Reviews of the financial terms for the Channel 3 and Channel 5 licences

Consultation

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Contents

Section 1

Executive summary

1.1 In July of this year, the Secretary of State for Culture, Media and Sport brought into effect The Communications Act 2003 (Commencement No. 4) Order 2009[1]. One of the effects of this order is that the holders of Channel 3 and Channel 5 licences may apply for a review of the financial terms attached to their digital replacement licences.

1.2 The earliest date from which revised terms could apply is 1 January 2010. In order for this to happen, licensees would need to apply for a review before the end of this year. The review of terms would then take into account the remaining period of the licence until expiry in 2014.

1.3 For each licence in respect of which an application has been made, the legislation requires Ofcom to determine two different types of payment. The first is a percentage of the licensee's qualifying revenue and the second is a fixed annual cash payment. To assess the amount that is appropriate for the annual cash payment, Ofcom is required to determine the amount which, in its opinion, would have been the cash bid of the licence holder were the licence being granted afresh in a competitive auction process.[2]

1.4 This consultation sets out Ofcom's proposed approach to undertaking reviews that licensees may request before the end of this calendar year. The last time such reviews were undertaken was in 2005. Overall, we propose that the approach taken by Ofcom to those reviews remains appropriate, subject to a small number of proposed adjustments which we set out in this consultation.

1.5 Ofcom's objectives for these reviews are to determine a fair and reasonable value for each licence which is in accordance with the statutory requirements and to set new financial terms according to a fair and objective process. To the extent possible, the process should also allow Ofcom to set terms that are reasonable within the context of the current market environment and that will continue to be reasonable for the period of the licence. This means that we need to take into account changes in the market and regulatory environment that will impact the financial terms for each licence.

1.6 This consultation invites views from stakeholders about our proposed approach. The consultation is open for eight weeks, until 5pm on 10th December 2009. This is shorter than our standard ten week consultation period. However, we consider this is appropriate given that the consultation is primarily of interest to a limited number of stakeholders who are aware of the issues involved and the proposals contained in this document are generally consistent with those we previously consulted on and used when Ofcom last conducted such reviews in 2005.

[1] This is available at http://www.opsi.gov.uk/si/si2009/uksi_20092130_en_1
[2] An application made in accordance with section 15 of the Broadcasting Act 1990

Section 2

Legal framework

2.1 On 27 July 2009, the Secretary of State for Culture, Media and Sport brought into effect The Communications Act 2003 (Commencement No. 4) Order 2009[3]. The effect of this order is that s272 and 273 of the Communications Act 2003 ('the Act') come into force on 31st January 2010.

2.2 These sections of the Act set out "must offer" obligations in relation to networks and satellite services. The purpose of these obligations is to secure that each relevant public service channel is offered as available in digital form on every network including every satellite service, is broadcast or distributed on those networks without charge and is available for reception by as many members of its intended audience as practicable.

2.3 Section 226 (2) of the Act states:

> *The holder of a licence in which conditions mentioned in section 272, 273 or 274 will fall to be included when the order comes into force may apply to OFCOM, at any time in the review period, for a review of the financial terms on which the licence is held.*

2.4 This means that an effect of the Communications Act 2003 (Commencement No. 4) Order 2009 is that the holders of each Channel 3 licence, the Channel 5 licence and the Public Teletext licence are entitled to apply during the "review period" for a review of the financial terms attached to each of their digital replacement licences. The review period is defined in section 226(3) as beginning with the day on which the Order is made and ending with the time at which, by virtue of the Order, the "must offer" obligations in the legislation come into force. This date is set under the order as 31 January 2010[4].

2.5 The financial terms attached to the Channel 3 and Channel 5 licences were last reviewed by Ofcom in 2005, following applications under s225 of the Act. The revised terms were backdated so that they were effective from 1 January 2005.[5]

Applications made not later than 31 December 2009 under section 226 of the Act

2.6 Under section 227 of the Act, following an application for a review, Ofcom must determine a fixed annual cash amount (the "cash bid") to be paid for the licence and a percentage of qualifying revenue (the "PQR") payable for each remaining year of the licence period. The Act does not set out any process that Ofcom must follow in order to determine the PQR. As regards the annual cash sum, however, the Act requires Ofcom to determine the amount that, in its opinion, would have been the cash bid of the licence holder were the licence being granted afresh on an application being made in a competitive tender process under section 15 of the Broadcasting Act

[3] This is available at http://www.opsi.gov.uk/si/si2009/uksi_20092130_en_1

[4] The current holder of the Public Teletext licence has indicated that it intends to hand back its licence in January 2010. This consultation does not, therefore, set out a methodology for a review of the financial terms of the Public Teletext licence since no such review is currently anticipated.

[5] A document setting out the revised terms and the background to those reviews is available at http://www.ofcom.org.uk/consult/condocs/channel3_consultation/ch3ch5fin/

1990 ('the 1990 Act'). This means that as regards the cash bid element of the financial terms Ofcom is required, in practice, to reproduce the effects of a hypothetical auction of the licences.

2.7 Ofcom is required to determine the amount of the fixed annual cash amount from the first calendar year falling wholly or partly within the period under review beginning after the application date; and the percentage of qualifying revenue in respect of each accounting period falling within the period under review. The period under review is so much of the period for which the licence will (if not renewed) continue in force after the application date. The time from which the new payments would take effect is therefore dependent on when the application for review is made and what the relevant accounting period of the licensee is.

2.8 By way of example, if the licensee applies for a review on a future date not later than the end of the 2009 calendar year, the revised cash bid would take effect from 1 January 2010. If the licensee's annual accounting period runs consistent with the calendar year (which we understand is the case for all Channel 3 and Channel 5 licensees), then the revised cash bid would also take effect from 1 January 2010.

2.9 The new financial terms would be set for the period up to the expiry of the licence. Since under section 224 of the Act, the 'initial expiry date' of each PSB licence is set as 31 December 2014, this means that the period under review would be 1 January 2010 to 31 December 2014 (a 5 year period).

2.10 Accordingly, we anticipate that if licensees wish to request a review of their financial terms to come into effect from the start of 2010, an application for such a review would need to be received by Ofcom by no later than 31 December 2009. Ofcom would then conduct a review of the terms and determine the new cash bid and PQR to apply from 1 January 2010.

2.11 In accordance with section 228 of the Act, Ofcom would then be required, as soon as reasonably practicable after making a determination of the new financial terms, to notify each applicant of its determination together with any licence modifications that are required to give effect to the determination, a date by which the applicant must notify Ofcom whether or not he accepts the determination and modifications and a subsequent date by which the applicant's licence would cease to have effect if the applicant does not accept the determination and modifications. If the applicant notifies acceptance of the determination, then the new licence would take effect with the modifications set out in Ofcom's notification and backdated to take effect from 1 January 2010 and any adjustments would be made to give effect to the modifications, in respect of any payments already made for periods affected by those modifications.

Applications made between 1 January 2010 and 31 January 2010 under section 226 of the Act

2.12 Were licensees not to apply for a review of financial terms under section 226 of the Act by the end of the 2009 calendar year, then it would still be open to them to apply for a review under section 226 of the Act but they would have to do so not later than January 31st 2010. In that case, the review would then determine a new cash bid and PQR payable which would apply from 1 January 2011.

Applications made under section 225 of the Act

2.13 Under the Act, it is also possible to apply for a review of the financial terms of these licences under section 225 which provides the opportunity to apply for a review of financial terms four years prior to the ‘initial expiry date’ (i.e. from 31 December 2010). However, in that case, any determination by Ofcom could not take effect before 1 January 2011, the beginning of the next calendar year and accounting period,[6] so the new financial terms would only cover the period 1 January 2011 to 31 December 2014.

2.14 However, if licensees do apply for a determination under section 226 as a consequence of the must offer obligations coming into force, then the Act prevents them applying for a further review under section 225 whilst the application under section 226 is pending or less than 12 months after Ofcom’s determination of new financial terms has been made.

Impact assessment

2.15 As is set out in this document, the Communications Act 2003 requires that where an application for review under section 226 is made to it, Ofcom must carry out its review of financial terms as if the licence in each case were being granted afresh in accordance with section 15 of the Broadcasting Act 1990 (ie: on the basis of a competitive tender.) It is a statutory requirement that Ofcom should carry out a review on this basis and a separate impact assessment on the statutory requirement is not therefore necessary or appropriate.

2.16 However, the purpose of this document is to consult on a proposed approach to such a review within the statutory framework. We have therefore set out in this document those factors which we propose to take into account in carrying out a review and have sought, in Section 3 in particular, to assess their likely impact. Where there are current uncertainties, we have invited views on what would constitute an appropriate approach for Ofcom to take in considering them. The document as a whole, but Section 3 in particular, therefore constitutes our impact assessment.

2.17 We invite respondents to comment further, if they wish to do so, on the impact of our proposals when responding to this consultation so that we can take their comments into account in reaching a decision.

2.18 Since the proposals in this document do not have any impact on equality issues, no impact assessment in terms of equality including disability equality, racial equality or equality in Northern Ireland is necessary.

[6] This is assuming that an application was made on the 31 December itself – if not the determination could not take effect until 2012

Section 3

Approach to the review

Introduction

3.1 This section sets out our proposed approach towards setting the PQR and determining the cash bid in any review of financial terms triggered by an application for a review received by 31 December 2009.

3.2 We propose that the methodology used in by Ofcom in 2005 remains broadly appropriate, with some modifications that are set out in this section. We provide an overview of the methodology in this section and invite views.

3.3 There have been a number of regulatory and market developments since the last time the Channel 3 and Channel 5 financial terms were reviewed in 2005. These will impact the outcome of any review we undertake.

Ofcom's statutory task

3.4 Section 227 of the Act sets out the statutory framework for re-determining the licence payments under a digital replacement licence following an application made by the licensee for a review of its financial terms. Since under section 224 of the Act, the 'initial expiry date' of each PSB licence is set as 31 December 2014, this means that the period under review would be 1 January 2010 to 31 December 2014 (a 5 year period). Ofcom must determine two elements:

(a) a fixed annual cash amount (the "cash bid") to be paid for the licence (i.e. the amount the licence holder would have bid were the licence being granted afresh in a competitive tender under section 15 of the Broadcasting Act 1990 (the "1990 Act")); and

(b) the percentage of qualifying revenue ("PQR") as determined by Ofcom to be payable for each year of the licence. The PQR can vary from year to year.

3.5 In a competitive tender application under section 15 of the 1990 Act, Ofcom is required to set out the PQR in the notice inviting licence applications. The PQR would therefore be determined before bids are made for the cash bid element. No guidance is given in the Act as to how Ofcom should set the PQR or indeed the relative sizes of the PQR payments and cash sum. The definition of qualifying revenue is set out in section 19(2) of the 1990 Act and Ofcom is simply required to determine a percentage of it which shall be payable to the Treasury.

3.6 As regards the amount of the cash bid, however, section 227(3)(a) requires Ofcom to reach its decision in accordance with section 15 of the 1990 Act. To assess this amount Ofcom must in effect carry out a hypothetical auction of the licence as though it were being granted afresh.

3.7 Ofcom therefore has a level of discretion in relation to setting the PQR that it does not have in respect of the cash bid. However, Ofcom has taken the view that to ensure a consistent approach to setting both the PQR and the cash bid it is appropriate to conduct a single economic valuation according to common principles. This valuation is intended to meet the requirements of the Act in relation to determining the amount that, in Ofcom's opinion, would have been the cash bid, and also to provide a robust basis for informing Ofcom's decision as to the appropriate level of the PQR, taking into account both the objectives and the uncertainties discussed in this document.

Ofcom's objectives

3.8 For the purposes of the 2005 reviews, we established a methodology to value each licence so that we could decide on the PQR and determine the cash bid. That methodology was presented in a statement published in October 2004 (the "October 2004 statement.") It can be viewed in full at the following address:

http://www.ofcom.org.uk/consult/condocs/channel3_consultation/c3mstatement.pdf

3.9 In that statement, we set out our objectives for the review as follows:

> *Ofcom's objectives for these reviews of financial terms are to determine a fair and reasonable value for each licence, and to set new financial terms according to a fair and objective process. This is necessary in order to ensure that the taxpayer gets a proper return for these licences and, in particular, the right to use scarce spectrum.*
>
> *To the extent possible, the process should also allow Ofcom to set terms that are reasonable within the context of the current market environment and that will continue to be reasonable for the period of the licence.*

Source: Paragraphs 2.7 – 2.8 of the October 2004 statement

3.10 We believe that the same objectives are appropriate if we receive applications for a review as a result of the "must offer" conditions coming into effect.

The market environment

3.11 The 2005 reviews resulted in a reduction in the amounts payable for Channel 3 and Channel 5 licences[7]. This reflected a number of changes in the market environment since the previous reviews. In particular, it was reflective of a significant reduction in value associated with what was considered to be the principal right attached to the licence – the privileged access to scarce analogue spectrum.

3.12 For five of the licences considered, we set the PQR at zero and the cash bid at a nominal sum of £10,000. This was because our analysis was that there was a sound case for concluding that few, if any, bidders would be prepared to bid for these licences given the rights and obligations attached to the licence and given the context of the market environment. In our opinion, therefore, the incumbent licensees would be likely to retain the licence by posting a nominal bid.

3.13 Since the 2005 reviews, there have been a number of changes to the market environment which will impact the value of the licence and will have a bearing on our decision about the PQR payable and the amount that, in Ofcom's opinion, would be the cash bid for the licence if it were being granted afresh in an auction. Two such developments are the further advance of digital broadcasting and the changes in the UK TV advertising market.

[7] A document setting out the revised terms and the background to those reviews is available at http://www.ofcom.org.uk/consult/condocs/channel3_consultation/ch3ch5fin/

3.14 Digital penetration and the proportion of viewing through digital signals have increased markedly since the last review, whilst the number of homes using analogue as their primary means of viewing has declined. Furthermore, the take up of digital broadcasting services has been faster than was anticipated in our 2005 review.

3.15 With the phasing out of the analogue signal in the period to 2012, the privileged access to analogue spectrum associated with the licences, and previously seen as the primary driver of value for the licences, will cease within a few years.

3.16 Television advertising revenues have declined since 2005, particularly on free to air channels that have an analogue presence[8]. Advertising revenue enjoyed on the licensed services today is lower in aggregate than was anticipated in our 2005 review. Furthermore, given the increased levels of digital adoption, less of this revenue appears to be earned as a result of analogue viewing than was expected at the time of the 2005 review.

3.17 These developments have triggered cost reductions among the licensees in recent years. This means that the level of several costs, such as the level of costs incurred in programming budgets, also appear to be lower than were anticipated in the 2005 review.

3.18 Generally, however, these cost reductions do not appear to have been sufficient, in the context of a lower revenue base, for profitability to have been maintained at either historic levels or at levels that would have been consistent with those anticipated in the 2005 review. Overall, these developments may therefore contribute to a reduction in the level of profits that could reasonably be expected to be earned from the licences, lowering their value to potential bidders.

Q 3.1 What other features of the market environment do you believe Ofcom should consider when deciding on the PQR payable and determining the amount that, in its opinion, would have been the cash bid for the licence if offered in a competitive tender process ('a hypothetical auction')?

Regulatory developments

3.19 There have also been a number of regulatory developments that have occurred since 2005 which will impact the value of the licence and will have a bearing on our decision about the PQR payable and the amount that, in Ofcom's opinion, would be the cash bid for the licence if offered at auction.

3.20 There have been relaxations of the amount and type of PSB programming that the licensees are required to provide. In particular, the number of different regional news programmes required has been reduced, as has the required volume of non-news regional programming, providing cost savings to licensees and so increasing the viability of the licence.

3.21 The amount of digital terrestrial television capacity available to PSB licensees has also increased, providing them with access to high definition capacity which they would not be eligible for, absent ownership of the licence. Use of this capacity is itself subject to a number of further, specific regulatory requirements that are associated

[8] See, for example, figure 2.14 of The Communications Market Report 2009. http://www.ofcom.org.uk/research/cm/cmr09/CMRMain_2.pdf

with it. Reorganisation of DTT spectrum has also given rise to further changes in the amount and type of capacity available to different licensees.

3.22 Many of the regulatory developments since 2005 have tended to reduce the cost of the PSB burden on licensees and have improved the profitability of the licence. The reduction in the PSB burden means that the licences could be expected to be more attractive to potential bidders than they would have been absent such changes.

Q 3.2 What other developments do you believe Ofcom should consider when deciding on the PQR payable and determining the amount that, in its opinion, would have been the cash bid for the licence if offered in a competitive tender process (‘a hypothetical auction’)?

Valuation methodology

3.23 The methodology set out in the 2004 statement was established to inform Ofcom’s decision when deciding on the PQR and determining the annual cash sum for each licence. Ofcom proposes to use a similar approach to any review that is requested by licensees before 31 December 2009. Below, we set out our proposed methodology and identify those areas where there are changes from the approach taken in the last review.

3.24 As was the case during the 2005 reviews, the aim of the methodology is to set fair and reasonable terms such that they recover, so far as possible, the combined value of the rights and obligations over the duration of the licence.

Overarching principles

3.25 Each licence should be valued as a whole, although for the purposes of explanation and analysis, the rights and obligations can be grouped into three broad categories: analogue rights, digital terrestrial rights and public service broadcasting (“PSB”) obligations. Likewise, although rights and obligations are considered separately, where possible the valuation should also seek to take into account any significant consequential effect that the presence of one right or obligation has on another.

3.26 In principle, the value of a licence to any potential bidder would equal the additional profits that could be made as a result of the net effect of having all of the rights and obligations associated with holding the licence, over and above the profits that could be made via the next best alternative (ie: if they did not hold the licence.)

3.27 The identity of the potential bidder will have a bearing on the value of the licence to that bidder, as it determines the counterfactual to be considered when estimating the additional profits that bidder could make as a result of holding the licence. Ofcom considers that alternative bidders with the highest valuations are likely to be existing television companies, either from the UK or abroad that wish to have a significant presence in the UK free-to-air market.

3.28 In general, if a right similar to one associated with the licence could be acquired through another source, the market value of the right would be equal to the cost savings to the licence holder from not having to obtain the right elsewhere. If the right could not be replicated elsewhere then the value would equal the total financial benefit to the licensee of having the right. Similarly, the cost of an obligation would be equal to the extra cost associated with meeting the obligation, net of any benefit to the licensee.

Circumstances of the hypothetical auction

3.29 The hypothetical auction to assess the overall value of the licence would replicate circumstances as set out below.

3.30 The auction would be designed, within the framework of the legislation, to recover the maximum possible value consistent with the requirement that the successful bidder is also able to fulfil programming and other obligations associated with the licence.

3.31 Each licence would be offered individually on a non contingent basis in a single round, sealed bid auction. This is because, as set out in the October 2004 statement, for the purposes of conducting a hypothetical auction, we consider that the statutory framework makes it infeasible to assume that there is a multiple contingent bid auction.[9]

3.32 The amount the incumbent would bid in a competitive auction would be the minimum required to beat the second-highest bidder, and as such would not necessarily represent the maximum amount the incumbent would be willing to pay. The difference between the value of the licence to the incumbent and the value of the licence to the second-highest bidder should equal approximately the cost of entry.

3.33 In order to determine the amount of the second-highest bid in an auction, Ofcom would estimate the net present value of the licence (efficiently operated) as represented by the expected value to the incumbent and then adjust this value to reflect the additional costs (eg: start-up costs) that a new entrant might incur.

Valuation of analogue and digital rights

3.34 Rights will be valued at the lower of the value of those rights in use and the cost of acquiring those rights in the market. This reflects the view that a licensee would not pay more for the rights via a licence payment than it would need to pay for equivalent rights elsewhere

3.35 In practice, the analogue element of the licence should be valued by reference to the cashflows that can only be achieved by acquiring the licence, since there is no other way of acquiring rights to broadcast on analogue spectrum.

3.36 In order to forecast cashflows for the analogue service, expected costs and revenues that are common to the multiple platforms will be allocated across services on the basis of the viewing share expected to be achieved on each platform. The value of the analogue element of the licence should also reflect any causal link between holding the analogue licence and changes in the value of the licensee’s business on any or all digital platforms. Likewise, start-up costs will also be apportioned across different platforms to reflect their value to each. Ofcom does not consider that a new entrant would necessarily replicate all existing assets owned by the incumbent license and may consider that leasing an asset for the duration of the licence would be preferable to purchasing it.

3.37 The value of the standard definition digital terrestrial television (“DTT”) rights would be based on the costs of replicating those rights through purchase in the market. This is because those rights conferred by the licence can generally be substituted by

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[9] Additionally, several licences already pay nominal levels of additional payments and therefore might be considered unlikely to seek a review of those terms during the current licence period; where such licences do not seek a review of financial terms, they are not participating in the hypothetical auction.

equivalent rights acquired elsewhere. The cashflows of the DTT business are therefore not included in the valuation, except to the extent that there is a causal link as described above.

3.38 Access to high definition DTT capacity is available only as a consequence of holding the digital replacement licence. Therefore, the net cashflows expected to be derived as a result of access to this capacity during the remaining period of the licence would be included in the valuation of the licence.

3.39 Digital satellite and cable services are not part of the licensed service. They are therefore not included in the valuation except to the extent that there is a causal link to profitability.

3.40 The cashflows associated with an associated production business are not included in the valuation of the licence as they do not arise as a result of owning the licence. Likewise, the costs of production facilities that do not arise as a necessary consequence of holding the licence would be excluded from the valuation.

3.41 The licence carries with it the right to an appropriate degree of prominence on electronic programme guides. As in the 2005 review, Ofcom considers that this is likely to carry some value and invites views on what evidence exists that could help quantify the value of this right to a new entrant. In considering such evidence, Ofcom would take into account that the new entrant may not necessarily have access to the same degree of prominence currently enjoyed by the incumbent.

Q 3.3 What evidence do you believe Ofcom should utilise when considering the value of the right to an appropriate degree of prominence to a new entrant?

3.42 In the 2005 review, Ofcom set out its view that the analogue licence brought with it a “viewer migration value” since, as analogue viewers migrate to a digital service, the providers of the licensed digital service would likely inherit a larger share of the new digital audience than they would had they been providing a standalone digital service under a digital programme service licence.

3.43 In principle, Ofcom considers that the presence of a channel on the analogue platform could serve to increase familiarity with the channel and therefore benefit the channel in the future digital environment. However, given the declining share of viewing achieved through the analogue signal and the proximity of switchover in many regions, the extent to which this advantage would be conferred on a bidder is considerably lower than it would have been in the 2005 review. Ofcom invites views on what evidence exists that could help quantify this value to a new entrant.

Q 3.4 What evidence do you believe Ofcom should utilise when considering the Viewer Migration Value to a new entrant?

Cost of meeting obligations

3.44 The valuation of the licence should also reflect the incremental costs that the licence implies as a result of the obligations it imposes. The primary cost is the cost of meeting the PSB obligations and the additional costs associated with providing such programming would be deducted in full when calculating the value of the analogue element of the licence.

3.45 As in the 2005 reviews, the expected cost of PSB obligations would be forecast and considered separately. The PSB cost calculation will include both the increased programming cost and the reduction in advertising revenue received as a result of showing PSB programming that attract less advertising revenue than might otherwise be received.

3.46 The valuation will reflect the net cost to the licence of any PSB obligations relating to digital switchover, where these are incurred. The valuation will seek to ensure that the licensee does not receive any financial benefit or suffer any financial loss as a result.

3.47 The valuation should also seek to take account of any significant impact the “must offer” obligations being brought into effect would have on the value of the licence and in particular, any additional costs that are likely to be incurred by the licence holder as a consequence of the obligations being brought into force.

Q 3.5 What evidence do you believe Ofcom should utilise when considering the impact that the “must offer” obligations would have on the value of the licence?

3.48 As was set out in the October 2004 statement, Ofcom recognises that there may be alternative approaches to individual elements of the licence valuation but considers that as a whole they provide a reasonable basis on which to conduct a valuation of the licence to inform Ofcom’s decision about the PQR and the amount that, in Ofcom’s opinion, would be the cash bid.

Q3.6 Do you agree that the overall valuation methodology, as adjusted above, remains appropriate for reviews that Ofcom may be required to undertake to inform our decision about the PQR and cash bid? If you do not, then please explain why you think it is inappropriate and what justifications exist for suggested alternatives.

Dealing with uncertainties for the purposes of the review

3.49 Valuation of licences on a forward looking basis involves taking account of a number of uncertainties. In the October 2004 statement, we highlighted this as follows:

.... [It] is important to recognise the very wide range of uncertainties that Ofcom faces in arriving at this valuation, including the following:

- *future trends in television advertising revenues and programming costs;*
- *the likely size and speed of structural change in the industry, associated with digital switchover; and*
- *the regulatory environment, including the long-term path of PSB obligations, and future political decisions on digital switchover.*

Replicating the outcome of a hypothetical single round sealed bid auction adds a further layer of complexity. Neither the exact circumstances of the auction, the identity of bidders, their business plans nor their bidding strategies can be predicted with certainty.

Ofcom is unable to eliminate these uncertainties. Therefore, in order to fulfil its statutory duty to determine the financial terms, it is necessary for Ofcom to make a series of assumptions on many issues.

This statement sets out Ofcom's approach. Ofcom recognises that there may be alternative approaches to individual elements of the valuation methodology. However, Ofcom believes that, when considered together as part of a coherent methodology, the overall approach provides a fair and reasonable basis for Ofcom to determine the financial terms for each licence.

Source: Paragraphs 2.9 – 2.12 of the October 2004 statement

3.50 Many of the uncertainties outlined in the October 2004 statement are still uncertainties now, although the passage of time means that the future path towards digital switchover is considerably more certain today.

3.51 One recent additional uncertainty that has emerged is the scope to which future independent funding for regional news provision might become available and the extent to which regional news obligations will therefore impact the value of Channel 3 licensees in the future.

3.52 As with all such uncertainties, Ofcom will need to form a reasonable view of the way in which such factors should be taken into account in the valuation exercise so as to achieve a fair and reasonable outcome for the licence valuation, consistent with Ofcom's statutory duties.

3.53 Furthermore, in order to determine a value for those elements of the licence which are explicitly modelled, Ofcom will need to project revenues and costs forward.

3.54 Ofcom's view will therefore be informed by a number of sources, including:

- market reports and externally generated analysis of cost, revenue and technological trends;
- public policy developments and statements;
- findings from Ofcom's work and research in relevant and related fields;
- evidence presented by stakeholders, such as forward looking financial projections; and
- evidence required to be provided by stakeholders to Ofcom, including consideration of pre-existing business plans and forward looking projections which are relevant

3.55 In respect of the future costs associated with public service broadcasting obligations Ofcom will take a cautious view about future changes in PSB obligations. However, we will assume that neither the regulator nor licensee will engage in economically irrational behaviour; the valuation will therefore assume that PSB obligations will not be maintained at a level that makes holding the licence no longer commercially viable.

Q3.7 Do you agree with Ofcom's approach to dealing with the uncertainties outlined above? If not, please explain why and what alternative approaches would be available?

Discount rate

3.56 As set out above, our view is that the value of the winning bid in a hypothetical auction can be approximated by the valuation of the second highest bidder and that the second-highest bidder would be an existing television company. In order to be consistent with the proposed circumstances of the hypothetical auction, Ofcom's proposed discount rate is intended to reflect the opportunity cost of investment faced by a hypothetical entrant that is assumed to be an existing television company.

3.57 Ofcom has calculated a real, pre-tax rate of 8.2%, which is meant to reflect the weighted average cost of capital (WACC) of a hypothetical entrant. The calculation is based on data and estimates relating to the existing licensees.

3.58 Full details of how we have calculated our discount rate are provided in Annex 5.

Q3.8 Do you agree that a real, pre-tax discount rate of 8.2% is appropriate? If not, then please set out what other considerations Ofcom should have in determining the discount rate.

Cut-off date

3.59 As in the 2005 reviews, Ofcom considers that it is necessary for it to be able to take into account any information relevant to deciding the revised licence payments that is or becomes available up to the date of determination. Applicants will have the opportunity to withdraw an application prior to a determination being made, for example, in light of information that becomes available after the date of application but before the determination of new financial terms by Ofcom. In cases where Ofcom is satisfied that a valid withdrawal has been made, the licensee may reapply within the same review period.

Annex 1

Responding to this consultation

A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 10th December 2009**. This eight week period is shorter than our standard ten week consultation period. However, we consider this is appropriate given that the consultation is primarily of interest to a limited number of stakeholders who are aware of the issues involved and the proposals contained in this document are generally consistent with those we previously consulted on and used when Ofcom last conducted such reviews in 2005.

A1.2 Ofcom strongly prefers to receive responses using the online web form at http://www.ofcom.org.uk/consult/condocs/review_c3_c5_licences/ as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.

A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email andy.causby@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.

Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.

Andy Causby
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 7981 3333

A1.4 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.

A1.5 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

A1.6 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Andy Causby on 020 7981 4155.

Confidentiality

A1.7 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

A1.8 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A1.9 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at http://www.ofcom.org.uk/about/accoun/disclaimer/

Next steps

A1.10 Following the end of the consultation period, Ofcom intends to publish a statement on its methodology at the end of 2009 or early in 2010.

A1.11 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom's consultation processes

A1.12 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.

A1.13 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk . We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.

A1.14 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is Ofcom's consultation champion:

Vicki Nash
Ofcom
Sutherland House
149 St. Vincent Street
Glasgow G2 5NW

Tel: 0141 229 7401
Fax: 0141 229 7433

Email vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.

A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.

A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.

A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.

A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title: Review of the financial terms for Channel 3 and Channel 5 licensees

To (Ofcom contact): Andy Causby

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing	☐	Name/contact details/job title	☐
Whole response	☐	Organisation	☐
Part of the response	☐	If there is no separate annex, which parts?	

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here. ☐

Name   Signed (if hard copy)

Annex 4

Summary of consultation questions

Q 3.1 *What other features of the market environment do you believe Ofcom should consider when deciding on the PQR payable and determining the amount that, in its opinion, would have been the cash bid for the licence if offered in a competitive tender process (‘a hypothetical auction’)?*

Q 3.2 *What other developments do you believe Ofcom should consider when deciding on the PQR payable and determining the amount that, in its opinion, would have been the cash bid for the licence if offered in a competitive tender process (‘a hypothetical auction’)?*

Q 3.3 *What evidence do you believe Ofcom should utilise when considering the value of the right to an appropriate degree of prominence to a new entrant?*

Q 3.4 *What evidence do you believe Ofcom should utilise when considering the Viewer Migration Value to a new entrant?*

Q 3.5 *What evidence do you believe Ofcom should utilise when considering the impact that the “must offer” obligations would have on the value of the licence?*

Q3.6 *Do you agree that the overall valuation methodology, as adjusted above, remains appropriate for reviews that Ofcom may be required to undertake to inform our decision about the PQR and cash bid? If you do not, then please explain why you think it is inappropriate and what justifications exist for suggested alternatives.*

Q3.7 *Do you agree with Ofcom’s approach to dealing with the uncertainties outlined above? If not, please explain why and what alternative approaches would be available?*

Q3.8 *Do you agree that a real, pre-tax discount rate of 8.2% is appropriate? If not, then please set out what other considerations Ofcom should have in determining the discount rate.*

Annex 5

Discount rate

Summary

A5.1 Ofcom's view is that the value of the winning bid in a hypothetical auction can be approximated by the valuation of the second highest bidder and that the second-highest bidder would be an existing television company. In order to be consistent with the proposed circumstances of the hypothetical auction, Ofcom's proposed discount rate is intended to reflect the opportunity cost of investment faced by a hypothetical entrant that is assumed to be an existing television company.

A5.2 Ofcom has previously considered calculating discount rates on a licence-by-licence basis. However, consistent with the approach taken in the 2005 reviews, we consider that to the extent that there are material differences between licences that may impact the discount rate (e.g. smaller licensees may have a higher proportion of fixed costs), they would be prohibitively difficult to estimate in a robust manner.

A5.3 Ofcom has calculated a real, pre-tax rate of 8.2%, which is meant to reflect the weighted average cost of capital (WACC) of a hypothetical entrant. The calculation is based on data and estimates relating to the existing licensees.

Introduction

A5.4 The discount rate applied to the forecast cash flows in an NPV analysis should reflect the opportunity cost to all the relevant capital providers, weighted to their relative contribution to the company's total capital base. This is approximated by calculating the firm's Weighted Average Cost of Capital (WACC). The opportunity cost that is borne by a class of investor is equal to the rate of return that investors could expect to earn on other investments of equivalent risk.

A5.5 A number of different asset pricing models exist for calculating the cost of capital. In addition to the Capital Asset Pricing Model (CAPM), which measures market risk via a single beta coefficient measured relative to a market portfolio. There are, for example, multifactor models which measure market risk using multiple risk coefficients estimated relative to different factors.

A5.6 Ofcom's preferred approach is to use the CAPM. The CAPM has a clear theoretical foundation and its implementation is simple and well established relative to that of other asset pricing models. This results in the continued wide use of the CAPM by the UK's economic regulators, and its wide use amongst practitioners.

A5.7 Under the CAPM the WACC is calculated according to the following formulae:

- WACC = (cost of equity x (1 - gearing)) + cost of debt x gearing;
- gearing = debt / (debt + equity);
- cost of equity = risk free rate + ({equity risk premium} x beta); and
- cost of debt = risk free rate + debt premium

Estimating discount rates

A5.8 Some of the parameters that influence the WACC calculation, specifically gearing ratios, equity betas, and debt premia may vary on a firm-by-firm, and hence potentially on a licence-by-licence, basis. However, Ofcom is proposing to apply a single discount rate in its NPV analysis for all of the licences. In theory, it may be desirable to make assumptions regarding the financial/operational leverage and debt premia of generic bidders for each relevant licence. However, in practice, any such assumptions are likely to be difficult to calculate. The most relevant data available to Ofcom to support its calculations relates to some of the existing licensees: ITV, STV and UTV.

A5.9 Data is unavailable on a licence-by-licence basis. Any adjustments made to this data to reflect licence-by-licence variations would be highly subjective. Ofcom has therefore based its analysis on country-wide indicators, erring on the side of conservative (i.e. high) estimates where appropriate in order to reflect any regional or national variations.

Risk free rate

A5.10 Ofcom proposes to use the 4.5% nominal risk free rate (2.0% real) as estimated in Annex 8 of its recent statement “A new pricing framework for Openreach ” (the “Openreach statement”)[10]. This uses estimates of yields on nominal gilts as a proxy for the real risk free rate. We are also proposing to use a forward looking inflation rate of 2.5%, consistent with the Openreach statement[11].

Equity risk premium

A5.11 The equity risk premium is the difference between the overall return on equities and the nominal risk free rate. Its value in the UK reflects the risk of investing in UK equities generally. Ofcom has used a value of 5% for this calculation in line with the equity risk premium used in Annex 8 of the Openreach statement.

Equity beta

A5.12 The value of a company’s equity beta measures the movements in returns (as measured by the sum of dividends and capital appreciation) from its shares relative to the movement in the return from the equity market as a whole. For a detailed discussion of issues relating to beta estimation, see, for example, *Issues in Beta Estimation for UK Mobile Operators, The Brattle Group, July 2002*[12].

A5.13 A number of beta estimates are shown below based on unadjusted two year daily rates against the FTSE All share index.

	Dec-07	Jun-08	Dec-08	Jun-09	Oct-09
ITV	0.79	0.84	0.70	0.75	0.80
STV	0.20	0.50	0.12	0.16	0.22
UTV	0.05	0.23	0.27	0.41	0.41

[10] http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/annexes.pdf
[11] See para 6.55 of Annex 6 of the Openreach statement
[12] http://www.ofcom.org.uk/telecoms/ioi/g_a_regime/sce/ori/beta/

A5.14 At this stage we are inclined to give most weight to ITV's equity beta, which has been in a range of 0.7 – 0.85 in the last 2 years. ITV's shares are relatively liquid and provide a reasonably robust beta estimate, whereas those of UTV and STV are more thinly traded, and therefore may be an unreliable estimator of those companies' equity betas.

A5.15 We adopt a point estimate of 0.80 from the above range, in line with the most recent observation of ITV's equity beta. We welcome stakeholders' comments on our approach in this area.

Optimal gearing

A5.16 Under the standard Capital Asset Pricing Model a firm can potentially lower its overall cost of capital by increasing its gearing. This is because debt is generally cheaper than equity as a result of tax advantages to debt.

A5.17 Our approach to gearing is to assume an optimal level of gearing, which is that at which the cost of capital is minimised and the value of the firm is maximised. Since the cost of debt is lower than the cost of equity, this suggests that the optimal rate would favour debt financing. However, if the level of debt gets too high the risk of financial distress increases very quickly, and equity investors recognise that their claim on the assets of a firm in financial distress comes after the claims of debt holders. Therefore, equity holders will be wary of high levels of gearing, particularly in firms where there are limited fixed assets (which could be liquidated in the event of distress).

A5.18 We would expect investors in a Channel 3 or 5 licence, which would have relatively few assets to sell in the event of financial distress, to want lower levels of gearing than those of a company like BT, where substantial valuable fixed asset investments might help to insulate investors from the risk of losing their investment. As a point of reference, we assume the optimal gearing rate to be 35% for BT Group, which was based on BT's long-run average gearing up until the last few years.

A5.19 Our estimates of ITV's recent gearing levels are show below:

	Dec-07	Jun-08	Dec-08	Jun-09	Average
Net debt £m	798	822	907	1,034	
Market cap	3,321	1,738	1,546	1,361	
Gearing	19.4%	32.1%	37.0%	43.2%	32.9%

A5.20 On the basis that investors should want a gearing rate that maximises the benefit from cheaper debt financing, but without jeopardising the financial viability of the firm, we assume an optimal gearing level of 30%. This is the same as the rate we used for Sky in our recent Pay TV phase three consultation document[13].

Debt premium

A5.21 The cost of corporate debt is made up of a risk free component and a company specific risk premium. ITV's most recently issued debt now trades at around 6.4% above equivalent government gilts, while the same figure for recently issued Sky debt is around 2%.

[13] http://www.ofcom.org.uk/consult/condocs/third_paytv/annex10.pdf, paras 2.44-2.46

A5.22 For the purposes of a hypothetical new entrant, Ofcom is minded to use a debt premium figure of 4%.

Conclusion

A5.23 Ofcom has estimated a single discount rate to be used in the licence valuations, being a real pre tax WACC of 8.2%. A summary of the components of the WACC calculation follows:

Variable	Estimate
Nominal risk free	4.5%
Equity risk premium	5.0%
Equity beta	0.80
Cost of equity (nominal, post tax)	8.5%
Debt premium	4.0%
Cost of debt (nominal, pre tax)	8.5%
Corporate tax rate	28.0%
Cost of debt (nominal, post tax)	6.2%
Gearing (D/{D+e})	30.0%
WACC (nominal, post tax)	7.8%
WACC (nominal, pre tax)	10.9%
WACC (real, pre tax)	8.2%