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Subject: **State aid No C 13/2008 (ex N 589/2007) – United Kingdom**
Aid to Channel 4 linked to digital switchover

Sir,

(1) The Commission wishes to inform the United Kingdom that, having examined the information supplied by your authorities on the aid referred to above, it has decided to initiate the procedure laid down in Article 88(2) of the EC Treaty.

I. Procedure

(2) On 2 August 2006, the Commission received a complaint (CP 186/06) by a UK-based television broadcaster against a possible funding support that the UK authorities were about to grant to Channel 4 to help it meet the costs of the digital switchover.

(3) On 10 October 2007, the UK authorities notified to the Commission their decision to grant an aid of £14 million to Channel 4 to assist it to meet the capital costs of digital switchover. In the notification the UK authorities acknowledged that the notified measure constitutes an aid within the meaning of Article 87.1, and invited the Commission "*to find that this aid is compatible with the EC Treaty by virtue of Article 86(2) EC, having regard (in particular) to the Commission's Communication*[1] *on the application of the State aid rules in relation to public service broadcasting ("the Communication")*".

[1] 2001/C 320/04.

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(4) On 23 November 2007, the Commission asked the UK authorities to provide further information and to clarify a number of aspects of the notification. On 22 January 2008, the UK authorities submitted their reply.

II. Description

Background: Digital Switchover and Public Service Broadcasting in the UK: A Brief Overview

(5) The system of Public Service Broadcasting ("PSB") in UK television has evolved over the course of more than 70 years and competition was introduced gradually into the system: Independent television (ITV) was launched in 1955, BBC Two went on air in 1964, Channel 4 came into being in 1982, and Channel 5 (later Five) was launched in 1997.

(6) Three appear to be the major sources of PSB in the UK:

- The BBC has historically been at the heart of the PSB system, with wide-ranging public service obligations. The corporation is exempt from commercial pressures, due to its licence fee funding, and as such has been able to maintain a broad portfolio of public service activities across television, radio and, more recently, new media.
- Channel 4, although financed by advertising, has an embedded specific public service remit to be distinctive and to experiment, innovate, educate and reach culturally diverse audiences freed from some of the restrictions on other commercial broadcasters, notably shareholder returns and some programming quotas.
- Commercial PSB broadcasters – ITV, Five and Teletext– also have specific programming obligations. The public service provision from the commercial players is delivered in return for privileged access to scarce analogue spectrum and the right to broadcast[2].

(7) In February 2005, Ofcom published the final report and conclusions of its statutory Review of Public Service Broadcasting (PSB)[3]. Previous phases of the Review underlined why the framework for delivering PSB would need to change. In those phases, Ofcom highlighted amongst other that the existing terrestrial analogue model of commercially-funded PSB will not survive the transition to digital and may erode rapidly prior to 2012.

(8) Phase 3 of the PSB Review committed Ofcom to conduct a more detailed review of Channel 4's financial position in 2006/07. The PSB Review identified that changes in the market are threatening the established PSB system, in the sense that the move from analogue to digital, and consequently

[2] Ofcom makes reference to a fourth source of PSB, the broadcasting market at large which includes all other commercial broadcasters which while not explicitly entrusted with a PSB remit and have received no funding or privileged access to spectrum, nonetheless produce content that meets the PSB purposes although the supply its not guaranteed, see "*Digital PSB, Public Service Broadcasting post Digital Switchover*", Ofcom Issue Paper, 27/7/2007, page 6.

[3] Section 264 of the Communications Act 2003 required Ofcom to report on the effectiveness of the existing television public service broadcasters - BBC, ITV, Channel 4, S4C , Five and Teletext - in the delivery of their PSB obligations; and to make recommendations for maintaining and strengthening the quality of PSB for the future

multichannel, television may mean it is no longer realistic to expect commercial broadcasters to deliver significant PSB obligations due to their fragmenting audience base. In particular, a key issue of the review concerned the future viability of and operating model for Channel 4.

Channel 4

(9) C4 Television Corporation (C4C) is an operator providing public service broadcasting whose principal function is to provide the public service television channel called "Channel 4". It is incorporated as a not for profit public corporation but run on a commercial basis. C4C receives no direct financial support from the State and all of its income is derived from its channels, such as by the sale of advertising and the commercial sponsorship of programmes, and from other commercial activities connected with its channels, such as the sale of books and DVDs.

(10) Channels 4's public service programming remit is defined in section 265(3) of the Communications Act 2003:

> "*The public service remit for Channel 4 is the provision of a broad range of high quality and diverse programming which, in particular—*
>
> *(a) demonstrates innovation, experiment and creativity in the form and content of programmes;*
> *(b) appeals to the tastes and interests of a culturally diverse society;*
> *(c) makes a significant contribution to meeting the need for the licensed public service channels to include programmes of an educational nature and other programmes of educative value; and*
> *(d) exhibits a distinctive character.*"

(11) C4C's statutory powers permit it to engage in activities apart from the provision of Channel 4 itself. On this basis, C4C has launched a series of other channels: two general entertainment channels called "E4" and "More4", a film channel called "Film4", and "C4+1", which runs Channel 4's schedules an hour later than the channel itself.[4] These channels are not public service channels under current legislation, and do not have public service remits.

(12) C4C is not permitted to engage in any commercial activity *only* for financial reasons: Section 199(1) of the 2003 Act provides that "*the activities that C4C are able to carry on include any activities which appear to them*

[4] E4, More4, Film Four and C4 + 1 are owned and operated by 4 Ventures Ltd., which is 100% owned by C4C.

(a) to be activities that it is appropriate for them to carry on in association with the carrying out of their primary functions; and

(b) to be connected, otherwise than merely in financial terms, with activities undertaken by them for the carrying out of those functions."

(13) Section 199(2) of the 2003 Act defines the "primary functions" of C4C as securing the continued provision of Channel 4, and the fulfilment of that channel's public service remit. Schedule 9 to the Act makes detailed provision as to the regulation of C4C's commercial activities by Ofcom who must approve arrangements prepared by C4C concerning the management of those activities, and those arrangements must (in particular) address any risks those activities could pose to the fulfilment of the primary functions, and financial transparency as between the primary functions and other activities.

The funding of C4C

(14) As stated above, C4C is run on a commercial basis only and does not receive any State funding. C4C financial results for 2006 showed post-tax profits of £14.5 million on a turnover of £937 million, compared with £48.5 million post-tax profits on a turnover of £894 million in 2005.[5]

(15) In the past, in order to ensure that Channel 4 can continue to provide public service broadcasting, the UK Government introduced a "safety net" in the form of a financial support that would be funded by a levy on the Channel 3 licence holders (that is, ITV) if Channel 4's advertising revenue proved insufficient. The commercial success of Channel 4 was such that the system never needed to be activated, and was repealed in 2003.

C4C and digital switchover

(16) Channel 4 operates under a licence granted to C4C by Ofcom. New licences were granted to ITV, Channel 4 and Five by Ofcom in December 2004, and in common with the other new licences, the Channel 4 licence requires C4C to provide the service in digital form, and to deliver that service by digital terrestrial television so as to secure coverage that is equivalent to, or substantially the same as, that currently achieved by the analogue service. According to those licences, switchover must be completed by 31 December 2012. C4C was obliged to accept the new licence whereas the legislation gave ITV and Five the opportunity to refuse the new licences.

(17) As part of the UK Government's switchover policy, all the operators of the PSB multiplexes will need to extend their transmission network from the current 80

[5] These results are for the C4C group which includes Channel 4, all other non PSB channels, its new media activities (Channel 4.com), and Channel 4 International Limited which is responsible for the exploitation of secondary rights. C4C also has partial stakes in a number of other subsidiaries including One Word Radio Limited in which C4C holds 51% of the equity, and the 4 Digital Group Limited (which holds the licence to a national DAB multiplex) in which it has a 55% stake. It also holds 50% of a joint-venture digital channel business with Emap, a very successful UK media corporation. 4 Ventures also holds equity stakes in a number of other businesses including Popworld (29%), SwitchCo (11%), Espresso Broadband (10%), Taste of London (50%).

digital transmitters to the 1,154 transmitters currently used for analogue transmissions.

(18) Channel 4, in digital form, is currently delivered on the *Digital 3 & 4 multiplex* (as well as on cable, satellite and DSL). That multiplex carries the national and regional ITV channels , Channel 4 and the free to view, commercial channels E4, More4 and C4+1 (all 100% owned by and provided by the C4C). The licence for this multiplex is held by Digital 3 & 4 a company which is owned in equal shares by the ITV companies and C4C. 48.5% of the capacity is reserved for ITV, 48.5% for C4C, and 3% for the digital version of the public Teletext service.

(19) C4C pays carriage charges to Digital 3 & 4 – the multiplex licence holder and operator. They are charged at cost, and charges are apportioned between the two main users of the multiplex in proportion to the capacity reserved for them. Thus, C4C and ITV each pays 48.5% of the multiplex's costs [6].

(20) In turn, the multiplex operator must negotiate with the owners of transmitting masts and sites and the providers of "managed transmission services" to secure the physical transmission of the services carried on the multiplex. Negotiations for new digital terrestrial transmission contracts were concluded in August 2007. The masts and sites owners actually will incur the capital expenditure needed to build the transmission network in order to meet the coverage obligation in the new licences. They will recover those costs from the multiplex operator over the life of the transmission contract, and the multiplex operator will in turn pass those costs on to the broadcasters seeking carriage.

(21) In its notification the UK authorities have estimated that C4C's share (48.5% of the total) of the costs of building out and running the *Digital 3 & 4* multiplex to the extent required to meet the coverage obligation in the new licence will be in the region of £[**confidential**] million through to the end of 2034. The elements of the capital costs of the project relevant to C4C are likely to be in the range £[**confidential**] million to £[**confidential**] million over the build-out period. Digital 3&4 has structured this into a 26 year management contract to manage the impact on their annual cash flows. The front-end of the management contract overlaps with the BBC's current licence fee period from 2008-2013. The amount payable by C4C over the latter period is £14 million, of which £7 million relates to the repayment of principal and the remainder to the cost of financing the capital over that period.

(22) To date, take-up of digital platforms is growing very rapidly in the UK. This has been driven both by rapid growth in digital terrestrial television (the Freeview platform), and continued growth by Sky (Satellite). Partly due to this rapid penetration of multichannel television, existing analogue channels as a whole have also lost share on every platform, due to increased competition from digital-only channels (although many of the more successful channel launches have been by the existing analogue channels themselves). Although analogue channels including the BBC and ITV have experienced over the last year a declining audience share, digital only channels have benefited from (and helped to cause) the main terrestrial broadcasters' declining audience share. In its

[6] C4C, by internal accounting, imposes a notional charge on Channel 4 and the other C4C channels for the capacity they occupy.

"Issue Paper" of July 2006, Ofcom noted that the digital channels launched by the existing terrestrial broadcasters have actually performed better and have compensated in part for the decline in the flagship PSB.[7]

Main features of the aid

(23) The UK government has announced that it will grant C4C £14 million to enable it to meet the costs of digital switchover. The main features of the notified aid can be described as follows.

(24) The aid will be calculated according to the actual costs to C4C of the capital expenditure (not running costs) incurred in converting the DTT transmission network to a fully digital operation. Negotiations between Digital 3&4 and its preferred transmission provider (Arquiva) were jointly conducted by ITV and C4C in order to reach the most advantageous deal with its broadcast transmission service provider. The actual costs of converting the network will be known by the time the aid becomes payable.

(25) The aid will be funded out of the proceeds of the TV licence fee (levied on every household that uses a television to receive broadcast services) and administered and disbursed by the BBC. The level of the licence fee, and hence the level of income to the BBC, has been set in a manner that takes account of the BBC's possible liability to pay aid to C4C.

(26) There will be a mechanism to ensure that the BBC is not over-compensated. The BBC will receive no more from licence fee proceeds than it is liable to disburse in aid to C4C or in meeting the reasonable administrative costs of the scheme proposed measure. In that sense, BBC is not in any way whatsoever the recipient or beneficiary of the aid, simply the administrator of the aid mechanism granted by the UK authorities to C4C.

III. Channel 4 Financial review by Ofcom (June 2007): the LEK Study

(27) During the PSB Review in 2006, Ofcom found no strong evidence of a short term funding gap at the time of the review for Channel 4 which could threaten the delivery of its remit but stated that there would be a need to revisit the issue. In 2007, Ofcom carried out the *Financial Review of Channel 4* to assess the Channel 4 Group's financial viability in delivering its PSB remit by looking into the historic and current financial position of Channel 4 and the likely resilience of its funding model in the face of changing competitive pressures. To that end, Ofcom asked LEK, a financial consultancy, to undertake, on its behalf, a detailed review of Channel 4 Group's financial statements, business plans and management accounts for the past five years, and of its future performance projections. In parallel to the LEK's report, Ofcom examined the delivery of Channel 4's public service remit, mainly how Channel 4 defines and implements its remit.

[7] Ofcom: "Digital PSB, Public Service broadcasting post Digital Switchover", Issue Paper 27 July 2006, "For Channel 4 – where the main channel has performed well – strong digital share and revenues have meant its overall performance has improved substantially", p. 16

(28) In short, LEK found that "there is likely to be a slow deterioration in the Group's surplus" to 2008[8], but noted that since Channel 4 has "substantial" cash reserves, there would be "no immediate, pressing risk to Channel 4".[9] Even taking into account significant variations between their "low", "high" and "central" scenarios, LEK identified "no significant risk of intractable financial challenges emerging before 2010"[10], and "little evidence to suggest that Channel 4's remit delivery would need to be fundamentally compromised before 2010".[11]

(29) LEK, however, concluded that "it is likely that the Group will cease to be profitable around 2010, and will become increasingly unprofitable thereafter….LEK's assessment is that Channel 4's funding model is likely, in the medium term, to become unsustainable". The Group's other channels are expected to move into profit in 2007 but LEK did not expect returns from this source to be sufficient to offset losses on the core channel.[12]

(30) LEK identified the following as the key trends driving the C4C future performance (i) flat or declining advertising revenues; (ii) higher prices for acquired programming and competition for its original productions; (iii) cost inflation; and (iv) a more pessimistic view of the likely profitability of the Group's ancillary businesses than the group itself takes.

(31) In the light of this analysis, Ofcom took the view that the current and future market pressures on Channel 4 "*could have a gradual, but cumulatively serious, impact on Channel 4's delivery of its remit*".[13] For Ofcom, there is a wider issue of how to measure and enhance the monitoring of Channel 4's PSB output.[14]

(32) Ofcom considered that there is a need to be open to looking at fundamental reform of Channel 4's financial model in the long term.[15] Contrary to LEK's figures which suggested that there is time to monitor performance further before intervening, Ofcom considered that it might take time to identify and implement a long-term intervention and that accordingly there is a case for the UK government to look at short-term, transitional measures which:

- they would provide support during the transitional period between now and 2011 – 2012;
- they would be quantifiable and hence provide the Group with greater certainty;

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[8] Section 3, paragraphe 3.2.

[9] Section 3, paragraphe 3.2.

[10] Section 3, paragraphe 3.5.

[11] *Ibid.*

[12] Section 3, paragraphs 3.6 and 3.7

[13] Section 3, paragraph 3.16.

[14] Section 3, paragraphs 3.16 and 3.17 and Section 5, paragraph 5.10.

[15] See Section 5, paragraphs 5.35 to 5.40.

- the Group would be able to demonstrate how these measures would help delivery of Channel 4's remit;
- they would not have long-term effects or implications for longer-term policy[16].

(33) Although Ofcom expressed no opinion on the notified aid, the UK authorities consider that the notified aid meets Ofcom's above listed criteria.

IV. Comments from the parties involved

The UK position: the justification for the aid

(34) The UK authorities argue that the aid to C4C is justified for two main reasons. First, as a public corporation with no shareholders, C4C has no access to the capital markets; and second, any calls on its resources would mean that there is less money available for other aspects of the business, including public service programming, since the reserves accumulated from previous years are finite and partly required to fund the working capital requirements of the business.[17]

(35) In cash terms, in 2007 C4C will have spent £636 million on programming for Channel 4 and its other non-PSB digital channels. At the same time, the UK expects that income from Channel 4 over the same period is likely to fall, as a result (in particular) of the fact that, in a fully digital environment, Channel 4's audience share will drop, with a corresponding effect on advertising revenue. In particular the UK has produced data showing that Channel 4's share of viewing is highest in an analogue terrestrial home (14.5%) with access to only five channels, and lowest in a cable or satellite home having hundreds of channels available (6.7%). Digital switchover would mean that the number of analogue terrestrial homes – where Channel 4 performs best – will eventually fall to zero as the remaining homes in the UK without digital television are required to opt for one or the other of the multi-channel platforms.

(36) The UK authorities add that while its audience is bound to decline with the advent of the DTT and the multichannel home environment, C4C must still assume the costs of simulcasting in analogue and digital mode until switchover is complete.

(37) Accordingly, the UK authorities argue that the negative effect of switchover on C4C's financial position is significant. Although the proposed £14 million aid is relatively small when compared to Channel 4's total programming expenditure, the aid will have a significant impact on the ability of C4C to continue to deliver its public service remit. As a commercial broadcaster, C4C's funding model involves an implicit cross-subsidy whereby its most profitable programming generates commercial surpluses to finance loss-making

[16] Section 5, paragraphs 5.24 to 5.27.

[17] The UK acknowledges that C4C's currently healthy cash balances are being used to acquire increased commercial footprint and further cross-media access, e.g. moving into radio to address long term structural issues, including through investment in a company which secured the newly-awarded national DAB multiplex as a joint venture with a consortium of radio broadcasters.

programming, particularly in traditional PSB genres such as News and Current Affairs, characterised by high costs and limited revenue potential. Without the aid, C4C may be forced to divert expenditure away from certain genres which deliver significant public value in order to focus on more commercial programming. In other words, without the aid, the costs of digital switchover will have a direct impact on the resources available to C4C to meet its public service remit. Moreover, since the obligations of digital switchover and the associated costs are essentially attributable to the Government's switchover policy, the UK authorities consider it appropriate for there to be a contribution to those costs from public resources.

(38) Thus, the UK authorities believe that it is appropriate to remove one of the pressures being faced by C4C, by granting State aid to give C4C assistance with meeting the capital costs involved in converting to a digital transmission the network that carries Channel 4.

Aid compatible with the Treaty

(39) The UK authorities accept that the notified measure constitutes aid within the meaning of Article 87.1. It argues however that the measure is compatible with the Treaty by virtue of Article 86(2) EC, having regard to the Commission's Communication[18] on the application of the State aid rules in relation to public service broadcasting ("the Communication") and the three particular criteria according to which the compatibility of aid of this nature falls to be judged, namely, *definition*, *entrustment* and *proportionality*.

(40) In particular, Sections 231, 264 and 265(3) of the Communications Act 2003, taken with the new licence, satisfy the "*definition*" criterion. Sections 23 and 24(3) of the Broadcasting Act 1990 and section 265(3) of the 2003 Act, along with the licence, will further satisfy the "*entrustment"* requirement.[19]

(41) With regard to the criterion of *"proportionality"* the UK authorities consider that the sums paid in support of Channel 4 will not exceed the capital costs of providing near-universal coverage as a public service, and that any market distortions implicit in the funding could not be avoided or reduced by adopting another means of delivering or funding the remit. They argue that the aid will correspond to the capital costs of converting the transmission network to digital broadcasting by analysing the charges paid by C4C to the multiplex operator for the transmission of its services. The UK authorities clarify that the costs to expand the multiplex are fixed regardless of any other channels that may be carried alongside Channel 4. Likewise any income or other economic advantage (higher advertising revenues from a larger audience) will need to be deducted from the amount of the aid. Although in the long term C4C will no longer have to incur any simulcast costs, which will help to reduce the overall cost of C4C, the UK authorities consider that the if C4C is entitled to an aid for

[18] Communication from the Commission on the application of Sate aid rules to public service broadcasting (2001/C 320/04) OJ C 320/5, 15.11.2001..

[19] The "definition", "entrustment" and "proportionality test" are the three cumulative conditions that need to be met in order or a measure to benefit from the derogation of Article 86(2), see paragraph 29 of the "Broadcasting"" Communication, op.cit.

the capital costs of digital conversion, it is also entitled to any consequential benefits that may result thereof.

(42) The UK authorities acknowledge that C4C has built substantial cash reserves through time (up to £170 million). They argue however that a significant portion of those reserves is required to manage C4C's working capital requirements (an average of £75 million per month). Its average capital balance for 2007 stood at £137 million. The UK argues that contrary to allegations by others, C4C need to keep these reserves to protect against revenue variations and to make further investments in new business activities that could offset the expected decline of the core PSB channel.

(43) Finally, the aid will not allow C4C to distort competition in the advertisement market, given that the advertisement market does not operate on the basis of discounted rates, but on the basis of annual purchases of airtime that deliver a number of "impacts" to the advertiser.

(44) In their reply to a request for further information, the UK authorities further clarified that the aid to C4C is indented to address not only the capital costs of switchover but also the broader impact that switchover will have on C4C medium-to-long term financial performance.

The complainant's position

(45) Although supportive of the PSB system and the State's intervention to maintain and sustain a high level of PSB, the complainant considers that the proposed aid to Channel 4 is not justified. Channel 4 has accumulated reserves of around £150 million through its commercial operations and is thus in a position to face up to the expected short term challenges identified by the LEK report and the Ofcom review.

(46) The complainant considers that the question whether in the longer term the funding mechanism of Channel 4 should be reviewed in detail to take into account the changes in the broadcasting market post digital switchover is a wholly separate issue, one which is currently under review by Ofcom. The aid should not therefore be used to address the longer term issues facing Channel 4 under the disguise of a support mechanism for the capital costs of digital switchover.

(47) More importantly, the complainant argues that the current decision-making process has been opaque given that there has not yet been any kind of assessment of the costs for Channel 4 to deliver its PSB remit. As a result, there is no correlation between the £14 million aid pledged for Channel 4 and the alleged threat that digital switchover will have on the delivery of its PSB remit.

(48) The complainant stresses that during the period 1999-2005, all the non-PSB commercial activities of Channel 4 made cumulative losses of £200 million which were offset by the profits made by the core Channel 4. The complainant argues that the aid will allow C4C to continue subsidising its non PSB commercial channels distorting competition in the market. For the complainant, C4C would be better off in the coming years sub-leasing the free DTT spectrum in has received for its other non-PSB channels and reinvest the money to support the core PSB channel. The complainant estimates that subleasing the

"free" spectrum used by the 3 commercial channels between 2007-2012, C4C would have between £52 and £116 million more than if it continued to provide its digital channels.

V. Analysis

1.1. The existence of aid

(49) Article 87(1) of the EC Treaty states:

> *Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.*

(50) In order for aid in the sense of Article 87(1) to be present, there needs to be an aid measure imputable to the State which is granted by State resources, affects trade between Member States and distort competition in the common markets, and confers a selective advantage to undertakings.

(51) In the present case, the Commission notes that the notified measure (i) constitutes a transfer of State resources to C4C[20]; (ii) it would favour a particular undertaking in the market, C4C - BBC is not a recipient or a beneficiary of the aid insofar as BBC will receive no more from the licence fee proceeds than it is liable to disburse in aid to C4C or in meeting the reasonable administrative costs of the proposed measure (see paragraphs 25 and 26 above; (iii) by helping C4C to meet switchover costs that other broadcasters might need to meet themselves it would distort, or threaten to distort, competition; and (iv) it could affect trade between Member States in that C4C operates in a European market, even though it is providing public service broadcasting in the UK – for example, it competes with other broadcasters for sports and other programme rights, and the market for the sale of broadcast advertising is to an extent international. The UK authorities have stated in the notification that the notified measure constitutes and aid within the meaning of Article 87(1) of the Treaty.

Conclusions

(52) In the light of the foregoing the Commission can therefore conclude that the notified State measure, in as much as it confers an advantage to C4C which is likely to distort competition and affect trade between Member States constitutes an aid within the meaning of Article 87(1).

[20] That conclusion is not affected by the fact that the aid will be funded from the proceeds of the licence fee of BBC. As the Commission found in the past, "the compulsory legal nature of the licence fee [of BBC] and the express approval by the State for the financing of the service from licence fee funds unequivocally establish the use of state resources"; see Commission Decision of 01.10.2003, State aid No 37/2003 – United Kingdom, "BBC Digital Curriculum", at paragraph 21.

1.2. The compatibility assessment

Preliminary remarks

(53) It should be recalled that the Commission is in principle in favour of public support for the digital switchover provided that a number of conditions are respected. In particular, the Commission has stated in the past that it would take a favourable view for "*financial compensation to public service broadcasters for the cost of broadcasting via all transmission platforms in order to reach the entire population, provided this forms part of the public service mandate*".[21]

(54) However, the situation of Channel 4 is different in some respects from that of other public service broadcasters. Although entrusted with a PSB remit, Channel 4 is supposed to conduct all of its business and operations on the strength of its commercial activities only. Thus, C4C does not receive any public financial support (like the BBC does through a licence fee or any other mechanism to that effect) but relies on the strength and the flexibility of a commercial operator to deliver its PSB remit. For that reason, there is a need to ensure that the market conditions within which C4C competes against other commercial broadcasters is not distorted by the notified measure. In this respect, the Commission notes that C4C, relying on the strength of its recent commercial successes, has over the last years launched other broadcasting commercial channels, has ventured into video on demand services and has made a foray into new media internet activities, increasing its market share and advertising revenues. Therefore, one would have expected that Channel 4, as the complainant has argued, might be in a sound financial position and able to pay for the costs of its digital expansion, drawing on its current cash reserves and commercial revenues.

(55) It is equally true that as Ofcom has noted in its Review of Channel 4's financial situation, in the future, Channel 4, like any other traditional analogue broadcasters, will most likely have to compete within a fiercely competitive digital multichannel environment, vying for advertising revenues and audience capable for sustaining the delivery of its PSB remit. In that sense, digital switchover presents new challenges for existing analogue broadcasters (but also more opportunities).In the present case, for the reasons explained in more detail below, the information provided by the UK does not enable the Commission to assess whether or not, taking into account the market development, C4C will have in the short term a net public service cost which could justify the granting

[21] See in particular, IP/05/1394 issued at the time of the adoption of the Commission Decision in case C 25/2004 "DVB-T Berlin-Brandenburg" where the Commission also explained how digital TV could be supported. The Commission is in favour of public support for the digital switchover also for broadcaster's activities beyond what is covered by their public service remit. As the Commission has stated in the past, grants can "aim at covering part of the additional cost of broadcasters caused by the additional burden to broadcast both in analogue and digital mode" and "it is also possible to award grants to broadcasters for investments enabling digital signal transmission." Beneficiaries of such grants can be both private broadcasters and public service broadcasters. Such grants have to be technologically neutral, beneficiaries have to be selected in open calls for proposals, the funding has to be necessary for the realisation of the project and be limited to the directly attributable, actually incurred eligible costs for the projects; see Commission decision of 16 March 2005, N 622/03 – Austria, "Digitalisierungsfonds".

of State aid. If such net public service cost cannot be demonstrated, any grant of State aid by the UK authorities would imply overcompensation of C4C.

Assessment of compatibility under Article 87(2) and 87(3)

(56) As stated in the Broadcasting Communication, State aid provided for public service broadcasting must be examined by the Commission in order to determine whether or not it can be found compatible with the common market. The derogations listed in Article 87(2) and Article 87(3) can be applied. However, the UK authorities have not relied on any of the above mentioned provisions nor have they argued that the notified aid falls under the cultural exemption of Article 87(3) (d). Instead, the UK authorities have argued that aid should be declared compatible under Article 86(2) concerning services of general economic interest.

Assessment of compatibility under Article 86(2): Risk of overcompensation

(57) As the Court has consistently held, Article 86 provides for a derogation and must therefore be interpreted restrictively. The Court has clarified that in order for a measure to benefit from such a derogation, it is necessary that all the following conditions be fulfilled: the service in question must be a service of general economic interest and clearly defined as such by the Member State (definition), (ii) the undertaking in question must be explicitly entrusted by the Member State with the provision of that service (entrustment), and (iii) the application of the competition rules of the Treaty (in this case, the ban on State aid) must obstruct the performance of the particular tasks assigned to the undertaking and the exemption from such rules must not affect the development of trade to an extent that would be contrary to the interests of the Community (proportionality test). In the present case, it is not contested that the two first above mentioned conditions that is "definition" and "entrustment" are fulfilled. Indeed, Channel 4 has been entrusted by law with the delivery of a public service remit and is also subject to the supervision of Ofcom. Channels 4's public service programming remit has also been defined in Section 265(3) of the Communications Act 2003.

(58) The Commission has doubts as to whether the financial support pledged for Channel 4 is necessary and proportional within the meaning of the Broadcasting Communication. As mentioned above, the Commission's practice has been to accept that public service broadcasters can receive aid for the extra capital costs that result from their obligation to switch to digital transmission and their obligation to continue covering as large a territory as in the analogue era. In fact, BBC is funding its own digital switchover from a corresponding increase in the licence fee.

(59) As stated above, Channel 4 position is however different to the extent that its PSB remit is funded and supported exclusively by the commercial activities (advertising revenues) of its core channel and all its other broadcasting, non-PSB channels. Thus, to the extent that C4C may have the financial resources to meet its PSB obligations on the digital terrestrial platform (cash reserves), the mere fact that the switchover may affect its profitability (but not viability) does not constitute a valid reason for claiming State funding.

(60) In particular on the basis of the LEK report, the Commission has doubts as to whether there can be a proper or adequate justification for the aid given to Channel 4 given the basic conclusion of the report according to which, although there may be a long term funding issue for Channel 4, in the short to medium term Channel 4 faces the prospect of declining profits, not the loss of its ability to deliver its PSB remit or indeed to maintain its current scheduling.

(61) In fact, in a recent Statement by Channel 4 concerning its Programme Policy for 2007, it is said that "continuing the corporate strategy initially set out in 2004, Channel 4 will extend the values of its remit across the digital channels More4, E4 and Film4 and in its new media services without diminishing its core channel offer. For the first time, Channel 4's entire digital TV channel portfolio will be available free-to-air on all digital platforms for the whole year in 2007. New media activities will increase considerably, with a 2007 budget of 22 million-key developments will include the re-launch of E4.com, improvements in the 4oD video on demand service, new automated online programme support and the redesign of channel4.com with new web2.0 tools for use across Channel 4 sites".

(62) Far from indicating any kind of financial difficulties or challenges, the above 2007 Statement shows that C4C will not only maintain its core channel offer (thus no perceived threat to its PSB remit delivery) but will also invest in new media, relaunch some of its non-PSB channels and invest in new video on demand services.

(63) In its reply to the Commission request for information, the UK authorities stated that the aid is not only intended to cover the capital cost of digital switchover, but also the overall impact of switchover on Channel 4's medium to long-term financial performance. However, Channel 4's long-term financial performance is a separate issue, linked to the question of what kind of funding support Channel 4 will need in the future to deliver its PSB remit.

(64) This exercise would require assessing the costs for delivering Channel 4's PSB remit. This has not been done by the UK authorities for the purposes of the notified aid mechanism. Accordingly, the Commission does not have at this stage the required information to assess whether the aid in question is indeed necessary and proportional to help Channel 4 meet its PSB remit post digital switchover.In fact, given that C4C is not currently facing any financial difficulty, the necessity of the notified aid is not clear.

(65) The Commission's doubts are further compounded by the fact that all the other non-PSB Channels of C4C are also benefiting from the digital expansion of the 3&4 Multiplex given to C4C without bearing the relative costs[22]. At this stage, it is not clear to the Commission why the non-PSB commercial activities of Channel 4 should benefit from the aid to Channel 4 if they are not entrusted by law with the delivery of a PSB remit

(66) In its reply to the request for information, the UK authorities stated that the current reserves of C4C (around £145 million) are earmarked to meet the monthly capital expenditure of the Corporation and cannot be treated as proper

[22] Non-PSB channels would not meet any of the investment costs related to the digital expansion. As mentioned in footnote 6, C4C currently charges non-PSB channels for the spectrum capacity they occupy by internal accounting.

reserves. At this stage, however, it is not clear to the Commission why the current reserves of C4C could not also be used for the costs of digital switchover and should only be used for the on-going financing of C4C's current and new media and broadcasting activities that are non related to C4's PSB remit.

(67) It may be recalled that in the most likely scenarios, LEK's analysis of Channel 4's business model points to declining profits from 2008 onwards. However, as Ofcom has also confirmed, in these scenarios Channel 4's cash reserves are more than sufficient to ensure the survival of the core channel until at least 2010, "*fluctuations in working capital notwithstanding"*.[23] This conclusion by Ofcom is at odds with the UK authorities' position that the cash reserves should remain intact to protect C4C against possible fluctuations in the working capital requirementsIn more positive scenarios, LEK's analysis indicates that Channel 4's business model may be able to deliver stable profits and growing cash balances throughout the period to 2012. According to Ofcom, the above suggests that in LEK's projections there are unlikely to be "*immediate, intractable financial pressures that would require Channel 4 to make significant reductions in its remit delivery before around 2010*".

(68) From 2010 onwards, LEK suggests that financial pressures on the core channel are likely to grow. However, the timing and extent of the pressures cannot be predicted with certainty. If the programme mix remains unchanged, LEK's analysis suggests that Channel 4's commercial performance is likely to deteriorate, as a result of increasing competition for its most profitable programmes, and some ongoing inflation in other programme costs at a time of flat or declining advertising revenues.

(69) These scenarios are however separate issues not linked as such to the capital costs of digital switchover, but to the consequences of the digital switchover itself. The analysis of these scenarios may result in an assessment of the ability of Channel 4 to deliver its PSB remit in a multichannel digital environment. Such an analysis however has not been undertaken by the UK authorities in the notification. The Commission notes that this issue is currently being analysed by Ofcom and no conclusions are available at this stage.

(70) One would have expected Channel 4 to have made an analysis of the expected costs of the public service and expected revenues from the commercial exploitation of that service (which according to the broadcasting communication must be discounted from the public service costs) in order to assess whether the capital costs of switchover can be met, or whether state aid is necessary.

(71) It is important to stress here that Ofcom in its latest financial review of Channel 4 [see above par. (32)] did not rule out the adoption of short term measures "*if they helped Channel 4 avoid making reductions in its public service delivery in response to uncertainty about it financial position*". For Ofcom such measures would need to have the following characteristics: (i) provide support between now and 2011-2012, (ii) their impact could be quantified and known to Channel 4 with a reasonable degree of certainty, (iii) Channel 4 would be able to demonstrate how such measures would help the core channel continue to deliver its remit, and (iv) such measures should not have any lasting consequences that

[23] Ofcom, *Channel 4 Financial review*, Statement, 14 June 2007, page 1.

might prejudice the Government's longer term policy for Channel 4"[24]. Even if we were to accept that the notified aid is in fact a short term measure aimed not so much at enabling Channel 4 meeting the capital costs of digital switchover, but the declining profitability in a multichannel competitive environment, the notified aid does not appear to have any of the above characteristics. In fact, although the notified measure does not appear to have any long lasting effect on how Channel 4 may operate in the future, there has not been any quantification so far of the net costs of C4Cs PSB remit in a digital environment, neither Channel 4 has demonstrated that the aid will be necessary to deliver its PSB remit.

Conclusions

(72) According to the broadcasting communication, in the case of state support for public service broadcasting, in order to determine whether there is overcompensation, the Commission would need first to determine the gross costs of the PSB, deduct the benefit of the commercial exploitation of the public service (e.g. advertising) so as to obtain the net public service cost. Moreover, the Commission has to ascertain that the broadcaster in question does not engage in distortions of competition which are not necessary for the fulfilment of the public service mission. Only if there is a net cost, then the said broadcaster should be entitled to obtain State aid.

(73) The information provided so far by the UK does not enable the Commission to assess whether or not given its digital switchover obligations, C4 will have in the short term net public service costs which would allow it to receive State aid.

(74) To conclude, the Commission doubts whether the notified measure is compatible with the common market.

VI. Decision

(75) In the light of the foregoing considerations the Commission requests the UK authorities to provide all necessary information to demonstrate (on the basis of the appropriate financial data) that the aid they intend to grant to C4 is necessary in order to enable C4 to deliver its public service remit, and is not going to result in overcompensation, taking into account also the revenues of C4C from its commercial activities.

(76) The Commission request your authorities to forward a copy of this letter to the recipient of this aid immediately.

(77) The Commission wishes to remind the United Kingdom that Article 88(3) of the EC Treaty has suspensory effect, and would draw your attention to Article 14 of Council Regulation (EC) No 659/1999, which provides that all unlawful aid may be recovered from the recipient.

[24] Ibid at p.5

The Commission warns the United Kingdom that it will inform interested parties by publishing this letter and a meaningful summary of it in the Official Journal of the European Union. It will also inform interested parties in the EFTA countries which are signatories to the EEA Agreement, by publication of a notice in the EEA Supplement to the Official Journal of the European Union and will inform the EFTA Surveillance Authority by sending a copy of this letter. All such interested parties will be invited to submit their comments within one month of the date of such publication. If this letter contains confidential information which should not be published, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to publication of the full text of this letter.

Your request specifying the relevant information should be sent by registered letter or fax to:

European Commission
Directorate-General for Competition
State Aid Greffe
SPA 3 6/5
B-1049 Brussels

Fax No: +32 2 296.12.42

Yours faithfully,

For the Commission

Neelie KROES

Member of the Commission