Methodology for the review of the financial terms for the extensions to the independent national radio licences

Statement

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Section 1

Summary

1.1 This Statement sets out Ofcom's valuation methodology for the financial terms to be applied to the potential extensions of the three licences (Classic FM, Virgin Radio and talkSPORT) relating to independent national radio services (INRs).

1.2 On 16 November 2005, Ofcom issued a consultation seeking views on the proposed valuation methodology[1] ("the Consultation")

Overriding Objective

1.3 Ofcom's overriding objective is to determine financial terms for the licence extensions, through determining a fair and reasonable value based on a methodology which is consistent with its statutory obligations. This involves consideration of the likely outcome of competitive auctions, similar to those staged in 1991 and 1993, albeit on a basis subject to a number of statutory and practical constraints. The terms for the extension should be set in accordance with an objective process which:

- ".. ensure[s] that the tax payer gets a proper return for the use of the valuable and scarce national resources constituted by broadcasting rights and, in particular, the use of the frequency spectrum"[2] ; and
- enables Ofcom to set terms that are reasonable within the context of the current market environment and that will continue to be reasonable for the extended period of the licence.

1.4 However, it is important to recognise the very wide range of uncertainties that Ofcom faces in arriving at its determination. The uncertainties include, but are not limited to, the following:

- future trends in radio advertising revenues;
- the likely size and speed of structural change in the industry including that associated with digital switchover; and
- future decisions on digital switchover.

1.5 The requirement for Ofcom to consider 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.

1.6 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.

[1] Ofcom Publication; *Consultation on the methodology for the review of financial terms for the extensions to the independent national radio licences*, 16 November 2005
[2] David Waddington (then Home Secretary) on 18 December 1989, when speaking in the Commons debate on the Bill which was to become the Broadcasting Act 1990

1.7 Ofcom believes that the methodology outlined in this statement is compatible with both Ofcom's objectives and statutory duties. Ofcom recognises that there may be alternative approaches to individual elements of the valuation methodology but considers that, taken as a whole, the methodology should provide a fair and reasonable result, which Ofcom can use to inform its estimate of the Cash Bid (the fixed payment) and determination of a PQR (being the Percentage of Qualifying Revenue which must be paid.)

Statutory requirements

1.8 Section 253 of the Communications Act 2003 (the "Act") allows holders of an INR licence to apply to Ofcom for an extension to their current licence for a period of up to four years.

1.9 Under the Act, the earliest date on which a licensee can apply for an extension is three years prior to the expiry date of its licence. The latest date a licensee can apply for an extension is three months before the day Ofcom would need to publish a notice under S98(1) of the Broadcasting Act1990 Act ("1990 Act"). This is the "Relevant Date". Ofcom has set out the Relevant Dates in the table below. As detailed elsewhere in this document, the relevant date for Classic FM differs from that set out in the Consultation;

Licence	Licence Expiry Date	Relevant Date
Classic FM	30 September 2007	7 August 2006
Virgin Radio	29 April 2008	31 January 2007
talkSPORT	31 December 2008	30 September 2007

1.10 Under Section 253(8) of the Act, following an application for an extension, Ofcom must determine a fixed annual cash amount (the "Cash Bid") to be paid for the licence and may set a revised Percentage of Qualifying Revenue (PQR) for each year of the extended licence period. Specifically, in respect of the Cash Bid, the Act requires that Ofcom determine the amount that, in its opinion, would have been the Cash Bid of the licence holder were the licence being granted afresh. This means that in respect of the Cash Bid, Ofcom is required to consider the effects of a hypothetical auction of the licences.

1.11 In the event that a licensee does not apply for an extension or, alternatively, does apply for an extension but does not consent to the terms subsequently notified, then the licence will expire on the licence expiry date shown above. Ofcom would take steps to utilise the relevant frequency in a way consistent with both Ofcom's stated policy objectives at that time and the statutory obligations upon Ofcom.

1.12 In the event that a licensee applies for an extension and accepts the revised financial terms offered then the duration of the licence will be extended for a period of up to four years. The licence will then expire at the end of the extension period and Ofcom will take steps to utilise the relevant frequency in a way consistent with both Ofcom's stated policy objectives at that time and the statutory obligations upon Ofcom.

Context

1.13 Ofcom believes that it is important to take into account in the valuation methodology the various changes that have occurred in the broadcasting environment since the original auction of the licences in the early 1990's and when the licences were renewed by the Radio Authority in 1999 and 2000. Ofcom believes that its approach reflects this aim.

Summary of Conclusions

1.14 Ofcom received three detailed responses to the Consultation, all of which were confidential. The same three respondents also submitted a joint confidential response (the "joint response"). Ofcom has taken account of the responses and, as a result, some of the original proposals have been modified. The key points made in the responses to the Consultation are referred to throughout this statement.

1.15 The Act is not prescriptive about the specific process that Ofcom must follow in order to determine the amount that would be bid for each licence in a competitive tender. Therefore, it is necessary for Ofcom to establish the circumstances of the hypothetical auction process that Ofcom aims to consider in the reviews and the corresponding valuation methodology.

1.16 Ofcom considers that when considering the outcome of a hypothetical auction it would replicate the following circumstances:

- As required by the s98 of the 1990 Act, Ofcom would design a sealed-bid auction in which the highest bidder would win the licence.
- The auction would be designed, within the framework of the statute, to recover the maximum possible value consistent with the highest bidder being able to fulfil the format and other requirements of the licence.
- 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.

1.17 On this basis, Ofcom will use the following approach when considering the valuation of the licence extension and when considering revised financial terms. This valuation is intended to meet the requirements of the Act in relation to determining the Cash Bid, and also to provide a robust basis for informing Ofcom's decision as to the appropriate level of the PQR.

- Ofcom considers that the value of the licence to a bidder would equal the net value of the rights and obligations associated with the licence.
- In order to determine the amount of the second-highest bid in an auction, Ofcom will estimate the net present value of the licence to the incumbent and then adjust this value downwards to reflect the reasonable additional costs of entry that a new entrant might incur.
- All profits made from providing a national analogue service will be attributed to the licence. Ofcom will value the national analogue element of the licence by using a discounted cashflow forecast to estimate the present value of the expected cashflows attributed to the analogue service over the relevant period.

- In order to forecast cashflows for the national analogue service, Ofcom will allocate costs and revenues that are common to the national analogue, local analogue and digital platforms. Ofcom will allocate these costs and revenues on the basis of a measure of listening on each platform. Ofcom will give consideration to the appropriate weightings that could be applied to each platform, based on representations made by applicants for an extension and other available information.
- A broadcaster does not need a national analogue licence to provide a national digital service, as this right can be obtained by acquiring a digital sound programme service licence and negotiating for carriage on the national digital multiplex and other digital platforms. Therefore, it would not be appropriate to attribute the revenues and costs from the digital services to the national analogue licence. However, simulcast of the national analogue service on the national digital multiplex is a requirement upon the licensees which will be required for the duration of the licence extension. To the extent that this obligation appears commercially onerous, Ofcom will take account of this obligation in its valuation of the licence.
- The licence will be valued through a discounted cash flow of a 12-year licence. Payment terms for a 12-year licence will be derived from that valuation. These payment terms will then be applied to the revenues expected to be generated by the licensees during the four-year extension period and the total value of payments will be determined. Terms will then be offered to the licensees which are expected to recover, in total, the same amount as the total value of payments described above.
- Ofcom will use a nominal, pre-tax discount rate of 15% for the valuations.
- Ofcom will set the relative weighting of the PQR and Cash Bid in its determination, but notes that respondents to the consultation specified a preference towards terms which recover a high proportion of the total value of the licence through the PQR element of the payments.

Section 2

Background

2.1 Section 253 of the Act allows the INRs to apply for extensions to their existing licences. These licences were renewed by the Radio Authority in 1999 and 2000. If a licensee applies for an extension, Ofcom is required to calculate new payment terms. These take the form of an annual fixed cash sum plus a percentage of qualifying revenue (“PQR”).

Timetable for the reviews

2.2 Section 253(3) of the Act indicates that the period in which an application may be made starts three years before the licence would expire and ends three months before the day that Ofcom have determined to be the day on which they would need to publish a notice to invite applications for a fresh licence under section 98(1) of the 1990 Act. Section 253 (3)(b) of the Act states that the date on which Ofcom would need to publish a notice for new applications is at least one year before the licence expiry date. The date is termed the Relevant Date.

2.3 In the Consultation Ofcom described the existing expiry dates for the licences, which are spread across a fifteen-month period. The Relevant Dates are similarly spread. Ofcom informally consulted licensees on the timetable for the application process in August 2005 in order to determine whether licensees would consider a more streamlined process for the determination of terms for a licence extension which would occur within a compressed timeframe. The outcome of these discussions was that licensees did not, on balance, believe that a compressed timeframe was appropriate. On that basis the timetable detailed in the Consultation reflected an application process in which each application would be dealt with in turn, as close as possible to the Relevant Date.

2.4 Subsequent dialogue with the INRs has allowed Ofcom to develop a revised timetable which, if followed, allows a more streamlined process in which Ofcom will be able to consider all three INR applications simultaneously.

2.5 Ofcom will set the Relevant Date for Classic FM as 7th August 2006. Classic FM will be required to submit its application by 28th April 2006. Ofcom will notify Classic FM of its determination in respect of the extension by 7th July 2006. If Classic FM wishes to accept the terms of the extension, then it must indicate acceptance by 7th August 2006. The new terms will come into effect following the expiry of the existing licence and upon commencement of the extension period. The licence expiry date is detailed in paragraph 1.9.

2.6 If Virgin Radio or talkSPORT or both also apply by 28th April 2006, Ofcom will process the applications at the same time that it processes Classic FM’s application. Ofcom will then notify all applicants of revised terms by 7th July 2006. All applicants will then be required to indicate acceptance of the revised terms by 7th August 2006. The new terms will come into effect following the expiry of the existing licence and upon commencement of the extension period. The licence expiry date for each licence is detailed in paragraph 1.9.

2.7 If Virgin Radio or talkSPORT does not apply by 28th April 2006, then their application will not be processed in line with the dates above, but will be dealt with at a later date, closer to the licence’s relevant date.

2.8 Ofcom still considers that a Relevant Date fifteen months before the date the licence expires provides the minimum desirable period required to publish a notice to invite applications for a fresh licence under section 98(1) of the 1990 Act, to conduct the resulting auction and to provide sufficient time for the winner of the auction to prepare for launching the service. However, in the case of Classic FM, Ofcom has set a relevant date which would imply a period which is slightly shorter than fifteen months. This is because in this particular case, Ofcom considers that the revised period is still sufficient for Ofcom to discharge its duties in the event that Classic FM does not extend its licence. Ofcom considers that the advantages of a slightly later relevant date outweigh the disadvantages of a shortened period for the issuing of a new licence in this instance.

2.9 The later relevant date implies a later application deadline and, therefore, the simultaneous submission and processing of applications. This provides benefits to Ofcom since it allows Ofcom to assess all three applications at the same time resulting in a simplified administrative process. A July determination date for all licence extensions also means that Virgin Radio and talkSPORT will benefit from having greater visibility in respect of the financial terms which will apply during the extension period.

2.10 However, this increased visibility must be balanced against the fact that under the accelerated timetable, Ofcom will be able to determine terms for the extension period based only on evidence available to Ofcom up to the point at which it makes its determination. Evidence which arises after Ofcom makes its determination cannot be taken into account.

2.11 This would be particularly significant if a major extraneous event occurred in between the dates on which the financial terms were determined for the period of the licence extension and the date on which the auction would theoretically have been held for a fresh licence under section 98(1) of the 1990 Act which could materially impact the valuation of the licence that would have been assessed at the latter date. If licensees apply based on the accelerated timetable then they must confirm that they are aware that no mechanism exists for Ofcom to re-asses the valuation or modify the terms which would apply to the extension in the light of such events or for any other reason and the terms, once set, therefore, are final.

2.12 Where Ofcom has granted the licensees an extension to their licence this will only take effect if the licensee has consented to the licence extension on terms and conditions presented. If a licensee does not consent to the new terms, then the existing licence will expire at the end of its duration.

2.13 In the event that a licensee does not apply for an extension to their existing licence at least three months before the relevant date or, alternatively, a licensee does apply for an extension but does not accept the terms offered, then the licence will expire on the licence expiry date shown in paragraph 1.9. Ofcom would take steps to utilise the relevant frequency in a way consistent with both Ofcom's stated policy objectives at that time and the statutory obligations upon Ofcom.

2.14 In the event that a licensee applies for an extension and accepts the terms offered then the duration of the licence will be extended for the period of up to four years. The licence will then expire at the end of the extension period, after which Ofcom will take steps to utilise the relevant frequency in a way consistent with both Ofcom's stated policy objectives at that time and the statutory obligations upon Ofcom.

2.15 The revised key dates in the review timetable are as follows:

Date	Activity
16 November 2005	Consultation document published. Consultation period began.
6 January 2006	Consultation period closed
14 February 2006	Publication of Statement setting out the principles to be used in setting the extended financial terms for all three INRs which will include the form of application, notes of guidance and details of the required financial data submissions
28 April 2006	Closing date for Classic FM to submit extension application. Closing date for Virgin Radio and talkSPORT to submit extension application for accelerated process
7 July 2006	Extended financial terms offered to Classic FM Extended financial terms offered to Virgin Radio and talkSPORT if they submit extension application by 28th April 2006
7 August 2006	Relevant Date for Classic FM Deadline for Classic FM to accept extended financial terms. Deadline for Virgin Radio and talkSPORT to accept extended financial terms if they submit extension application by 28th April 2006
30 October 2006	Closing date for Virgin Radio to submit extension application if not submitted on accelerated timetable
31 December 2006	Extended financial terms offered to Virgin Radio if application not submitted on accelerated timetable
31 January 2007	Relevant Date for Virgin Radio Deadline for Virgin Radio to accept extended financial terms if application not submitted on accelerated timetable
29 June 2007	Closing date for talkSPORT to submit extension application if application not submitted on accelerated timetable
31 August 2007	Extended financial terms offered to talkSPORT if application not submitted on accelerated timetable
30 September 2007	Relevant Date for talkSPORT Deadline for talkSPORT to accept extended financial terms if application not submitted on accelerated timetable

Other Ofcom Consultations and Projects

2.16 Ofcom will shortly consult on its policy objectives in relation to the frequencies currently utilised by the INRs as part of a broader consultation on the future of analogue radio licensing. This consultation is expected to commence later this year. The outcome of this consultation will form the basis for Ofcom's policy in respect of the future use of these frequencies.

2.17 Ofcom has completed and is in the process of consulting on other areas which impact upon commercial radio. Recent consultations that could have an impact are summarised below.

2.18 On 21 December 2005 Ofcom published "Statement: Radio - Licensing Policy for VHF Band III, Sub-band 3", which concluded that subject to the outcome of the Regional Radio Conference (RRC) on international spectrum usage and the vacating of the spectrum by existing users, Ofcom would licence one further national radio multiplex and additional local multiplexes to cover areas not presently served.

2.19 On 21 December 2005 Ofcom began a consultation entitled "The Future Licensing of DAB Digital Radio". This consultation proposed to advertise a second national multiplex as soon as possible after the RRC, which takes place in summer 2006, and to advertise local multiplex in descending order of population coverage. In addition the consultation proposed that the line up of services on a second digital multiplex should appeal to tastes and interests that are distinct from those catered for on the existing national multiplex. The consultation also drew attention to issues which Ofcom will be considering in the near future, namely the re-licensing of existing analogue services when their licences expire, and the desirability or otherwise of a digital migration path for all services. This consultation closes on 15 March 2006.

Section 3

Overview of Ofcom's approach

Considerations

3.1 Under Section 253 of the Act, following an application for an extension, Ofcom must determine two elements which comprise the additional payments ("licence fees") payable by licence holders during the extension period. These are 1) a fixed annual cash amount ("Cash Bid"), which rises in line with RPI and 2) the Percentage of Qualifying Revenue ("PQR") to be payable for each year of the licence extension[3].

3.2 In respect of the Cash Bid, the Act requires that Ofcom 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 made in accordance with section 98 of the 1990 Act which established the process for the original auction of the national licences.

3.3 Under the 1990 Act the consideration procedure for licences is described in section 99. Section 100 of the 1990 Act indicates that the award of national licence would be made to the person submitting the highest Cash Bid, subject to the applicant meeting a quality threshold. On this basis, Ofcom must consider the results of a hypothetical auction and determine what, in its opinion, was likely to have been the level of Cash Bid for the licence.

3.4 In an auction of a licence under section 98 of the 1990 Act, Ofcom must set out the PQR in the notice inviting licence applications. The PQR would therefore be determined before Cash Bids are made. No guidance is given in the Act as to how Ofcom should set the PQR nor, indeed, as to the relative proportions of licence payments which should be comprised of the PQR payments and Cash Bid. The definition of qualifying revenue is set out in section 102 of the 1990 Act and Ofcom is required to determine a percentage of it which shall be payable to the Treasury.

3.5 Ofcom therefore has a greater level of discretion in relation to setting the PQR compared to the determination 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 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 Ofcom's overall objectives and the uncertainties discussed below.

3.6 The circumstances proposed by Ofcom for considering the outcome of a hypothetical auction differ from the actual auction of licences in the early 1990s and the proposed valuation methodology differs from the Radio Authority's past approach in certain respects because of changes in the broadcasting and regulatory environment since 1999.

3.7 It is important to take account of the development of new platforms (including digital) for the delivery of national radio services and the impact that this has on the valuation of the licences being considered. In this context, Ofcom has reviewed, and revised where necessary, the past approach to setting financial terms.

[3] Different percentages may be determined for different accounting periods.

Section 4

Hypothetical auction process

Considerations of the hypothetical auction process and estimation of the incumbent's bid

4.1 In the Consultation, Ofcom set out what it considered to be the key circumstances of the hypothetical auction process which it aims to consider in respect of determining the Cash Bid.

4.2 The 1990 Act specifies a single round sealed-bid auction, in which the licence is awarded to the highest bidder, subject to the bidder meeting a quality threshold. Because Ofcom is setting extended financial terms for the licence holder, Ofcom stated that it would assume in its valuation that the incumbent licence holder would win the auction, and therefore would be the highest bidder.

4.3 S85 (2) of the 1990 Act confines quite closely the formats available to the different INR licences. Within those constraints, Ofcom stated that the general nature of the formats chosen by the existing INRs would be assumed to represent the potentially most profitable options, as this is what has been delivered by the market. Ofcom stated that it did not believe that it would be a valuable exercise to try and compute the hypothetical profits of alternative stations offering different formats.

4.4 Ofcom stated that the bid of the incumbent would depend on several additional factors including its attitude towards the risk of losing the licence, the speed of audience migration to digital platforms, its assumptions about the level of competition for the licences and its assumptions about the individual circumstances of potential alternative bidders. Ofcom stated that it seemed sensible to assume that the incumbents would be relatively risk-averse because their existing business models are dependent on holding the broadcasting licences. Also, Ofcom stated that it believed it appropriate to assume that there would be competing bidders for all of the licences because they would be valuable to new entrants and that the identities of competing bidders with the highest valuations would be likely to be existing media companies, either from the UK or abroad, that would wish to take advantage of scarce analogue frequency to operate a national analogue radio service.

4.5 Ofcom stated that it considered that the maximum amount an incumbent would be willing to pay for a licence would equal the surplus value of the rights and obligations associated with the licence after an acceptable rate of return but that in principle the value realised in a competitive auction should be closer to the amount that would be bid by the second highest bidder than to the maximum amount the incumbent would be willing to pay. This is because the incumbent would aim to bid the minimum amount necessary to win the auction. The incumbent would therefore attempt to beat the bid of the second-highest bidder by the smallest margin possible. Ofcom noted that in a sealed-bid auction, the exercise would be complicated by the lack of information about who the competitors would be and how they would value the licence.

4.6 Ofcom proposed that 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. Therefore, in theory, the incumbent could estimate the value of the licence to the second-highest bidder by estimating the cost of entry and subtracting that amount from its own valuation of the licence. Then, the incumbent could bid slightly more than that amount to win the licence.

4.7 Ofcom noted that there were various reasons why a risk-averse incumbent might bid an amount greater than that suggested above, but noted that it would be very difficult to quantify the effects of the above considerations on the amount the incumbent would bid for the licence.

4.8 Ofcom proposed to estimate the bid of the incumbent by calculating the present value of the licence to the incumbent, after a reasonable rate of return, and then subtracting a reasonable estimate of entry costs that would be incurred by the second-highest bidder. This approach should result in a prudent estimate of the value of the licence to the second-highest bidder. The result of this would be a conservative estimate of the incumbent's winning bid, given that it would not reflect any assumption that the incumbent would increase its bid above this value in order to reduce further the risk of losing the licence.

4.9 In respect of these proposals, Ofcom asked:

QUESTION 1: Are the proposed circumstances of the Hypothetical Auction appropriate given the statutory requirements, market and regulatory environment?

*QUESTION 2**:** Do you agree with Ofcom that this is the appropriate basis on which to consider the outcome of a Hypothetical Auction? If not, what other frameworks could be adopted and what do you think the benefits of your suggestion would be? Are the proposed circumstances of the Hypothetical Auction appropriate given the statutory requirements, market and regulatory environment?*

4.10 In their joint response, respondents stated that they agreed in principle with the proposed method of adopting a hypothetical auction process for determining that financial terms of an INR licence, subject to Ofcom considering the impact of market and technological factors and trends for each individual licensee.

4.11 However, in their joint response respondents also made a number of points which appeared to relate to certain aspects of Ofcom's approach to outlining the circumstances of the hypothetical auction and estimating the incumbent's bid. These included the following points:

- Ofcom should not prejudge the identity of a new entrant
- Ofcom should include the cost of adhering to format requirements and reflect the costs of meeting public purpose requirements in the valuation of the analogue INR licence
- Ofcom's assumption that the INR licences are valuable to new entrants is in stark contrast to evidence which demonstrates that the value of an analogue licence to a new entrant is in decline and is certainly less valuable now than in 1999/2000
- That there are considerable uncertainties which have an impact on the future value of an analogue INR licence

4.12 Ofcom cannot take into account every factor or uncertainty that might arise in a real auction in considering an auction which is purely hypothetical. Ofcom's approach is therefore attempting to simplify consideration of the likely outcome of an auction in a way which is transparent and ensures that due consideration is taken of the business models of the incumbent operators.

4.13 Ofcom has considered each of the points raised carefully.

The identity of the new entrant

4.14 As has previously been stated, it is neither necessary nor practical for Ofcom to exactly replicate or reflect each and every uncertainty in respect of the hypothetical auction. However, in the case of the Cash Bid element of the licence payments, the Act requires Ofcom to consider the outcome of such an auction.

4.15 The fundamental means by which Ofcom has proposed to replicate the outcome of an auction is to assume that the incumbent would win the auction but would pay no more than necessary to win the auction (and therefore would bid only fractionally higher than the second highest bid.) Ofcom considers that a potential bidder's valuation of the licence would be equivalent to the valuation of the incumbent, less an allowance for the reasonable costs of entry (which a new entrant would have to incur, but which would not be incurred by the incumbent.)

4.16 In their joint response, the respondents questioned why Ofcom had assumed that existing media companies would be the highest bidder and stated that this assumption seemed to presuppose that a media business would operate with spare capacity, which it could use to launch the new service and that it would incorporate the benefits of scale economies in their bid. The response went on to list examples of non-media companies which had recently launched radio stations and of other companies which had entered into industries in which they had not previously been involved.

4.17 As stated, Ofcom considers that the auction would be likely to attract several competing bidders. Therefore Ofcom does not disagree that some of the bidders in the hypothetical auction might not be existing media companies. However, Ofcom is not concerned with the identities of all bidders; Ofcom need only consider the level of the second highest bid.

4.18 Ofcom has proposed to calculate the second highest bid with reference to the valuation of the incumbent, less an allowance for the reasonable costs of entry of a new entrant. This means that the new entrant is essentially very similar to the incumbent, but will need to incorporate into its bid additional costs (of entry) which the incumbent would not incur. Ofcom considers that other media companies and, in particular, other radio companies would be likely to have lower costs of entry and greater cost and revenue synergies with the new service than companies without prior media interests. This would enable them to extract more value from the licence, and hence reflect this in their bid, making it more likely that such companies would be the second highest bidder.

4.19 It seems implausible to Ofcom that cost and revenue synergies with the new licence would be likely to be greater for players with no pre-existing interests in the industry than for players which have pre-existing involvement. For the second highest bidder to be other than a media company, the bid would appear to be likely to be factoring in other benefits perceived by the new entrant (which are not being factored in by either the incumbent or Ofcom's assumed new entrant) which must be at least as great as the synergistic benefits available to an existing media player but not available to a company without prior interests in the industry. Ofcom believes that such hidden sources of value may exist in a real auction but that it is difficult to take account of such benefits in a hypothetical auction.

4.20 Radio companies are not highly capital intensive and Ofcom considers that the benefits that arise are likely to be from the transfer of existing knowledge, skills and other intangibles. This assumption is therefore representative of synergistic benefits rather than the utilisation of "spare capacity."

4.21 Ofcom considers that the assumption that the second highest bidder would be an existing media company is therefore reasonable, and far less subjective than the alternative assumptions, which would require the definition of and estimation of benefits to a new entrant which are not transparent to the incumbent.

Reflecting the cost of licence requirements

4.22 Because Ofcom's estimation of the bid is rooted in an estimation of the value of the licence to the incumbent, Ofcom considers that the costs associated with meeting format requirements and any other significant costs which are directly related to the holding of the licence will already be incorporated implicitly in the base year used for the purposes of deriving the forecast and valuation. This is because the base year is derived from the financial performance of the incumbent licence holder which is, of course, subject to the licence requirements in question. Ofcom therefore considers that the costs of adhering to format (and other) requirements are generally already substantially reflected in its proposed approach and are reflected appropriately for each different licence.

The assumption that the licences are valuable to new entrants

4.23 Ofcom considers that the fact that the licences are currently operated by their respective owners suggests that the licences currently have value to the incumbent. Ofcom does not dispute that the scarcity value associated with analogue spectrum may decline in future, as radio experiences a platform shift towards digital spectrum. However, current listening trends suggest that the licences continue to attract substantial quantities of listening hours. Ofcom considers that these listening hours, and the revenues which could be achieved if replicated, would be valuable to a new entrant.

4.24 Whether the licences are valuable to new entrants will therefore be dependent upon whether the level of additional costs expected to be incurred by the new entrant as a result of holding the licence were more or less than the additional revenues which the new entrant would receive as a result of holding the licence. Based on its experience of dealing with numerous radio licence applications and upon published data relating to incumbent operators, Ofcom considers that it is likely that new entrants would be able to devise business plans under which the incremental revenues available from ownership of a national analogue licence would be more than sufficient to offset the incremental costs that would be incurred.

4.25 Ofcom has not prejudged the outcome of the review of financial terms. However, based on the evidence presented to date and Ofcom's experience in related matters, Ofcom does not consider that the supposition that the licences would have no value to a new entrant is an appropriate starting assumption for its methodology.

4.26 Two of the respondents indicated that particular aspects of their own licence made them particularly unattractive to a new entrant. Ofcom considers that the particular circumstances of each licence is substantially reflected in the use of financial estimates which are rooted in the actual costs and revenues experienced by the incumbent operator.

4.27 One respondent argued that Ofcom should reflect in its consideration of the hypothetical auction the possibility that some bidders may bid a value for the licence, even in the event that they believed the licence had negative value. Ofcom considers that this is another uncertainty that may exist in a real auction process which is difficult to reflect in a hypothetical auction. If Ofcom were to assume that bidders may make bidding decisions which appear to be either economically irrational or reflect assumptions of imperfect information, then this would decrease substantially the transparency of the methodology it has outlined, which implies that a positive NPV is required before a bid can be considered. Ofcom's methodology therefore does not reflect the possibility that participants appear to over bid in an auction, although in an actual auction, this could be real possibility.

Consideration of uncertainties

4.28 Ofcom must take into account a wide range of uncertainties in determining the value of the licence and in reaching its determination of the financial terms for the extension period. Ofcom considers that all forecasts are subject to uncertainty, including those provided by the applicants.

4.29 Ofcom will model a number of different scenarios and consider a range of different outcomes in order to inform its determination of financial terms. As stated previously, Ofcom will seek to set terms which are fair and reasonable within the context of the current market environment and that will continue to be reasonable for the extended period of the licence subject to a number of statutory and practical constraints. The valuation is intended to meet the requirements of the Act in relation to determining the Cash Bid, and also to provide a robust basis for informing Ofcom's decision as to the appropriate level of the PQR.

Determining the relevant period for valuation

4.30 Whilst the financial terms being determined will, if accepted, apply to a four year extension of the existing licence, s253 (9) the Act clearly requires Ofcom to set a Cash Bid payable based after considering the outcome of a Hypothetical Auction were the licence granted afresh. The Act is silent, however, on the duration of the licence being offered in the Hypothetical Auction.

4.31 The extensions will extend the current licence renewal period from a total duration of eight years to a total duration of 12 years. In its consultation, Ofcom proposed that it would conduct the valuation of the extension on the valuation of a 12 year licence and then apply the result in an appropriate way to the four year extension period of the license.

4.32 When setting the PQR for a licence advertisement, statute allows Ofcom to specify a different PQR for each period. In the context of setting revised terms for the period of the extension, this means that, at Ofcom's discretion, it could choose to weight payments across the different time periods incorporated into the licence (and the licence extension period) without changing the total expected amount of the payments (which would still equal the valuation.) In setting the PQR rate for the 12 year licence period proposed in the hypothetical auction, Ofcom will assume that the same PQR rate is set for each one year period. This means that there will be a single PQR rate which would be carried forward to determine the total amounts payable during the extension period by those licensees that accept the terms.

4.33 However, Ofcom reserves its discretion to set a different PQR rate for different periods of the extension, subject to setting terms which overall would be expected to recover the same total value of payments over the extension period as would have been the case had the PQR rate been constant throughout.

Definition of qualifying revenue

4.34 Qualifying revenue is the pool of revenues to which a PQR rate is applied for the purposes of collecting additional payments.

4.35 Ofcom's interpretation of the relevant statute is that the definition of qualifying revenue must include revenue derived from the national analogue but not from local analogue or digital services[4] which may in part or in whole represent a simulcast of the national analogue service. This is because qualifying revenue is defined with reference to the 'licensed service'. Any local simulcast analogue services are covered by a separate licence. Section 41 and 56 of the Broadcasting Act 1996 ("1996 Act") indicate that there is a difference between the 'licensed service' and the digital simulcasts. This is supported by the way the licences and Radio Authority's Statement of Principles[5] are currently drafted.

4.36 The statutory definition of "qualifying revenue" does not determine what future revenue derived from the licence Ofcom should take into account for the purposes of valuing the licence. The latter is one important output to Ofcom's view for valuation purposes of the amount of revenue expected to be generated over the course of the licence which will in turn determine the level of actual payments. The former is the benchmark used to calibrate the PQR in order to collect that element of the additional payments which relates to the variable element. In the Consultation Ofcom stated that for the purposes of valuing the analogue licence, the definition of revenue (as opposed to qualifying revenue) would not be straightforward to establish. This is because in commercial practice the revenues from the national analogue services are often not formally separated from the revenues of the simulcast. The responses to the Consultation provided evidence that there are significant platform dependent differences for the price paid for listener hours.

4.37 For administration purposes in calculating and collecting the PQR element of additional payments, Ofcom considers that the most transparent and robust means of determining qualifying revenue and, therefore, the PQR payable, remains apportionment on the basis of listener hours. Whilst this does not impact the valuation itself (and, therefore, does not impact the total amount of additional payments expected to be collected) it will impact the setting of the PQR. Ofcom will therefore need to make assumptions regarding the distribution of future listening hours across different platforms.

[4] Section 102(2) of the Broadcasting Act 1990 defines qualifying revenue as "all payments received or to be received by [the licence holder] or by any connected person in consideration of the inclusion in the licensed service of advertisements or other programmes, or in respect of charges made in that period for the reception of programmes included in that service".

[5] The current process for calculating and charging PQR payments is set out in the Computation of *Qualifying Revenue Statement of Principles: Broadcasting Acts 1990 and 1996 (Revision 2 – November 1998)*. Ofcom plans to issue a new edition of this document this summer which will confirm its interpretation of qualifying revenue, the process of weighting the two categories of qualifying revenue and the methodology for calculating PQR payments.

4.38 As described above and in section 5 the concept of revenue of the purpose of the valuation of the licence will be determined on the basis of apportionment by listening hours, with certain weightings applied to each platform where Ofcom consider appropriate in all the circumstances. This will give a valuation to be recovered via the PQR and cash sum. The PQR rate will be applied to actual qualifying revenue calculated on the basis of listener hours per platform on an unweighted basis.

Section 5

Valuation Methodology

General approach

5.1 In its consultation, Ofcom outlined that it considers it is required to consider the value of the rights and obligations associated with the licence. The primary right associated with the licence is the right to broadcast on scarce analogue spectrum and the primary obligation associated with the licence is the provision of the service in accordance with the terms of the licence. There are also other rights and obligations associated with the licence such as, for example, the requirement to simulcast the national analogue service on the national digital multiplex.[6]

5.2 Ofcom stated that 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, i.e. if they did not hold the licence. In general, Ofcom considers that, 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, 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.

5.3 The licences being extended require the provision of the following radio services, in the required format:

- The provision of a national analogue service

A simulcast of that service on the national digital multiplex

5.4 In respect of the provision of a national analogue service, Ofcom proposed that, since the right to broadcast on scarce analogue spectrum cannot be replicated in the market, Ofcom would value the right to broadcast on scare analogue spectrum by undertaking a discounted cashflow calculation.

5.5 A holder of the licence also has the opportunity to provide other forms of distribution for the service. As observed in the case of the incumbent holders of the licences, such distribution channels can include internet streaming and carriage on digital television platforms. In the case of Virgin, substantial amounts of output are shared between the licensed national AM service and the licensed London FM service.

5.6 In commercial reality, the incumbents do not treat the licensed service when broadcast on the national analogue frequency or on the national multiplex as being a separate business to the simulcast of the same service on other distribution platforms. This is because revenues and a substantial part of the cost base are common to several platforms. In respect of valuing the national analogue element of the business Ofcom therefore proposed that it would undertake an apportionment approach to audience, revenues and common costs, whilst costs and revenues

[6] Ofcom considers that it is fair and reasonable to take into account the digital rights and obligations conferred by holding the current licences (which are to be extended) because this is what will be required of licensees who choose to extend their licences.

which were transparently related to an individual platform would be applied to that individual platform.

5.7 Ofcom proposed that the apportionment would be undertaken on the basis of listener hours on each platform, potentially adjusted for differential rates of value that could be applied to listening on each platform, where robust and credible data existed for such an adjustment. Ofcom invited views on this approach and asked what evidence was available in relation to the current differential rates which might apply to each platform and how these might vary in the future.

5.8 Therefore, in respect of these aspects of valuation and apportionment, Ofcom asked the following questions:

QUESTION 3: Is Ofcom’s proposed methodology for estimating the value of the rights and obligations of digital simulcasting on a national multiplex reasonable?

*QUESTION 5**:** What is the most appropriate basis for calculating revenues for the analogue national, analogue local and digital services for use in the valuation exercise? What available evidence exists as to the current differential rates and how will they move in future?*

5.9 In their joint response to Question 3, respondents argued that simulcasting on the national digital multiplex was a burden and that a new entrant would not be obliged to simulcast but would make a commercial decision on whether to do so.

5.10 Given that the respondents argued that a new entrant would not be obliged to simulcast this would point towards valuing the licence excluding the obligation to simulcast on the national digital multiplex, since this obligation applies only to the current incumbents who are extending their licences, not to the hypothetical new entrants.

5.11 However, Ofcom considers that such an approach would be unlikely to be fair and reasonable on the incumbents, since the obligation to simulcast the analogue service will be extended as part of the extension of the licence. Therefore, in performing its valuation, Ofcom will consider the net costs and benefits related to the simulcast on the national digital multiplex and, in the event that this appears commercially onerous, will take account of the net costs and benefits in its determination of financial terms for the national analogue licence.

5.12 The respondents also argued that the value of airtime allocated to promoting DAB (which the licensees undertake to do as part of their license to broadcast on the national digital multiplex) was significant. One respondent extended this argument to certain other responsibilities, such as Party Election Broadcasts. The respondents argued that the value of this airtime should be taken into account in the valuation.

5.13 Ofcom considers that licence obligations are generally reflected in the base year cashflows of the incumbents. Since these provide the basis of the forecast calculation, they are therefore likely to already be substantially reflected in Ofcom’s proposed approach.

5.14 In their joint response to Question 5, the respondents suggested that it was appropriate to apportion the revenues between various platforms according to listener hours but that this approach should be adjusted for factors specific to each licensee on each particular platform, including, for example CPT differentials.

5.15 This was in line with Ofcom's proposal, although it did not indicate where Ofcom would be able to source robust and credible data for such adjustments to listener hours.

5.16 In respect of costs, the respondents broadly agreed with Ofcom's proposal that costs which are incurred as a direct result of broadcasting on a particular platform should be attributed to that platform. For example, the costs of national analogue transmission should be attributed to the national analogue licence, whereas the cost of internet streaming should be attributed to the internet platform.

5.17 However, in respect of common costs which impact more than one platform, the respondents disagreed with Ofcom's approach. Respondents argued that a stand-alone approach should be adopted with respect to the analogue licence and that all costs, including shared or common costs, should be allocated to the analogue licence.

5.18 The respondents argued that a stand-alone analogue licence would cost nearly the same amount as the current total costs of an INR business because of the small level of avoidable or incremental costs associated with the non national analogue platforms and that an allocation on the basis of hours therefore bears no relation to how costs are incurred in an INR business.

5.19 Subsequent to the consultation period, the respondents provided Ofcom with a further joint response covering the issue of apportionment and cost attribution. In respect of the allocation of common costs, the respondents suggested that there was no "theoretically" correct method of allocating costs on a fair and reasonable basis (in line with the overriding principle Ofcom considers to apply to this process) and hence a range of alternatives could be explored.

5.20 The respondents proposed a methodology for the allocation of common costs which included reference to the uptake of DAB sets. Common costs would be allocated between platforms based on listening hours, but then weighted according to the take up of DAB. The allocation made to digital platforms would be subject to a discount, with would reduce as take up of DAB sets increased.

5.21 Whilst DAB set household penetration was below 33.3%, common costs would be allocated entirely to the national analogue licence. Between 33.3% and 75% penetration, the allocation of common costs would continue to be weighted towards the national analogue licence, but with the digital platforms taking a share of common costs which was downweighted by use of a "cost allocation multiplier." Once DAB set household penetration exceeded 75%, then common costs would be allocated on a pro rata basis with listening share between the national analogue licence and the digital platforms.

5.22 The respondents argued that it was reasonable to allocate all common costs to the national analogue licence until household penetration of DAB sets reached 33.3% since this was consistent with the obligations on Digital Sound Programme Service (DSPS) licensees to invest in significant studio and programming costs one the level of household penetration of 33.3% is passed. The respondents also argued that the proposed approach would reflect that costs are not linear with respect to revenue and that there is a minimum cost level which an analogue station has to operate at and that the INRs have an obligation to simulcast on, and to promote, DAB.

5.23 In its consultation Ofcom stated that 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, i.e. if they did not hold the licence. It should be noted that these additional profits might not be limited to the operation of the national analogue licence itself, since there is the potential for the national analogue licence to provide access to revenues on other platforms that might not otherwise be available. For example, the revenues available as a result of operating the national analogue licence might provide the scale required for the licence holder to invest in high quality programming. This programming would then also be utilised on the operator's digital service and would have the potential to attract more listening on the digital platform than would have been attracted by the programming that would have been produced in the absence of the national analogue licence.

5.24 In a real auction, potential bidders would make estimates about the value that the national analogue licence would bring to their businesses and set their bid accordingly. However, in the case of this hypothetical auction, Ofcom must make a judgement about the likely level of any additional profits that would be generated by ownership of the national analogue licence and the amount that would therefore be bid.

5.25 In estimating the bid, Ofcom must consider what evidence is available to it. Ofcom can observe the incumbent operators of the licence and the profits that they achieve. Based on the assumption that the incumbent operators are profit maximising, then these profits provide a reasonable reflection of the profits available as a result of owning the licence.

5.26 Ofcom must also consider what evidence is available to it in respect of the value of the next best alternative (i.e.: not owning the licence) since the difference between the two is the amount that might be bid for the licence by a new entrant.

5.27 In respect of the incumbents, it is not possible to identify what the revenues and costs (and, therefore, profits) would be in the absence of the national analogue licence. This is because revenues, and a substantial proportion of costs, are generated across all platforms. In the absence of the national analogue platform, certain costs and revenues would cease, but the actual amounts are not clear. In the absence of the national analogue licence, the incumbents' business model may change substantially to reflect the platforms available to them and the absence of access to the national analogue spectrum. However, the actual business model that might be followed is not clear and it would be difficult to estimate such a counterfactual robustly.

5.28 If, in estimating the next best alternative, Ofcom considers other operators which operate national stations without a national analogue licence (i.e.: digital only operators) then the revenues attracted by those stations appear to be very small in comparison with stations which hold a national analogue licence. This would indicate that it is the national analogue licence which is substantially responsible for the profits available to the incumbents.

5.29 However, Ofcom considers that this is likely to become less relevant over time, as listening moves away from the analogue platform.

5.30 Because Ofcom cannot directly observe the additional profits which are available as a result of owning the analogue licence and because those observations which can be made may not always be appropriate to apply to the incumbents, Ofcom cannot robustly estimate the value of these additional profits incrementally and must therefore find an alternative means of estimating the value of the national analogue licence to a non holder of the licence.

5.31 Ofcom therefore proposed an apportionment approach which apportioned common costs and revenues of the basis of a weighted share of listening. Although such an approach might not reflect fully the option value associated with the national analogue licence (which allows the holder or the licence to obtain benefits which would be wholly unavailable in the absence of holding the national analogue licence) Ofcom considered that it would provide a conservative estimate of the value of the licence to the incumbent and would also reflect that the changing importance of the platform mix over time.

5.32 Ofcom has considered the arguments made by the respondents in their initial response, which suggested that because a stand-alone national analogue licence would cost nearly the same as the current total costs of an INR business the full costs should be allocated to the national analogue business. The approach outlined by the respondents is to consider the incremental value to an operator of the national analogue licence of providing the service on incremental platforms and then to deduct this from the value of the entire business to give the value of the national analogue element of the business. Ofcom does not agree with this approach.

5.33 Firstly, the underlying approach adopted by Ofcom is to assess the incremental value of the licence to a new entrant, which does not own the national analogue licence. As such, the additional profits that an organisation that already owns the national analogue licence can achieve by providing its service on incremental platforms is not a relevant test. The relevant test is the additional profits that a non holder of the national analogue licence could achieve if it acquired the licence. For the reasons outlined above, such values cannot be observed directly.

5.34 Further, even in the scenario described by the respondents, the only reason that the national analogue licence holder can make incremental revenues on other platforms with low incremental costs because it runs a licensed national analogue service which covers all common costs. A new entrant without that national analogue licence would recognise that in addition to the profits it could make from the national analogue licence, acquiring that licence would enable it to earn additional revenues from incremental platforms with low incremental costs. As such the profits from the incremental platforms would be conditional on first obtaining the national analogue licence and therefore the value of those profits would necessarily be reflected in the winning bid. Because the revenues associated with these incremental platforms are being excluded from the valuation, these profits would not be captured by the approach proposed by the respondents.

5.35 In respect of the second response provided by the respondents, this is an adaptation of a cost allocation approach which introduces certain elements of the incremental approach to valuation which was outlined earlier. These elements are introduced by means of a “cost allocation multiplier” which weights the apportionment that would otherwise be made in respect of common costs.

5.36 The approach relies upon estimating a relationship between DAB set household penetration and a cost allocation multiplier which Ofcom considers is difficult to estimate robustly and which would require a large number of assumptions.

5.37 The respondents indicated that use of DAB set household penetration represents the best indicator of the potential to generate audience rather than the actual audience achieved and that this therefore reflects the incentives to create profitable platforms since increasing revenue does not attract an increasing allocation of common costs. However, in the case of the new entrant, as already outlined, the increased revenues being considered are the increased revenues which would result from owning the national analogue licence, not from other platforms.

5.38 Furthermore, given that it is the national analogue licence which is being acquired by the new entrant, it is the uniqueness of the national analogue licence, versus any other means of distribution, which is being valued. The scarcity value of the analogue licence cannot be defined simply with reference to DAB set household penetration since the scarcity value of the analogue licence relates to the availability of all alternative delivery mechanisms (including DAB, digital satellite, digital cable, internet streaming and all other platforms which are not the national analogue licence.) Therefore, even if it were possible to estimate a robust relationship between DAB set household penetration and a cost allocation multiplier, these relationships would also need to be estimated for all other platforms individually.

5.39 Each individual platform relationship would also need to be estimated for each individual licence, since the importance of each alternative platform will differ for each licence, reflecting both the station format and the current mix of platforms utilised. For example, the presence of a simulcast on a given digital platform may have very different implications for a national analogue licence on the FM band to one on the Medium Wave band. Ofcom considers that the estimation of these relationships would be highly complex, difficult to undertake robustly and difficult to apply appropriately to each INR service individually.

5.40 Furthermore, even if such relationships could be robustly estimated, then Ofcom considers that a similar cost allocation approach should be applied to both costs and revenues. The respondents' proposal applied the "cost allocation multiplier" only to costs and left revenues apportioned on an unweighted basis. Because access to the national analogue licence is likely provide additional profits which reach beyond the creation of additional profits from the national analogue service itself (including creating options for business activity which would otherwise have been unavailable) an approach which seeks to differentiate the incremental effects on costs from the incremental impact on revenues is unlikely to provide an answer which is fair or reasonable. In this case, Ofcom considers that the respondents' approach would be likely to understate the value of the analogue licence.

5.41 Therefore, Ofcom will proceed with the valuation on the following basis:

5.42 Revenues and costs which arise directly and causally from the presence on a particular platform will be allocated to that platform (e.g. the cost of national analogue transmission will be allocated to the national analogue licence.)

5.43 Ofcom will apportion common costs and revenues between platforms based on each platform's share of listening hours, with weightings potentially being applied to listening hours on each platform as described below.

5.44 Ofcom believes that this approach will reasonably reflect the changing importance of the national analogue platform relative to other platforms over time and will also reflect more reasonably than the alternative approaches proposed by the respondents the interrelationships between the overall level of costs and the overall ability to generate revenue.

5.45 In its consultation, Ofcom noted that apportionment on the basis of listener hours alone may not be a true indicator of the value of listening on each platform. Ofcom stated that, if credible data existed, it would take account of available evidence in respect of differential rates paid by advertisers for listener hours on different platforms. Ofcom will give consideration to representations which licensees may make in their applications in this regard, together with other available sources of evidence, and may adjust the apportionment to reflect such a weighting where it considers such an adjustment appropriate.

5.46 As an overriding point, and as outlined in the consultation, the use of an apportionment approach as outlined would be expected to represent a reasonable proxy through which the various elements of revenues and costs can be disaggregated for the purposes of the valuation. However, the result of the apportionment should also be credible and consistent with the observed economics and business models of radio broadcasters. Ofcom will take account of such factors in conducting the valuation, consistent with the overall objectives of the valuation exercise.

5.47 In the joint submission, respondents stated that they expected Ofcom to grant financial terms for INR licence extensions that recognised the significant investment which the INRs had made to date on Digital Radio. Ofcom's interpretation of the statute is that it does not allow the recovery of the sunk costs of digital broadcasting through this process.

Financial Base Year

5.48 The Consultation document stated that the base year to which future forecasts will be applied will be the revenues and costs of the present Licence holder in the year immediately before the Relevant Date. One response noted that it should be the year after the Relevant Date. On reviewing, Ofcom wishes to clarify that the base year from which forecasts of the new licence period will be made is the year immediately before the Licence Expiry date. The base year will be estimated using information supplied by licensees at the date of application since there could potentially be a period of around 32 months between closing date and licence expiry date.

Approach to revenue projection

5.49 The Consultation proposed that Ofcom would require the applicants to use a top down approach to revenue projection, deriving market share figures for each of the INRs with reference to a common Net Advertising Revenue (NAR) forecast for the radio industry as a whole. Ofcom asked;

> *QUESTION 4 (a): Is the proposed approach to forecasting advertising revenue the best approach available?*

5.50 In their joint response the respondents recommended that a bottom up approach should be adopted for the first six years, and a top-down approach adopted for the second half of the 12-year period. The respondents suggested that the bottom up approach would provide a better forecast of each applicant's share of national revenue, given the complexity of industry relationships and the specific issues associated with each licensee. As the detailed assumptions on which a bottom up forecast can be based become increasingly uncertain further into the forecast period, a top down approach should be used to project revenue for the second half of twelve year period.

5.51 Ofcom has considered these comments and believes that there is some merit to examining a bottom-up forecast in conjunction with a top down approach since this would increase transparency in relation to assumptions in relation to advertising estimates. Ofcom will therefore require applicants to submit a bottom up forecast for the first six years along with the top down forecast for the whole 12 year period together with explanations in relation to any areas in which the results of the two approaches appear to diverge.

5.52 In the Consultation Ofcom proposed that the Long Term and Short Term forecasts of advertising spend published by the Advertising Association (AA) provided the most suitable benchmark for revenue forecasts. Ofcom also asked:

QUESTION 4 (b): Is the Advertising Association forecasts the most appropriate global benchmark to use, if not what other sources should be used and why?

5.53 The joint response asserted that Ofcom’s reliance on the AA as a single source for the advertising revenue forecasts would not result in a comprehensive, robust and unbiased view of future advertising revenues as it did not reflect a range of available forecasts and the complexities and subtleties of radio advertising dynamics at the national and regional level for each INR licensee.

5.54 Ofcom’s view remains that the AA forecasts represent a transparent reference point for total radio NAR and an appropriate global benchmark. In its existing radio licensing activities, Ofcom has first hand experience of the AA forecasts being used as the basis of top down forecasts in the preparation of business plans for the majority of applications Ofcom receives for larger licence areas, from a range of applicants. As a result of further discussion with the joint respondents, Ofcom will investigate whether it is appropriate to commission bespoke work in relation to advertising forecasts, the results of which it would share with the applicants. If applicants decide to use a range of advertising forecast information instead of, or in addition to, the AA forecasts to determine their top down forecast, applicants should narrate how the forecast is constructed and where it diverges from the stand alone AA forecasts, provide suitable explanations.

5.55 Ofcom believes that these additional data sources, in conjunction with the AA forecasts, should provide a comprehensive range of estimates which Ofcom can consider in its valuation and determination.

5.56 Ofcom will make its own assumptions regarding the transfer of listeners and advertising from analogue to digital and will supply forecast digital penetration figures to the INRs to assist them in their applications. Ofcom will also take due account of representations made by applicants on this issue.

Market Shares

5.57 In the Consultation, Ofcom stated that it would form its own view as to what proportion of radio advertising is “national” by nature and what share of this the INRs can be reasonably expected to take on the basis of the applications submitted, market intelligence and historical trends.

5.58 In the joint response, respondents argued that Ofcom should be guided by the applicants when forecasting the share of national revenue, given the complexity of industry relationships and the specific issues associated with each INR licensee. Ofcom accepts that this is a complex area, with a range of possible outcomes and will give due consideration to the views of the INRs when forming its view. Ofcom would therefore request that the applicants rationalise and quantify changes in forecast market share in their applications, so that these views can be taken into account.

Approach to cost projection

5.59 Ofcom considers that, in order to determine a value for each licence, it is necessary to project programming and operating costs for each licence individually. In its consultation, Ofcom proposed that the starting point for the cost projections should be the expenditure of the incumbent licence holder in the year prior to the review. Ofcom proposed that it was also reasonable to take account of information submitted by the current licence holders about possible changes in expenditure over the licence period. However, because Ofcom aims to determine the value of the licence to a hypothetical second-highest bidder, Ofcom believes it must assume in its projections that the business will be operated in an efficient manner. Therefore, Ofcom stated that it would need to develop its own view about what constitutes a reasonable level of expenditure to operate the licensed business. In assessing the cost projections, Ofcom stated it would also have regard to relevant relationships between expenditure and revenue, for example the relationship between the programming budget and advertising revenue.

5.60 In their joint response, respondents asked that Ofcom to be explicit and transparent in relation to how it defines the relevant relationships between expenditure and revenue. Respondents suggested that such relationships (including the relationship between the programming budget and advertising revenue) are very complex and subject to mis-interpretation.

5.61 Ofcom's consideration of these relationships will relate to assessing, on a broad basis, the overall reasonableness or otherwise of the projections relating to revenues and costs and the inter-relationships between the two. In the specific instance of the relationship between the programming budget and advertising revenue, Ofcom considers that a range of plausible relationships could be observed to be rational and logical, depending upon the individual circumstances of the business plan. Where these relationships appear to have broken down and where Ofcom considers there may be scope for misinterpretation, Ofcom will seek further explanations for the rationale for the forecast in order to further develop Ofcom's view in relation to what constitutes a reasonable level of expenditure to operate the licensed business.

Listener Migration Value

5.62 In the Consultation Ofcom stated that other benefits from holding a national analogue licence may also arise. These could include a listener migration value where a new bidder for the licence may consider that holding a national analogue licence may confer an advantage upon its digital station in the post-analogue world. This would occur where listeners have a greater familiarity with the analogue service when they migrate to the digital environment. Ofcom asked:

> *QUESTION 7: Is it appropriate to include in the valuations a 'listener migration value' for the analogue licence as described? If so, what would be a suitable methodology for estimating the value?*

5.63 In their joint response the respondents argued that the INR licence confers no 'listener migration value.' Among the reasons cited for this view was that third party evidence suggested that increased choice is the main driver for DAB (and therefore Digital) uptake. In Ofcom's view, the presence of a digital migration value would not be dependent upon absolute levels of listening to the service on a digital platform, but would be demonstrated by a greater propensity for listeners to listen to the station on the digital platform if they had experienced the service on the national analogue platform when compared to another group of listeners that had not experienced the service on the national analogue platform and encountered the station for the first time on the digital platform. Among those listeners, absolute levels of listening may be impacted by the availability of alternative stations, but the INRs may still be benefiting from familiarity with a service which was previously available on analogue.

5.64 The respondents also argued that recently launched digital stations have already demonstrated an ability to achieve significant audience share quickly without having any analogue presence and that, unlike TV, radio does not have a defined switchover date which might lead to greater digital uptake in the short-term and more interest in holding an analogue licence in order to gain a foothold in the digital market place.

5.65 Ofcom has considered further the value that might be created by holding a national analogue licence in respect of improving competitive positioning in the digital environment and whether it is possible to calculate such a value robustly. Ofcom notes that the calculation of this value is potentially particularly problematic because of the absence of any defined digital switchover date. This means that there is considerable uncertainty in relation to future trends in respect of digital listening and the development of digital platforms for radio listening.

5.66 Ofcom considers that it is likely that a new entrant would consider that the opportunity to own a national analogue licence could also provide longer term benefits for the service on digital platforms. However, it does not appear likely that the new entrant would calculate such a value specifically and any such value would be unlikely to be transparent in the near term. Therefore, in a change to its original proposals, Ofcom considers that it would not be appropriate to apply a listener migration value to its valuation of the analogue licence extension.

Costs of entry and residual value

5.67 In the Consultation Ofcom said that an incumbent would take account of the estimated costs of entry for potential alternative bidders when calculating its bid for a licence. Ofcom proposed to include an allowance for the cost of assets required to operate the business or to meet the requirements of the licence. Ofcom asked:

QUESTION 6: Is Ofcom's proposal to include in the valuations an allowance for the value of assets required to operate the broadcasting licence appropriate? What other types of 'investment' costs, if any, should be included in the estimate of entry costs? If so, how should these allowances be robustly estimated

5.68 The joint response broadly agreed that the difference between the value of the licence to the incumbent and the value of the licence to the second-highest bidder would equal approximately the cost of entry. The response suggested that Ofcom should consider a range of possible bases to estimate the cost of entry, including an MEA approach, use of comparable benchmarks or current cost estimates. The joint response also listed a substantial number of specific costs which the respondents argued would need to be reflected in the valuation. The respondents argued that the consultation document did not reflect fully a number of steps and considerations which would be necessary to define and measure the cost of entry comprehensively.

5.69 In line with its proposals, Ofcom will make an allowance in the valuation for the reasonable costs of entry of a new entrant and will consider submissions from licensees on their views as to the value and scope of these costs and the methods of financing that might be utilised to gain access to such assets. Ofcom will only include such costs in the valuation to the extent that Ofcom considers such costs would reasonably be expected to be incurred by a new entrant. Ofcom does not consider that the new entrant would necessarily replicate the existing assets owned by the licensee. Ofcom considers that the allowance made for start up costs must be evaluated within the overall scheme of the business plan and that it is therefore necessary for Ofcom to consider the reasonableness of the scope or magnitude of such costs in conjunction with the overall costs and revenues that are estimated in the valuation.

5.70 As in the Consultation, Ofcom also recognises that both the hypothetical licence and the actual licence extension period are for a fixed term and expire at a given date. Therefore Ofcom does not propose to include any residual value at the end of the licence period.

Discount rate

5.71 The Consultation expressed Ofcom's view that the discount rate applied in a net present value analysis should reflect the opportunity cost of an investment to the relevant capital providers. This is generally approximated by a weighted average cost of capital (WACC). As discussed earlier, Ofcom aims to calculate the net present value of the licence to the second-highest bidder in a competitive auction, and assumes that the second highest bidder would be an existing broadcaster. Therefore, Ofcom believes that it is appropriate to use a discount rate in the valuation that reflects a representative opportunity cost of investment faced by a hypothetical entrant.

5.72 In the Consultation Ofcom considered the possibility that a licence held by a pure-play radio company might entail a level of exposure to systematic risk that differs from that faced by a group that operates in a number of different areas of the media sector. If this were the case, it would be inappropriate to base estimates of the discount rate used to estimate the NPV of the licences on benchmarks that related to media groups that typically engage in a broader set of activities than just radio. Ofcom considered, though, that, even if it did have any *a priori* reasons for thinking that radio might be more (or less) risky than other media activities, it would not be possible for Ofcom to translate any such differences into differential estimates in a robust manner. On this basis, Ofcom proposed to use a single discount rate in the valuation of all licences.

5.73 In the context discussed above, Ofcom calculated the WACC of a hypothetical entrant using the Capital Asset Pricing Model. This calculation is based on Ofcom's own analysis and the discount rates used by equity analysts for UK media companies. Based on this analysis, Ofcom proposed to use a nominal, pre-tax discount rate of 15% in the licence valuations and asked:

QUESTION 8: Is Ofcom's proposal to use a single nominal, pre-tax discount rate of 15% for all licence valuations reasonable? If not, please provide supporting evidence.

5.74 Respondents made the following arguments in their responses to Ofcom's proposed approach to setting the discount rate:

- it might be appropriate to add a small companies premium to the discount rate (citing regulatory precedents including Ofwat and the Radio Authority);
- using a single discount rate for all licences is inappropriate since there are different amounts of risks associated with different licence types, e.g.:
  - different licences are associated with different proportions of fixed costs/operating leverage, and hence would be associated with different equity betas (e.g. it was argued that operating the INR3 licence would require more operating leverage than the other licences); and
  - there might be different risk levels associated with operating AM as opposed to FM services with one respondent suggested that there should be a 'poor frequency' premium for operating on AM.

5.75 The joint responses also argued that Ofcom should provide clarity on the extent to which its forecast cash flows treated both industry-wide and licence-specific uncertainty over various diversifiable parameters such as opex trends and changes in the level of competition.

5.76 Ofcom has considered these issues carefully and its views are described below:

Small firm risk premium

5.77 As pointed out by the respondents, the calculation set out in the consultation did not include a "small firm risk premium", i.e. the calculation did not explicitly appear to take account of the size of the firms carrying out the activity in question.

5.78 A natural intuition is that small firms have higher risk than larger firms, and hence that their cost of capital is likely to be higher. To the extent that this idea relates to diversifiable risk, particular to an individual firm (e.g. small pharmaceuticals companies pursuing R & D on a single molecule, as opposed to a larger pharmaceuticals company with a broad portfolio), it is not relevant to WACC in the CAPM framework, as explained in the risk consultation. On the other hand, insofar such an effect relates to greater systematic risk associated with smaller size (e.g. a greater tendency to go bankrupt in recessions or grow quickly in a boom), it would be dealt with within the CAPM framework by small firms tending to have higher equity betas than large firms where beta estimates are based on actual market data is available. In estimating a beta where no market data is available, firm size might be a qualitative factor to be taken into account.

5.79 This might imply that, if Ofcom believed that the second highest bidder would be a smaller company than the ones included Ofcom's sample of media companies (see paragraph A6.16 of the consultation), then it should apply an uplift to its average equity beta of 1.3. We do not, however, think that this would necessarily be the case. In Ofwat's recent water and sewerage charge determination, which was cited in stakeholder responses, a premium was allowed in the case of smaller firms that were able to demonstrate that they operated at “arm’s length” from parent companies. We do not think that this is the case, however. Our initial sample of the betas of media companies was based on companies of comparable size to the parent companies of the current licence holders, and Ofcom is not aware of any reason to think that the parent companies of second highest bidders would necessarily be any smaller than these firms – indeed, it is very plausible that the bidder might be a large multinational firm. The size of the activities spanned by the licences themselves is not relevant unless it is envisaged that the licences would be operated as standalone activities that did not benefit from the size of any parent company.

5.80 Ofcom therefore considers that it would not be appropriate to add a small firm premium to its WACC estimate of 15%. The relatively high equity beta estimate of 1.3 used in the arriving at this estimate should reflect any increase in systematic risk involved in operating a licence. Ofcom notes that inserting this equity beta estimate but taking out the small firm risk premium used in the Radio Authority’s 1999 exercise would result in a higher WACC than was obtained then.

Differences in the riskiness of different licences

5.81 Of the factors that were suggested as contributing to differences in risk levels, only differences in operating leverage would be expected to lead to differences in systematic risk. It is important to note, though, that most of the major costs of operating a radio licence are fixed with respect to volume, i.e. number of listeners/advertising revenue. Whilst it does seem plausible that, for example, committing to a long-run contract for expensive live sports rights could lead to an increase in the operating leverage for talkSPORT, Ofcom is not aware of any evidence to suggest that in practice the level of commitment to such contracts would be sufficient to create a significant or measurable difference in operating leverage between licences. It is therefore not appropriate to modify the approach set out in the consultation, namely the use of a single discount factor for all licences.

5.82 As stated on the Consultation, Ofcom reserves the right to use a different WACC if market conditions indicate that it may have significantly changed.

Section 6

Calculation of financial terms

6.1 Ofcom intends to calculate financial terms that will allow for the recovery of the combined net present value of the rights and obligations associated with the analogue and digital terrestrial elements of the licence. The Radio Authority aimed to recover approximately 75% of the surplus value of each licence via the PQR payments and the remaining 25% via the annual fixed cash sum payments when it set the terms of the renewal

6.2 In the Consultation Ofcom set out the advantage of recovering a higher proportion of PQR as it would align the payments with licensees' revenues and therefore would offer some protection against the risk of revenue downturns. It also would help to mitigate some of the risk of forecasting error.

6.3 The Consultation also recognised that there are arguments in favour of a higher annual fixed cash sum. A high PQR may distort a licence holder's behaviour by reducing its incentive to engage in commercial activities that involve significant variable costs, i.e. lower margins. A move towards a higher Cash Bid element reduces the impact of this problem and also provide licensees more certainty about the absolute level of their future payments.

6.4 The consultation noted that each licensee's preferred split between the fixed and variable portion of the payments will depend at least in part on its attitude towards risk, which may differ by licence holder and asked:

> *QUESTION 9: What considerations should Ofcom take into account when determining the split between the Cash Bid and the PQR? What would be an appropriate split?*

6.5 The joint response indicated a preference for a high PQR and low Cash Bid to reflect the uncertainties facing analogue INR services. This broadly agreed with the arguments set out in the Consultation supporting a higher weighting of the PQR element.

6.6 Ofcom will make the final determination regarding the structure of the payments but notes from the joint response that there is preference to have the financial terms should be specified on the basis of a high PQR element.

Section 7

Administrative Details

Application process

7.1 Each licensee wishing to apply for an extension and review of its financial terms must submit the following to Ofcom:

- A formal letter of application requesting an extension and stating the period of the extension required under Section 253 of the Act
- A cheque for the application fee of £20,000 per licence
- Financial information in the required format with a supporting statement; and
- An auditor's letter opining on the basis of preparation of the financial information submitted.

7.2 The official application date will be the date that Ofcom receives the formal letter of application, accompanied by the application fee and the financial information outlined below. An Application must be received by 5pm on the date specified in paragraph 2.15

7.3 If Virgin Radio and talkSPORT choose to follow the accelerated timetable as set out in paragraph 2.6, the deadline is 5pm 28th April. The application must also be accompanied by a letter acknowledging;

- that the revised terms, once accepted, are binding and there is no mechanism for reviewing terms for the extension period once they are announced. This includes the period between the date of announcement of the terms and the date of commencement of the extension period.
- that the revised terms for the extension period will apply to the extension period only. Existing terms will apply to the existing licence period and revised terms will only take effect upon expiry of the current licence period, regardless of how far in advance of that date the terms are determined.
- that if applicants wish to accept the revised terms, then this acceptance must be provided to Ofcom by the date specified by Ofcom (which will not be less than 28 calendar days from the date revised terms are notified to licensees) in its notification.

Required information

7.4 Ofcom considers that it will be important to ensure that licensees provide sufficient information to allow Ofcom to develop an informed view about the value of each licence. However, Ofcom does not wish to place an undue burden on licensees.

7.5 In order to achieve these objectives and still give licensees sufficient opportunity to provide their views, Ofcom will require licensees to submit a minimum set of information, and to make additional information submissions optional.

7.6 Ofcom requires that forecasts can be reconciled to the most recent audited financial statements. The Consultation set out the following minimum set of information from each licensee:

- A profit and loss account, balance sheet and cashflow forecasts, in accordance with proforma statements provided by Ofcom, for the following periods:
  - last reported financial year ('Actual Statements') and the previous financial year if the Actual Statements are not audited.
  - a best estimate of results for the current financial year, capable of being reconciled to statutory accounts for current financial year when they become available ('Current Statements')
  - A forecast of the licensee's results for its next financial period to align them to the licence year end
  - Forecast results on an annual basis until expiry of the hypothetical licence together with an explanation and justification of the key underlying assumptions

For those licensees with an accounting reference period in other than 12 months, the Actual Statements should be based on the 12 months to the current accounting reference date and the licensee should explain the basis for calculating the results for the 12 month period. In the event that the licensee's statutory accounts are published before the terms are announced, the licensee should provide immediately a reconciliation between the results as submitted to Ofcom and the audited results.

7.7 Significant differences between periods provided should be explained. In addition forecasts should be accompanied by sufficient narrative to allow Ofcom to determine that the projections are fair and reasonable.

7.8 Licensees will also provide an analysis of the major fixed assets held by the licensee as at the start of the period covered by the Current Statements, explaining the nature of the assets, whether they are required by the licence holder in order to provide the licensed service and, if so, why, and an estimate of their modern equivalent asset value, where significantly different from the book value.

7.9 To make submissions more straightforward for licensees and more useful for Ofcom, electronic templates will be provided for licensees to complete with the required information. Ofcom expects that licensees will not be required to provide forecasts based on alternative scenarios, but applicants will have the option of supplying such additional information if they are of the view that it will assist Ofcom in assessing their application.

7.10 To the extent that licensees consider that a new entrant would incur significant start up costs, licensees will be invited to provide an estimate of those likely entry costs.

7.11 Licensees will also provide further information to inform Ofcom's assessment of the longer term forecast. This will include a more detailed justification of its revenue forecasts based on forecasts of listening share, share of total hours, price premium, total revenue and the share that is expected to be attributable to each platform. In addition, following comments made on the consultation, Ofcom are expecting licensees to provide a suitably justified bottom-up revenue forecast, reconciled to their top down approach.

7.12 Ofcom reserves the right to request additional information or explanation from applicants, as necessary or appropriate, at any time after the application is made and before a determination is made, in order to complete the review and make its determination. The joint response requested that In light of Ofcom being able to use the most up to date information available in making its determination, the INRs should be allowed to submit further information up to the point of determination, which is one month before the Relevant Date. 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. Ofcom will therefore seek to incorporate consideration of representations made by licensees where it can reasonably do so.

7.13 Ofcom intends to conclude the reviews by the 7th July or no later than one month before the Relevant Date if the applications are received after 28th April 2006. Ofcom considers that, in order to ensure that its determination of new terms is a fair and accurate reflection of the value of the licences; it should take into account available information that has a material bearing on the valuation until the time the review is concluded.

7.14 Accordingly, Ofcom will require the licensee to provide financial information in the required format and an auditor's letter providing assurances relating to the degree of accuracy of historical data and the reasonableness of the calculation of forecast data to be submitted by 28th April 2006 or three months prior to the Relevant Date if the financial information is submitted after 28th April 2006. It should be noted, then, that regardless of when applications for a review are received, financial information should be provided so as to be as up to date as possible at the time that Ofcom makes its determination. The Consultation asked;

QUESTION 10: Is the proposed set of information required from licensees reasonable?

7.15 The joint response broadly agreed that the proposed minimum set of information was reasonable but stated that the information requested should reflect the points raised in response to other consultation questions.

7.16 Ofcom recognises that additional information will be required to fully understand the applicants' business plan and emphasises that the above list is a minimum. As a general point, Ofcom would encourage applicants to provide sufficient evidence to provide Ofcom with a full appreciation of the basis for their submission. Ofcom expects that all communications between Ofcom and applicants will be strictly confidential between Ofcom and the applicant.

Information that Ofcom will provide

7.17 The Consultation recognised that it would be helpful for licensees in deciding whether or not to apply for a review if they have information about the key assumptions that Ofcom plans to use in its forecasts. This will be particularly important because licensees will only be allowed to apply once within the relevant review period. However, Ofcom considers that the assumptions on key drivers may be time sensitive. For this reason, it would not be appropriate to determine specific values far in advance of the application date. In the Consultation Ofcom said it would provide licensees with further information on certain assumptions to be used in its valuations in respect of total radio NAR and digital penetration at a time closer to the licensee's application deadline. The consultation asked:

QUESTION 11: Is it appropriate for Ofcom to provide licensees with further information on certain assumptions to be used in its valuations closer to the earliest possible application date of 30 March 2006

7.18 The joint response requested that Ofcom provide this information at least three months before the requisite application date. The joint response was also concerned about the lack of clarity and visibility in the information that Ofcom proposed to publish prior to each licence application. In particular the assumptions behind the valuation of total radio NAR and the digital penetration forecasts for periods potentially up to 14 years which Ofcom proposes to publish close to a licensee's application deadline.

7.19 Ofcom will provide applicants with further information on certain assumptions as soon as it is able and in advance of the first deadline of 28th April 2006. Ofcom has commissioned independent consultants to produce Digital Penetration forecasts and will be providing the applicants with both the results and the main assumptions behind them. Since the consultation was published Ofcom has been engaged in dialogue with the licensees regarding the potential range of data sources that could be utilised for the purposes of forecasting total radio NAR. As noted in Paragraph 5.54, Ofcom will consider whether it would be appropriate to commission and fund bespoke research on advertising. If it does so, then the results of this will be shared between Ofcom and the INRs. In respect of all of these assumptions, 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. Should this result in a significant change in the assumptions provided to applicants, then Ofcom will provide a revised set of assumptions.

Timetable for notification and licensees' decisions

7.20 Ofcom expects to send a written notification of the determination of new financial terms to any licensee applying for a review one month before the Relevant Date or by 7th July for applications received by the 28th April 2006. The notification will describe the determination made in respect of the Cash Bid and the PQR payable as required by Section 253(8) of the Act. Ofcom will make public the financial terms offered to the licensees shortly after Ofcom has communicated it to them.

7.21 Section 253(12) of the Act requires each licensee to consent to the licence extensions and modifications notified by Ofcom before the licence extension can take effect. The licensees will be required to notify Ofcom in writing of its decision to consent to the terms for the extension within one month of the notification date. Any failure to consent to the licence extension by the date specified in the notification will be deemed to be a rejection of the licence extension grant.

7.22 If the licensee does not accept the licence extension notification then the licence will not be extended. The licence will then expire at the end of its duration and Ofcom will then take steps to utilise the vacated frequency in a way consistent with both Ofcom's stated policy objectives at that time and the statutory obligations upon Ofcom.