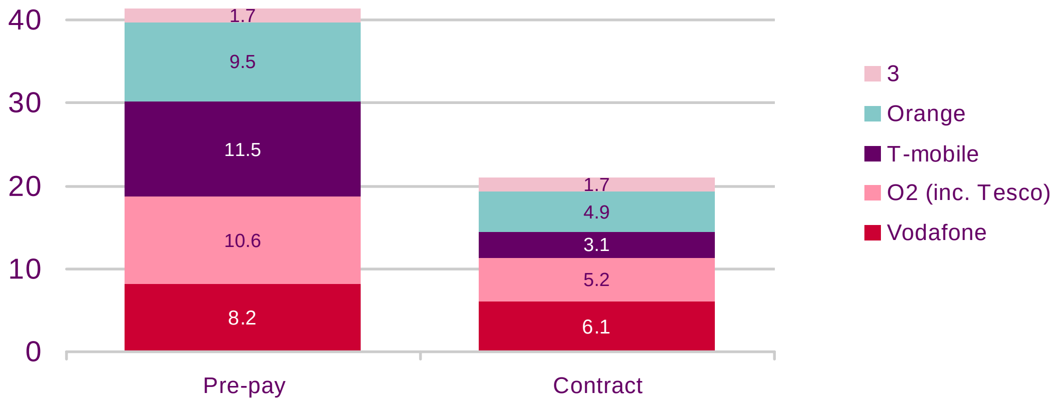
Source: Ofcom / operators

Note: based on figures reported by network operators; likely to overstate activity in reference quarter

There remains some inconsistency in the method of reporting subscriber numbers by each of the network operators. Nevertheless, Ofcom's tracker research shows that the proportion of UK adults with a mobile phone has been stable at around 80% over the first three quarters of 2005. Figure 51 shows the operators' subscriber bases in the contract and pre-pay markets.

Figure 51: Network share of active mobile subscriptions

September 05 (millions)



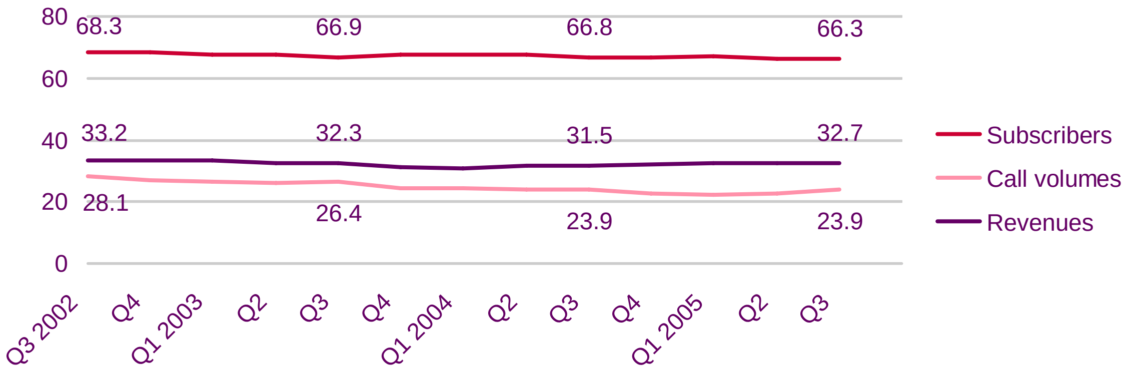
Source: Ofcom / operators

9.9: Proportion of pre-pay mobile subscriptions declines further

During the year to September 2005, the proportion of pre-pay subscriptions fell by 0.5 percentage points to 66.3% (Figure 52). There has been a downward trend in the proportion of pre-pay subscriptions over recent periods as operators have attempted to lure pre-pay customers onto monthly contracts against a background of slowing overall subscriber growth. On average contract subscribers spend around four times more per month on mobile services than pre-pay customers (£44 and £11 per month respectively including VAT).

Figure 52: Pre-pay as a proportion of total mobile

%



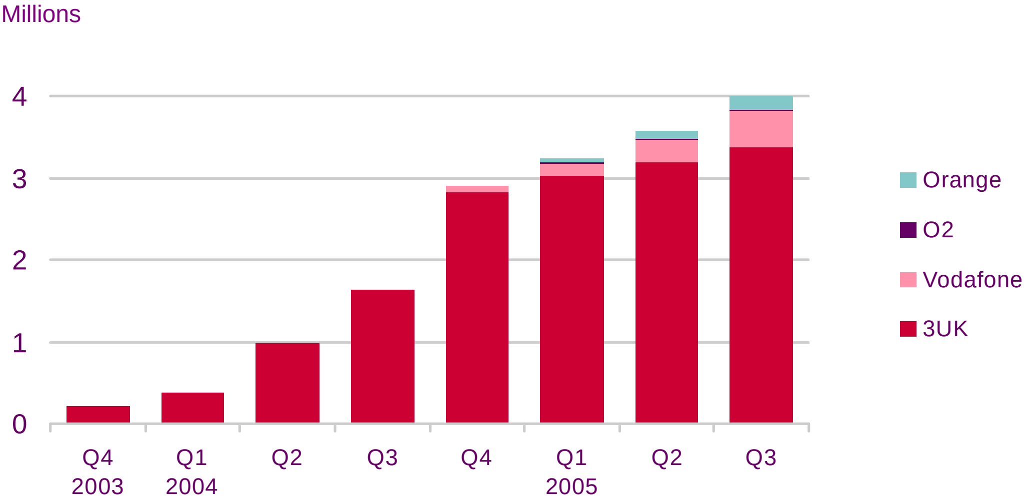
Source: Ofcom / operators

9.10: 3G subscriber base showing steady growth

The number of 3G mobile subscriptions continues to grow, and we estimate that there were around 4 million in the UK at the end of September 2005 (Figure 53). The actual number of subscribers actually using 3G services is difficult to measure; for example, some users who are unhappy with the size and battery life of their 3G handsets will put the 3G SIM card into a 2G phone, and thereby be unable to access 3G services.

This may become a cause for concern to the 2G operators who are seeking to move all of their customers to 3G in order to eliminate dual network running costs. It appears that 3G is still seeking the so-called 'killer application' to stimulate its growth to mass-market, and Carphone Warehouse recently reported significantly fewer 3G handset sales over the Christmas period of 2005 compared to Christmas 2004 (in part owing to the higher subsidies attached to 3G handsets in 2004).

Figure 53: 3G mobile subscribers

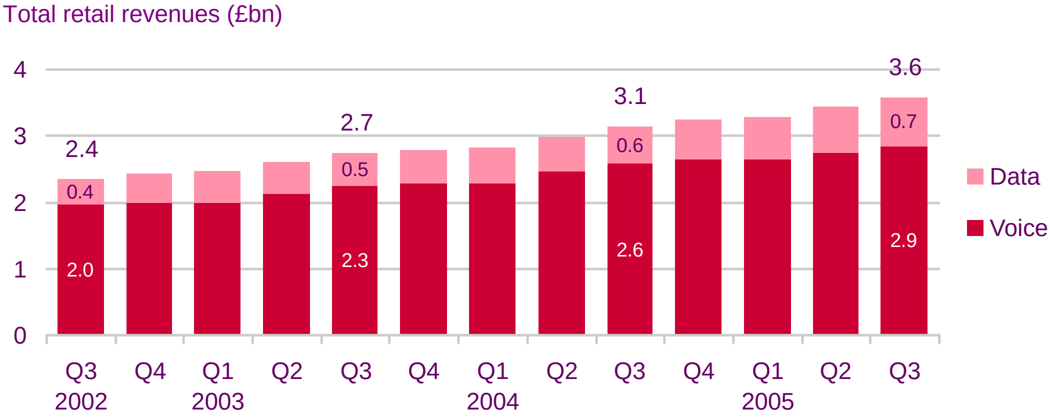


Source: Ofcom / Informa

9.11: Mobile revenues rise 16% year-on-year…

The increasing proportion of contract subscribers, together with increasing data revenues, meant that estimated overall revenue growth was 9% in the six months to September 2005 (Figure 54). Total mobile revenues were £13.6 billion in the year to September 2005, some 16% higher than the previous 12 month period. While MVNO and independent service provider customers made up 13% of UK mobile subscribers, Ofcom estimates that they only accounted for 9% of total mobile revenues.

Figure 54: Mobile retail service revenues

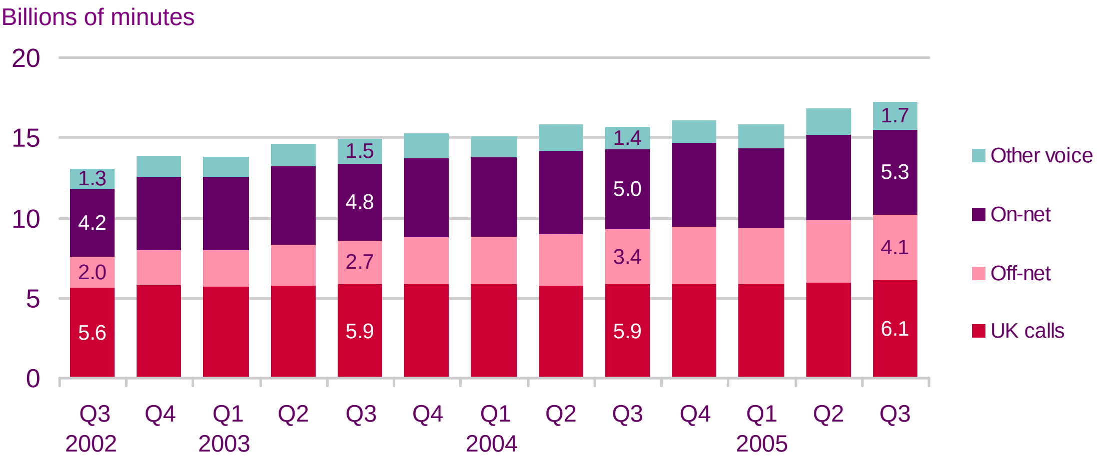


Source: Ofcom / operators
Note: Data includes revenues from SMS, MMS and WAP; voice includes all rental charges and connection

9.12: … fuelled by further increases in mobile usage

Mobile call volumes continue to grow and were 10% higher in the three months to September 2005 that they had been in the same period a year earlier (Figure 55). During the same period, the volume of text and picture messages increased by 33% to 8.7 billion per quarter. Given the slowing growth in customer numbers, operators have focused on growing revenue streams via increased usage, particularly of data services; in the three months to September 2005 data revenues (overwhelmingly from SMS text services) accounted for 20% of total retail mobile revenues, compared to 18% in the same quarter a year earlier.

Figure 55: Mobile call volumes

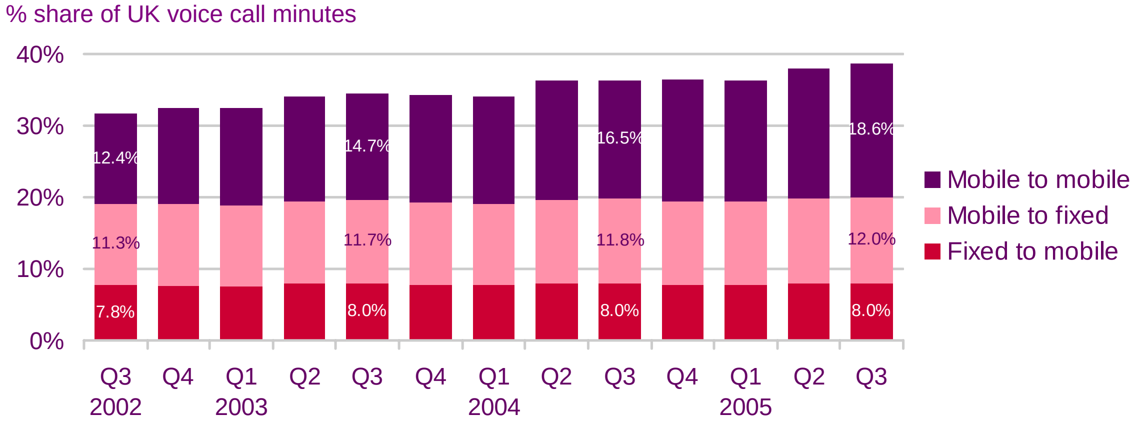


Source: Ofcom / operators

9.13: 39% of UK voice call volumes are to or from mobiles

Much of the growth in mobile revenues is as a result of growing volumes of mobile voice traffic. Voice calls either originating or terminating on mobile networks accounted for 39% of all UK voice calls compared to 36% a year previously. 31% of all UK voice calls were mobile-originated (Figure 56).

Figure 56: Share of total UK voice call volumes



Source: Ofcom / operators
Note: Excludes international, data, and non-geographic voice traffic

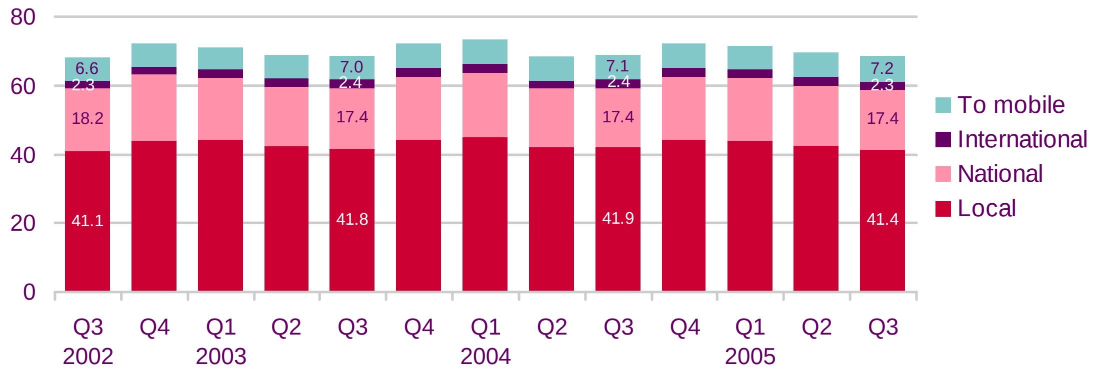
10: The telecoms user

10.1: Residential fixed line use remains constant

There was little change in the use of residential fixed lines in Q2 and Q3 2005. Continuing a five year trend, consumers spent around 70 minutes per week making and receiving calls (Figure 57). The slight decrease of 4% in average use over the half-year is likely to be a result of seasonal variation, as weekly call volumes matched the corresponding quarters of the last two years.

Figure 57: Average use per residential fixed line

Minutes per week



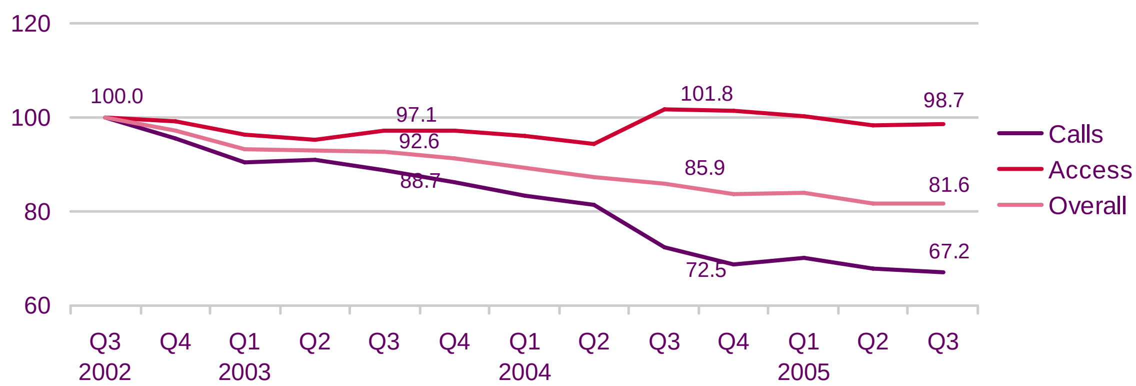
Source: Ofcom / operators

10.2: Fixed line prices continue to fall

Average fixed line call volumes remained unchanged despite ongoing cuts in fixed line prices, as shown in Figure 58.The majority of this decline can be attributed to call prices, while cost of access stayed largely stable during Q2 and Q3 2005 following a re-balancing of charges between access and calls in 2004.

Figure 58: UK residential fixed voice price trends

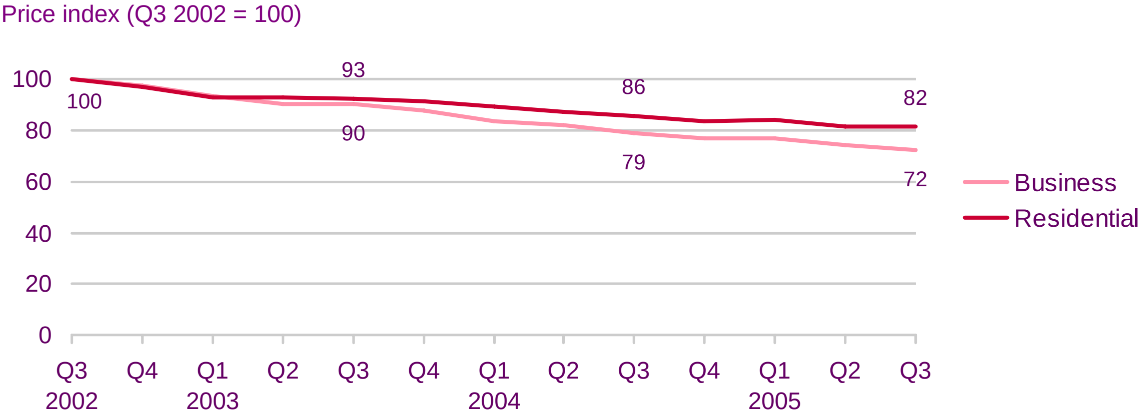
Index (2002 Q3=100)



Source: Ofcom / operators
Note: Figures based on calls to UK only fixed and mobile numbers.

Increasing competition and continued growth in take-up of CPS and WLR services is contributing towards falling fixed prices. In the six months to September 2005, overall fixed voice call prices fell by 4% in real terms and were 7% lower than they had been a year previously. In the residential sector fixed prices fell 5% in the year to September 2005, while in the business sector this figure was higher at 9%. Figure 59 below shows fixed price movements in the residential and business sectors over the past three years.

Figure 59: Fixed voice prices



Source: Ofcom / operators

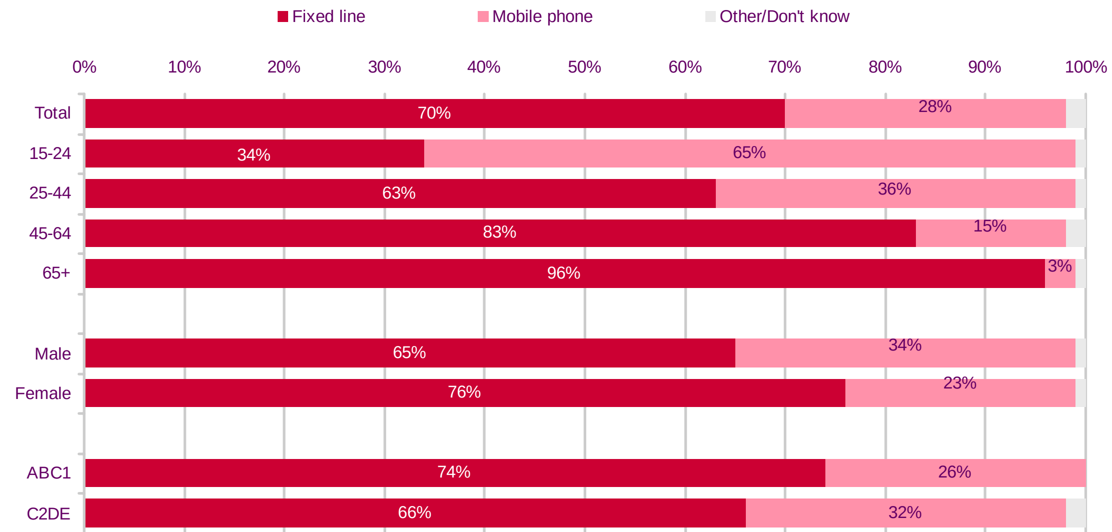
10.3: Fewer consider fixed lines as the main method for making calls

Although there has been little change in the average volumes of fixed line calls over the last five years, there are increasing signs of fixed lines losing importance as the primary call method for UK consumers. According to our consumer research, 28% of residential consumers used mobile phones as the main method of making calls in Q2 2005, a rise from 21% a year ago.

The trend is particularly evident amongst the young, with 65% of 15 to 24 year olds using mobiles as the main method of making and receiving calls, as shown in Figure 60. Interestingly, there is a rather substantial difference in terms of gender, with 76% of female respondents stating landline as the main call method, compared to 65% of males. Consumers in the lower social grades have a higher propensity to use mobile as the primary call method, partly reflecting the higher proportion of mobile-only households among these groups.

Figure 60: Main method of making calls

% consumers



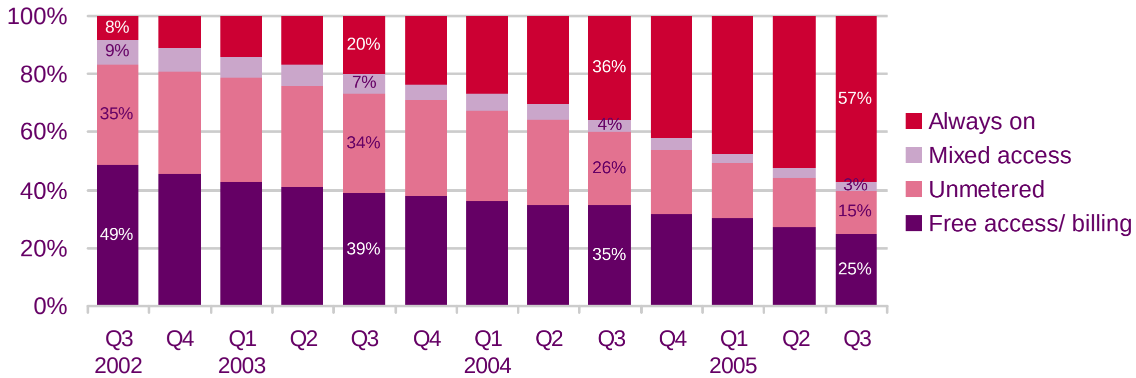
Source: Ofcom tracking study, Q3 2005

10.4: Consumers continue to switch to broadband

The share of broadband internet connections has continued to increase over recent months, reaching 57% at the end of Q3 2005 (Figure 61). This represents nearly a 10 percentage-point rise, at the expense of free and unmetered access (which declined by 5 and 4 percentage points respectively).

Figure 61: Proportion of internet subscriptions by connection type

Percentage of connections



Source: Ofcom / operators

The share of broadband users is even higher amongst residential consumers – 63% of homes were connected to broadband in September last year, a significant rise from 47% at the end of 2004. This growth may well continue – Ofcom's consumer research showed that 40% of narrowband subscribers said that they intended to upgrade their connections within the next 12 months, and a further 10% said they were certain to.

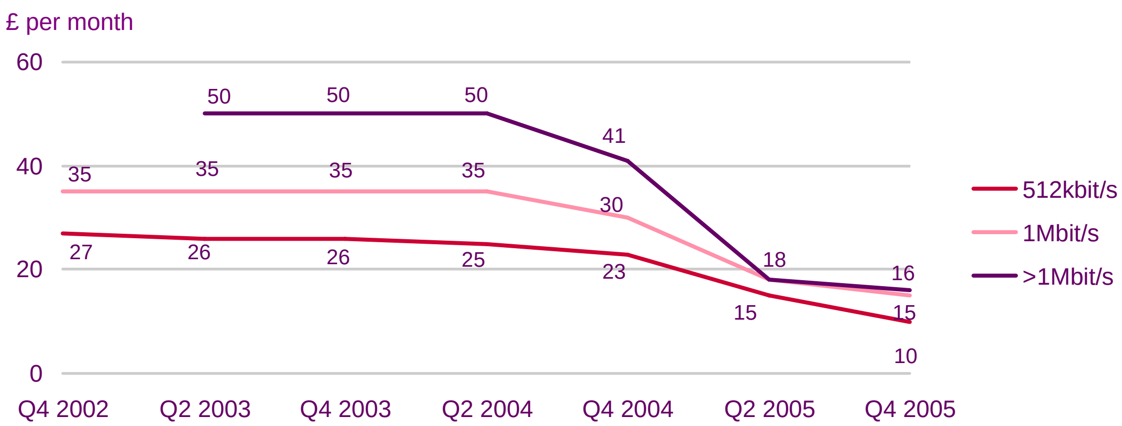
However, over the past year the total number of home internet connections has stayed relatively constant, and stood at 58% at the end of Q3/05. This is despite the fact that around a fifth of non-internet homes said at this time last year that they intended to connect over the following 12 months. Home PC penetration also remains unchanged at 67%.

For those consumers who are not already connected to the internet, Ofcom's consumer research suggests that while cost and affordability remain the key barriers for a minority (12% said they were unlikely to connect to the internet as it was too expensive to set up), and lack of understanding is preventing others (14% of those without connections said they 'don't know how to use computers'), for the majority it is simply a lack of perceived need that is preventing them from connecting to the internet. Nearly two thirds of those without home internet access are not connected for this reason, often because they have access at other locations such as a workplace or educational institution.

10.5: Broadband prices continue to fall

The move towards LLU could further accelerate recent package trends which have seen falling prices while downstream speeds have increased. The cheapest broadband package currently available is only £9.99 a month for a 1Mbit/s connection with no usage cap (Figure 62).

Figure 62: Broadband prices over time



Source: Ofcom

10.6: Broadband users spend twice as long online as dial-up users

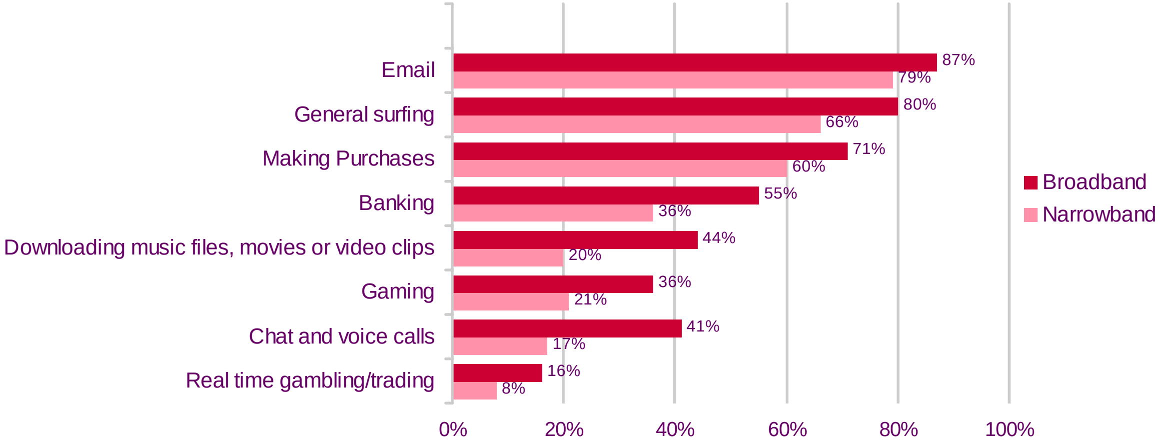
Nearly half (49%) of those with internet access use it on a daily basis, and, according to research carried out for Ofcom's Media Literacy Audit[21], UK adults spent an average of 9.9 hours a week online in Q3 2005. Perhaps unsurprisingly, those with broadband access spend nearly twice the time, at 12.7 hours, compared to those with dial-up access, at 6.6 hours.

Home is the most common location of usage, accounting for nearly two thirds of average weekly hours online, while access at work and educational institutions accounts for one third. Access at other locations constitutes only a minor share of average users' weekly hours online, at 5%.

[21] Due to be published in spring 2006

Email and surfing continue to be the most popular internet activities, followed by online shopping, banking and media downloads, as shown in Figure 63. Interestingly, there has been little change in terms of the proportion of users engaging in these activities over the past six months, despite the increased proportion of broadband users, and the gap between narrowband and broadband users has remained similar for most activities.

Figure 63: Online applications used by broadband and dial-up users



Source: Ofcom

Increasing broadband penetration and the corresponding growth in the number of people making purchases online have led to the internet becoming an increasingly significant retail channel, and 2005 saw impressive growth in online retail. According to IMRG's[22] data, UK consumers spent £19.2bn on online purchases in 2005, nearly a third more than in 2004. The growth was particularly evident towards the end of the year, with an average consumer spend of £208 in the month before Christmas – over a quarter of the average £816 spent shopping online in 2005 and a nearly 50% increase compared to the previous year.

The growing number of broadband users has continued to affect the music industry, where track sales have experienced something of a boom over the year. According to the BPI (British Phonographic Industry), downloads now account for more than 60% of single track sales – a jump from only 3.6% at the beginning of 2004.

Awareness of VoIP (voice over IP) services is also growing, and, according to Ofcom's consumer research, nearly half (49%) of UK consumers are aware of the possibility of making calls over the internet. This rises to 59% amongst internet customers, and rises further still to 63% amongst those using broadband. However, use of VoIP is still relatively low in comparison to use of other voice telephony services – only 9% of internet customers said they were using VoIP in Q3 2005.

10.7: Mobile voice usage remains flat, while messaging increases

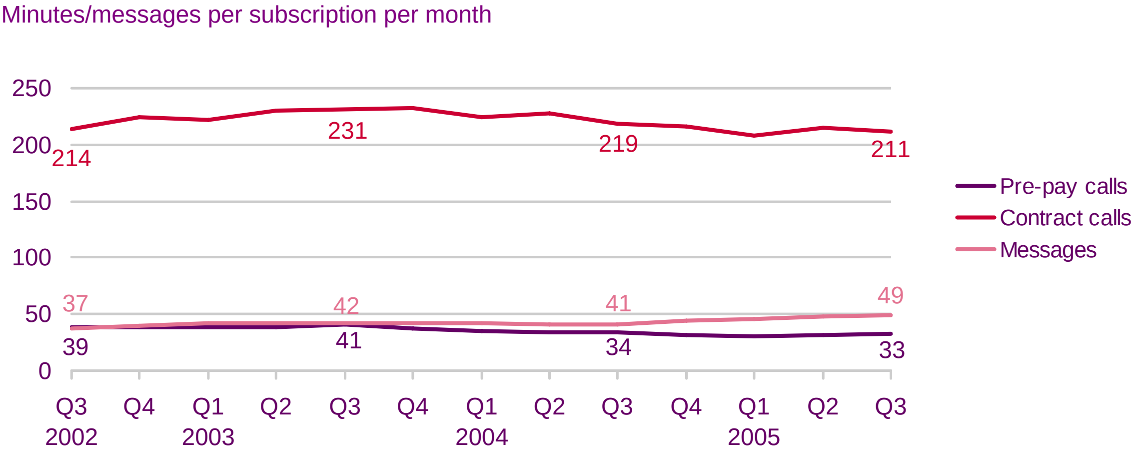
According to Ofcom's consumer research, mobile telephony penetration has stayed largely constant over the past six months, at around 80%. Of those using mobile phones, 30% were contract subscribers and 68% used pre-pay packages.

The downward trend in average call minutes per subscription (which, as noted earlier, does not equate to 'per user') continued over the past six months for contract

[22] Interactive Media in Retail Group

customers, while average time spent on pre-pay calls marginally increased (Figure 64). Mobile users spent an average of 93 minutes a month per subscription making calls in Q3 2005, representing a modest 1% increase over the previous quarter. Messaging volumes have grown slowly, and in Q3 mobile users sent an average of 49 text and multimedia messages a month.

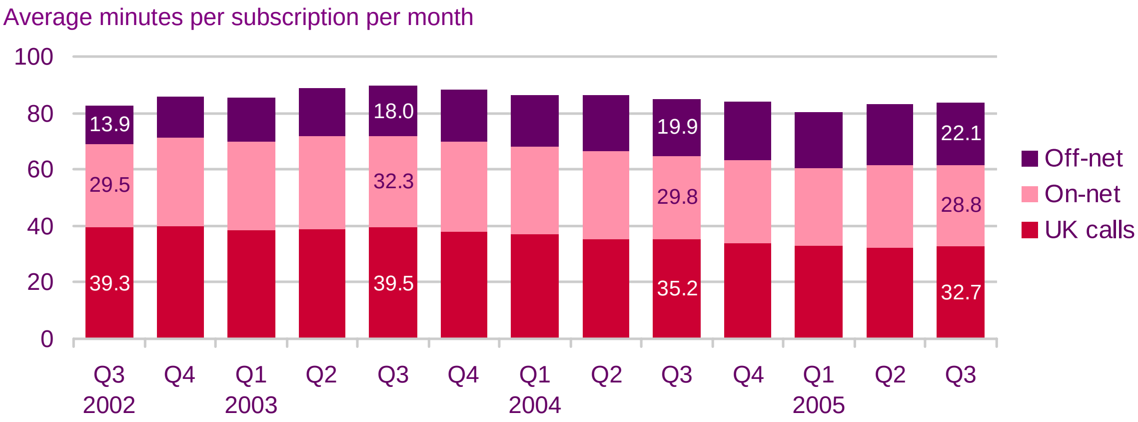
Figure 64: Average use per mobile subscription



Source: Ofcom / operators

Average mobile voice minutes for UK calls per subscription grew only slightly over the half-year, to 84 minutes per month in Q3 2005 (compared with 80 minutes in Q1 2005). This was mainly due to a 12% increase in the use of mobiles for making off-net calls. However, UK per-subscription call volumes have fallen compared with the same period last year – in Q3 2004 they stood at 85 minutes/month. Off-net calls now account for over a quarter of monthly mobile voice use for UK calls, compared to 17% three years ago (Figure 65). This may in part be due to the fact that call bundles increasingly include calls to any network, rather than on-net-only bundles that used to be the norm.

Figure 65: Average UK mobile call volumes per subscription

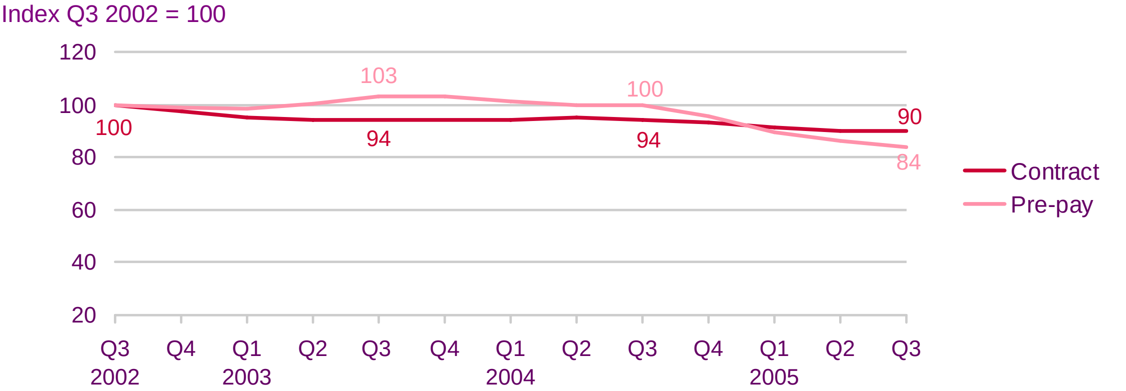


Source: Ofcom / operators
Note: Excludes 3

10.8: Mobile price reductions continue, especially in pre-pay

Call price reductions have continued during Q2 and Q3 2005, albeit at a slower rate than in previous quarters (Figure 66). Price decreases were particularly evident in pre-pay, with a 6% fall, reflecting the ongoing competition in the segment. Overall, mobile prices fell by 10% in the year to September 2005, compared to a drop of only 2% in the previous year. Heavy promotions from 3 and MVNO entrants, who have heavily discounted their tariffs in order to attract customers, have contributed to the acceleration in price reductions.

Figure 66: Average UK mobile unit price indices

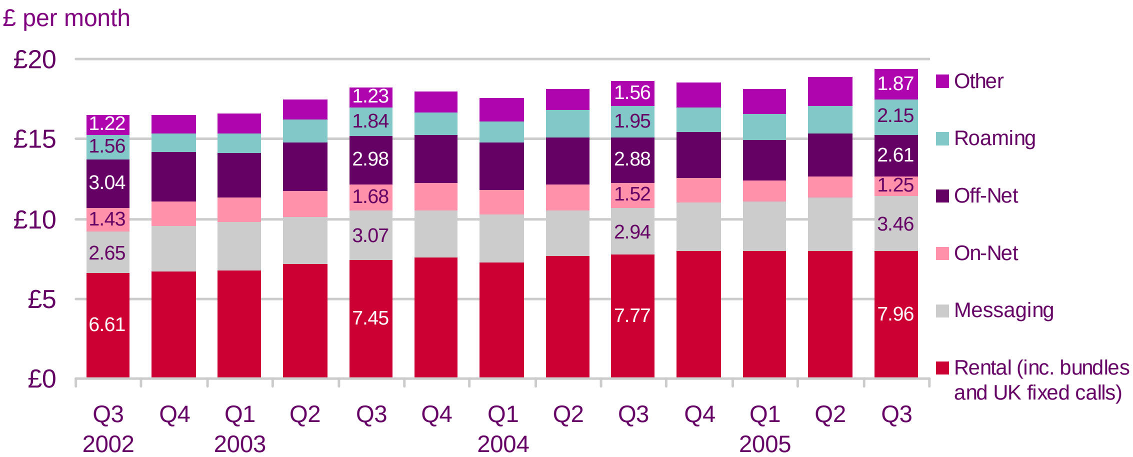


Source: Ofcom / operators

10.9: Average mobile bills rise, fuelled by messaging, new applications and roaming

Consumer spending on mobile services is again on the increase after dipping early last year. In Q3 2005, users paid an average mobile bill of £19.31 per month – over £1 more than in Q1 2005 (Figure 67). The biggest absolute rises were in messaging payments and ‘other’ services (including MMS, ring tones, wallpapers etc). Average monthly spend on roaming in Q3 2005, at £2.15 per subscriber, was 11% higher than in the corresponding quarter of 2004. The falls in on- and off-net spend can be explained by the continuing trend for users to buy bundled tariffs, which offer inclusive calls within the ‘rental’ charge.

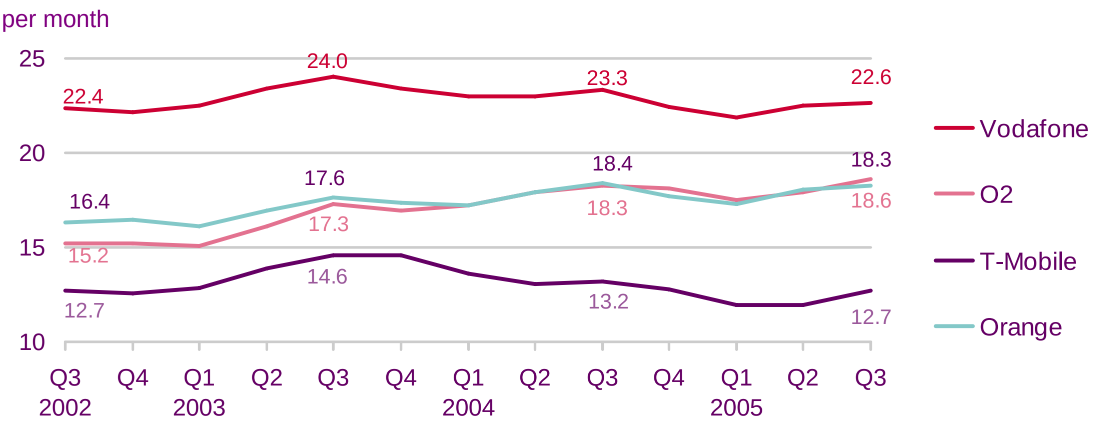
Figure 67: Monthly spend of average UK mobile user



Source: Ofcom / operators
Note: Excludes 3

The four largest networks have seen ARPU growth during Q2 and Q3 2005, partly reflecting the seasonal variation in demand. Vodafone's subscribers continued spending significantly higher amounts on mobile services than those of other operators; all operators except Orange saw ARPU fall slightly in Q3 2005 compared with the same quarter a year previously (Figure 68).

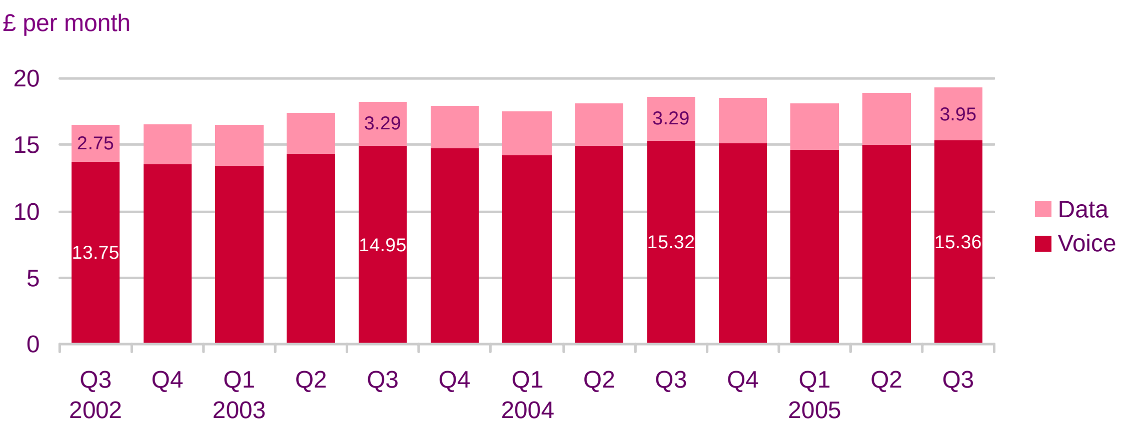
Figure 68: Mobile ARPU split by operator



Source: Ofcom / operators

Total voice revenue per subscriber fell slightly in Q3 2005 compared with the same quarter in 2004. However, average spend on data services was 20% higher in Q3 2005 than in Q3 2004 (Figure 69).

Figure 69: Mobile ARPU split by voice/data



Source: Ofcom / operators

10.10: MMS usage starts to take off

Voice calls and SMS remain by far the most popular uses of mobile, with 85% and 70% of consumers respectively using each service at least weekly, according to our research carried out in June-August 2005[23]. These traditional uses were followed by photo-related activities, reflecting the growing penetration of cameraphones, and nearly a quarter of mobile subscribers used their handsets to take photographs.

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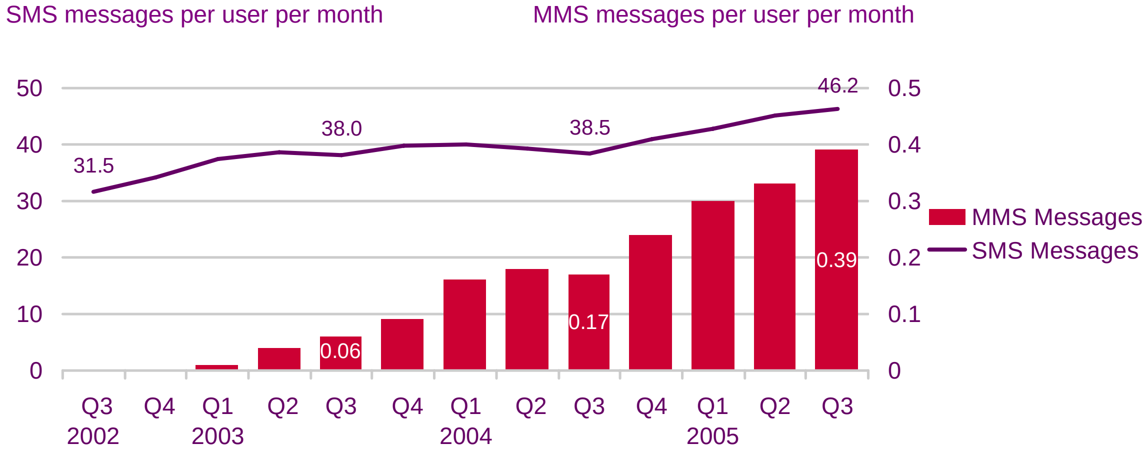
[23] Research carried out for Ofcom's Media Literacy Audit, due for publication in spring 2006.

Multimedia messaging (MMS) appears to be on course to becoming a mass-market service. Although the average number of monthly MMS sent is still only a fraction of SMS volumes, as shown in Figure 70, there has been a significant increase in usage, with 36% of consumers sending or receiving multimedia messages in the three months to the end of 2005, up from 22% in Q1.

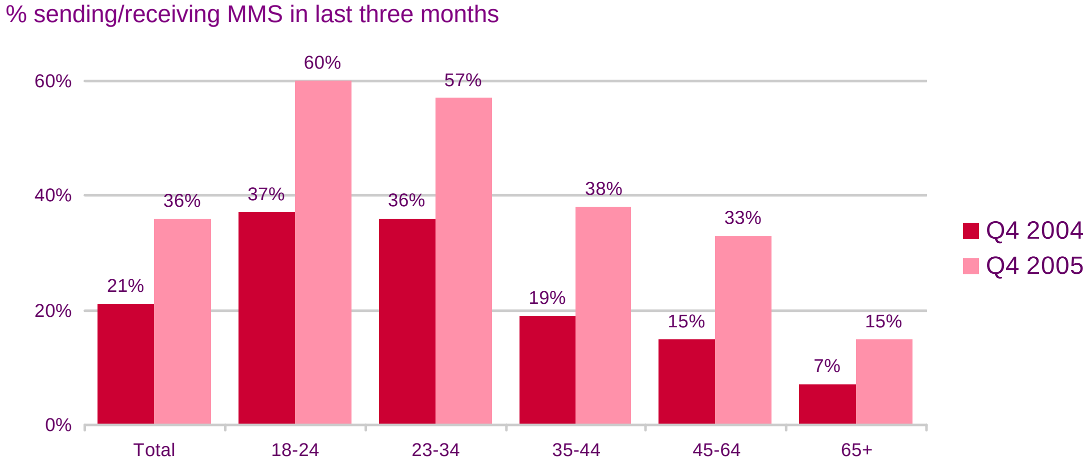
Figure 70: Average MMS and SMS use per active mobile customer



Source: Ofcom / operators

Over half of mobile users aged between 18 and 34 now use MMS, according to research carried out by Enpocket. Particularly interesting is the fact that older age groups have shown the highest jump in usage patterns: 38% in the 35-44 age group and 33% of those between 45-64 used the service in Q4, representing an increase of almost 20 percentage points for both age groups (Figure 71).

Figure 71: MMS usage by age group



Source: Enpocket

11: Theme – MVNOs

11.1: The MVNO model

What is an MVNO?

Mobile Virtual Network Operators (MVNOs) offer mobile telecoms services to customers by reselling wholesale minutes that they have purchased from an existing infrastructure owner (a Mobile Network Operator, MNO). In this way, MVNOs avoid the need to own and operate their own end-to-end mobile radio access networks.

The number of MVNOs in Europe has increased substantially over the last three years, with seven new operators launching in the UK alone over this period. Many well known consumer brands have launched services, or have publicly announced their intent to enter the market. However, the degree to which these MVNOs have successfully attracted customers (either new mobile customers, or customers from other operators), and the business models they have adopted, vary considerably from case to case. In this section, we examine the underlying economics of MVNOs, the growth of the MVNO model in Europe, the strategies adopted by different operators, and potential success/failure factors.

The MVNO position in the value chain

MVNOs have adopted a position in the mobile value chain between traditional mobile 'service providers' and the MNOs. The role of traditional mobile service providers was to act as a commercial interface between network operators and retail customers. In the UK, when Cellnet (now O2) and Vodafone were awarded mobile licences in 1985, the Government stipulated that all retail sales must come via service providers, as a way of introducing an extra layer of competition in a duopoly network environment. When One2One (now T-Mobile) and Orange were awarded licences in 1992, bringing competition at the network level up to four players, the mandatory usage of service providers was abolished and MNOs began offering retail services directly.

However, a number of service providers remain; they typically restrict their activities to distributing handsets (but do not issue their own SIM cards), billing (though usually through an outsourced billing platform), customer care and credit management services. In return, they receive a commission from the network operators for customer additions, and they make a mark-up on the minutes they re-sell. The UK's largest independent service provider is Genesis Communications, which has 170,000 business subscribers.

The key difference between MVNOs and the traditional mobile service providers is in increased ownership of both the customer and elements of network infrastructure. MVNOs may (under the terms of their agreements with the MNO supplying capacity) set tariffs, manage billing and account authentication, own the subscriber database, and control customer service, distribution, branding and marketing. MVNOs typically also own, issue and activate their own SIM cards, and receive number range allocations from the network operators. This is demonstrated in Figure 72.

Figure 72: Comparison between mobile service provider, MVNO and MNO business models

Network Element	Service Provider	MVNO	MNO
Spectrum / Network	• No ownership	• Some network ownership	• Own licence and network
SIM Card	• No SIM ownership	• Issues SIM, manages activation • Owns national numbers • Owns right to transfer the customer database	• Issues, owns SIM • Outright ownership to the customer database
Core Network	• Outsourced billing platform	• Billing platform • Home Location Register (HLR) • Content hosting • Authentication	• Owns all elements of the fixed and radio networks and service platforms
Pricing	• % mark up	• Independent – free to set retail tariffs • Limited only by wholesale pricing from MNO	• Fully independent pricing
Branding	• Some independence but marketing heavily tied to MNOs	• Independent, largely free to address any market segment under its own initiative	• Fully independent
Examples	• Genesis Comms	• Virgin Mobile • Tesco Mobile	• Orange • O2

However, even among MVNOs there is a large variance in the degree of infrastructure ownership. Some consumer brands entering the market may seek to use their own billing systems, whilst others choose to adopt a 'thinner' approach to infrastructure ownership, potentially outsourcing billing functionality. Some MVNOs also own intelligent software or hardware infrastructure sitting at the edge of the network, which allows them to offer more advanced applications and services.

The relationship between MVNOs and network operators

Since MVNOs operate in the 'hinterland' between simple service provision and full network operation, they often enjoy a similarly ambiguous relationship with the MNOs. Typically, the MNO is an invisible entity in the relationship between the MVNO and retail subscriber (for example, most Virgin Mobile customers are unaware that their calls are carried over the T-Mobile network). This means that MNOs lose some brand equity at the expense of the MVNOs, and indeed often end up competing for customers against MVNOs that are using their network.

One of the key differentiators between MVNOs and service providers is the former's ability to switch between network providers for wholesale minutes, although MVNOs would typically have to compensate a network operator for any subscriber that is switched onto a different network.

The motivation for network operators to deal with prospective MVNOs varies. In general, they have allowed MVNOs to participate in strategies aimed at specific customer segments, to potentially reduce churn (using a partner's brand) through affinity marketing, to access wholesale incremental revenue streams, or to further leverage fixed investments. It is also not uncommon for the operator to take a stake in the MVNO – examples include Virgin Mobile's original deal with Mercury One2One and Tesco's 50:50 joint venture with O2 in the UK.

11.2: The MVNO business model

Most MVNOs' financial strategies have largely been dictated by cost structure. MVNOs can avoid many of the fixed costs incurred by MNOs such as spectrum licences, network infrastructure, and platforms for new services. This typically results in two significant advantages for MVNOs:

- significantly lower levels of capital expenditure; and
- much shorter time taken to reach positive cash flow than a network operator.

However, since MVNOs pay out a large proportion of their revenues in fixed-agreement wholesale fees to network operators, their operating margins are far lower than those of MNOs. This results in a significant financial risk to the MVNO business model:

- risk to margins if retail prices fall.

As a result of the characteristics outlined above, the MVNO model is widely regarded as an economically effective model for late market entry. The strengths and weaknesses of the MVNO model are summarized in Figure 73 below.

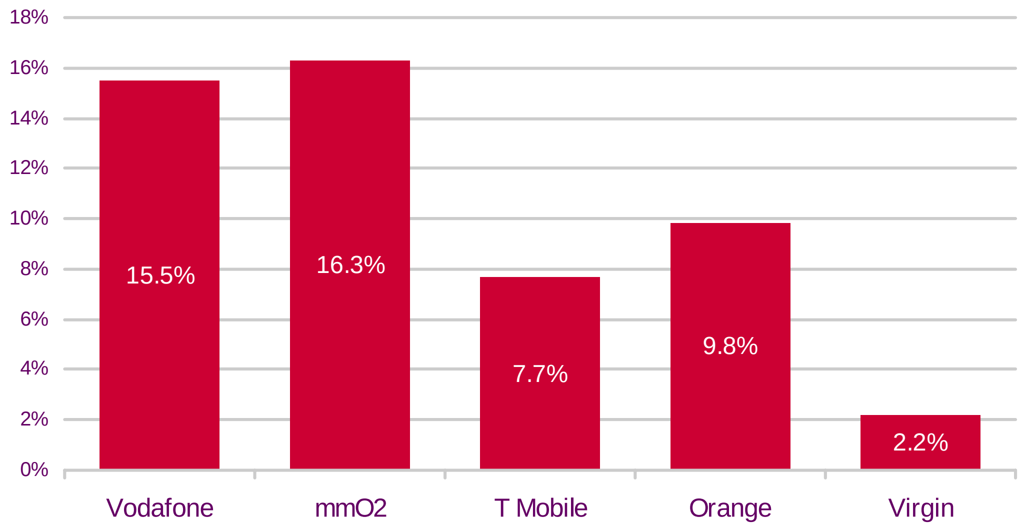
Figure 73: Key strengths and weaknesses in the MVNO business model

Strengths	*Weaknesses*
• Lower investment need, without sacrificing control of the customer	• Potential for higher margin erosion in price war
• Management focus on key areas of the value chain	• Dependence on third-party performance
• Ability to source capacity from the lowest cost provider	• Potential disruption if switching network

Reduced capital expenditure
Avoiding network investment means that MVNO capital expenditure is substantially lower than that of a network based operator. Capital intensity (the ratio of annual capital expenditure to sales) is likely to be in the 2-3% range compared to the current 8-15% for MNOs. Figure 74 below compares the capital intensities for the major UK operators. The only quoted MVNO, Virgin Mobile, has a far lower capital intensity than its MNO peers.

Figure 74: Comparative capital intensity of UK MNOs vs MVNOs

2005 Capex/Sales (per cent)

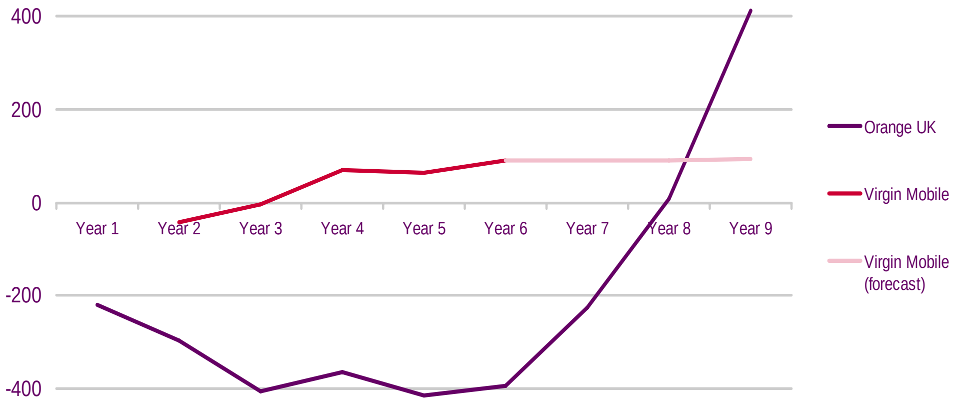


Source: Ofcom / operators

Decreased time to positive cash flow
A low level of capital expenditure is also helpful in driving positive free cash flow. As an example, Virgin Mobile reached positive cash flow within two years of operation, compared to seven or eight years for a network operator such as Orange. However, it is also noticeable that Orange's positive cash flow has grown far more steeply, once start-up capex and operating losses have been absorbed (Figure 75).

Figure 75: Yearly cash flow since launch for Orange UK and Virgin Mobile

Cash flows (£m)



Source: Ofcom / operators

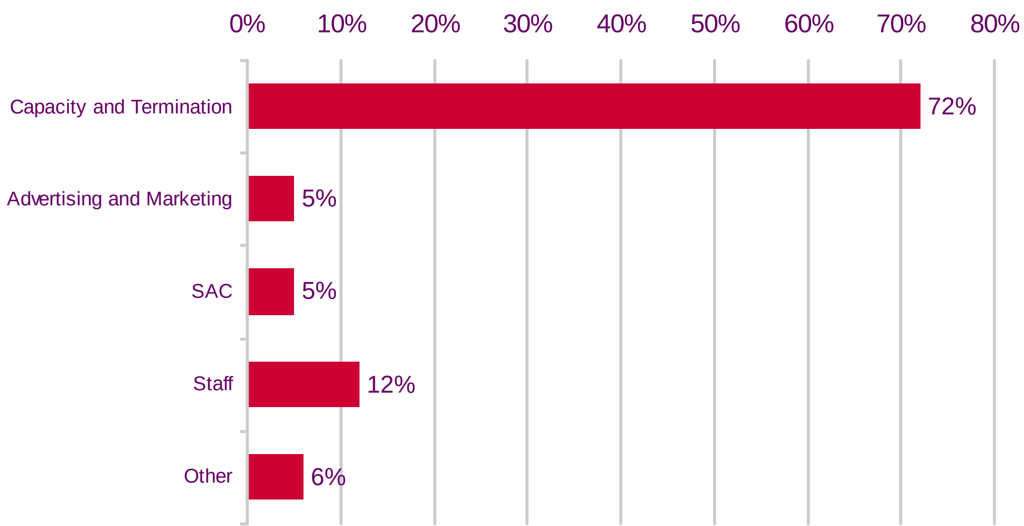
Greater operating costs

However, MVNO operating margins are correspondingly lower than those of MNOs, due to a significantly increased level of operating costs. This increase in MVNO operating expenditure is almost entirely due to wholesale capacity costs. MNOs own their own network, and incur variable operating expenses associated with powering and operating the network.

MVNOs, on the other hand, pay the network operators for Minutes of Use (MoU) used for subscriber call traffic. The amount that they pay is a wholesale rate that not only covers the network operators' variable costs of running the network, but also a portion of the MNOs' fixed costs – most notably those costs associated with building the network. Figure 76 below shows a breakdown of Virgin Mobile's cost structure. It shows that over 70% of Virgin's operating costs are due to capacity (SACs are Subscriber Acquisition Costs – commissions and subsidies associated with attracting new subscribers).

Figure 76: Virgin Mobile 2005 operating expenditure by type

2005 opex breakdown (percentage)

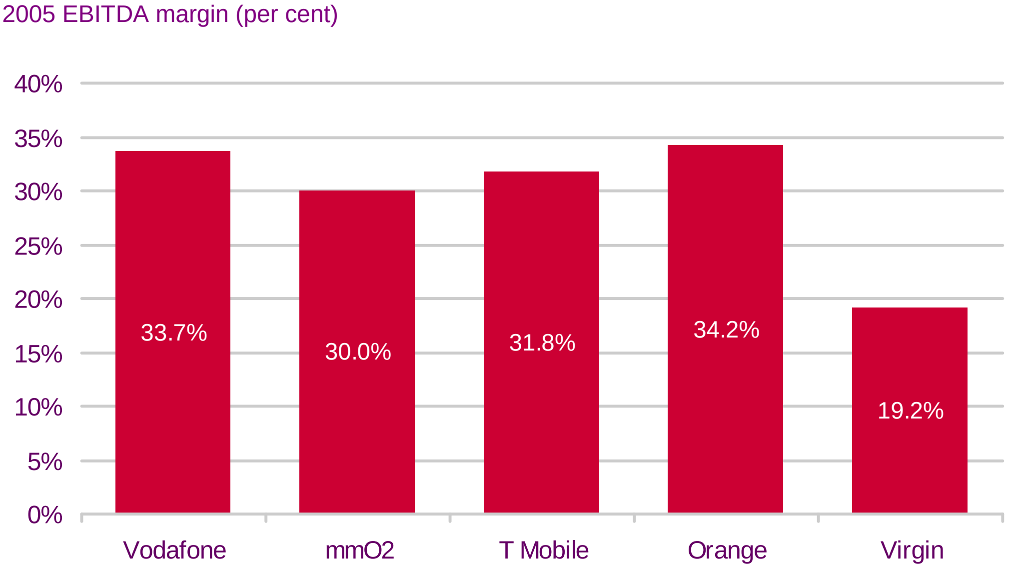


Source: Ofcom / Virgin Mobile

Lower operating margins

Since most MVNOs have significantly higher operating costs than MNOs (for the reasons outlined above), as a result their operating margins are proportionately lower. Figure 77 shows 2005 EBITDA margins for the four largest UK MNOs alongside MVNO Virgin Mobile (EBITDA – earnings before interest, tax, depreciation and amortization – is a measure of operating profit).

Figure 77: EBITDA margins for UK MNOs vs. MVNOs



Source: Ofcom / operators

Of course, the network operators carry large amounts of network assets on their balance sheets, which result in large annual depreciation charges through their profit and loss accounts. They are also likely to have borrowed significantly to finance the construction of their networks, and this will be reflected in high interest charges on the P&L.

Margin sensitivity of MVNO business plans

Owing to their thinner margins underpinned by contractually-agreed wholesale capacity costs, MVNOs tend to have a high degree of sensitivity to declines in retail prices. On the other hand, network-based operators are slightly better-insulated from declines in retail prices for usage. This is because there is a certain degree of 'elasticity' between prices and volumes – in other words, if prices fall, usage rises. Therefore, because the MNOs' marginal cost of capacity is low (meaning that large volume increases result in only a small commensurate rise in costs), their margins suffer less than those of MVNOs in an atmosphere of falling retail prices.

As discussed above, MVNOs' marginal capacity costs are significantly higher – additional minutes of use attract additional wholesale per-minute charges payable to the MNOs. The result is that margins may come under greater pressure should retail prices decline (e.g. in a price war) more quickly than the wholesale price agreed with the MNO.

In addition, the relatively high levels of variable costs associated with capacity result in a business model that is less sensitive to scale than that of an MNO – substantial increases in traffic result in a direct increase in operating expenses. Consequently the overall scale of returns available to MVNOs are lower than those for MNOs, with EBITDA margins varying from 5% for resellers up to 20% for MVNOs (depending on the commercial terms agreed with the MNO) compared with over 30% for MNOs.

11.3: A history of UK MVNOs

The UK's – and world's – first MVNO was Virgin Mobile, which launched in 1999. By mid-2005, there were seven major MVNOs in the UK market, out of an estimated 53 MVNOs across Europe as a whole.

In addition to Virgin Mobile, which continues to be the largest UK MVNO, other operators have been established by existing telecoms companies such as BT, Carphone Warehouse and OneTel, as well as by supermarkets such as Tesco and Sainsbury's, and by other companies with high-profile brands, such as EasyGroup. The UK MVNOs are summarised below in Figure 78.

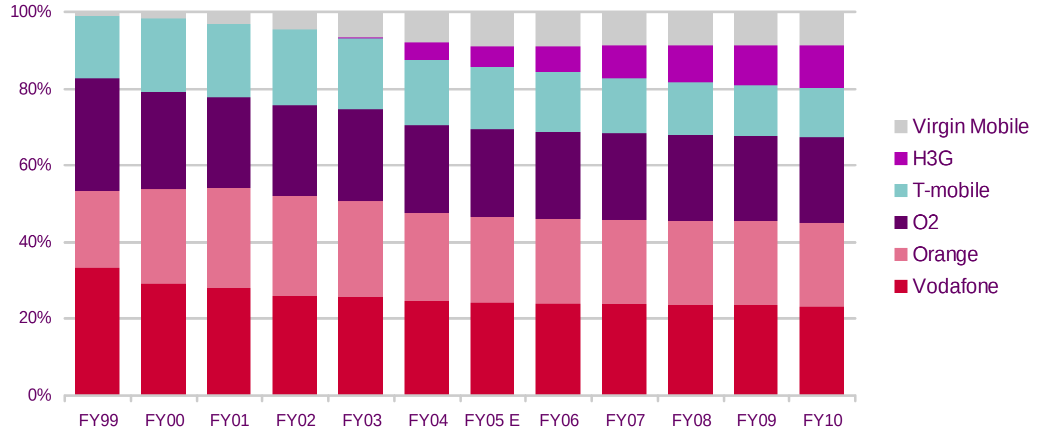
Figure 78: The main UK MVNOs

MVNO	Launch date	Network	Subscribers *(active)*	Notes
Virgin Mobile	1999	T-Mobile	4m (Dec 05)	• Predominantly pre-pay with new post-pay offering in late 05 • Handset and SIM • In merger discussions with Ntl
Tesco	2003	O2	1m (Dec 05)	• 50:50 JV with O2 • Pre pay, SIM and handset
Fresh (Carphone Warehouse)		T-Mobile	429K (Q4 05)	
BT Mobile	2003	Vodafone	350K (Q4 05)	• Established after demerger of O2
OneTel Mobile		Vodafone	100K (est 05)	• Acquired from Centrica by CPW Dec 05
Sainsbury's	2004	O2	30K (mid 05)	• Controlled by Carphone Warehouse. • Contract offering
Easy	2005	T- Mobile	23Kk (Sept 05)	• JV with TDC • SIM only, low cost, SIM only model

Of the UK operators, Virgin has been the most notable success. The operator launched in 1999 and had grown its base of active subscribers to around 4.1m by the beginning of 2006 – this gives it an estimated market share of 9% of the pre-paid market in the UK, and an overall market share of customers of 6% (Figure 79).

Figure 79: Virgin Mobile's market share of UK mobile subscribers

UK mobile operator market shares (per cent)



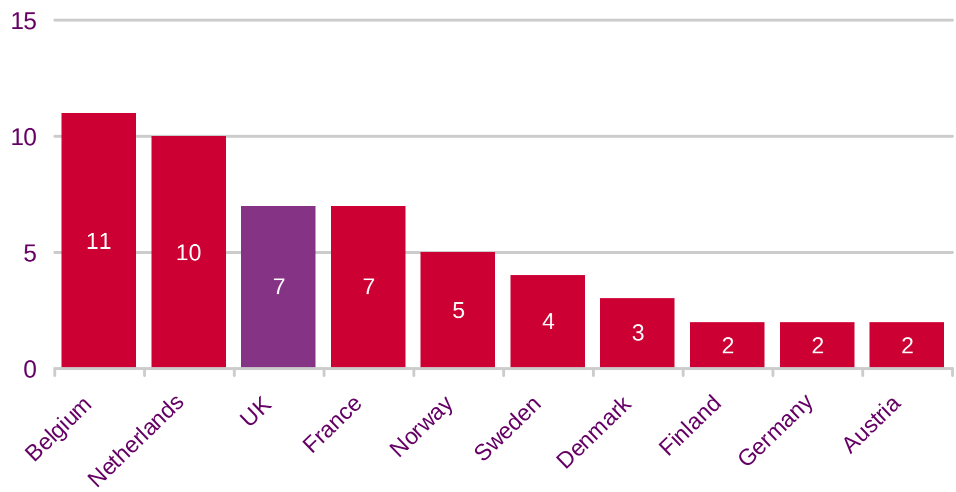
Source: Ofcom / operators / ABN AMRO

In the UK, most MVNOs have been associated with an established brand, and have mainly concerned themselves with addressing niche markets which either have specific brand relevance and appeal, or those which may be uneconomic to target with an infrastructure-based positioning. Indeed, the successes of both Virgin Mobile and Tesco Mobile to date have been based partly on their ability to target specific segments, and on their successful use of brand and distribution – both are discussed further below.

11.4: European MVNOs – two distinct models

Elsewhere in Europe, success has been dependent on timing of entry, market strategy, the regulatory environment, and the degree of existing competition. Figure 80 shows a summary of the number of MVNOs by country.

Figure 80: Number of MVNOs across Europe by country, Q2 2005



Source: Ofcom / operators

Within Europe, three different MVNO market situations have evolved. Broadly, the more competitive and mature mobile markets of Scandinavia witnessed earlier launches of MVNOs, followed by a period of intense price competition and a number of acquisitions and consolidation. The less aggressive markets – notably France and Germany – have only recently begun to see new MVNO entrants, often as a result of actual or threatened regulatory intervention. We briefly examine each market type below.

Nordic Region: consolidation in price-competitive markets
Most Nordic/Scandinavian countries have undergone similar experiences with MVNOs. These countries were the earliest mass-adopters of mobile services, and MVNOs were largely limited to trying to take customers away from the powerful incumbent network operators. They did this primarily through price-cutting, usually with adverse financial effects for all operators.

- **Denmark:** By 2003, the Danish market was characterised by aggressive price competition – the fourth quarter alone saw a 12% decline in average ARPU. 14 different MVNOs were competing alongside the network operators on voice and text message prices, leading to price falls of up to 50% across the market. This aggressive price-cutting meant that the largest MVNO – Telmore – could achieve a 12% customer share 3 years after its 2000 launch. In contrast, the incumbent MNO – TDC – saw its average revenue per user and subscriber numbers fall by 50% and 20% respectively in 2003. This resulted in the acquisitions of Telmore and CBB Mobil (another leading MVNO) by TDC and Sonofon respectively last year. ARPU in Denmark has now risen for three quarters, and it appears that consolidation has calmed retail pricing volatility.

- **Finland:** The Danish experience of fierce price competition driven by multiple MVNOs was repeated in Finland. Three major MVNOs managed to capture over 25% market share during a price war that began in Q4 2004, which had an adverse impact on all operators' revenues and margins. Pricing levels came down by 20-30% over the first half of 2005, in a market which already had some of the lowest mobile prices in Europe. This resulted in a decline in average service revenues by over 10% quarter-on-quarter during the first half of 2005, and margin contraction of almost 20% during the same period.

  The Finnish mobile market finally began to consolidate at the end of 2005 with the major MVNOs being acquired by incumbent network operators. Elisa (formerly Radiolinja) acquired Saunalahti (with a subscriber base of around 500,000 – around 10% market share) and ACN effectively sold out to TeleFinland (owned by TeliaSonera). DNA, the other major MVNO (owned by Sweden's Tele2) with around 750,000 subscribers, remains highly price aggressive. However, analysts widely believe that the consolidation will continue through 2006 with the expected acquisition of DNA by one of the existing groups.

- **Norway:** Norway has also experienced the general Scandinavian/Nordic trend of multiple MVNOs aggressively chasing market share through price competition, followed by a period of consolidation. By mid-2005, there were five MVNOs in operation, the largest of which – Chess – had around 9% market share with over 400,000 subscribers.

  The two network operators, Telenor and Netcom (controlled by TeliaSonera), experienced margin pressure in the face of this price competition. As a result, TeliaSonera decided to act by announcing the acquisition of Chess in August

2005. Even after this acquisition, MVNO market share in Norway is still around 8%, and further consolidation is anticipated.

France and Germany: slow start by reluctant MNOs
The two major economies of Continental Europe, with a combined total of almost 120 million subscribers, have been relatively slow to adopt MVNOs.

- **France:** MVNOs have had little impact on the French market to date, with French regulator Arcep estimating that there were 108,300 MVNO subscribers (0.2% share) in France by the end of Q3 2005. This has mainly been due to the reluctance of the French network operators to allow MVNOs to use their networks, despite attempted intervention by Arcep.

  In April 2005, the French regulator submitted a draft decision to the EU with the intent to legislate mandated MVNOs as a way of stimulating competition. The submission was rejected, but since then the network operators have begun to voluntarily carry MVNOs – with seven players currently in operation.

  The MVNOs' poor market share since launch has in part been driven by factors such as complex number portability arrangements, and lengthy subscriber contracts which discourage churn. There are also substantial differences in wholesale pricing by the operators – particularly when compared to the UK where rates are reportedly much lower.

  Of the existing operators, Orange provides MVNO network capacity to Tele2, Omer Telecom (owned by the Carphone Warehouse subsidiary Breizh) and M6. SFR has signed deals with Debitel, Cegetel/Neuf and NRJ (a national radio station) and Bouygues has signed a deal with the recently launched Universal Mobile. Most recently, Virgin Mobile and Carphone Warehouse announced an MVNO joint venture (over the Orange network) to be launched in H1 2006;

  The French market remains one of the least aggressive in Europe. Penetration is relatively low at around 75% in Q4 2005, and market shares have varied less than 1% over a five year period.

- **Germany:** Although nascent to date, the MVNO market is now showing signs of activity. Aldi, one of the biggest supermarket chains in Germany, signed up 60,000 new subscribers in its first week of operation in December 2005. Its MNO partner is E-Plus (a subsidiary of the Dutch operator KPN), which had around 13% direct market share in Q2 2005.

  The carriage of an MVNO by E-Plus is integral to its recently announced diversification strategy. This also includes the launch of its wholly-owned SIM-only simyo brand, which is believed to have acquired around 100,000 subscribers by the end of Q4 2005.

  Further recently-announced MVNOs include Tele2 (over the Viag Interkom network) and EasyMobile. It is expected that Germany will be an increasingly attractive market for foreign players to set up MVNO operations.

11.5: MVNOs and the European regulatory environment

In various European countries, MVNOs' fortunes have been greatly affected by the decisions and actions of national regulators and the European Union. In a handful of countries, most notably the **UK**, operators opened their networks to MVNOs entirely voluntarily, with no regulatory intervention sought or required. However, in other countries, the national regulator has taken steps to force the MNOs to sell capacity to MVNOs, citing competition issues. This has been the case in countries such as **Denmark** (MVNOs mandated in 2000), **Ireland** (2004), **France** (ongoing), and **Spain** (2007).

Italy stands out in Europe as the only significant country where the regulator has determined that network operators do not have to open their networks to MVNOs on request. The Italian regulator Agcom has decreed that the network operators should be afforded a level of protection to develop their 3G businesses, in a decision that was upheld by the EU in December 2005.

11.6: MVNO Strategies

In their early stages of evolution, core MVNO strategies have typically fallen into two main categories:

- 'no frills' low-cost; and
- mass market focus

As mobile markets mature, however, MVNO strategies have begun to diversify to include portfolio expansion, brand affiliation or concentration on profitable niche markets. These are summarised below in Figure 81.

Figure 81: Potential MVNO strategies

Strategy	Characteristics	Examples
No frills	Price competition; no customer services or value added services included	easyMobile FRESH
Mass market MVNO	Competitive offering against MNOs, usually one of the first entrants	Virgin mobile TELE2 Why pay more?
Expand product portfolio	Extension to fixed telecoms products; builds on existing competencies	BT TELE2 Why pay more?
Brand extension	Possibly low margin, marketing-focussed MVNOs, akin to branded credit cards	Tesco mobile Universal (US)
Niche market	Product offering focussed on specific segments e.g. extreme sports fans, old, ethnic groups	Extreme (sports), Movida (Hispanic, US)

Source: Ofcom

In addition, the need to expand telecommunications service portfolios from largely fixed to mobile has driven cable operators, incumbent fixed line operators and even distributors and retailers to launch MVNOs. Most recently, the MVNO model has been also been used as a brand extension tool by players such as Disney and Extreme. Some of these strategies are discussed further below.

- **No frills** is by far the dominant strategy. We estimate that of the c.53 MVNOs operating in Europe, almost 80% have adopted a no frills model. The focus has been on aggressive consumer pricing and the minimisation of operating expenses. The MVNO Telmore launched in 2001 in Denmark (discussed above) with a no frills strategy. Between January 2003 and September 2003 the operator cut its prices by almost 40%, sparking a price war (also as discussed above).

  By mid 2005, Telmore's subscriber base had grown to around 500,000. The service was SIM only (no handsets and therefore no subsidies) and all customer service including top ups were carried out online, reducing staff numbers to around 15 just prior to its acquisition by incumbent mobile operator TDC.

  The low fixed cost structure of the MVNO lends itself to a price-based strategy. However, Telmore was aided by a number of factors – for example, SIM locking is illegal in Denmark, which lowers switching barriers for consumers.

  EasyMobile, a joint venture with TDC, entered the UK market this year to leverage Telmore's success in Scandinavia. Like Telmore, EasyMobile's concept is to undercut the market by focusing on a no frills, prepay, SIM-only offer distributed online. Since its launch in April, it had attracted 23,000 customers by September 2005. Pricing was aggressive at 6p per minute for voice at launch, but the operator raised tariffs to 15p per min flat for any network. This compares with 3's pricing of 10p per min for fixed and on-net calls and 20p per min for calls to mobile.

  It is also worth noting that, on the whole, it is not the MVNOs alone which have demonstrated aggressive pricing strategies in the UK. In particular, 3 has in the past offered a variety of low-priced packages to prepay customers (the traditional target base for new start up MVNOs).

  Price competition may not be sustainable as a standalone strategy in the future. Many MVNOs have not achieved their original business plan targets; additional sources of competitive advantage such as high profile consumer brand, high street presence, and more substantial investment in customer service may be required in more mature or competitive markets.

  Tesco Mobile, a 50/50 joint venture with O2, provides a no frills offer with a simple tariff which does not differentiate between on and off peak rates, and which is focused on the lower end of the market. The operator's very low cost of distribution – through its retail outlets – has proved valuable in not only growing the base (1m subscribers by Dec 05), but in substantially reducing subscriber acquisition costs (SACs).

- **Mass market:** Virgin Mobile is probably the most successful operator to date in adopting a mass market strategy. At launch, the operator had a clear niche focus on younger pre-pay users in the UK with relatively high usage (by pre-pay standards), especially of data, and rising income levels. Virgin's positioning leveraged its historic reputation for representing the consumer against large incumbent businesses, and advertising campaigns focused on developing a fun, 'cool' image combined with a value for money message.

  In addition to increasing competition in pre pay from other MVNOs – Tesco has entered the market as a pure prepay operator together with EasyMobile (as discussed, the MVNO model lends itself to prepay) – competition is also increasing from incumbents. Vodafone's prepay SACs increased by over 100% in 2004 compared with 2003, as a result of its effort to increase its prepay base, and 3 continues to price aggressively. Virgin has responded by becoming a mass market MVNO and launching a post pay / contract offering.

- **Portfolio expansion** for existing distributors and retailers (such as Carphone Warehouse), cable operators (Ntl's recent bid for Virgin Mobile), fixed incumbents (BT and BT Mobile) and ISPs (eg FastWeb's intention to launch an MVNO in Italy) has also been a driver for new launches and investment activity. This strategy allows operators to offer bundled services via a single account – such bundling will become ever more important as fixed, mobile and broadband technologies and platforms converge over the next few years.

- **Brand extension**: Companies with strong brand values and customer bases, such as supermarkets, banks, high-street retailers or entertainment networks, can leverage their brands and customer bases via an MVNO. Tesco Mobile has already been a very successful proponent of this strategy in the UK, and the next few years are expected to bring further brand-led MVNO plays across Europe.

11.7: The future for MVNOs

Over the next few years, the strategy focus for MVNOs may start to shift away from cheap voice based services (the 'no-frills' products) to longer term strategies in addition to the 'mass market' strategy, such as product portfolio extension or brand extension.

Overall, the MVNO business model may need to evolve as market conditions change – Telecom Service Agreements are likely to become more difficult to negotiate as operators gain the experience necessary to assess their true value in specific segments. Additionally, SACs in the industry may well continue to rise in line with increasing competition; coupled with further predicted declines in retail prices, MVNO margins will likely continue to come under pressure.

Increasingly, mobile revenues in mature markets will be derived from enhanced services, while the impact of bundled 3G voice and data offerings from MNOs is likely to erode voice-focused MVNO business models. In this environment, 'service provider'-style MVNOs, with limited ability to move network provider, will see few financial benefits from new services (they will either get little or no access to them, or will have to accept commercial terms similar to initial voice-based deals). On the other hand, true MVNOs may be better placed to negotiate new commercial agreements that extend to include data services.

The data- or content-based MVNO business model is becoming increasingly attractive, and a number of MVNOs (e.g. Amp'd in the US) are starting to offer video, games and viral downloads on the host MNO (e.g. Verizon's) network targeted towards the youth market. We anticipate that this trend will continue as high-bandwidth mobile data services become more popular.

Price-elastic behaviour may help MVNO economics, but the scale-insensitive nature of the business model may offset any benefits. However, combined with low cost distribution and brand, the model is proving to be a highly cost effective method of late market entry in mobile telecommunications markets.

12: Television market developments

12.1: Introduction

The second half of 2005 was a defining period for the television market. Commercial broadcasters, faced with fragmentation in audience share and diminishing advertising revenues, began to experiment with new funding models and portfolio expansion.

The trend for convergence in broadcasting continued with Sky, Ntl / Telewest and BT emerging as significant cross-platform players. New technologies were a key area of opportunity, with most of the major broadcasters trialling new approaches to mobile, broadband and high-definition services.

Negotiations for the BBC Licence Fee continued, with the BBC presenting its arguments in the most transparent form yet. In October the corporation published its request for RPI plus 2.3% per year, in order to be able to deliver the quality content, digital services, digital infrastructure and local services, specified in the Government's March 2005 Green Paper.

Finally the European Commission announced that it had received improved commitments regarding the sale of the media rights to Premier League football, which would involve the rights being sold in six separate packages, with no one party allowed to own all six.

12.2: Media consolidation continues

The Ntl / Telewest merger was the major consolidation of the period. Announced on 3 October and cleared by the Office of Fair Trading on 30 December, the move ended a long period of speculation about the future of the UK cable industry and paved the way towards the creation of a larger player capable of competing with BSkyB and BT. (See the theme section below.)

On 21 October, BSkyB announced that it had agreed terms for the purchase of Easynet. The transaction valued Easynet at £211m and was approved by the Office of Fair Trading on 30 December. The deal enabled BSkyB, for the first time, to offer its customers a range of television, broadband and fixed-line telephony services, known as 'triple-play'. Previously, this had been offered only by the cable operators and Homechoice. The move comes at a time when BT is planning to add television to its existing telephony and broadband services and Ntl and Telewest are forming a single cable company (see Telecoms section for further details).

As well as offering triple play to its existing customers, the Easynet deal will also allow BSkyB to target some of the households which have hitherto been unable to receive Sky services. There are believed to be around 2 million such households in the UK, many of which are in blocks of flats or other 'multiple dwelling units'. BSkyB believes the deal will play an important role in helping the company to achieve its goal of 10m customers by 2010.

Easynet made a pre-tax loss of around £17.4 million in 2005 and had been expected to break-even in 2006. Currently the vast majority of the company's revenues are generated from services to businesses, with just 1% coming from approximately 21,000 consumer subscribers. However, as one of the companies that carries out local loop unbundling, Easynet has created a broadband network infrastructure that covers 5.8 million households. BSkyB has stated that its unique access to these homes will provide an attractive opportunity for future growth.

12.3: Convergence picks up

BT announced in September the launch of its new broadband television service in the summer of 2006, following a series of pilots earlier in the year. The move into television represents a major shift in strategic direction which will bring the company into direct competition with both BSkyB and Ntl / Telewest.

The proportion of BT's revenues generated from fixed-line calls has been falling over recent years. This area of business accounted for around 12% of revenues and this proportion is widely expected to decline further. Competition from VOIP services, such as Skype, is expected to challenge the traditional fixed-line business model. It is possible that the provision of a range of television services could help BT to retain its broadband customers and drive revenue per customer.

The new BT service is expected to offer a combination of DTT and broadband on-demand content. BT broadband subscribers will be charged a one-off payment of around £80 for over 30 Freeview channels. In addition, they will be able to pay for a range of on-demand services, as well as instant messaging, videophone calls on television and various other interactive services. The set-top boxes have been designed by Phillips to include a PVR with up to 80 hours of storage space and capable of delivering High Definition content. BT will use Microsoft TV's IPTV for its software. BT has already secured content distribution rights with the BBC, Warner Music and Paramount Film Studios (see Telecoms section for further details).

In January 2006, BskyB said that it was to offer Sky Digital customers a new on-demand service that would enable subscribers to download and watch films and sports content, via broadband, on their personal computer. *Sky by Broadband* is the fruit of a new partnership with Microsoft and will be powered by Microsoft's Windows Media Centre software.

Also in January, Channel 4 announced that it is looking to expand its radio interests with a joint bid for a new national digital radio multiplex (see radio section for further details).

12.4: Broadcasters develop mobile services

BBC Worldwide continued to build on its deal with mobile content provider Rok Player by securing the mobile rights to *Little Britain* and *League of Gentleman*. These 'DVDs for mobile' will be available as full episodes, alongside other BBC programmes like *Red Dwarf* and *Dr Who*. As part of its public service ambition to offer content over all digital platforms, the BBC itself continued to develop a range of non-chargeable mobile services in the areas of news and sport, as well as a *Spooks* interactive game. These can be used on mobile phones, PDAs and other emerging technologies.

ITV signed a year-long content deal in November with mobile company 3. *I'm a Celebrity Get Me Out of Here!* was the first in a range of programmes to be made available on mobile platforms. Other content included a mixture of exclusive previews, one-off specials, repeated highlights and behind the scenes footage from some of the most popular ITV shows, including *Emmerdale*, *Coronation Street* and *This Morning.* The content will be available to all of 3's 3G customers. Both ITV and 3 have made clear their belief that TV will be a major driver of growth in 3G usage.

On 3 November, Channel 4 announced the launch of a mobile TV channel for 3G subscribers with Vodafone and Orange. The channel shows clips from popular Channel 4 programmes including *Grand Designs*, *Brat Camp* and *Supernanny*, edited into a two-hour block. The content is streamed on a continuous loop and updated daily. As the service develops Channel 4 New Media plans to commission bespoke content as well as special mobile versions of Channel 4 shows. The service was offered free on Vodafone until the end of Jan 2006 and at £10 per month for Orange customers.

BSkyB launched its mobile TV service, Sky Mobile, on 1 November. Vodafone acted as the initial network partner, although the service will be available on other mobile networks later in 2006. It offers 19 mobile channels, which can be downloaded in 5 minute blocks, and features Sky Sports, Sky News and Sky Weather.

In September mobile network O2, in partnership with Nokia and broadcaster Arqiva, began a six-month mobile television trial in Oxford. The pilot involved 400 participants and was the first in the UK to use DVB-H television broadcast signals rather than 3G streaming technology. 16 television channels, including BBC ONE, BBC TWO, ITV1, ITV2, Channel 4 and five took part. Interim results released in January showed that users watched more television if they had access to more channels. Usage was highest in the morning, lunchtime and early evening and 36% of viewing was at home (more than at work or on public transport). 83% of triallists said they found the service satisfactory and 76% said they would sign up for a service costing £10 a month.

12.5: Terrestrial broadcasters pilot broadband services

There have been more broadband than dial-up home internet connections in the UK since May 2005. There are now over 8 million home broadband connections in the UK and, with 250,000 users signing-up each month, broadband is one of the fastest-growing parts of the media industry. In response to this growth broadcasters are trialling a range of broadband television services.

Peer to peer (P2P) broadband operations have become an area of interest for broadcasters and internet operators alike. AOL, for example, has developed its Hi-Q service. The new format promises to deliver DVD-quality video capable of full-screen display, delivered through a P2P distribution grid. The BBC’s Integrated Media Player (IMP) is set to operate on a similar basis in order to keep the service running during periods of exceptionally high demand. The BBC has also invested in rights management software to ensure that content can only be viewed for a finite amount of time, and includes Geographic IP-address software to ensure that only people with UK web addresses can view the content.

In late September the BBC began trials of an ‘integrated media player’, branded MyBBCPlayer. This application service allows people to find and download programmes from the last seven days, as well as to stream live television channels. The trial was scheduled to end in December but has been extended to allow usage patterns to stabilise once the initial ‘honeymoon period’ is over.

Alongside the MyBBCPlayer pilot, the BBC also announced that 2006 will see the start of simultaneous internet and television broadcasts. BBC TWO will be the first channel to take part, allowing internet users to watch a range of live programmes, including *Extras*, *Newsnight* and *Top of the Pops*.

BT staged a trial of its mobile digital and broadband service between June and September. One thousand Virgin mobile subscribers within the M25 area were given special smartphones and portable media centres for the trial, as no other manufacturer yet makes handsets that can receive DAB digital audio broadcasts. Subscribers could access 50 radio stations and video clips from, amongst others, Sky News and Sky Sports. The pilot revealed that two thirds of customers would be prepared to pay up to £8/month for the BT Movio service. The service is set to launch later in 2006.

ITV launched a three-month pilot of its broadband local TV service, ITV Local, on 17 October. The trial is taking place in Brighton and Hastings, ahead of what is hoped will be a full UK roll-out. The channels include local news, local weather, local films, an entertainment guide and community video. There is considerable emphasis on user-generated content with viewers being asked to provide and upload their own ‘Citizen’s TV’ reports. ITV has already signed a partnership deal with Screen South to show the work of young filmmakers. It plans to use the channels to sell local classified advertising.

In a separate online development, ITV purchased Friends Reunited on 6 December, paying £120 million up front, with a further £55 million due in 2009, depending on performance. ITV’s CEO, Charles Allen, explained that the deal was an integral part of ITV’s ongoing attempts to diversify its revenue sources. Friends Reunited has 15 million registered UK members, with 1 million subscribing members who generate 80% of revenues. It has four offshoot sites – Genes Reunited, Friends Reunited Dating, Friends Reunited Jobs and Connections (a social networking site). ITV plans to cross-promote between these sites, itv.com and ITV Local. Friends Reunited is also expected to provide a source of programming ideas. The Friends Reunited management team will play an active role in helping to develop ITV’s online and broadband strategy.

Channel 4 launched FourDocs in August 2005. The broadband channel allows users to upload their own four-minute films, download archive material free of charge, get advice from experienced programme-makers and judge each other's films. In September Channel 4 became the first broadcaster to commission original programming exclusively for broadband distribution with a show about the recent Frankfurt Motor Show from Ideal World.

12.6: Changes in digital terrestrial ownership

On 12 October ITV and Channel 4 each took a 20% stake in Freeview. The Freeview platform is strategically important to both companies since ITV1 and Channel 4 perform relatively well in share terms in DTT homes, where viewers have fewer channels to choose from, compared to satellite and cable. The decision will enable them to exert influence over the platform as it evolves. The BBC, BSkyB and National Grid Wireless are the remaining shareholders.

Five became the last terrestrial broadcaster to gain a presence in digital television when it bought a stake in Top Up TV on 18 November. The channel did not declare the size of its investment, but stated that it intends to use the Top Up TV platform to launch further free-to-air and pay TV services over the course of 2006.

Top Up TV was founded in 2003 and offers Freeview consumers 11 extra channels for a monthly subscription of £7.99. It had 140,000 consumers in early 2005. Chairman, David Chance, predicts 250,000 by mid 2006.

ITV and BBC announced a joint plan in September to launch a free digital satellite service, after the idea was first mooted in 2003. The BBC / ITV Freesat service is set to be launched in the first half of 2006 and will be aimed in particular at the 27% of UK households who are currently unable to receive subscription-free digital services through Freeview. As part of the development of Freesat, ITV also announced that it intends to start broadcasting ITV channels unencrypted within the next few months on BSkyB's digital satellite platform. This follows a period of negotiation with BSkyB over the cost of BSkyB's encryption service. The BBC / ITV service will compete with BSkyB's own free digital satellite service, Freesat from Sky, launched in October 2004. Freesat from Sky costs a one-off payment of £150 and offers 120 TV channels and 80 radio stations. The BBC / ITV Freesat service is expected to retail for a similar one-off payment of £150. Initially the service will offer only BBC and ITV services. However, it is possible that Channel 4 and five could sign up once their encryption deals with BSkyB have expired.

12.7: New channel launches

Channel 4 launched More4 on 10 October. Marketed as an 'adult channel', it offers factual programmes, drama and comedy to over 35s. Channel 4 declared it was their first new public service channel since the launch of Channel 4 itself in 1982. The channel has a programming budget of £30 million, to be spent on a mixture of original content, Channel 4 repeats and imports such as *Curb your Enthusiasm* and *The West Wing*. During its first month on air More4 achieved 0.52% share, compared with BBC4's 0.36%. During the hours when both are on air, however, their share is very similar at 0.66% and 0.69% respectively (BBC4 only broadcasts between 7pm and 6am). In December Channel 4 launched More4 +1 on Freeview, a time-shifted version of More4, having secured the necessary bandwidth from National Grid Wireless. Channel 4 stated that this was a short-term move, whilst options are considered for the development of a new Freeview television service over the longer term.

ITV closed its news channel on 23 December. Falling audiences had previously led ITV to reduce the channel's airtime on Freeview to twelve hours per day, with ITV4 taking over the remaining time on the slot. ITV plans to use the savings to invest in news bulletins on ITV2 and ITV3, a news bureau in Beijing and an expanded news gathering facility in the north of the country. The difficulty of making rolling news channels commercially viable has recently been brought to light by the lack of audience uplift achieved by the newly revamped Sky News.

Meanwhile, ITV has announced plans to launch a new children's channel in February 2006. It is possible that this could take over the Freeview slot previously occupied by the ITV News Channel. The children's channel will run on an annual budget of £35 million, compared to just under £50 million for CBeebies and CBBC together in the year 2004/05.

A year after the launch of ITV3, ITV4 was launched on 1 November. Targeted at men, ITV4 showcases US acquired material, sports and movies. The channel kicked off with live coverage of Chelsea playing Real Betis in the Champions' League and ITV claimed that in audience terms it was 'the most successful launch of a new digital channel to date'.

ITV's Men and Motors has more than doubled its audience since acquiring a slot on Freeview in May 2005. Despite earlier speculation that the channel faced possible closure, ITV has confirmed that for the foreseeable future its two men's channels, Men and Motors and ITV4, will continue to run alongside each other.

Another new growth area for ITV has been 'call-TV'. ITV1 has begun broadcasting 3 hours of *Quizmania* each night from 1am. In addition, the organisation soon plans to launch ITV Play, an interactive service featuring participation TV, quizzes and other gaming formats to be showcased across ITV's channels, mobile content and online sites. ITV's interest in viewer-paid telephony-based models is in line with the wider industry move towards identifying new sources of income as advertising revenues come under increasing threat. Currently there are around 20 quiz channels on digital satellite television. Channel 4 launched a similar service on Freeview called Quiz Call in August 2005, and five has formed a joint venture with YooMedia to extend its *Brainteaser* quiz to digital channel YooPlay TV.

Sky 3 was launched in October. It features programmes from the Sky One library as well as original lifestyle commissions and travel documentaries from Sky Travel. It also includes programmes from Sky News, Sky Movies, Sky Sports and Artsworld.

12.8: High-Definition television (HDTV) arrives

BSkyB has announced that Sky One will become the first HD channel early in 2006. It will be followed by Artsworld, Sky Sports and Sky Movies later in the year. BSkyB expects about 2 million HD-ready television sets to be in use by Christmas 2006. To kick-start take-up, Sony and Sky have been running a joint promotion, selling Sky + set-top boxes together with Sony's Bravia Flat Screen TV at a reduced price.

The BBC is to begin trials of HDTV in mid-2006, with 'highlights of the schedule' being made available to selected digital and cable viewers. The format will also be tested on digital terrestrial television in London. The BBC has said that the trial may include coverage of the football World Cup later this summer. Subject to the terms of its new Charter, the BBC has said that it would aim to produce all output in HD format by 2010.

Telewest began HDTV trials in December 2005 and plans a full roll-out early in 2006. Its service, TV Drive, involves a set-top box and PVR, and will cost £10-15 a month.

HDTV has implications for the different distribution platforms. Currently DTT has insufficient bandwidth to carry all its services in HDTV format. Whilst it is possible that new compression technology may overcome this, BSkyB believes that, as consumers increasingly come to expect HDTV, the larger bandwidth available via satellite or broadband connections may be a source of competitive advantage over Freeview.

12.9: Further activity in the independent production sector

In recent months investors have grown increasingly interested in the independent production sector. Industry analysts believe that two main factors underpin this interest: first, the Communications Act of 2003, which has enabled independent producers to retain more programme rights and thereby increase their returns and, second, the BBC's 'Window of Creative Competition', which is expected to lead to more programme commissions from independent producers.

Tinopolis, Shed and RDF all floated in 2005, in January, March and May respectively. Following these flotations a number of further deals have taken place:

- Shed bought Ricochet in November. Ricochet made £2.1 million pre-tax profit last year, from hit programmes *Supernanny* and *No Going Back*.

Shed is hoping to exploit Ricochet's relationship with American networks as well as its regional classification that allows it to benefit from regional production quotas. Founder and managing director, Nick Powell, and creative director, Nick Southgate, will remain on the board.

- In November, the Welsh production company, Tinopolis, announced a hostile takeover bid for TV Corp, the company that makes *Question Time*. The offer, worth £36 million, was rejected by the board, which advised shareholders not to accept the bid. Despite attempts to find an alternative buyer, the takeover was completed in late December.

- In December, RDF bought Glasgow-based Wark Clements for £14 million. The business was founded in 1990 by Kirsty Wark and her husband, Alan Clements. The company became the largest independent producer in Scotland when it merged in 2004 with Ideal World Productions, makers of *Location, Location, Location*. Alan Clements will remain with IWC, but Kirsty Wark will no longer have any involvement with the business.

- Apax bought Hit Entertainment in May 2005 for £489 million.

- Finally, in November Telefónica floated a minority stake of 22.3% in Endemol on the Amsterdam stock market. The move valued the firm at 1.1 billion euros (£752 million), below the 5.5 billion euros (£3.5 billion) that Telefónica paid for Endemol in 2000.

12.10: Ofcom review of the independent production sector

On 10 January, Ofcom published a review of the UK's television production sector and set out proposals for consultation. The ITC's 2002 review of the sector recommended the establishment of new Codes of Practice; these recommendations were subsequently incorporated into the 2003 Communications Act, and the Codes have been implemented by broadcasters based on guidance from Ofcom. The Codes set out principles guiding the way in which public service broadcasters commission programmes from independent producers and purchase rights to programmes.

The review stated that continued regulatory intervention in the production sector will be necessary in the medium-term. The consultation document sets out proposals in three main areas:

- **Key production quotas:** the review concluded that the 25% independent production quota will remain in place for the next five years at least, providing an important source of certainty for the sector. It also recommended that the quotas for production outside London should remain, with additional measures possibly needed in the future. Ofcom continues to hold the view that the BBC has a key role to play in promoting production outside London, and that the BBC should aspire to a target of 50% of network production by volume and value produced outside London.

- **Codes of practice and new media rights:** Ofcom has developed initial principles and options for a new approach to the definition of *rights windows* – the period of time during which broadcasters retain control of a programme before the rights to exploit the programme revert to the producer. Ofcom's suggested new approach could involve two main rights windows: a *primary* window in which the rights acquired by a public service broadcaster apply across any distribution platform, and a subsequent *holdback* period in which the broadcaster is able to apply a restriction on the exploitation of rights by the producer. Ofcom is asking the industry to reach agreement by the end of this consultation period on how these issues might be resolved. In the absence of any such agreement, Ofcom will have little choice but to intervene by proposing variations to Ofcom's guidance on the Codes of Practice later this year.

- **The role of the BBC:** the review recommended that the BBC's proposed Window of Creative Competition (WOCC) is critical to the future of the external production sector. The WOCC refers to the proportion (25%) of the BBC's programme output over and above the (25%) independent production quota for which both external and in-house producers can compete. The review called for greater clarity on how the BBC's commissioning structure will work to ensure in-house and external producers can compete on equal terms. Ofcom also believes it should work with the BBC Trust to review the operation of the WOCC.

The consultation document follows publication, in September, of the results of a survey of the television production sector, jointly carried out with PACT, the independent producers' trade association. The analysis found that, in 2004, UK broadcasters spent £2.6bn on the commissioning of originated output (excluding news). Over the period 1999-2004, broadcasters increased spending on original programming by approximately 4% per year. The most rapid growth came from multichannel broadcasters, whose spend on original programming was up 19% per annum over the same period. In 2004, multichannel accounted for £123 million of the £2.6 billion spent in total on original programming.

The analysis also shows:

- 56% (£1.5bn) of originated output was produced in-house by the broadcasters, and 44% (£1.1bn) by external producers

- 63% (£1.6bn) of all original productions are made in London or within the M25 area and divided relatively equally between in-house and external producers at 55% and 45% of the total respectively

- Outside London and the M25 area, 58% of production (£550m) is accounted for by in-house producers and the balance, 42% (£400m), by external producers.

12.11: Relaxation of product placement regulations

Ofcom published a three-month consultation about product placement on 19 December. The document advocated restricted use of product placement, so long as viewers were clearly informed at the start of a programme. It excluded certain products like tobacco and prescription drugs as well as all children's programmes, news and documentaries.

The report recommended that the market for product placement was ultimately limited and estimated its value after 5 years at around £25 – 35 million a year. In contrast, sponsorship revenues last year were £114 million and television advertising spend was £3.4 billion. In the US, whilst product placement was the fastest growing area of advertising spend, it is still worth only £1.06 billion, or 1% of the total market. Ofcom anticipates that regulations in the UK will restrict it to an even smaller share of the market.

The document was published against the backdrop of the European Commission's revision of its Television without Frontiers Directive. This is set to liberalise rules on product placement, which until now, has been prohibited in Europe. Commercial broadcasters such as ITV have been pushing for the move for some time as traditional advertising revenues have come under pressure from audience fragmentation, PVR take-up and the growth of video on demand.

The new regulations are set to apply to both linear (scheduled) broadcasting and non-linear (on-demand) services, although they will be less strict for the latter. They will also include broadband and 3G mobile. Some internet companies have expressed opposition to this attempt to regulate their content alongside that of traditional broadcasters.

12.12: ITV calls for an end to the Contract Rights Renewal system

On 13 December Ofcom announced that it does not intend to carry out a full review of the television advertising sales market at this time. Previously the Competition Commission had suggested such a review be considered and Ofcom had itself proposed conducting a review in its Annual Plan 2005/06. However, Ofcom now believes that the case for undertaking a full review has not been made. It had not received any complaints about the existing state of the market and had no evidence of consumers being disadvantaged.

In any case, Ofcom declared that there would be little point in carrying out a wider review prior to examination of the base for review of the CRR (Contract Rights Renewal).

The CRR dates from October 2003 at the time of the Carlton and Granada merger and was set up to ensure that advertisers and media buyers would be no worse off as a result of the increased market power of the combined Carlton / Granada entity. Late in 2005, however, ITV Chief Executive Charles Allen called for an end to the system, claiming that it penalised ITV by allowing advertisers to move money out of the network to multichannel services whilst retaining discounted rates.

Ofcom has stated that any modification to the CRR would have to be based on evidence that such a change would not adversely affect the wider market.

12.13: BBC Charter review

The BBC published its case for a new licence fee settlement on 11 October. In order to deliver the future vision set out in the Government's March 2005 Green Paper, the BBC said that it would need to spend an additional £5.5 billion over the first seven years of the next Charter period, from 2007/08 to 2013/14. This would necessitate an increase in the licence fee, from April 2007, of RPI plus 2.3% per year. In today's prices, this means that households would be required to pay £150.50 per year by 2013, compared to £126.50 today. The current licence fee settlement is based on RPI plus 1.5%.

The BBC said that the new money would also be spent on producing 'high quality original content and services that will be universally available to everyone, irrespective of age or income.' In particular, the BBC's plan aims to deliver four objectives:

1. Quality content: the BBC would deliver more ambitious programming, with greater emphasis on excellence and distinctiveness and fewer repeats and derivative programmes.

2. Digital services: the BBC would offer new on-demand and archive services, enabling audiences to make the most of the BBC's content via a range of emerging technological devices.

3. Digital infrastructure: the BBC would play a leading role in driving the country's digital agenda – in relation to digital terrestrial television, digital radio, free satellite, the internet and HDTV – thereby helping to bring the benefits of digital to all households.

4. Local relevance: the BBC would connect with audiences and reflect the country in new ways at the local level – for example, with local television services, new local radio stations and by moving several key departments to Manchester by 2010. The move is thought to be more likely now that the projected cost has reduced from £640 million to £400 million due to the creation of a Media Enterprise Zone which would house the BBC campus, and which would offer a pool of resources to broadcasters, independent producers and other media companies.

Figure 82: The BBC's case for Licence Fee renewal

(Cumulative billions of pounds at constant prices, 2007/08 - 2013/14)

Additional cumulative costs	
Quality content	£1.6
Digital services	£1.2
Digital infrastructure	£0.7
Local relevance	£0.6
Increase in base costs	£1.4
Total	£5.5
'Self-help' measures	£3.9
Funding Gap	£1.6
Digital switchover	
Digital UK	£0.2
Spectrum tax	£0.3
Total additional funding required	£2.1

Total additional funding is equivalent to RPI + 2.3% per year
Source: BBC

The BBC said that £3.9 billion (about 70%) of the additional £5.5 billion costs would be met by a range of home-grown measures including 'job losses, rationalising processes and commercial disposals and dividends', rather than from additional licence fee funds. The £1.6 billion funding gap left after these 'self-help' measures could be met by a licence fee settlement of RPI plus 1.8%. However, the BBC was also expecting to fund some additional costs related to digital switchover, such as the marketing costs of DigitalUK (£200 million). It also made provision for £300 million of costs associated with its use of spectrum. Therefore, the BBC believes that the full licence fee settlement required to meet the total funding requirement is RPI plus 2.3%.

Mark Thompson, the Director-General of the BBC, said in evidence to the House of Commons Select Committee for Culture, Media and Sport that although the licence fee would grow in real terms it would actually become less of a burden on tax payers, as a proportion of projected earnings.

On 1 November 2005, the House of Lords Select Committee published its report on the Review of the BBC Charter. Lord Fowler, the Committee Chair said the increases were difficult to justify. He claimed that licence fee payers were unfairly having to bear the cost of digital switchover and that the increases would affect low-income households in particular.

The BBC Charter Review process is being run by DCMS and began at the end of 2003. It has consisted of a period of consultation, a programme of research, a series of seminars and a report from an independent panel of experts, led by Lord Burns. In March 2005 the Government published its Green Paper on the future of the BBC and invited further public consultation. Although the White Paper was originally intended for autumn 2005, it is not now expected until some time in spring 2006. Alongside funding, one of the key issues to attract attention has been the proposed reform of the BBC's governance and regulation.

12.14: Channel 4 announces board changes

Channel 4 appointed Lord Puttnam as its deputy chairman in place of Barry Cox, who has held the position for seven years. A Labour peer and veteran film-producer, he took up the post in February 2006.

Channel 4 also appointed two further non-executive directors, Martha Lane Fox, co-founder of Lastminute.com and Stephen Hill, the former chief executive of online betting exchange Betfair. They replace former Emap boss, Sir Robin Miller and Ian Ritchie, Channel Five's first chief executive. Their positions will last for a minimum of 3 years.

12.15: Premier League media rights resolution

On 17 November, the European Commission announced that it had received improved commitments regarding the sale of media rights to Premier League football from the 2007 season onwards, which would involve the FA Premier League selling live television rights to matches in six 'balanced' packages, with no one bidder allowed to buy all six packages and with each package sold to the highest standalone bidder. Since 1992 BSkyB has held all rights to live Premier League football.

Neelie Kroes, the European Competition Commissioner, said that the revised commitments would ensure that media rights would be sold in a 'fair and transparent manner' and that British football fans would be given 'greater choice and better value'.

The European Commission began its investigation into the sale of media rights by the Premier League in 2001 and set out its concerns in a Statement of Objections in

December 2002. The Premier League submitted provisional commitments to the Commission in December 2003, which were the subject of a consultation in 2004, following which the Commission sought clarifications from the Premier League concerning the adequacy and detail of the provisional commitments.

In October 2004 the Commission asked Ofcom and the OFT to assist in its investigation. In response to this request, Ofcom commissioned a programme of market research and economic analysis. The findings of this work were provided to the Commission.

The Commission has stated that its final decision, which would make the Premier League's commitments legally binding, will be issued no later than the first quarter of 2006.

13: The television industry

13.1: Digital growth continues

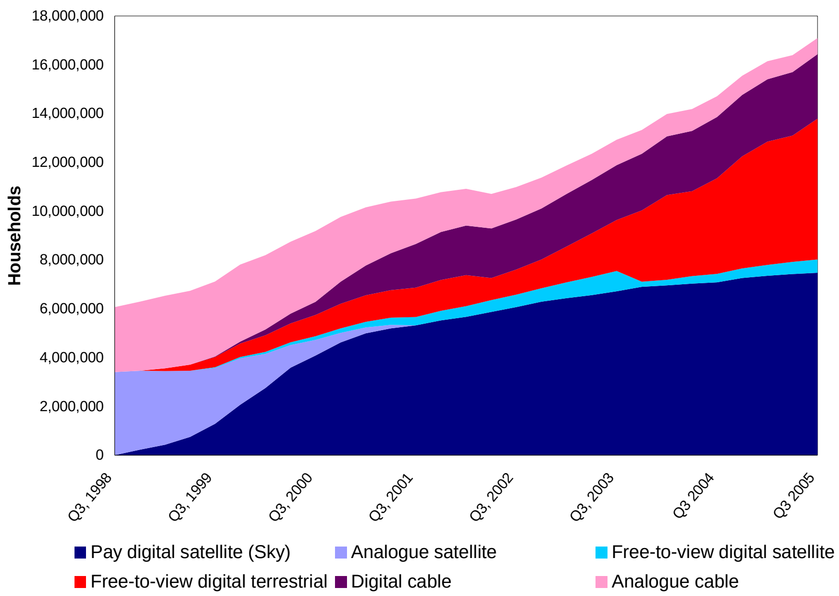
By the end of Q3 2005 Ofcom estimated that take-up of digital television had reached 66% of households across the UK, equivalent to almost 16.5 million homes. This was up from 56% in Q3 2004 and up from 62% in Q1 2005. The number of multichannel households (i.e. digital households plus analogue cable households) stood at 17.1 million.

Over the six months from April to September 2005, digital terrestrial take-up grew by just over 716,000 households, compared to 123,000 additional pay-TV digital satellite households and 101,000 digital cable households. The number of free to view satellite homes grew by 100,000. In terms of growth rates, digital terrestrial grew at 14% over the period, pay-TV digital satellite by 2% and digital cable by 4%.

The number of Freeview-only homes was 5.8 million at the end of the third quarter of 2005, compared to 7.5 million UK BSkyB subscribers and 3.3 million cable homes (of which 2.6 million have digital cable). Half a million households had access to free-to-view satellite. Broadband television take-up was relatively low at just short of 40,000 households, comprising subscribers to Homechoice and Kingston Interactive Television (Figure 83).

Figure 83: UK multichannel penetration

Households (000s)



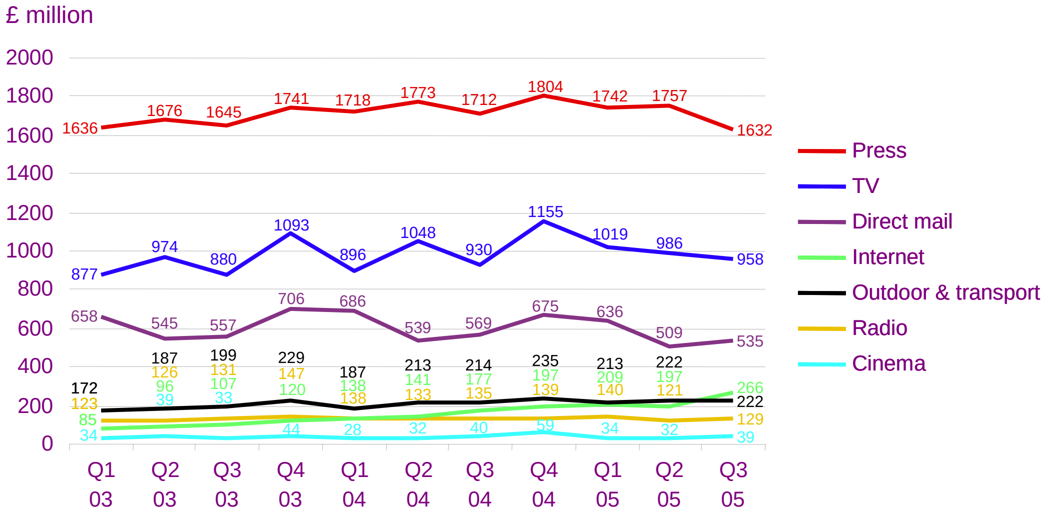
Source: Ofcom/platform operators

13.2: Television advertising revenues remain flat

Total advertising expenditure, for all media, in Q3 2005 was lower than Q2 according to the Advertising Association with total expenditure at £3,781 million, representing 0.1% year-on-year growth. Four types of media declined year-on-year; radio by 4%, press by 5%, cinema by 3% and direct mail by 6%. TV and outdoor both grew by 3 and 4 % respectively.

Internet advertising was the star performer in Q3, growing 50% year-on-year. Globally, internet advertising revenue is reported to be growing at three times the rate of the all-media average. ZenithOptimedia predicts that global advertising spending will remain strong despite economic uncertainties, projecting growth of 1.3% after inflation over the year (Figure 84).

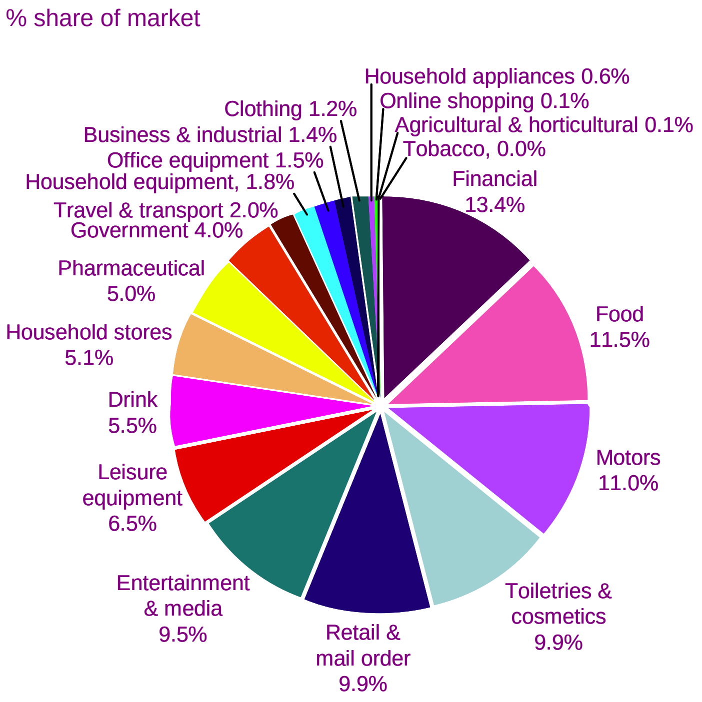
Figure 84: Advertising expenditure by medium since 2003



Source: Advertising Association

Figure 85 shows advertising expenditure for Q3 2005, broken down by sector. Financial services was the largest market in terms of advertising spend, with food and motors close behind.

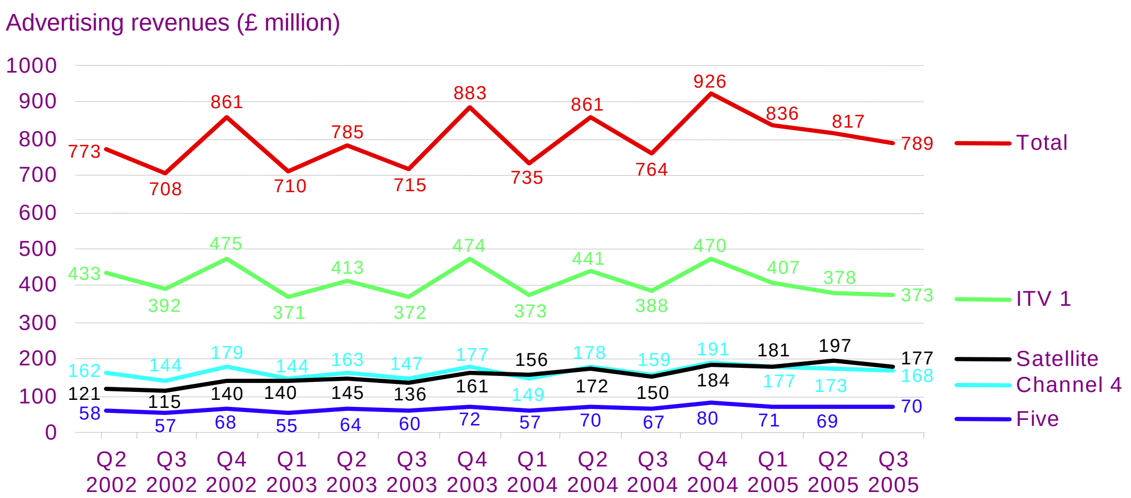
Figure 85: Q3 2005 TV advertising expenditure by sector



Source: Advertising Association

Television advertising revenues peaked in late 2004 and then declined consistently through to Q3 2005. Satellite channels were the only channels to show growth during this period, but in Q3 they too began to decline. However, they overtook Channel 4 in Q1 2005 (Figure 86).

Figure 86: Estimated TV network net advertising revenue



Source: MediaTel

NB. Discrepancy between television advertising data in Figures 3 and 5 is because of the difference between expenditure and revenues (expenditure includues production costs, commissions, etc)

14: The television viewer

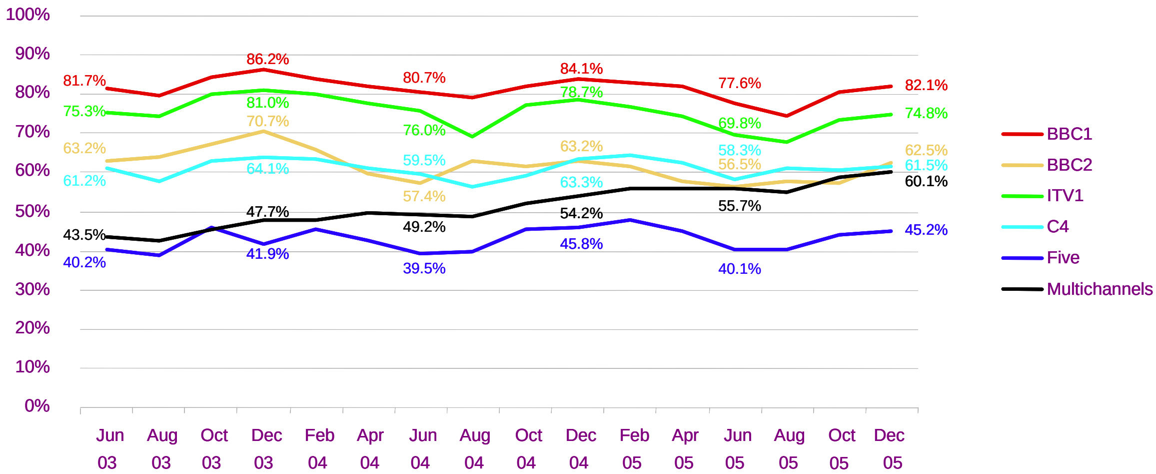
14.1: Multichannel reach continues to grow, while terrestrial reach falls

Reach of both terrestrial and multichannel television showed a seasonal increase between August and December 2005. Year-on-year multichannel reach increased by 5.9 percentage points, from 54.2% in December 2004 to 60.1% in December 2005. This continues a long-term trend that has seen multichannel reach grow by a quarter over the last twenty four months.

In contrast, year-on-year reach of all terrestrial channels continued to fall. ITV1 experienced the greatest drop, with reach in December 2005 3.9 percentage points lower than in December 2004. BBC ONE saw a year-on-year decrease of 2.0 percentage points, while BBC TWO declined by 0.7 percentage points, Channel 4 by 1.8 percentage points and five by 0.6 percentage points (Figure 87).

Figure 87: Channel audience reach (15 minute) – all homes (all day)

Channel reach: all individuals 4+ (%)

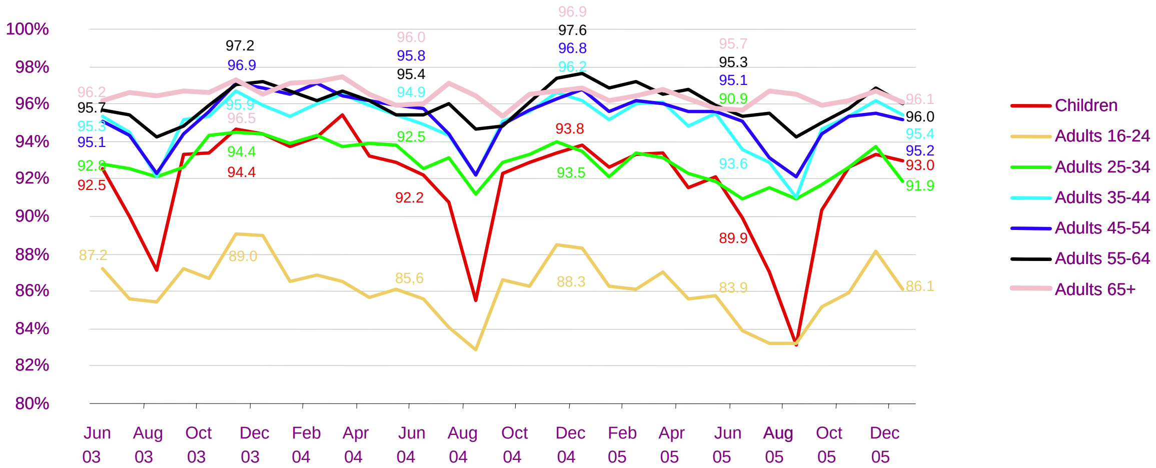


Source: BARB

14.2: 16-24 age group experiences largest decrease in reach

Over the last two years, from December 2003 to December 2005, reach to all age groups fell. However, whilst reach to older age groups fell by between 0.4 (65+) and 1.7 (45-54) percentage points, reach to younger adults declined: by 2.5 percentage points for 25-34 adults and by 2.9 percentage points for 16-24 adults. Amongst 16-24 adults, 2.2 percentage points were lost in the last year alone (Figure 88).

Figure 88: Total television audience reach (15 minute) by age group – all homes (all day)



Source: BARB

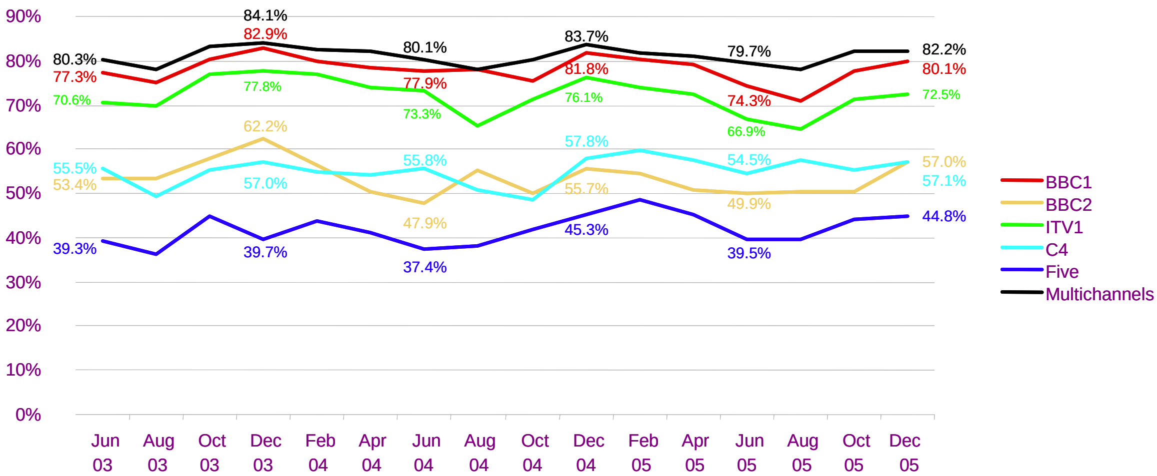
14.3: Reach in multichannel homes falls year-on-year

BBC TWO was the only terrestrial channel to have achieved an increase in reach over the year. It went up 1.3 percentage points to 57.0%.

ITV1 experienced the greatest fall in reach over the 12 months from December 2004 to December 2005 – by 3.6 percentage points to 72.5%. For BBC ONE the comparable reduction in reach was 1.7 percentage points. Similarly, Channel 4 reach fell 0.7 percentage points over the year and five reach went down by 0.5 percentage points.

Whilst in all homes multichannel reach grew over the year to December 2005, in multichannel homes multichannel reach fell by 1.5 percentage points to 82.2% (Figure 89).

Figure 89: Television channel audience reach (15 minute) – multichannel homes (all day)

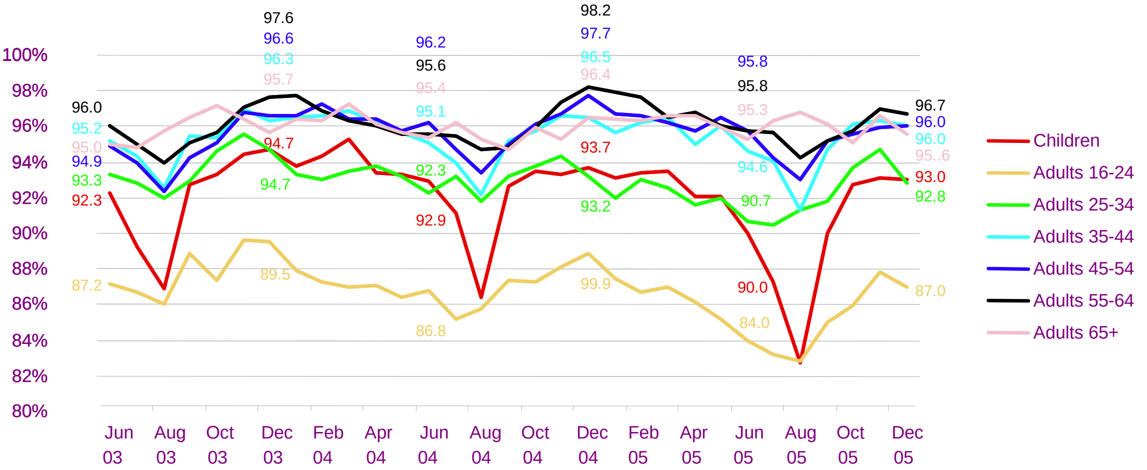


Source: BARB

14.4: Young adults show largest fall in reach in multichannel homes

As in all homes, reach of total television in multichannel homes is declining in all age groups. Again, the decline is largest in adults 16-34. Over the last two years to December 2005, 35+ age groups experienced declines in reach of less than 1 percentage point, whilst reach to 25-34 adults fell by 1.9 percentage points and reach to 16-24 adults by 2.5 percentage points (Figure 90).

Figure 90: Total television audience reach (15 minute) by age group – multichannel homes (all day)

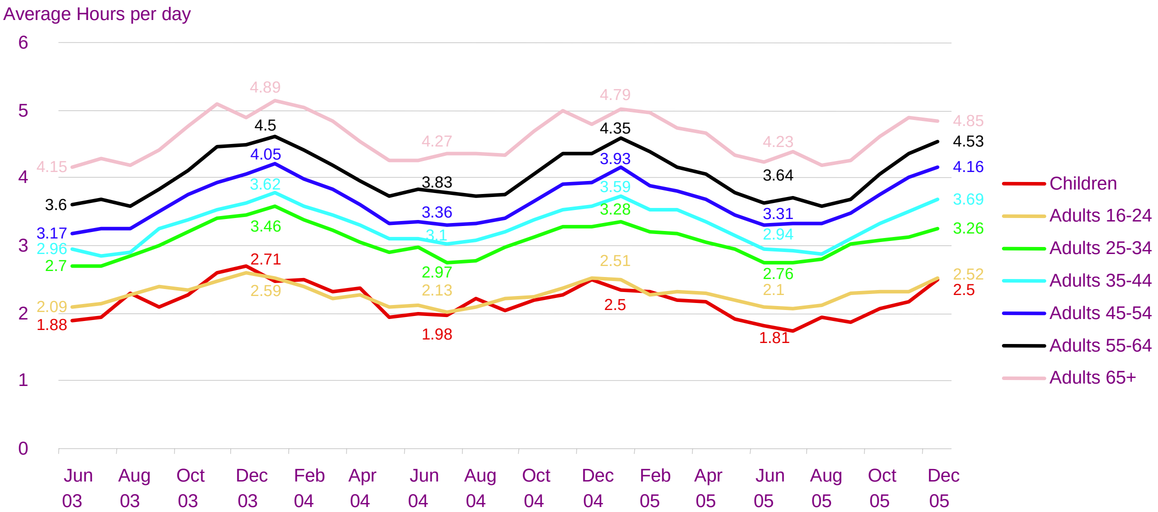


Source: BARB

14.5: Volume of viewing falls for younger age groups

Over the last year, to December 2005, the number of hours of television watched per day in all homes increased slightly amongst 35+ age groups. However, amongst 25-34 adults the number of hours watched fell slightly and amongst 16-24 the amount of viewing was flat (Figure 91).

Figure 91: Number of television hours viewed per day by age group – all homes (all day)



Source: BARB

14.6: Multichannel share continues to grow at the expense of the five terrestrial channels

Between June and November the long-term growth of the multichannels continued, with their share up by 0.8 percentage points. The bulk of this growth occurred between June and August, when multichannel share grew by 0.7 percentage points. In December 2005 multichannel share was almost 8 percentage points higher than BBC ONE and over 9 percentage points higher than ITV1 (Figure 92).

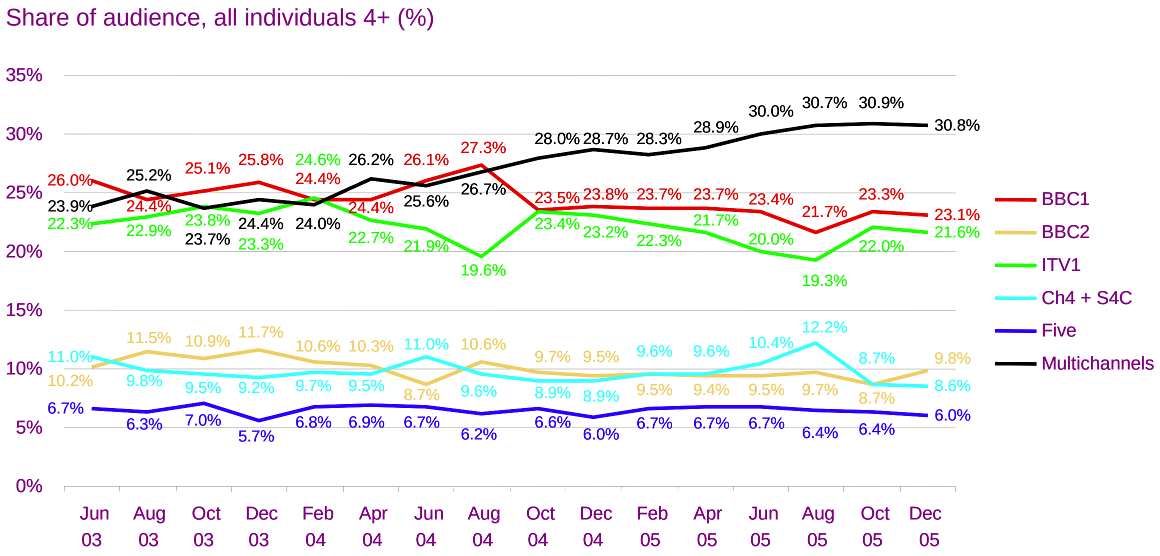
The BBC ONE audience share fell by 0.3 percentage points between June and December. It dropped during the summer, with a 1.7 percentage point drop between June and August, but recovered during the early autumn and held fairly steady thereafter. The August share figure was over 5 percentage points lower than August 2004 when BBC ONE benefited from viewing of the Olympics and European Championship football.

ITV1's share demonstrated a similar pattern over the period and continued to lag behind BBC ONE. Audiences appear to have responded to its autumn schedule which included a season of dramas, a new series of *The X Factor* and a run of 50th anniversary programmes featuring *Ant & Dec's Gameshow Marathon*. Overall, ITV1's share increased by 1.7 percentage points between June and December.

In contrast to BBC ONE and ITV1, Channel 4 grew its share over the summer, as usual. *Big Brother* helped it to achieve an August peak of 12.2%. Over the whole June to December period, however, Channel 4's share declined by 1.8 percentage points.

BBC TWO saw a slight rise in share over the summer, with an increase of 0.2 percentage points. BBC TWO's share dropped to 8.7% in the early autumn, but rose in December to a year high of 9.8%. five experienced a drop in share of 0.7 percentage points over the entire period and there are signs that its growth is slowing. This would be consistent with the long-term decline of the other terrestrial channels.

Figure 92: Channel audience share – all day (all homes)

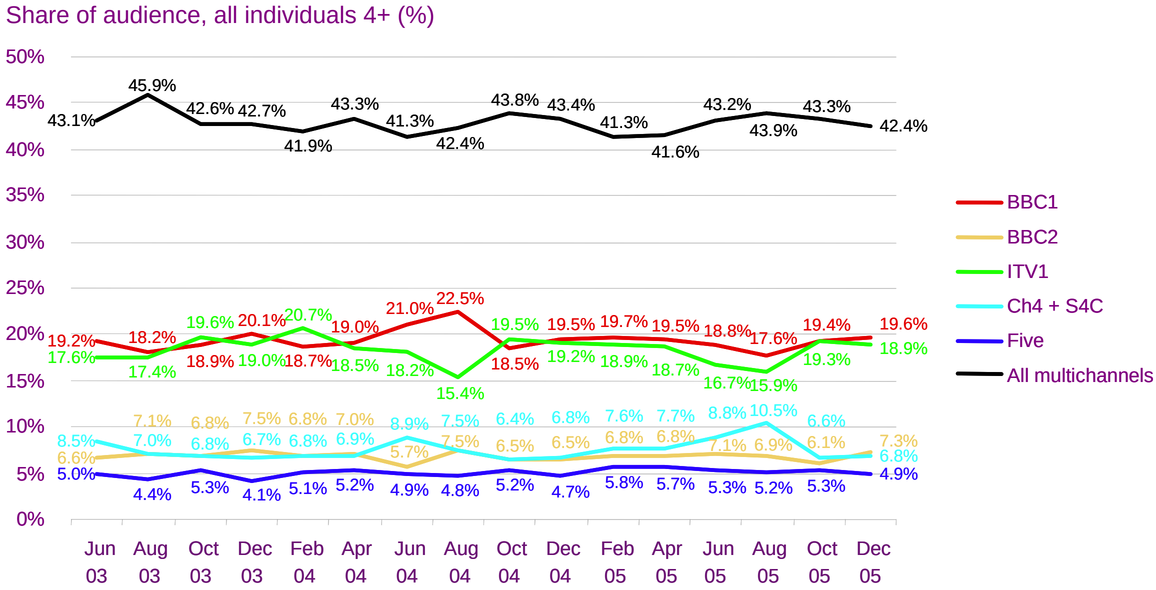


Source: BARB

14.7: Multichannels have the largest share in multichannel homes

In multichannel homes, multichannel share was 42.4% in December 2005. It fell slightly over Q4, from 43.9% in August as BBC ONE and particularly ITV1 increased their share over the autumn months. Despite these slight fluctuations, multichannel share was reasonably steady and had over twice the share of the biggest terrestrial channel, BBC ONE, at the close of the year (Figure 93).

Figure 93: Audience share by channel – multichannel homes (all day)



Source: BARB

14.8: Broadcasters' portfolios allow them to consolidate share

ITV and Channel 4 continued to consolidate their portfolio strategies over the second half of 2005. Channel 4 launched More4 on 10 October to complement E4 and Film Four, whilst ITV launched ITV4 on 1 November to join ITV1, 2 and 3 (ITV News was closed soon after, in December).

Following a summer dip, ITV's portfolio reached a year-high share in multichannel homes of 22.8% in October 2005. ITV4 played a role in this, with a 0.52% average peak-time share since launch.

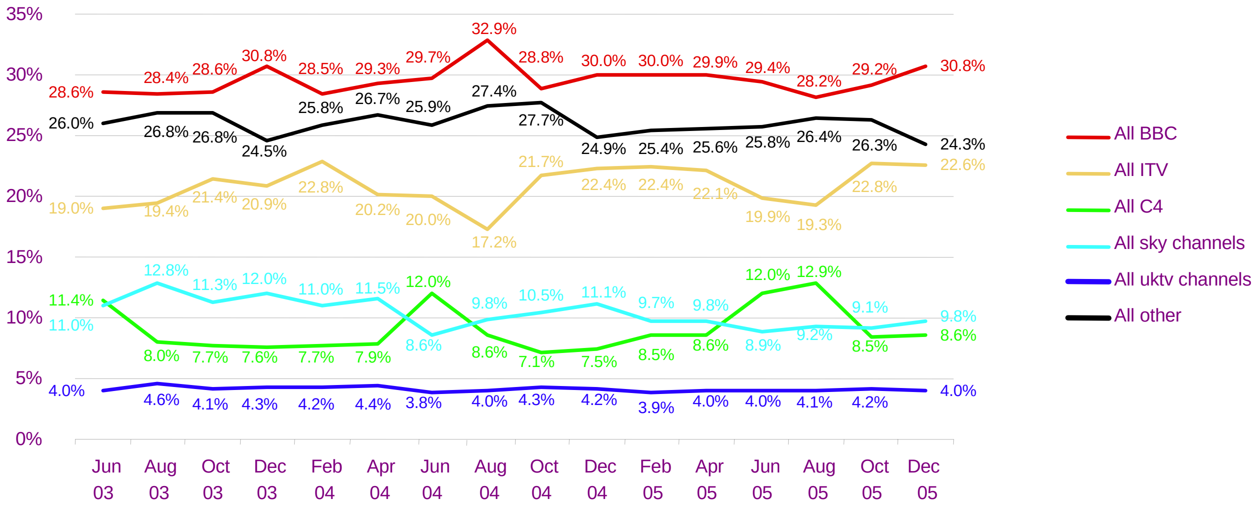
Channel 4's portfolio had a particularly high share of viewing over the summer as a result of *Big Brother* but the increase in share had been lost by the autumn. Nevertheless, Channel 4's share in December was up 1.1 percentage points compared to December 2004. The October launch of More4 is likely to have contributed to this year-on-year increase. Its average, peak-time audience share has been 0.53% since launch.

The BBC's portfolio (BBC 1-4, News 24, CBBC and CBeebies) saw its share remain relatively steady over the year. Not surprisingly, it failed to replicate the share it experienced during the Olympics in summer 2004, achieving 28.2% in August, compared with 32.9% the previous year. The BBC portfolio ended 2005 with a year high share of 30.8% in December.

In all multichannel homes the share of the UKTV portfolio remained steady at around 4%, while the Sky portfolio declined from 11.1% share in December 2004 to 9.8% in December 2005 (Figure 94).

Figure 94: Broadcaster portfolio share in all multichannel homes (all day)

Share of audience, all individuals 4+ (%)

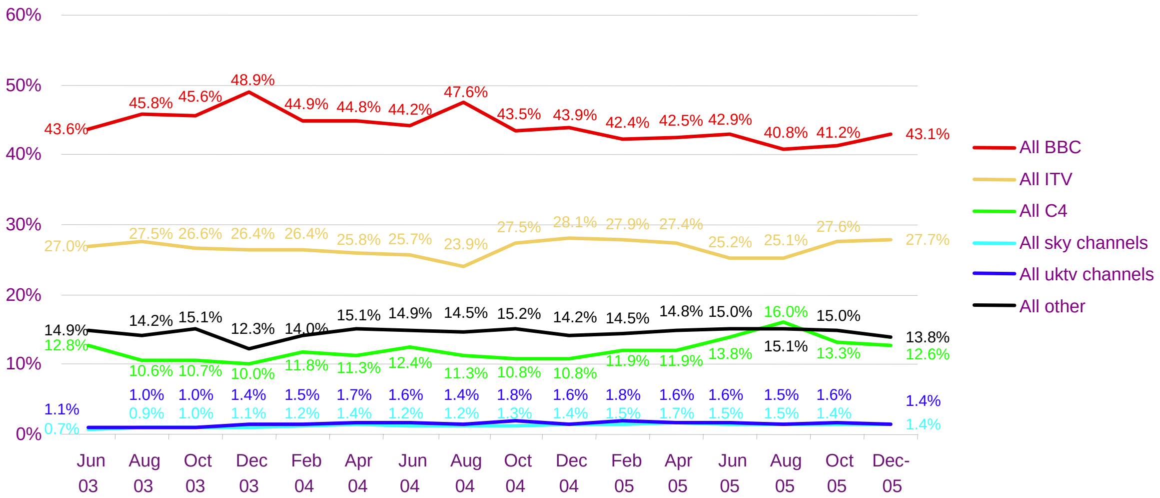


Source: BARB

In digital terrestrial-only homes the BBC's portfolio share declined by 0.8 percentage points from December 2004. ITV's portfolio share also fell, down 0.4 percentage points year-on-year. Channel 4's portfolio hit a high of 16% in August 2005, although it fell back to 12.6% by December. Nevertheless, this still represents year-on-year growth of 1.8 percentage points (Figure 95).

As would be expected, given their limited presence on Freeview, the shares of the UKTV and Sky portfolios were relatively low in digital terrestrial only homes. UKTV channels available on digital terrestrial comprised only UKTV History and UKTV Bright Ideas, while Sky's channels included Sky 3, Sky News and Sky Sports News.

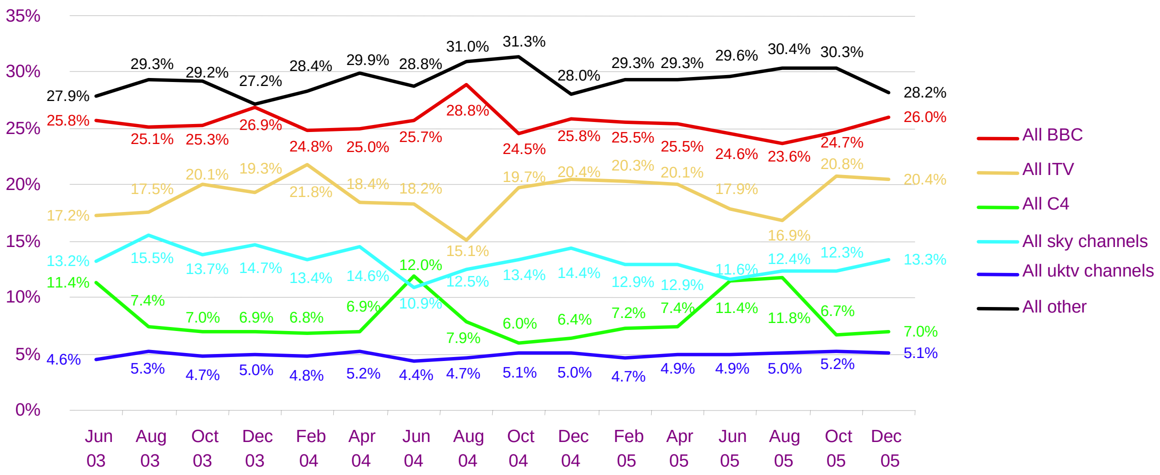
Figure 95: Broadcaster portfolio share in digital terrestrial-only homes (all day)



Source: BARB

In cable and satellite homes the trends were broadly similar, although the larger range of channels on offer meant that the terrestrial channel portfolios tended to have lower share. Nevertheless, the overall trends were similar to DTT homes: ITV experienced a summer dip, while Channel 4 peaked (Figure 96).

Figure 96: Broadcaster portfolio share in all digital satellite and digital cable homes (all day)



Source: BARB

15: Theme – The UK cable sector

15.1: The context

The 1984 Cable and Broadcasting Act established a regulatory framework that created a patchwork of cable networks. Their purpose was to provide local television and telephony services.

Over a long period, the cable operators came together in a series of mergers and acquisitions in order to exploit economies of scale. However, the costs of network integration were frequently very high.

By 1999, following a decade of consolidation, Ntl and Telewest were the only two major players to remain in the market[24]. Both faced serious financial problems as a result of the cost of consolidation and the difficulty of realising merger synergies. These difficulties were further exacerbated by the rapid growth of satellite broadcaster BSkyB. After a series of restructuring and refinancing arrangements, Ntl emerged from bankruptcy protection in 2003 and Telewest from refinancing in 2004.

A merger between the two companies had long been the subject of speculation. As competition from BSkyB and BT intensified the merger became increasingly likely.

[24] The other key cable players were Kingston Communications and Isle of Wight

Figure 97: A brief history of cable in the UK

1984	• Cable and Broadcasting Act establishes the Cable Authority: it has a duty to promote the development of cable networks in local franchise areas • Between 1984-1991, the CA issues licences for 124 individual cable franchise areas • Croydon Cable formed
1988	• Croydon Cable acquired by United Cable (US company)
1989	• United Cable merges with United Artists Cable
1990	• Broadcasting Act creates a new regulatory authority, the ITC, to replace the Cable Authority
1991	• United Artists merges with TCI (now Liberty Media); TCI creates JV with US West, renamed Telewest Communications • Cable companies permitted to provide telephony services
1993	• International CableTel founded in the UK – acquires Insight Communications, taking over franchises in Northern Ireland, Glamorgan and Wales
1994	• Telewest floats on LSE • International CableTel floats on Nasdaq; begins construction of high-speed fibre-optic network; acquires English Cable Enterprises
1995	• Telewest merges with SBC Communications (adding franchises in the Midlands and North West)
1996	• International CableTel acquires National Transcommunications; forms JV with Virgin • International CableTel changes name to Ntl
1998	• Telewest merges with General Cable and acquires outstanding interest in Birmingham Cable (adding franchises in Yorkshire, West London and Birmingham) • Ntl acquires Comcast UK, ComTel and Diamond Cable, adding franchises in the Midlands and South East • Ntl and Telewest launch first on-demand movie service, Front Row, as a JV
1999	• Telewest purchases remaining 50% stake in Cable London from Ntl • Ntl invests in Cablelink and the BT franchises of Westminster and Milton Keynes • Ntl acquires Cable & Wireless
2000	• Telewest merges with Flextech; acquires Eurobell • Ntl begins roll-out of digital cable network and launches internet service, ntlworld • Ntl moves into content provision with a movie JV with Universal
2001	• Ntl announces large job cuts; launches two broadband services • Ntl and Telewest launch joint broadband marketing campaign
2002	• Telewest enters financial restructuring discussions • Ntl files for Chapter 11 bankruptcy protection in the US; recapitalisation and reorganisation follow
2003	• Ntl exits from US Chapter 11 and relists on Nasdaq
2004	• Telewest emerges from financial restructuring and begins trading on Nasdaq • Ntl acquires the remaining 51% of Virgin.net
2005	• Ntl announces the launch of its VOD service, Ntl On Demand; and that 10Mb will be its standard access speed • Ntl / Telewest merger announced and cleared by the OFT
2006	• Ntl / Telewest merger implementation

15.2: The proposed merger

Ntl and Telewest announced their intention to merge on 3 October. A joint press release said that the merger would create:

'The UK's second largest communications company and leading triple play service provider, with a cable footprint covering more than 50% of UK households. The combined company will have nearly 5 million residential customers. It will be the largest provider of residential broadband services in the country with 2.5 million subscribers, the second largest pay TV provider with 3.3 million subscribers and also the second largest fixed telephony provider with 4.3 million subscribers.'

On 15 December, Ntl announced that Stephen Burch, an executive at US cable giant Comcast, would lead the integration process. He took over from Simon Duffy as chief executive, with Simon Duffy becoming executive vice-chairman.

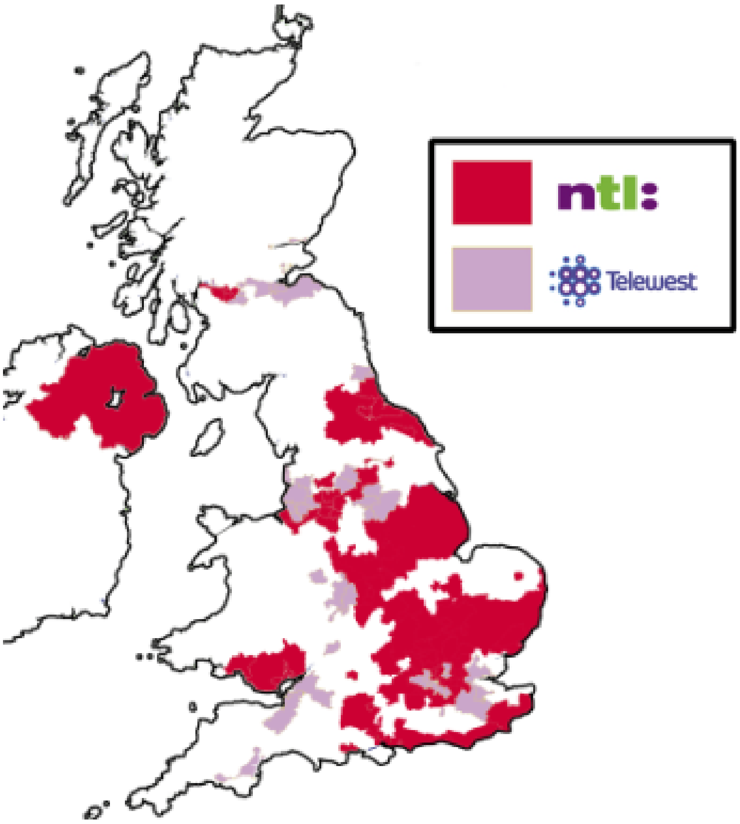
Following clearance by the Office of Fair Trading at the end of December, the deal is expected to be completed in the spring of 2006.

Figure 98: Subscriber numbers and financial data for Ntl and Telewest

		Telewest						Ntl					
		2000	2001	2002	2003	2004	2005[25]	2000	2001	2002	2003	2004	2005[26]
Number of subscribers (millions)	Total TV	1.2	1.3	1.3	1.3	1.3	1.3	0.6	2.3	2.1	2.0	2.0	1.9
	Digital TV	0.3	0.7	0.9	1.0	1.1	1.2	N/A	1.3	1.2	1.3	1.4	1.4
	Broadband	0.0	0.1	0.3	0.4	0.7	0.9	0.5	0.1	0.5	0.9	1.3	1.7
	Telephone	1.5	1.6	1.6	1.6	1.7	1.7	0.6	2.6	2.4	2.5	2.6	2.6
	Total	1.7	1.8	1.8	1.7	1.8	1.8	0.6	2.8	2.7	2.9	3.0	3.3
(Annualised) Churn rate		22.8%	14.4%	18.0%	14.4%	13.2%	16.8%	20.4%	17.7%	15.9%	13.2%	18.0%	18.0%
Triple play penetration		N/A	N/A	10.4%	16.8%	27.4%	35.0%	N/A	N/A	13.9%	20.6%	24.0%	27.2%
Homes passed and marketable (millions)		4.8	4.7	4.7	4.7	4.7	4.7	7.7	7.7	7.7	7.8	7.9	7.9
Revenue (£million)		1,069	1,254	1,283	1,298	1,318	1,123	1,376	1,928	1,855	1,887	2,000	1,463
Operating income/ loss (£million)		(359)	(1,121)	(2,440)	20	67	105	N/A	N/A	(955)	(194.4)	(52.5)	14.7
(Monthly) ARPU (£)		37.5	40.0	41.8	43.4	45.0	45.2	35.7	41.0	40.0	42.0	42.4	39.1

Source: Ntl, Telewest

Figure 99: Franchise areas for Ntl and Telewest



Source: Ntl

[25] 9 months ending September 30 2005
[26] 9 months ending September 30 2005

15.3: Potential benefits of the merger

Industry analysts expect the combined company to seek to deliver benefits to consumers in four key areas.

The first of the areas is content. Ntl / Telewest's content strategy is a vital part of the business plan. By 2008 the merged company plans to make annual cost savings of about £250m, which can be directed towards investment in 'must have' content. The company previously expressed interest in securing the rights to live Premier League football. Now that BSkyB's exclusive control is set to come to an end there is the potential for them to make a bid.

Secondly, the combined entity will continue to seek competitive advantage through the bundling of services. These are likely to include a PVR capable of competing with Sky^{+}, on demand television services and HD content. In telephony, the offer will include VOIP services and broadband upgrades.

Customer service is the third area in which consumers are set to benefit. It is widely believed that the long struggle for survival had a detrimental impact on the cable operators' ability to deliver high-quality customer service. It is expected that the companies will see the merger as an opportunity to turn around performance in this area by streamlining call centre operations and exploiting the opportunity to launch a single marketing campaign. This could operate under the Virgin brand name if the takeover of the mobile operator goes ahead.

Finally, the merger is set to generate cost savings. The company has announced it will save up to £1.5 billion across the company through synergies in programming, marketing and other operating costs.

15.4: The competitive dynamics

Ntl / Telewest faces three major competitors in the form of BSkyB, Freeview and BT.

As described elsewhere in the report, BSkyB and BT have both made recent strategic moves to enable them to compete in the same 'triple play' space as Ntl / Telewest. BSkyB has acquired Easynet and BT has set a date of September 2006 for launching a broadband television service. Media convergence appears to be becoming a reality and Ntl / Telewest will be required to fight a battle on several fronts.

On one hand, the cable operators believe they own three key competitive advantages. Firstly, the cable platform offers a strong interactive capability. The 'return path' is integrated with the platform and does not need to rely on a separate telephone connection. This means that 'red-button interaction', such as voting, does not generally result in charges, as it does for satellite-based interactivity. This is a clear advantage over BSkyB, although BSkyB hopes that the Easynet acquisition will strengthen its position in this regard. In addition, compared to DSL-based television, cable is more capable of supporting multi-room television.

Secondly, the digital cable infrastructure should be able to deliver speeds of at least 20Mbit/s without further significant investment (Ntl and Telewest already offer 10Mbit/s as a premium product). In contrast, DSL-based services are constrained by the condition and length of the copper local access network over which they are delivered. Current DSL compression technology (ADSL2+) enables the provision of 20Mbit/s services only to premises that are within around 2km from the local exchange (as measured by line length, not straight-line distance). We estimate that only around 14% of UK households currently meet this key distance criterion. In addition, provision of ADSL2+ and further DSL technologies will require significant levels of investment in exchange equipment.

Thirdly, cable companies see the provision of on demand services as a key advantage over satellite or terrestrial television platforms. Following an initial trial in Cheltenham and Gloucester, Telewest recently announced that it had completed roll-out of its ‘Teleport’ on demand service to all digital subscribers. Ntl hopes to have a similar service fully up and running by the third quarter of 2006. They also plan to offer PVRs, which they believe will be complementary to the on demand service. The new PVRs will be capable of supporting HDTV, which is likely to be rolled out later in 2006.

On the other hand, Ntl / Telewest’s competitors believe they, too, own significant competitive advantages (Figure 100).

Figure 100: Relative competitive advantages in the television market

Company	Competitive Advantage in TV
Ntl / Telewest	- Interactive capability - Broadband capacity - Video on demand - High Definition capability
BSkyB	- National coverage - Brand strength - Rights holder for live Premier League football (and movies) - Installed PVR base - Reputation for customer service - High Definition capability
BT	- National coverage - Size of customer base
Freeview	- Low cost - Ease of set-up

Figure 101 below illustrates the relative sizes of the key players in the ‘triple-play’ market following the Ntl / Telewest merger. Ntl / Telewest has a presence in all three areas and covers around half of UK households. BSkyB’s strength is still principally as a television provider. Its purchase of Easynet has, at this stage, only brought in a small number of residential internet customers. BT continues mainly to be a provider of telephones and broadband. Its television service is set to launch later this year.

Figure 101: Comparison of subscriber and financial data 2005 (Q1-3)

9 months ending September 2005		Combined Ntl /Telewest	BSkyB	BT
Number of subscribers (millions)	TV	3.2	7.8	N/a
	Digital TV	2.6	7.8	N/a
	Broadband	2.6	0[27]	1.6[28]
	Telephone	4.3	N/a[29]	18.7[30]
	Total	**5.1**	**7.8**	**18.7**
Homes passed and marketable (millions)		12.6	24.5	24.7
Revenue (£ million)		2,586	3,137	14,475
Operating income (£ million)		119.7	681	1,934
(Monthly) ARPU (£)		Ntl: 39.1 Telewest: 45.2	£32.1[31]	£21.1[32]
(Annual) Churn rate		Ntl: 18.0% Telewest: 16.8%	11.7%[33]	Undisclosed

Source: Ntl, Telewest, BSkyB, BT

15.5: The potential challenges ahead

Whilst Ntl / Telewest believe the merger represents an opportunity to create value for their shareholders, a number of challenges lie ahead.

Firstly, integrating the back office systems will be a sizeable task, which carries the potential of disrupting customer service. This was a particular issue when Ntl bought Cable and Wireless's residential business in 1999. Secondly, Ntl / Telewest will have to maintain margins in the face of intense competition. BSkyB and BT are both well-funded companies, aiming to offer the triple play package to consumers. With fierce competition anticipated, the pressure to maintain margins by growing ARPU is likely to increase. Thirdly, Ntl / Telewest is currently investigating the possibility of buying Virgin Mobile and becoming the UK's first 'quadruple play' provider, capable of offering mobile telephony as well as a fixed-line service, television and broadband (See the Telecoms section for further discussion of the deal).

[27] Includes 21,000 Easynet subscribers although the acquisition is not yet complete
[28] Includes 0.07m ISDN lines
[29] Sky has a carrier pre-select product, SkyTalk, but subscriber numbers are not released
[30] Total number of phone lines
[31] Average monthly ARPU based on a rolling 12 month consumer household ARPU of £253
[32] Rolling 12 month consumer revenue, less mobile polos, divided by average number of phone lines
[33] Quarterly (annualised) churn for July to September