Consultation on the methodology for the review of the financial terms for the extensions to the independent national radio licences

Consultation

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Contents

Section 1

Summary

1.1 This consultation seeks views on Ofcom's proposed 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). Responses are invited by 23 December 2005. Ofcom intends to publish a statement on the results of the consultation, including a decision on the final methodology for the reviews, in late January 2006.

Overriding Objective

1.2 Ofcom's overriding objective is to determine a fair and reasonable value of the licences on the basis of a methodology consistent with its statutory obligations. In practice this means estimating 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. These terms should be set in accordance with an objective process to:

> ".. ensure 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"[1] ; and

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

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.

1.7 This consultation document sets out Ofcom's approach to dealing with these issues and arriving at a determination which is consistent with both Ofcom's objectives and Ofcom's statutory duties. Ofcom recognises that there may be alternative

[1] 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

approaches to individual elements of the valuation methodology. However, Ofcom believes that a holistic approach should be adopted and the final methodology should provide a fair and reasonable basis for Ofcom to determine the financial terms for each licence

Statutory requirements

1.8 Section 253(1) 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 1990 Act (“Relevant Date”). Ofcom has set the Relevant Dates at as follows;

Licence	Licence Expiry Date	Relevant Date
Classic FM	30 September 2007	30 June 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 Ofcom is required, in practice, 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.

Detailed proposals

1.14 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.

1.15 Ofcom proposes 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.
- 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.

1.16 On this basis, Ofcom proposes to value each licence and set the financial terms as follows:

- 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 proposes to estimate the net present value of the licence to the incumbent and then adjust this value downwards to reflect the additional costs that a new entrant might incur.
- Without a national licence, a broadcaster could not provide an analogue service. Therefore, all profits made from providing a national analogue service can be attributed to the licence. Ofcom proposes to 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 need to allocate costs and revenues that are common to the national analogue, local analogue and digital platforms. Whilst Ofcom believes that the simplest and most transparent basis of allocation is on the expected percentage of listening hours on each platform, it will look at the evidence supplied by respondents before determining whether a more complex allocation methodology is required.
- 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 all of the revenues and costs from the digital services to the national analogue licence. Instead, the value of the digital rights equals the cost savings to the licence holder from not having to obtain the rights elsewhere.

- It is a requirement of S103A of the 1990 Act (as inserted by S92 of the 1996 Act) that the national analogue licence should be digitally simulcast. To the extent that this is a commercially onerous obligation, such costs will be deducted from the valuation of the licence.
- The licence will be valued through a discounted cash flow and 12 year licence and payment terms will be derived from that valuation. The terms offered to licensees will reflect the payments that would be generated from the terms derived from the 12 year licence valuation exercise being applied to the expected revenues of the licence holder for the four year extension period.
- Based on its own analysis, Ofcom proposes to use a nominal, pre-tax discount rate of 15% for all licence valuations.
- In the past, the Radio Authority aimed to recover approximately 75% of the surplus value of each licence via variable payments based on PQR payments and the remaining 25% via the annual fixed cash sum payments. Ofcom proposes to reconsider the split between the PQR and cash sum and invites views.

Section 2

Background

2.1 Section 253 of the Act allows the INRs to apply for extensions to their licences which 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 PQR. Licensees' current payment terms are set out in Annex 5 of this document.

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 they 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 Given that the existing expiry dates for the licences are spread across a fifteen month period, the Relevant Dates are also similarly spread. Ofcom informally consulted licensees on the timetable for the application process in August 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 this basis, Ofcom has determined that applications will need to be dealt with in turn, as close as possible to the Relevant Date.

2.4 In practice, Ofcom considers that the Relevant Date should be fifteen months before the date the licence expires. This provides the minimum period which, in Ofcom's opinion, would be 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.

2.5 The INRs are allowed to apply once for their extension at any time during the time period that starts three-years before the current licence expires and ends three months before the Relevant Date. Licensees have the right to apply as early or as late within this period as they wish. However, Ofcom considers that in respect of the cash bid element of the terms, it must consider the outcome of a Hypothetical Auction which would occur at some point soon after the Relevant Date. Therefore, notwithstanding licensees' right to apply for a review at any time within the three year period, Ofcom will use the most up to date information available in making its determination in respect of modifying the licence extension terms and conditions and will seek to incorporate all available information up to the point of determination, which will be approximately one month before the Relevant Date.

2.6 In circumstances in which an actual auction were held for a fresh licence under section 98(1) of the 1990 Act, potential applicants would determine their cash bids by forecasting what they estimate the value of the licence over the entire term is likely to be. Ofcom believes that it should, so far as possible, reflect the date on which such an auction would be conducted when considering the outcome of a Hypothetical Auction in the case of a licence extension.

2.7 If the INRs submit their applications at the earliest opportunity, this could potentially be nearly two years in advance of the date of the at which such an auction would theoretically be held. If Ofcom made its determination based on the information available and provided on the date of the application, Ofcom would have to determine what the cash bid in the auction would be substantially in advance of the point in time at which such an auction would theoretically be held. Such a time lag would mean that the setting of terms would therefore be subject to a likely reduction in accuracy due to the assumptions that would need to be made about the intervening period.

2.8 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 by bidders at the latter date. Ofcom considers that if such an event occurred 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. The risk increases as the length of time between the Relevant Date of the licence and the date on which the terms of the extension are determined increases.

2.9 Section 98(3) of the 1990 Act indicates what is required in an application for a national licence. Included in the national licence application is information Ofcom may reasonably require as to the applicant's present financial position and his projected financial position during the period for which the licence would be in force.[2] Under S98(4) of the 1990 Act, Ofcom may request additional information as it may reasonably require to supplement that provided as to the applicant's present financial position and his projected financial position during the period for which the licence would be in force.

2.10 It would be expected that using the most up to date financial information both in relation to the licensees' valuation of the licence and the financial viability of the proposed service under S99 of the 1990 Act would deliver a more accurate valuation and a fairer outcome. Ofcom therefore proposes that it will carry out the financial review as near to the Relevant Date as practically possible, regardless of when the application was submitted. Ofcom will endeavour to take into account all information available to it up to the point at which Ofcom makes its determination of financial terms for the review, which is likely to be approximately one month before the Relevant Date.

2.11 Where Ofcom have granted the licensees an extension to their licence it 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.

2.12 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 para 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.

2.13 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.

[2] Section 98(3)(e)(i) BA

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.

2.14 Ofcom will consult on its policy objectives in this regard as part of a broader consultation on the future of analogue radio licensing. This consultation is expected to commence in 2006. The outcome of this consultation will form the basis for Ofcom's policy in respect of the future use of these frequencies.

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

Date	**Activity**
16 November 2005	Consultation document published. Consultation period begins.
23 December 2005	Consultation period closes
late January 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
30 March 2006	Closing date for Classic FM to submit extension application.
30 May 2006	Extended financial terms offered to Classic FM
30 June 2006	Relevant Date for Classic FM Deadline for Classic FM to accept extended financial terms.
30 October 2006	Closing date for Virgin Radio to submit extension application
31 December 2006	Extended financial terms offered to Virgin Radio
31 January 2007	Relevant Date for Virgin Radio Deadline for Virgin Radio to accept extended financial terms
29 June 2007	Closing date for application for talkSPORT to submit extension application
31 August 2007	Extended financial terms offered to talkSPORT
30 September 2007	Relevant Date for talkSPORT Deadline for talkSPORT to accept extended financial terms

2.16 Ofcom is inviting views on specific questions in relation to the methodology for determining new financial terms. The consultation questions are highlighted and italicised in the main document and listed in Annex 4. The time period for this consultation is five weeks and the consultation is due to close on 23 December 2005. Generally, Ofcom aims to allow ten weeks for responses to consultations. However, in this case, a shortened time period is necessary in order to allow licensees sufficient time to prepare their applications after the final methodology document is published and prior to the latest application date for an extension of the licence terms for Classic FM, which is 30 March 2006. Ofcom intends to publish a statement on the results of the consultation, including a decision on the final methodology for the reviews, in late January 2006.

Section 3

Statutory Requirement

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 (the "cash bid") to be paid, 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 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 sum. 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.

3.4 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 was likely to have been the level of cash bid for the licence.

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 both the objectives and the uncertainties discussed below.

3.6 The circumstances proposed by Ofcom for the 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.

Hypothetical Auction process

3.8 In order to set a framework to determine an amount that would be bid for each licence in a competitive tender, it is necessary first to establish the circumstances of the Hypothetical Auction process that Ofcom aims to consider.

3.9 The 1990 Act specifies a 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 believes that it must assume in its valuation that the incumbent licence holder would win the auction, and therefore would be the highest bidder.

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

3.11 Ofcom considers that the bid of the incumbent will 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.

3.12 It seems 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 believes it is appropriate to assume that there would be competing bidders for all of the licences because they would be valuable to new entrants. Ofcom considers that the identities of competing bidders with the highest valuations are 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 radio service.

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

Estimating the incumbent's bid

3.13 Ofcom considers 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. However, Ofcom believes that the value realised in a competitive auction should in principle 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. However, 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.

3.14 Ofcom considers 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. However, in reality, it is likely that a risk-averse incumbent would bid an amount greater than that suggested above, for the following reasons:

3.15 The individual circumstances of alternative bidders could affect the incumbent's estimates of their entry costs. For example, an existing licensee may have lower up-front marketing costs if it has an established brand. This possibility may persuade the incumbent to bid a higher amount.

3.16 Similarly, if the incumbent considers that there is a risk that a potential bidder could bring some of its own value to the licence, such as premium content or cost efficiency, that is equivalent to or greater than that of the incumbent, the incumbent may bid a higher amount. Given that alternative bidders with the highest valuation would most likely be existing broadcasting companies, Ofcom considers that this would be a real possibility.

3.17 The incumbent would also need to take account of the possibility that a new entrant may be overly optimistic about the value of the licence. There is therefore a risk that a new entrant may therefore bid an amount that appears to be irrationally high given the information on the value of the licence to the new entrant that is available to the incumbent.

3.18 Ofcom believes that it would be very difficult to quantify the effects of the above considerations on the amount the incumbent would bid for the licence. Therefore, Ofcom proposes 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.

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?*

Determining the relevant period for valuation

3.19 There are two distinct steps which Ofcom must take when calculating the revised PQR and Cash Bid for the purposes of setting financial terms which will apply to an extension period. Firstly, Ofcom must determine the appropriate value to apply to the extension period. Secondly, Ofcom must then set a Cash Bid and a PQR which, when applied to the amounts of qualifying revenue expected to be achieved during the period, will recover an amount of additional payments equal to the value determined. The amount of qualifying revenue to which the PQR must be applied is the qualifying revenue that is expected to be achieved by the incumbent licensee during the four year period for which the licences are extended.

3.20 Although 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.

3.21 The extensions in question will extend the current licence renewal period from a total duration of eight years to a total duration of 12 years. Therefore Ofcom considers that the appropriate basis on which to conduct the valuation of the extension is to base this 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. Ofcom will conduct a 12 year valuation and set a PQR and a cash bid to recover the value of the 12 year licence from the qualifying revenue that would be expected over the duration of the licence. The resulting PQR and cash bid would then be used to set the revised terms for the four year extension. The outcome of this process will be that licensees who accept the terms of the extension will, during the four year extension period, make total payments which would be consistent with the payments that might be expected to be made during the first four years of a twelve year licence, as determined by the outcome of the Hypothetical Auction.

3.22 As noted previously, 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 proposes to exercise its discretion so as to set the same PQR rate 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.

3.23 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

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

3.25 Ofcom's reading 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 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] 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 when the statement is published, which will set out its interpretation of qualifying revenue, the process of weighting the two categories of qualifying revenue and the methodology for calculating PQR payments.

3.26 Because in commercial practice the revenues from the national analogue services are often not formally separated from the revenues of the simulcast, Ofcom must determine the appropriate way to define the relevant pool of revenues that can be considered qualifying revenue. The definition of qualifying revenue can be different from the definition of revenue taken into account for the purposes of valuing the licence. The latter partly determines the absolute sums expected to be paid over the course of the licence through additional 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. Ofcom considers that for the purposes of defining qualifying revenue, it will maintain the approach used by the Radio Authority in its Statement of Principles. This means that for the purposes of defining qualifying revenue and setting the percentage of qualifying revenue to be paid in additional payments, qualifying revenue will be determined through apportionment based on the respective shares of the expected volume of listening on platforms giving rise to qualifying and non qualifying revenue.

Section 4

Approach to licence valuation

General approach

4.1 As discussed earlier, Ofcom believes that it is required to consider the value of the rights and obligations associated with the full licence, including both the analogue and digital radio elements, when determining the amount that would be bid for the licence in a competitive tender and when setting payment terms for the licence.

4.2 The holding of an INR licence confers certain rights and benefits upon the licence holder. These include the right to broadcast on scarce analogue frequency and reserved capacity on the national digital multiplex on more financially favourable terms for carriage than digital only service providers. The holding of an INR licence also confers certain obligations and costs upon the licence holder. These include a commitment to simulcast the national analogue service on the national digital multiplex.

4.3 Under an auction held for a fresh licence under section 98(1) of the 1990 Act the right to broadcast on scarce analogue frequency would be available to a fresh bidder. The purpose of the valuation exercise is to reflect the value of a four year extension to the existing eight year renewal. This extension period involves the licensee benefiting from all the rights and benefits and being subject to the obligations and costs conferred by their existing renewed licence. Therefore, Ofcom considers that it is fair and reasonable that all of these factors are reflected in the terms which will be offered to licensees for the period of the licence extension and that this should be done on the basis of a bidder's valuation of these factors in a competitive auction, since the legislation appears to guide Ofcom towards considering the value of the licence in this context.

4.4 Ofcom judges 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.

Right to reserved capacity on the national digital multiplex

4.5 A broadcaster could replicate the right to broadcast on the national digital multiplex by obtaining a digital sound programme service licence from Ofcom at minimal charge. Therefore, Ofcom considers that there is minimal value associated with this aspect of the digital simulcast.

4.6 Under s48 of 1996 Act the INRs currently have reserved capacity on a national digital multiplex for the period of their renewed and extended licence. The INRs make payments towards the operation of the multiplex and are obliged to pay a percentage of revenue derived from the digital simulcast to the National Multiplex operator. Unlike the non simulcast services they do not pay any additional fees related to the size of the audience as they promote digital radio on their analogue broadcasts. Ofcom considers that the value of the right to reserved capacity equals the difference between the total carriage fees that would be charged by multiplex operators, including the cost of operating the multiplex and the charge for carriage paid by the non simulcast services plus the incremental cost of the analogue inventory used to promote digital radio. Ofcom believes that due to the relatively low audience listening to services on the national digital multiplex these differential figures are currently low, but will increase as the uptake of digital radio increases. Ofcom proposes to estimate the net present value of the right to reserved capacity on this basis. Given that there is no available capacity on the multiplex at present, Ofcom believes that this is demonstrative of demand for such capacity. Ofcom therefore expects that this right is likely to have a positive net present value, as evidenced by the commercially based decision to take carriage by existing operators.

Obligation to simulcast on the national digital multiplex

4.7 The costs of digital simulcasting on the national digital multiplex will be excluded except for those incremental costs which an INR licence holder would incur over and above those that a non INR licence holder would incur if broadcasting on the national digital multiplex.

> ***Question 3****: Is Ofcom's proposed methodology for estimating the value of the rights and obligations of digital simulcasting on a national multiplex reasonable?*

Right to broadcast on scarce analogue spectrum

4.8 The right to broadcast on scarce analogue spectrum cannot be replicated in the market. Access to analogue spectrum is highly regulated and restricted. Ofcom must, therefore, identify the value of the right to broadcast on scarce analogue spectrum absent these market benchmarks.

4.9 Ofcom will value the right to broadcast on scarce analogue spectrum by undertaking a discounted cashflow calculation. Details of the proposed methodology for the discounted cashflow calculation, including the means by which Ofcom proposes to estimate the value that can be attributed to the analogue element of the licence, are in the following sections.

Financial Base Year

4.10 The base year to which future forecasts will be applied will be the actual revenues and costs of the present Licence holder in the year immediately before the Relevant Date.

Approach to revenue projection

4.11 Ofcom must determine a value for each INR that develops a separate forecast of advertising revenue. In Ofcom's view the most appropriate way to do this is to develop top down approach, deriving growth figures for each of the INRs with reference to a common Net Advertising Revenue (NAR) forecast for the radio industry as a whole. Ofcom is minded to use the Long Term and Short Term Forecasts of advertising spend published by the Advertising Association at the time of the assessment of the applications.

4.12 Ofcom will make its own assumptions regarding the transfer of listeners and advertising from analogue to digital, but will take due account of representations made by applicants on this issue.

> ***Question 4****: Is the proposed approach to forecasting advertising revenue the best approach available? Is the Advertising Association forecasts the most appropriate global benchmark to use, if not what other sources should be used and why?*

Approach to cost projection

4.13 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. Ofcom proposes 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 proposes that it is 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 will 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 will also have regard to relevant relationships between expenditure and revenue, for example the relationship between the programming budget and advertising revenue.

Market Shares

4.14 Ofcom will form its own opinion 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.

Apportionment of audience, revenues and costs

4.15 Empirically, broadcasters earn a relatively small amount of revenue for the separate provision of services on digital platforms, compared to the revenues available from an analogue service. The limited revenue is primarily reflective of relatively small audiences and the more limited reach available on digital platforms.

4.16 In the case of Virgin Radio a similar but more significant issue occurs in relation to its FM service in London. Whilst this is a separately licensed service, its output, with the exception of 21 hours off peak programming per week, is a simulcast of the national AM service. Unlike digital, the service attracts a significant proportion of the total Virgin Radio audience (37% of analogue listener hours–RAJAR Q3 2005) with part of the airtime sold separately (namely Sponsorship and local advertising during the London only programming and National advertising broadcast only on the FM).

4.17 In respect of the cost base, a large proportion of each broadcaster’s cost base is common to provision of the service on all platforms.

4.18 Therefore, in order to value cashflows for only the analogue service, it will be necessary to apportion revenues and common costs between the analogue and digital services and, in the case of Virgin Radio, also between the local and national services. In respect of valuing the rights associated with the national analogue licence, the relevant cashflows will be those that are apportioned to the national analogue service. As noted previously, the apportionment of revenues and costs for the purposes of valuing the licence does not have to be the same basis of apportionment used for the purposes of defining qualifying revenue.

4.19 For the purposes of establishing the value of the analogue rights, Ofcom considers that apportionment on the basis of listener hours remains the most transparent method. However, in some respects, apportionment on the basis of hours alone may not be a true indicator of the value of listening on each platform. Ofcom will consider the available evidence to establish where differential rates for listener hours exist for AM analogue, digital and FM listening. If robust and credible data does exist then Ofcom will consider whether to forecast revenue on a 'bottom' up calculation of the separate revenue streams rather than a uniform rate. This would be a departure from the previously used top-down apportionment of total revenues by platform that was undertaken in previous reviews.

4.20 As a general principle, the use of an apportionment approach as outlined would be expected to represent a reasonable proxy through which the analogue, digital, national and local 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, as set out earlier in this consultation.

***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 the current differential rates and how they will move in the future?*

4.21 As described previously, for administration purposes in calculating and collecting qualifying revenue, 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. Although 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 each platform.

Listener Migration Value

4.22 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. A new bidder for the national analogue licence would be aware of the growth in digital radio services. Holding a national analogue licence during the period in which the digital market is growing would potentially confer an advantage to the analogue licence holder in the post-analogue world. This is because listeners would have greater familiarity with the analogue service when they migrate to the digital environment. Listening on the digital platform is likely to be higher for those stations where the listener is already familiar with the service due to their experiences on analogue.

4.23 A new bidder would recognise this and may reflect this advantage in the amount it would be prepared to bid for the licence. Ofcom considers that such a value is likely to exist and may not be insignificant, although Ofcom also recognises that estimating such a value in a robust way may be difficult and invites views as to how it might approach this task.

Question 6*: 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?*

Costs of entry and residual costs

4.24 As discussed earlier, Ofcom believes that an incumbent would take account of the estimated costs of entry for potential alternative bidders when calculating its bid for a licence. Ofcom proposes to include an allowance for the cost of assets required to operate the business or to meet the requirements of the licence. Ofcom believes that the most objective method for determining the amount of this allowance in the valuation would be to use the net book value of assets on the existing operator's balance sheet. However, Ofcom recognises that the net book value may not be an accurate means of estimating the cost to a new entrant of acquiring the asset. Furthermore, a new entrant may use off balance sheet methods of financing and may utilise assets which are different from those which were purchased historically by the existing operator. Therefore, Ofcom proposes to consider submissions from licensees on their views as to the value and scope of modern equivalent assets required for the operation of the licence and the methods of financing that would be utilised in gaining access to such assets. Ofcom will only include such costs in the valuation to the extent that Ofcom considers such costs would reasonably be assumed to be incurred by a new entrant.

4.25 Ofcom recognises that a new entrant would also be likely to consider other start up expenses which are not asset related, such as marketing costs to establish a listener base. However, estimating these costs in a robust way would be difficult. Ofcom invites proposals on the types of costs that should be taken into account and a reasonable method for quantifying these costs.

4.26 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. To the extent that any value may arise related to the station beyond the licence period, this is likely to be already be substantially accounted for within the listener migration value.

Question 7*: 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?*

Discount rate

4.27 In Ofcom's view, 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.

4.28 Ofcom has considered the possibility that a licence held by a pure radio company may carry greater risk than one held by a more diversified media group, and therefore may warrant a higher discount rate. However, Ofcom considers that, if this is the case, it would be difficult to translate into differential estimates in a robust manner and that it may make very little difference to the result. Therefore, Ofcom proposes to use a single discount rate in the valuation of all licences.

4.29 In the context discussed above, Ofcom has 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 proposes to use a nominal, pre-tax discount rate of 15% in the licence valuations. Annex 6 of this document provides further information on the methodology and assumptions used to arrive at this rate. Ofcom reserves the right to use a different WACC if market conditions indicate that it may have significantly changed.

4.30 Ofcom invites views on the proposed discount rate with supporting evidence.

***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.*

Section 5

Calculation of financial terms

5.1 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

5.2 Ofcom believes that there would continue to be advantages to recovering a high proportion of the licence fees through a PQR, and whilst it may make sense to collect a higher proportion of the licence fees in this manner, in considering the results of a hypothetical auction it would be expected that there would be a non nominal level of cash bid. A higher proportion of PQR 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.

5.3 Ofcom recognises that there are also 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. The continued development of Digital platforms and alternative forms of delivery has introduced ever increasing problems on how to calculate the analogue audience and apportion the revenue. A move towards a higher cash bid element reduces the impact of this problem whilst a higher fixed cash sum would give licensees more certainty about their future payments.

5.4 Ofcom considers 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. Ofcom must make the final determination regarding the structure of the payments but invites views on how it should exercise its discretion in this regard and on the appropriate split between the PQR and cash sum.

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?*

Section 6

Administrative Details

Application process

6.1 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
- An assurance that the financial data will be provided at the appropriate date

6.2 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.

Required information

6.3 For the renewal, the Radio Authority required licensees to submit detailed eight-year business plans, apportioned between the analogue and digital businesses, supported by written commentary to inform the licence valuations. 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, particularly in light of the long period that will have passed since the date of the last audited financial data at the time of the earliest application date. However, Ofcom does not wish to place an undue burden on licensees.

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

6.5 Ofcom proposes to require the following minimum set of information:

- The licensee's results for its last reported financial year (the "Actual Statements"), to include a profit and loss account, closing balance sheet and a cashflow statement to be presented in accordance with proforma statements to be provided by Ofcom and reconciled to the licensee's statutory accounts for its last financial year. 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.
- The licensee's best estimate of its results for its current financial year (the "Current Statements"), to include a profit and loss account, closing balance sheet and a cashflow statement to be presented in accordance with proforma statements to be provided by Ofcom. The Current Statements should be based on the licensee's best estimate of the Actual results for the year based at the time of the application. The Current Statements should be capable of reconciliation to the licensee's statutory accounts for current financial year when they become available. 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.

- A forecast of the licensee's results for its next financial year (the "Current Forecast Statements"), to include a profit and loss account, closing balance sheet and a cashflow statement to be presented in accordance with proforma statements to be provided by Ofcom together with an explanation of significant differences between the Current Statements and the Current Forecast Statements.
- Forecast results for the twelve year period from the start of the licence extension to be presented in accordance with proforma statements to be provided by Ofcom together with an explanation and justification of the key underlying assumptions.
- 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, why they are required by the licence holder in order to provide the licensed service and an estimate of their modern equivalent asset value, where significantly different from the book value.

6.6 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.

6.7 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. Licensees will also be invited to provide further information to inform Ofcom's assessment of the longer term forecast. This may 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.

6.8 Ofcom proposes to hold working-level meetings with licensees to assist them in preparing their applications.

6.9 Ofcom would reserve 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.

6.10 Ofcom intends to conclude the reviews and no later than one month before the Relevant Date. 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.

6.11 Accordingly, Ofcom will require the licensee to provide financial information in the required format and an auditor's letter providing various assurances relating to the financial information to be submitted three months prior to the Relevant Date. 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.

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

Information that Ofcom will provide

6.12 Ofcom recognises that it will 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. Therefore, Ofcom proposes to provide licensees with further information on the assumptions to be used in its valuations for, at a minimum, total radio NAR and digital penetration at a time closer to the licensee's application deadline. For the licence with the earliest expiry date, Ofcom expects to provide this information by early-February.

> ***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?*

Timetable for notification and licensees' decisions

6.13 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. 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:

6.14 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 from one month after notification will be deemed to be a rejection of the licence extension grant.

6.15 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.

Annex 1

Responding to this consultation

How to respond

Ofcom invites written views and comments on the issues raised in this document, to be made by **5pm on 23 December 2005** - extended on 7/12/05 to 6th January 2006.

Ofcom strongly prefers to receive responses as e-mail attachments, in Microsoft Word format, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), among other things to indicate whether or not there are confidentiality issues. The cover sheet can be downloaded from the 'Consultations' section of our website.

Please can you send your response to gary.carey@ofcom.org.uk.

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

Gary Carey
Competition Finance
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 7983 4303

Note that we do not need a hard copy in addition to an electronic version. Also note that Ofcom will not routinely acknowledge receipt of responses.

It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 3. It would also help if you can explain why you hold your views, and how Ofcom's proposals would impact on you.

Further information

If you have any want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Gary Carey on 020 7783 4393.

Confidentiality

Ofcom thinks it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt (when respondents confirm on their response cover sheer that this is acceptable).

All comments will be treated as non-confidential unless respondents specify that part or all of the response is confidential and should not be disclosed. Please place any confidential parts of a response in a separate annex, so that non-confidential parts may be published along with the respondent's identity.

Ofcom reserves its power to disclose any information it receives where this is required to carry out its legal requirements. Ofcom will exercise due regard to the confidentiality of information supplied.

Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use, to meet its legal requirements. Ofcom’s approach on intellectual property rights is explained further on its website, at www.ofcom.org.uk/about_ofcom/gov_accountability/disclaimer.

Next steps

Following the end of the consultation period, Ofcom intends to publish a statement around the end of January.

Please note that you can register to get automatic notifications of when Ofcom documents are published, at http://www.ofcom.org.uk/static/subscribe/select_list.htm.

Ofcom's consultation processes

Ofcom is keen to make responding to consultations easy, and has published some consultation principles (see Annex 2) which it seeks to follow, including on the length of consultations.

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

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

Vicki Nash
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA
Tel: 0141 229 7433
Fax: 0141 229 7401
E-mail: vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

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

Before the consultation

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

During the consultation

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

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

A2.5 We will normally allow ten weeks for responses to consultations on issues of general interest.

A2.6 There will be a person within Ofcom who will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. This individual (who we call the consultation champion) will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why. This may be because a particular issue is urgent. If we need to reduce the amount of time we have set aside for a consultation, we will let those concerned know beforehand that this is a 'red flag consultation' which needs their urgent attention.

After the consultation

A2.8 We will look at each response carefully and with an open mind. We will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

A3.1 In the interests of transparency, we will publish all consultation responses in full on our website, www.ofcom.org.uk, unless a respondent specifies that all or part of their response is confidential. We will also refer to the contents of a response when explaining our decision, without disclosing the specific information that you wish to remain confidential.

A3.2 We have produced a cover sheet for responses (see below) and would be very grateful if you could send one with your response. This will speed up our processing of responses, and help to maintain confidentiality by allowing you to state very clearly what you don’t want to be published. We will keep your completed cover sheets confidential.

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

A3.4 We strongly prefer to receive responses in the form of a Microsoft Word attachment to an email. Our website therefore includes an electronic copy of this cover sheet, which you can download from the ‘Consultations’ section of our website.

A3.5 Please put any confidential parts of your response in a separate annex to your response, so that they are clearly identified. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only so that we don’t have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

What do you want Ofcom to keep confidential?

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

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

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response. It can be published in full on Ofcom's website, unless otherwise specified on this cover sheet, and I authorise Ofcom to make use of the information in this response to meet its legal requirements. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

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

Name　　　　　　　　Signed (if hard copy)

Annex 4

Consultation questions

A4.1 Comments are invited on any aspect of the consultation document. However, we are inviting views, specifically, on the following questions:

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?

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 4: Is the proposed approach to forecasting advertising revenue the best approach available? Is the Advertising Association forecasts the most appropriate global benchmark to use, if not what other sources should be used and why?

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 the current differential rates and how they will move in the future?

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?

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?

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.

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?

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

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?

Annex 5

Licencees' current payment terms

Licensee	Percentage of Qualifying Revenue	Fixed Annual Cash Sum Payable in 2005 (£k's)
Classic FM	14%	1,134
Virgin Radio	12%	1,098
talkSPORT	6%	549

Annex 6

Cost of capital calculation

Summary

A6.1 As discussed earlier, Ofcom's view is that the value of the winning bid in a hypothetical auction can be approximated by the valuation of the second-highest bidder and that the second-highest bidder would be an existing media company. In order to be consistent with the proposed circumstances of the hypothetical auction, Ofcom's proposed discount rate is intended to reflect the opportunity cost of investment faced by a hypothetical entrant that is assumed to be an existing media company.

A6.2 Ofcom has calculated a nominal pre-tax rate of 15%. This rate is intended to reflect the weighted average cost of capital (WACC) of a hypothetical entrant. The calculation used to reach this value (set out below) is based on data and assumptions relating to the existing licensees and other relevant comparators.

Introduction

A6.3 The discount rate applied to the forecast cash flows in an NPV analysis should reflect the opportunity cost to all the relevant capital providers, weighted to their relative contribution to the company's total capital base. This is approximated by calculating the firm's Weighted Average Cost of Capital (WACC). The opportunity cost that is borne by a class of investor is equal to the rate of return that investors could expect to earn on other investments of equivalent risk.

A6.4 A number of different asset pricing models exist for calculating the cost of capital. In addition to the Capital Asset Pricing Model (CAPM), which measures market risk via a single beta coefficient measured relative to a market portfolio, there are, for example, multifactor models which measure market risk using multiple risk coefficients estimated relative to different factors.

A6.5 Ofcom's preferred approach is to use the CAPM. The CAPM has a clear theoretical foundation and its implementation is simple and well established relative to that of other asset pricing models. This results in the continued wide use of the CAPM by the UK's economic regulators, and its wide use amongst practitioners.

A6.6 Under the CAPM the WACC is calculated according to the following formulae:

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

A6.7 A number of the key aspects of cost of capital estimation were assessed in Ofcom's recent consultation on risk and the cost of capital. For details, see the following documents (henceforth collectively referred to as "the risk consultation"):

- January 2005 –first consultation: http://www.ofcom.org.uk/consult/condocs/cost_capital
- June 2005 – second consultation: http://www.ofcom.org.uk/consult/condocs/cost_capital2; and
- August 2005 –final statement: http://www.ofcom.org.uk/consult/condocs/cost_capital2/statement.

Estimating discount rates

A6.8 Some of the parameters that influence the WACC calculation, specifically gearing ratios, equity betas, and debt premium may vary on a firm-by-firm, and hence potentially on a licence-by-licence, basis. However, Ofcom is proposing to apply a single discount rate in its NPV analysis for all of the licences. Ofcom is not aware of any factors that obviously point towards differences in the appropriate parameter values across the three licences.

A6.9 Ofcom has based its parameter estimates based on publicly available data for comparator companies that Ofcom has judged to have systematic risk profiles that are comparable to what would be expected of a hypothetical entrant.

A6.10 This data is clearly unavailable on a licence-by-licence basis. Any adjustments made to this data to reflect licence-by-licence variations would be highly subjective. Ofcom has therefore based its analysis on the above country-wide indicators, erring on the side of conservative (i.e. high) estimates where appropriate in order to reflect any regional or national variations.

Risk free rate

A6.11 The risk free rate measures the expected rate of return on a risk free investment.

A6.12 Ofcom uses current estimates of yields on nominal gilts as a proxy for the risk free rate, the objective as outlined above being to obtain a forward-looking estimate of the risk free rate. Recent returns on nominal gilts have been low by historical standards, with yields on gilts of all maturities having typically been below, and in many cases some way below, 4. 5% for a number of months. As outlined in the risk consultation, Ofcom considers that, given very low current yields and following regulatory precedent it is appropriate to put some weight on longer-term data in order to arrive at a forward-looking estimate. As explained in the risk consultation (final statement), a real figure of 2.0% was recently used in the PricewaterhouseCoopers report, *Rates of return for FSA prescribed projections*, June 2003, and corresponds to a nominal value of 4.6%. We have used this value in our calculations.

Equity risk premium

A6.13 The equity risk premium is the difference between the overall return on equities and the nominal risk free rate. Its value in the UK reflects the risk of investing in UK equities generally. There is considerable debate about the appropriate method of calculating the value of the equity risk premium and the calculation is problematic because different methods produce different values. In particular, methods based on an analysis of current market expectations tend to give lower values than those based on analysis of historical estimates from stock market data. Also, determining current market expectation is a difficult and controversial task. Estimates based on historical stock market data can also vary widely depending on the time period of the data used.

A6.14 Ofcom has used a value of 4.5% for this calculation. This is based on giving weight to a number of estimates, including those based on all of: (1) historical data; (2) ex-ante estimation; and (3) survey data. A full description of the sources used by Ofcom in arriving at this final estimate is set out in the risk consultation.

Equity beta

A6.15 The value of a company's equity beta measures the movements in returns (as measured by the sum of dividends and capital appreciation) from its shares relative to the movement in the return from the equity market as a whole. A discussion of some of the key issues in beta is provided in the risk consultation, particularly in the second consultation and final statement.

A6.16 Based on data obtained from the LBS Risk Measurement Service, Ofcom has carried out an analysis of the equity betas of a number of players in the UK media sector within the last 1-2 years, with particular weight put on companies with significant operations in the radio sector. This analysis suggested that asset betas within the sector vary from around 1.0 to about 1.4, with an average in the region of 1.1-1.2. Given that betas for companies focusing on radio have frequently between towards the top end of this range, Ofcom considers that a value of 1.3 represents an appropriate estimate of the asset beta of a hypothetical bidder. This suggests an average equity beta of 1.45 at a gearing ratio of 10% (see below). This figure reflects the relatively high level of systematic risk (relative to an average firm) inherent in this industry.

Tax rate

A6.17 Ofcom has assumed an effective tax-rate of 30%, i.e. the UK statutory rate. This approach is commonly used by regulators in the UK.

A6.18 Ofcom considers that it is appropriate to carry out its analysis on a pre-tax basis, and hence has estimated both future cash flows and the cost of capital in pre-tax terms.

A6.19 Ofcom recognises that, where results calculated on a pre-tax and post-tax basis are likely to differ materially, and sufficient data is available to enable a robust tax calculation, that a post-tax DCF analysis may be preferable in some cases. The post-tax approach will yield valuation results that most accurately reflect the value of future cash flows and tax payments. However, Ofcom's view is that the use of a pre-tax calculation is preferable in this instance.

A6.20 Ofcom intends to estimate the value of the licences based on an estimate of the costs and time preferences of a new entrant, relating only to the licences in question. In order to make a tax calculation on this basis, it would be necessary for Ofcom to make a series of assumptions in respect of variables such as tax rates, the timing of tax payments, interest payments, capital structure, capital allowances, and so on. Ofcom's view is that such assumptions cannot be made with any certainty given that such standalone activities are not currently observable, and that, under these circumstances, the use of a pre-tax approach is preferable.

Optimal gearing

A6.21 Under the standard Capital Asset Pricing Model a firm can potentially lower its overall cost of capital by increasing its gearing. This is because debt is generally cheaper than equity as a result of tax advantages to debt.

A6.22 Companies in this sector tend to take on relatively small amounts of debt. Based on an assessment of recent industry gearing averages, and a view that this activity is characterised by a relatively high level of systematic risk (see above for comparator asset beta figures), Ofcom's view is that a central assumption of a gearing ratio of 10% is appropriate.

Debt premium

A6.23 The cost of corporate debt is made up of a risk free component and a company specific risk premium. Ofcom's view is that a hypothetical entrant into these markets is not likely to be highly financially geared, based on the optimal gearing set out above. This means that the debt premium is, relatively speaking, not a key input into the WACC calculation as changes in the debt premium do not have a material effect on the overall rate. We have assumed a range of 1-2%, with an average of 1.5%, based on recent market data and the likely size and credit ratings of licensees.

Conclusion

A6.24 Ofcom has estimated a single discount rate to be used in the licence valuations. This discount rate is based on the WACC of a hypothetical entrant into the Radio advertising market. Ofcom's estimate for a nominal post-tax WACC is **15.0%** (rounded up from 14.9%). A summary of the components of the WACC calculation follows:

Summary of calculation

Variable	Estimate
Risk-free rate	4.6%
Equity risk premium	4.5%
Equity beta	1.45
Cost of equity (post tax)	11.1%
Debt premium	2.0%
Cost of debt (pre tax)	6.6%
Corporate tax rate	30%
Cost of debt (post tax)	4.6%
Gearing	10%
WACC (post tax)	10.5%
WACC (pre tax)	**15.0%**