Reviews of financial terms for Channel 3, Channel 5 and Public Teletext licences

13 October 2004

Introduction

- Ofcom announcing today valuation methodology for reviews of financial terms of Channel 3, Channel 5 and Public Teletext licences
- Ofcom has also confirmed today that it will allow Channel 5 and Teletext licensees to request reviews of financial terms to same timetable as Channel 3, i.e. from 31 December 2004
- We will describe the background to this process, and then main elements of methodology.

Background - 1

- Channel 3, Channel 5 and Public Teletext Licensees make licence payments to the Treasury for their broadcasting licences. Payments consist of a fixed annual sum (“cash sum”) plus a percentage of qualifying revenue (“PQR”).

- In accordance with Communications Act, and following earlier consultations by Ofcom, all licensees may now apply for reviews of their financial terms from 31 December 2004. Following an application, Ofcom must determine new financial terms. Review expected to be concluded by the end of June 2005.

- Current terms based on the ITC’s assessment of the value of the licences at the time of the last reviews (1999-2003) after allowing a reasonable rate of return. Terms intended to recover analogue cashflows over duration of licence. Licence payments of around £280m in 2003 for C3, C5 and Teletext.

- Review leads to statutory determination, not negotiation.

Background - 2

Licence reviews taking place against background of significant regulatory change:

Digital replacement licences

New licences to replace existing analogue licences by end of 2004. DRLs primarily digital terrestrial (DTT), with right to simulcast in analogue till digital switchover (DSO). DRLs proposed to contain obligations to achieve DSO. DRL consultation now under way. Formal offer in November. DRLs to be in place by 29 December 2004.

Existing financial terms carry forward to DRLs, but licensees may ask for reviews from 31 December 2004. Cable and satellite activities not licensed by DRLs, though may be affected by holding DRLs.

PSB review

New 5 yearly review of PSB, as set out in Communications Act. Ofcom proposals published on 30 September, include potential changes to certain PSB obligations.

Ofcom's objectives

Ofcom considers that alignment of timing of these processes should help to create a more coherent regulatory environment for licensees.

More broadly, Ofcom has identified three objectives for the process, consistent with its statutory duties:

- To determine fair and reasonable value for each licence, and to set new terms according to a fair and objective process
- To improve clarity and transparency of financial reviews, by providing more information and guidance than previously
- To simplify the application process, by reducing information requirements and providing licensees with greater assistance with the application process.

Ofcom's task

- Under the Communications Act, Ofcom must determine:
  - the percentage of qualifying revenue to be payable for each year of the licence; this can vary from year to year; and
  - the bid that would be made for the licence by the incumbent, assuming it were being granted the licence afresh
- Ofcom must in effect carry out a hypothetical auction of the licence, and estimate the amount that the incumbent would need to pay if it won the auction and were granted the licence afresh.

Overview of methodology

- Licence to be valued as a whole, including all rights and obligations (analogue and DTT)
- Rights and obligations that can only be obtained via the licence (eg right to broadcast on analogue spectrum) valued in use and on discounted cashflow basis
- Rights and obligations that are obtainable in market (eg right to broadcast on DTT) valued on market value basis
- Financial terms to be set to recover the combined value of the rights and obligations over the duration of the licence

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The hypothetical auction

- Winning bid based on the amount necessary to beat the second highest bidder. This may not be the maximum amount the incumbent is willing to pay.
- Second highest bid will be based on the value of the rights and obligations to a new entrant. Ofcom will estimate the NPV of the licence (assuming it is operated efficiently) and then adjust this value to reflect additional costs (eg start-up) incurred by a new entrant.
- Our consultation proposed assuming that licences would be auctioned simultaneously with contingent bids allowed for multiple licences. We now consider this is not feasible for a hypothetical auction, given the wide range of assumptions required.
- The licences will therefore be valued individually, as per previous ITC approach. Valuation will therefore not assume common ownership at point of auction (relevant to analogue element of broadcasting business).

Value of analogue rights

- Valuation of analogue rights based on analogue cashflows. Broadcasters do not earn revenues or incur costs separately for provision of services on each platform. Therefore necessary to apportion revenues and common costs between the analogue and digital services

- In previous licence reviews, apportionment based on share of households with analogue-only receiving equipment ('digital homes basis').

- Ofcom considers that the proportion of all viewing that is analogue is a better reflection of the value of analogue rights, and a more appropriate basis for valuation.

- Digital homes basis implies no value to analogue viewing in digital homes, and we do not consider this to be correct. The share of household viewing that is analogue better reflects incremental effect of analogue rights on total value.

- Ofcom will also take into account viewer migration value – value of analogue rights as a means of acquiring higher viewing share after viewers migrate to digital (eg via opportunities for cross-promotion, reduced marketing spend).

Value of digital rights

- Digital rights include:

  i. The right to broadcast on digital terrestrial
  ii. Reserved capacity on a digital terrestrial multiplex
  iii. Appropriate degree of prominence on electronic programme guides
  iv. Must-carry obligation on cable providers

- Ofcom considers (i) and (iv) to have no material value. (ii) and (iii) may have some value, though these rights can be substituted by other rights acquired elsewhere

- Valuation will be by reference to cost of replicating those rights

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PSB obligations, costs and revenues

- Costs of PSB obligations include:
  - Additional cost of providing PSB programming, over alternative programming
  - Opportunity cost, ie effects on advertising revenue

- These costs will be taken into account in the licence valuation. Valuation will take account of causal effects across all platforms (including satellite and cable), as PSB obligations flow from DRLs though they may affect satellite and cable.

- Ofcom will take a reasonable view as to any future changes in PSB obligations, including changes currently under consideration in PSB review.

- Valuation will also take account of estimated net cost to licensees of meeting any licence obligations related to digital switchover. Ofcom will take into account most up to date information on DSO timing prior to determination.

- Underlying costs and revenues will be forecast on basis of best available information as to TV NAR and programming costs.

Calculation of licence payments

- Terms are set to recover value of licence and consist of the variable PQR and fixed cash sum. Historically terms have been set to recover 75% of value via PQR and 25% via cash sum.

- Relative sizes of the PQR payments and cash sum is at Ofcom's discretion. Ofcom considers high PQR share has attractions (mitigates forecasting risk, aligns incentives with DSO).

- Ofcom will determine PQR payments to recover between 75% and 95% of the value of the licence. Exact proportion to be recovered via the PQR payments will be determined at a later date

Questions ….?