



Proposed methodology for a review of the financial terms of the Channel 3 and Channel 5 licences

Sky response to Ofcom consultation

August 2023

Introduction

Ofcom's proposed methodology is unlikely to reflect the true value of the Channel 3 and Channel 5 licences (the "Licences") to a prospective new entrant, and it should consider alternative methodologies that would properly meet its objective of setting fair and reasonable terms for recovery of the value of the rights granted to the licensees once account has been taken of the costs of meeting the relevant public service obligations.

Sky is concerned that the fees resulting from this exercise will be nominal because of various erroneous assumptions included within the methodology; these invariably result in an assumption that no hypothetical entrant would bid for the licences. Sky considers that the Licences are likely to have significant value for a range of potential bidders and Ofcom should revise its methodology to more accurately reflect reality.

Sky's further comments relate to Ofcom's proposed approach to uncertainties concerning the Media Bill and Ofcom's review of the rules in its Code on the Scheduling of Television Advertising ("COSTA"). In summary:

- We do not believe that a new entrant would take a cautious approach to ascribing value to new benefits and obligations introduced by the Media Bill. It would have a significant degree of confidence that these benefits will be delivered and that they will provide material value for holders of the Licences. Accordingly, this value ought to be reflected in the Licence valuation; and
- The consultation anticipates that Ofcom will publish its decision on whether to remove the stricter COSTA rules that apply to the commercial public service channels by the end of September 2023. As set out in Sky's response to that consultation, we do not consider this timetable to be feasible given the material failings of that consultation. Ofcom should allow sufficient time to complete its COSTA review before finalising the financial terms, including reaching a conclusion on the financial impacts of the proposals on PSBs and non-PSBs alike, which is an essential input into any valuation of the Licences.

We expand on these concerns in more detail below.

The current methodology is not fit for purpose

Ofcom should use this opportunity to carry out a 'bottom up' review of its methodology to comply with its statutory obligations to determine the amount that the incumbent licence holder would have bid in a competitive tender to secure a licence. The existing methodology is inadequate, and its outputs do not correspond with our view that PSB status would be materially valuable to a new entrant.

Ofcom is overly reliant on its previous assessments of the merits of alternative counterfactuals. In Sky's view the rejection of counterfactuals comprising either a national non-PSB channel or an 'all or nothing' approach, each have greater credibility than Ofcom's regionalised non-PSB broadcaster and are more likely to arrive at a realistic valuation of the Licences.

Any valuation of the licence must reflect the value of the Channel 3 licences as a single branded channel (this is, after all, how they are presented to audiences and

advertisers), and any bidder would take account of likely profits over the course of the licence period (through consolidation) in determining the value of their bid.

Ofcom's consultation states that *"the statutory framework makes it infeasible to assume there is a multiple contingent bid auction"*, referring to its 2004 statement on this issue. Ofcom's position then was more nuanced, and it left open the possibility of taking account of the value of holding multiple licences over time. Paragraph 3.13 of the statement makes clear that this possibility could be factored into Ofcom's assessment:

"However, while Ofcom does not believe that it can proceed with the valuation of multiple licences through contingent bids in the hypothetical auction, it continues to believe that potential bidders for individual licences would be aware of the potential advantages of winning more than one licence and also of the scope for post-auction transactions to achieve the ownership of multiple licences. This provides further support to Ofcom's view that any auction would be competitive with multiple bidders for individual licences. If appropriate, Ofcom will also take into account the expected costs and benefits of achieving a more efficient cost structure over time in judging the value of the licences."

For these reasons, a methodology that enables Ofcom to conclude that *"a new entrant would not be prepared to make financial payments as well as deliver PSB programming in return for the rights attached to the licences"* as it did in previous awards, and which accordingly results in nominal payments for the Licences totalling £170k, is not justifiable. PSB status confers material value on the beneficiaries which ought to be reflected in the licence fees.

Ofcom's statutory duties, including those requiring it to act in a reasonable, proportionate, and targeted manner, require that Ofcom not simply recycle and reuse old analyses, but that it considers the most appropriate methodology for this next licence period, considering current circumstances.

Ofcom's approach to the Media Bill

The Bill introduces significant new benefits for the Channel 3 and Channel 5 licences holders

A new entrant is unlikely to be cautious when ascribing a value to new benefits and obligations introduced to by the Media Bill.

The Media Bill introduces several extremely valuable changes for public service broadcasters. First, it will reduce the cost of operating the Licences by:

- introducing a streamlined PSB remit; and
- affording the Licence holders greater freedom and flexibility in meeting their PSB obligations by enabling them to fulfil their PSB remit and productions quotas via a broader range of media, including online.

Second, the Media Bill will also provide the Licence holders with several significant additional benefits, notably:

- guaranteed inclusion and prominence on popular TV platforms for their "designated internet programme services". There can be little doubt that

ITVX and My5 will be designated by Ofcom and benefit from these new public service privileges across a range of popular platforms on materially more beneficial terms than competing services, including Sky services; and

- amending the “qualifying conditions” for the listed events regime so that a qualifying service must be provided by a PSB. This provides an additional benefit to public service broadcasters versus the current position as it gives them a guaranteed first right of refusal to acquire popular events of national interest such as the FIFA World Cup.

The public service broadcasters rightly ascribe significant value to the changes introduced by the Media Bill. These are changes which ITV and Channel 5 (along with the other public service broadcasters) have been lobbying extensively for over several years.

As set out in the Secretary of State’s recent letter to Ofcom regarding renewal of the Licences, Government’s publication of the draft Media Bill is intended to provide clarity and certainty around the changes to be introduced under the Media Bill:

“These reforms will not only help maintain the value of the PSB compact but also strengthen and secure the long term sustainability of PSB.

I agree with your report’s conclusion that the reforms proposed for inclusion in the Media Bill will help further strengthen the sustainability of these licences over the next 10 years. In recognition of this, and alongside my response to your report, I am publishing the Bill in draft to underline my commitment to introduce the Bill when parliamentary time allows. In doing so, I want to give the current licence holders greater business certainty and additional clarity around the potential new obligations and benefits to be brought forward in the next licence period to assist with upcoming negotiations on the new licences”.¹

Upon applying to Ofcom to renew the Channel 3 licences, ITV’s Chief Executive Officer, stated that:

“The new framework in the draft Media Bill will be fundamental to ITV’s future as a PSB. ITV is confident that the proposed reforms will give us the certainty to commit to renewing our Channel 3 licence in 2024 and to continue to deliver our public service provisions for a further 10 years”.²

While there remain some uncertainties as the Bill passes through Parliament and Ofcom finalises its codes and guidance, a new entrant would nonetheless have a significant degree of confidence that the above benefits will arise and will deliver material value. This must be reflected in the Licence valuation.

Ofcom should consider alternative sources in addition to evidence provided by licensees

The current Licence holders are incentivised by Ofcom’s consultation process to provide conservative financial valuations of the new benefits and obligations under

¹ Letter from Lucy Frazer to Melanie Dawes dated 29 March 2023 (Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1147038/DCMS_Secretary_of_State_letter_to_Ofcom_on_C3_ans_C5_Licence_Renewals.pdf)

² ITV press release dated 4 May 2023 (Available at: [https://www.itv.com/presscentre/media-releases/itv-applies-renewalllicence0#:~:text=Following%20the%20publication%20of%20the,national%20Channel%203%20breakfast%20licence\).](https://www.itv.com/presscentre/media-releases/itv-applies-renewalllicence0#:~:text=Following%20the%20publication%20of%20the,national%20Channel%203%20breakfast%20licence).)

the Media Bill. Sky therefore supports Ofcom's proposal to look at alternative sources for the purposes of the Licence valuations. Ofcom must also evaluate information provided by the current licensees with rigour and scepticism. For example, the minimum that would be expected would be that Ofcom has verified submissions through formal information requests for relevant internal documents assessing the impact of the changes in addition to considering renewal of the Licences *per se*.

Similarly, the costs and benefits of existing *commercial* arrangements for distribution and prominence via new, unregulated platforms ought to provide important indicators of the value of the new regulated benefits for distribution without charge.

Ofcom's approach to COSTA

Ofcom should allow for more time to complete its COSTA review

The current consultation anticipates that Ofcom will publish its decision on whether to remove the stricter COSTA rules that apply to the commercial public service channels in Q2 2023/24, and that it will have certainty on the future status of the COSTA rules for the purposes of setting the financial terms for the Licence renewals.

As set out in detail in Sky's response to Ofcom's COSTA consultation, that consultation contains significant failings, notably the absence of any credible evidence in support of its proposals.³ In order to address those failings Ofcom needs to carry out substantial research and analysis.

Given the significant financial benefits that at least some of the PSBs (notably ITV) would derive from Ofcom's proposed COSTA changes, Ofcom must not decide on the financial terms until it has finalised its decision on COSTA.

As noted above, were Ofcom to decide to harmonise the rules on the amount of advertising, this would provide a windfall to the Channel 3 licensees through a transfer of value from non-PSBs. One would expect this outcome to result in increased bids for the Licences, regardless of the counterfactual. The Channel 3 licensees would be able to generate greater advertising income in future, at the expense of non-PSBs.

However, Ofcom's consultation appears to contemplate that the prospective new entrant would be indifferent to changes in the advertising rules for commercial PSBs. Ofcom's hypothetical bidder would likely see incremental value in a change in the rules because: a) it would be able to sell more advertising in peak periods compared with the counterfactual of no change in the rules and/or b) it would be prepared to pay an amount to mitigate the adverse impact from a change in the rules on its advertising business. These effects should be reflected in Ofcom's valuation.

Sky notes that in its COSTA consultation, Ofcom failed to analyse the likely financial impact of its proposals (see pages 8-9 of Sky's response), merely stating that:

³ Sky's response to Ofcom's consultation on the quantity and scheduling of television advertising on public service channels is available at: https://www.ofcom.org.uk/__data/assets/pdf_file/0026/263456/Sky-response.pdf

“It is not possible to predict with any certainty what the impact on the market or particular broadcasters would be should the stricter rules that apply to PSB channels be removed”.⁴

Ofcom cannot take the same approach in relation to its valuation of the impact of such changes on the value of the Licences.

As noted above, it is essential that Ofcom considers alternative sources of evidence (including information provided by non-PSBs) and that it verifies information provided by the current licensees through formal information requests for relevant internal documents assessing the impact of the changes.

Conclusion

The methodology is designed to set licence fees which capture some of the value of PSB status by determining what a new entrant would be prepared to pay in a hypothetical auction. Sky has material concerns that the current methodology is inadequate and that the licence fees would be set too low because of Ofcom’s underlying assumptions regarding a hypothetical bidder. Ofcom should reconsider those assumptions to ensure a more realistic and credible outcome, and not underplay the value of PSB status by failing to recognise properly the benefits to PSBs contained in the Media Bill and any future changes in the COSTA rules (should they occur).

Sky

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⁴ Paragraph 1.23 of Ofcom’s consultation on the quantity and scheduling of television advertising on public service channels.