Consultation on methodology for reviews of financial terms for Channel 3 licences

Consultation document

The deadline for comments is **6 August 2004**.

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Section 1
Summary

1. This consultation seeks views on a proposed valuation methodology for the reviews of financial terms for Channel 3 licences. Responses are invited by 6 August 2004. Ofcom intends to publish a statement on the results of the consultation, including a decision on the final methodology for the reviews, in September 2004.

Objectives

2. Ofcom hopes to achieve three policy objectives through the proposed methodology that is set out in this document. First, Ofcom intends to determine a fair value for each licence, within the framework of the statute, and to set licence payment terms according to a proportionate and objective process. To the extent possible, the process should allow Ofcom to set payments that are reasonable within the context of the current market environment and that will continue to be reasonable for the full period of the licence. Second, Ofcom aims to improve the clarity and transparency of financial reviews by providing applicants with more information and guidance prior to the application date than was provided in the past. Third, Ofcom proposes to simplify the application process by reducing information requirements and providing licensees with greater assistance with the application process. In order to promote a more clear and consistent regulatory environment, Ofcom agreed earlier this year to offer Channel 3 licensees the opportunity to align their review dates.

Statutory requirements

3. Section 225 of the Communications Act 2003 (the Act) allows for Channel 3, Channel 5 and Public Teletext licensees to apply to Ofcom for optional reviews of their financial terms for payments to the Treasury.

4. Separately, the Communications Act requires Ofcom to offer to replace the existing analogue broadcasting licences with digital broadcasting licences prior to 29 December 2004. The digital licences will be, primarily, licences to provide a service on a digital terrestrial multiplex with a requirement to simulcast the service in analogue. In accordance with the statute, the existing financial terms will carry forward to the new digital licences and will remain in force until licensees apply for reviews.

5. Under the Act, the earliest date on which a licensee can apply for a review of its financial terms is four years prior to the expiry date of its analogue licence. Following a consultation earlier this year, Ofcom decided to offer Channel 3 licensees the opportunity to align the expiry dates of their analogue licences and, therefore, the dates for their reviews. As a result, Channel 3 licensees will be allowed to apply for reviews from 31 December 2004.

6. Under Section 227 of the Act, following an application for a review, Ofcom must determine a fixed annual cash amount to be paid for the licence and a percentage of qualifying revenue payable for each year of the licence period. Specifically, 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 reproduce the effects of a hypothetical auction of the licences.

7. The Act requires Ofcom to conduct a review of public service broadcasting (PSB), which is due to be completed later this year. The timing of the financial reviews will allow Ofcom to reflect in the new financial terms any changes to licence holders' public service obligations that may result from the PSB review.

Context

8. Ofcom believes that it is important to take account in the valuation methodology of the fact that the regulatory environment for broadcasters has changed significantly since the auction of the Channel 3 licences in 1991 and since the original methodology for financial reviews was developed by the ITC in 1998. In particular, regulatory reform has led to a less intrusive regime for broadcasting licensees. For example, more responsibility is being passed to licence holders with regards to complying with public service broadcasting obligations. Also, restrictions on ownership of multiple licences have been eliminated, and there has been large-scale consolidation of Channel 3 companies. The foreign ownership restriction has also been lifted, allowing foreign companies to acquire Channel 3 licences. The licensing regime will also change at the end of 2004 when the new digital licences replace the existing analogue licences. Ofcom has taken account of these changes in reviewing the approach that should be taken to setting financial terms.

Detailed proposals

9. 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 replicate in the reviews and the corresponding valuation methodology.

10. Ofcom proposes that the hypothetical auction would replicate the following circumstances:

- As required by the Broadcasting Act 1990, 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 all of the programming and other obligations associated with the new digital licence.
- Licences are likely to be most valuable when held as a group because this offers the greatest opportunity for efficiency. Therefore, as far as it is possible, Ofcom would offer the licences simultaneously. Ofcom would also allow contingent bids for multiple licences, as there are no longer ownership restrictions preventing this.
- 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.

11. 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, e.g. start-up costs that a new entrant might incur.
- Without a Channel 3 licence, a broadcaster could not provide an analogue service. Therefore, all profits made from providing an analogue service can be attributed to the licence. Ofcom proposes to value the 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 analogue service, Ofcom will need to allocate costs and revenues that are common to the analogue, digital terrestrial, cable and satellite services. Ofcom believes it may be most appropriate to base the allocation on the expected percentage of viewing on each platform. This would be a change from the past approach of apportioning common costs and revenues on the basis of the percentage of households with digital receiving equipment.
- In order to reflect the current market and regulatory environment appropriately, Ofcom proposes to take account in its forecasts of the benefits of common ownership of licences. Ofcom believes that the second-highest bidder in a competitive auction would bid for multiple licences and would reflect the cost efficiencies in its bid. This approach differs from the past approach of valuing each licence as though no other licences were held.
- Based on its own analysis, Ofcom proposes to use a real, pre-tax discount rate of 12% for all licence valuations. This is an increase from the 10% rate used in past valuations.
- Ofcom considers that it must also take account in the licence valuations of the net value of the rights and obligations associated with the digital terrestrial element of the licence. However, Ofcom's preliminary view is that the net value is unlikely to be significant.
- A broadcaster does not need a Channel 3 licence to provide a digital terrestrial television service, as this right can be replicated by obtaining a digital programme service licence and negotiating for carriage on a digital terrestrial multiplex. Therefore, it would not be appropriate to attribute all of the profits from the digital terrestrial service to the Channel 3 licence. Instead, the value of the digital terrestrial rights would equal the cost savings to the licence holder from not having to obtain the rights elsewhere.
- Ofcom proposes to take into account the present value of the net costs associated with meeting the public service broadcasting obligations and any obligations related to digital switchover that are imposed by the licence.
- In the past, the ITC aimed to recover approximately 75% of the surplus value of each licence via variable payments based on qualifying revenue (the 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

12. Section 225 of the Communications Act 2003 (the Act) allows for Channel 3, Channel 5 and Public Teletext licensees to apply for optional reviews of their financial terms for payments to the Treasury, which were set by the Independent Television Commission (ITC) at the time of the most recent renewal of their analogue broadcasting licences. If a licensee applies for a review, Ofcom is required to calculate new payment terms, which take the form of an annual fixed cash sum plus a percentage of the licensee's qualifying revenue (PQR). Licensees' current payment terms are set out in Annex 4 of this document.

Digital replacement licences

13. Separately, the Communications Act requires Ofcom to offer to replace the existing analogue broadcasting licences with digital broadcasting licences prior to 29 December 2004. Ofcom intends to consult on draft versions of the digital licences in August and plans to offer the licences in November. Each licensee will have the option to accept or reject the digital licence. However, if a licensee rejects the licence, its existing analogue licence will cease to have effect within eighteen months of the closing date of the offer, at a date set by Ofcom. The digital licences, if accepted, will expire on 31 December 2014, as set out in Section 224 of the Act.

14. The process of issuing digital replacement licences is not directly linked to the reviews of financial terms. Each licensee's existing financial terms will carry forward to its new digital licence, in accordance with the Act, and will remain in place until the relevant licensee applies for an optional review of its financial terms.

15. A replacement licence will be, primarily, a licence to provide a service on a digital terrestrial multiplex with a requirement to simulcast the service in analogue. Ofcom expects that the digital licences will include obligations related to digital switchover. These obligations will most likely take the form of coverage requirements that must be achieved by a target date for switching off the analogue signal and possibly requirements to participate in marketing digital services in association with a public awareness campaign and to cooperate with the management of the switchover project. Provision of the Channel 3 service on cable and satellite is covered by a separate television licensable content service licence, which is not subject to licence payments.

Timetable for the reviews

16. Ofcom consulted on the timetable and general approach to the reviews of financial terms for Channel 3 licensees earlier this year and published a statement on the timetable for the reviews in April. In the statement, Ofcom set out its decision to offer Channel 3 licensees the opportunity to align the dates for their reviews, so all will have the option to apply as early as 31 December 2004.

17. The key dates in the review timetable for licensees with the earliest possible application date of 31 December 2004 are as follows:

Date	Action
31 December 2004	Earliest date on which relevant licensees could submit applications[1]
By end June 2005	Ofcom plans to determine new financial terms for licensees that submit applications on 31 December 2004
1 January 2005	New fixed annual cash sum backdated to take effect on this date for licensees that submit applications on 31 December 2004
Start of licensee's next accounting period after application date	New PQR rate to take effect

18. Each eligible licensee will be allowed to apply for a review at any time during a three-year time period, e.g. between 31 December 2004 and 31 December 2007, but will be allowed to apply only once. A review will cover the remaining period of the licence after the application date, as set out in Section 227(8) of the Act. For licensees applying on 31 December 2004, the review will cover a ten-year period.

19. Licensees who apply for reviews will have the option to accept or reject the new terms offered. If a licensee rejects the new terms, the existing financial terms will remain in place. If a licensee accepts the new terms, the terms will take effect retrospectively as set out in the table above. The Act sets out that the new fixed annual cash sum will take effect from the first calendar year after the application date and the new PQR rate will take effect from the next accounting period after the application date. Any overpayments made between the effective date and determination date will be refunded to the licensee. The Treasury has agreed to pay interest on any such amounts at the rate of the 3-month Treasury bill.

Consultation process

20. 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 3. The time period for this consultation is six weeks and the consultation is due to close on 6 August 2004. 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 for reviews after the final methodology document is published and prior to the earliest possible application date of 31 December 2004. Ofcom intends to publish a statement on the results of the consultation, including a decision on the final methodology for the reviews, in September 2004.

[1] Reviews of financial terms are optional, and some licensees may have later review periods if they choose not to take up the option to bring forward the dates for their reviews.

Section 3
Statutory requirement and context

Statutory requirement

21. Under Section 227 of the Act, following an application for a review, Ofcom must determine a fixed annual cash amount to be paid for the licence and a percentage of qualifying revenue payable for each year of the licence period[2]. Specifically, 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 15 of the Broadcasting Act 1990. This section established the process for the original auction of the Channel 3 licences.

22. Because the statute is not prescriptive about every aspect of the process that Ofcom must follow in order to determine the amount that would be bid for each licence in a competitive tender, Ofcom considers that it is necessary to make certain assumptions.

Context

23. Certain circumstances of the hypothetical auction proposed by Ofcom differ from the actual auction of Channel 3 licences in 1991 because the regulatory environment for broadcasters has changed in a number of important respects since then. Also, the proposed valuation methodology differs from the ITC's past approach in certain respects because the regulatory environment has changed since the original methodology for financial reviews was developed by the ITC in 1998.

24. In general, regulatory reform has led to a less intrusive regime for broadcasting licensees. For example, more responsibility is being passed to licence holders with regards to complying with public service broadcasting obligations. Also, restrictions on ownership of multiple licences have been eliminated, and there has been large-scale consolidation of Channel 3 companies. The foreign ownership restriction has also been lifted, allowing foreign companies to acquire Channel 3 licences. As discussed earlier, broadcasters will be subject to a new licensing regime from the end of 2004 when the new digital licences replace the existing analogue licences.

25. Ofcom believes that, in setting licence payment terms, it is important to take account of the current regulatory environment, including the more liberal conditions for entry and ownership that have been created. In this context, Ofcom has reviewed, and revised where necessary, the past approach to setting financial terms.

Hypothetical auction process

26. 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 replicate.

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

27. The Broadcasting Act 1990 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 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.

28. If Ofcom were to offer the Channel 3 licences for tender, it would design the auction, within the framework of the statute, to recover the maximum possible value consistent with the licensee being able to fulfil all of the programming and other obligations associated with the licence. Ofcom believes that in general the licences are likely to be most valuable when held as a group because this offers the greatest opportunity for efficiency. Therefore, Ofcom considers that it would offer as many of the licences as possible simultaneously and would allow contingent bids for multiple licences.

29. Ofcom considers that the bid of the incumbent will depend on several other factors as well, including its attitude towards the risk of losing the licence, its assumptions about the level of competition for the licences and its assumptions about the individual circumstances of potential alternative bidders. First, 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 entrants, particularly if they are offered as a group. Ofcom considers that alternative bidders with the highest valuations are likely to be existing television companies, either from the UK or abroad that wish to gain a presence in the UK free-to-air market.

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

Estimating the incumbent's bid

30. 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.

31. 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:

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

- 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 programming 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 television companies, Ofcom considers that this would be a real possibility.

- 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. The new entrant may therefore bid an amount that appears to be irrationally high given the information on value that is available to the incumbent.

32. 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: *Given practical considerations, is Ofcom's proposal to estimate the bid of the incumbent by estimating the value of the licence to the second-highest bidder reasonable? If not, please suggest an alternative approach.*

Definition of qualifying revenue

33. In relation to the digital replacement licences Ofcom's reading of the relevant statute is that the definition of qualifying revenue must include revenue derived from both the analogue and digital terrestrial services[3]. This is because qualifying revenue is defined with reference to the 'licensed service' and the digital licences will cover provision of the service on both analogue and digital terrestrial. Also, Ofcom believes that it is required to consider the value of the full licence, including both the analogue and digital terrestrial elements, when determining the amount that would be bid for the licence in a competitive tender.

34. Ofcom is aware that this differs from the approach taken in the past by the ITC in relation to previous licences. The ITC included only revenue earned from the licensed analogue broadcasting service within the definition of qualifying revenue under the Broadcasting Act, for the purposes of calculating PQR

[3] Section 19(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".

licence payments. The ITC also considered only cashflows attributed to the analogue broadcasting service in licence re-valuations. However, Ofcom considers that in relation to the digital replacement licences the statute requires Ofcom to take account of both the analogue and digital terrestrial services.

35. This change will not have any effect on the amounts of the payments that licensees make at the point when their digital replacement licences are issued. The change may have an effect (positive or negative) in any subsequent review of the value of the licences. However, Ofcom's preliminary view is that any such change is unlikely to be significant. This is discussed in more detail below. Annex 5 provides more detail on the effect of this change at the time the digital replacement licences are issued.

Section 4
Approach to licence valuation

General approach

36. 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 terrestrial elements, when determining the amount that would be bid for the licence in a competitive tender and when setting payment terms for the licence.

37. Each holder of a digital replacement licence will have the following rights and obligations as a consequence of holding the licence:

    Rights

    - The right to broadcast on scarce analogue spectrum
    - The right to broadcast on digital terrestrial
    - Reserved capacity on a digital terrestrial multiplex
    - Appropriate degree of prominence on electronic programme guides (EPGs)
    - Must-carry obligation on cable providers

    Obligations

    - Digital switchover obligations
    - Public service programming (PSB) obligations on the analogue and digital terrestrial services

38. Each licence will need to be valued as a whole, but Ofcom considers that for the purposes of explanation and analysis, these rights and obligations can usefully be grouped into two broad categories: analogue and digital terrestrial. The analogue element of the licence comprises the right to broadcast on scarce analogue spectrum and an apportionment of the cost of public service broadcasting obligations to the analogue service. The digital terrestrial element includes all of the other rights listed above, digital switchover obligations and an apportionment of the cost of public service broadcasting obligations to the digital service.

39. Ofcom proposes that, in order to determine the amount that the incumbent would bid for the licence, it will be necessary to determine the present value of each of the rights and obligations individually. Then, Ofcom should set payment terms to recover the combined value of the rights and obligations over the period of the licence.

40. 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.

41. The following sections cover Ofcom's specific proposals for valuing each right and obligation associated with the licence.

Right to broadcast on digital terrestrial

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

Right to reserved capacity on a digital terrestrial multiplex

43. The Channel 3 licensees currently have reserved capacity on a digital terrestrial multiplex. Therefore, each licensee makes payments towards the operation of the multiplex but does not pay any additional carriage fee associated with the market value of capacity. If a broadcaster did not have access to reserved capacity on a multiplex, it would need to negotiate with a multiplex operator for carriage on commercial terms. Therefore, 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 market rate for carriage, and the cost to the broadcaster of operating the multiplex. Ofcom considers that the market value of digital multiplex capacity is currently low, but may increase as the analogue switch-off date approaches, depending on available capacity. Ofcom proposes to estimate the present value of the right to reserved capacity on this basis.

Question 3: *Is Ofcom's proposed methodology for estimating the value of the right to reserved capacity on a digital terrestrial multiplex reasonable?*

Right to appropriate degree of prominence on EPGs

44. Although the right to an appropriate degree of prominence on EPGs relates not only to the digital terrestrial service but also to the cable and satellite services, which are covered by a separate licence, broadcasters will have this right as a consequence of holding the digital replacement licence. Therefore, Ofcom believes it will be relevant to consider the full value of this right in the overall valuation of the digital licence. If a broadcaster did not have the right to an appropriate degree of prominence on EPGs, it might have to accept a less prominent position on EPGs. This could possibly mean that the broadcaster would lose market share or that more advertising expenditure would be necessary in order to maintain the same market share. However, the value of the right is unclear and is difficult to estimate. Ofcom invites evidence supporting a view as to whether or not this right will have significant value and, if so, views on an appropriate method for valuing it.

Question 4: *Does the right to an appropriate degree of prominence on EPGs have material value? If so, what would be an appropriate method for valuing this right in practice?*

Must-carry obligation on cable providers

45. Under Section 64 of the Act, cable providers are required to carry all of the Channel 3 services, as Ofcom considers appropriate. Although the must-carry right relates to the Channel 3 cable service, which is covered by a separate licence, any benefit to the Channel 3 licensees from the obligation on cable providers will be a consequence of holding the digital licence. Ofcom's preliminary view is that there is a mutual commercial benefit to broadcasters and cable providers of carriage of these channels on cable and that it is likely that the channels would continue to be carried on cable at minimal or zero charge without the must-carry obligation. Therefore, the value of the must-carry obligation on cable providers will be minimal for the Channel 3 licensees.

Question 5: *Is it reasonable to assume that the must-carry obligation has minimal value?*

Costs of obligations related to digital switchover

46. Ofcom believes that a potential bidder for a broadcasting licence would consider the present value of the costs associated with fulfilling the licence obligations when determining the amount they would be willing to pay for the licence. Therefore, Ofcom proposes to take account in the licence valuations of the estimated net costs to the licence holder of meeting any licence obligations related to digital switchover, as appropriate. Ofcom believes that it will be appropriate to take account of costs that would not be incurred by the licence holder under the next best alternative to holding this licence. To the extent that there are also benefits to licence holders as a result of the expenditure, Ofcom proposes to include the net amount in the valuation.

47. Ofcom considers that any additional costs to broadcasters related to digital coverage obligations could be reflected in the licence valuations in two ways depending on the specific nature of the costs.

- To the extent that broadcasters are required to make capital investments in transmission infrastructure in order to achieve a level of coverage required by the licence, Ofcom proposes that the investment should be treated as a fixed asset investment in the valuation. Specifically, Ofcom would reflect in the valuation an outgoing capital expenditure cashflow at the time of the investment(s) and an incoming cashflow at the end of the licence period to reflect the remaining value of the asset at that time.

- To the extent that transmission companies incur any necessary infrastructure costs and then contract with licence holders to recover the costs over time, Ofcom proposes that, for the purposes of the licence valuation, the costs should be treated as operating expenses as they are incurred by the broadcasters.

48. Ofcom considers that, in valuing the coverage obligation, it would only be appropriate to include expenses specifically related to meeting the coverage obligation, not ongoing costs of digital transmission that would be incurred if the licensee held a digital programme service licence without coverage obligations.

49. In assessing the additional amount that the licence holder would have to pay as a result of the coverage obligation, Ofcom will need to take a view as to the

amount the relevant broadcaster would spend on increasing coverage and other transmission-related costs regardless of whether it held a digital replacement licence, i.e. the costs it would incur if it held a digital programme service licence with no coverage obligations. Ofcom believes that it would be appropriate to subtract this amount from the total cost of meeting the coverage obligation.

50. Ofcom also believes that it will be appropriate to reflect the costs to broadcasters of meeting any other licence obligations related to digital switchover. For example, if broadcasters are required to contribute to certain marketing costs associated with a public awareness campaign, Ofcom proposes to reflect in the licence valuations the expected outgoing cashflows, as they relate specifically to this obligation, in the years they are expected to be incurred. If Ofcom considers that there are ancillary benefits to the licence holder associated with the expenditure, Ofcom proposes to subtract the value of those benefits from the costs to be reflected in the valuation.

Question 6: *Are Ofcom's proposals for taking account in the licence valuations of obligations related to digital switchover appropriate?*

Obligation to provide PSB on the digital terrestrial service

51. Under a digital broadcasting licence, the broadcaster will be required to fulfil public service broadcasting obligations that relate to provision of the Channel 3 service on both analogue and digital terrestrial. Ofcom considers that, when deciding the amount to bid for the licence, a bidder would determine the excess cost associated with these obligations, over and above the cost associated with the next best alternative. Because the next best alternative is different for the digital terrestrial and analogue elements of the licence, Ofcom proposes to determine and reflect in the licence valuations the cost of PSB obligations separately for the two elements of the licence.

52. The alternative to holding a Channel 3 digital broadcasting licence would be to obtain a digital programme service licence to broadcast on digital terrestrial. This licence would not confer any public service broadcasting obligations on the licence holder. Therefore, under this alternative scenario, the broadcaster would not incur any costs related to public service broadcasting. Because there is an alternative available that would allow broadcasters to avoid these obligations if they did not hold the digital broadcasting licence, Ofcom considers that it will be necessary to reflect in the valuations the opportunity cost of public service broadcasting obligations associated with the digital terrestrial element of the licence. Specifically, Ofcom proposes to reflect as an outgoing cashflow, for each year of the licence period, an estimate of the amount by which cashflows to the digital terrestrial service are reduced as a result of the PSB obligations. In order to do this, Ofcom will need to project the amount of revenues and programming costs attributed to the digital terrestrial service with and without PSB obligations and determine the difference in each year. The proposed methodology for attributing common costs and revenues to the digital terrestrial service is discussed in a later section.

Question 7: *Is the proposed methodology for valuing the PSB obligations on the digital terrestrial service appropriate?*

53. Under the Act, a commercial television broadcaster will only be allowed to broadcast in analogue if it holds a digital broadcasting licence, which confers

public service broadcasting obligations. Because broadcasters will have no alternative available to provide a service in analogue without PSB obligations, Ofcom considers that it will not be appropriate to reflect as an outgoing cashflow in the licence valuations an amount equal to the additional profit that could be earned on an analogue service without PSB obligations. A further explanation of Ofcom's proposed treatment of the costs of PSB obligations related to the analogue element of the licence is discussed later in this document.

Right to broadcast on scarce analogue spectrum

54. A digital broadcasting licence will give the holder the right to broadcast on scarce analogue spectrum. There is no alternative method for acquiring this right, and therefore without this licence, a broadcaster would have no access to analogue spectrum and would not be able to provide an analogue service. For this reason, all profits made from the provision of an analogue service can be attributed to the licence. On this basis, Ofcom proposes to use a discounted cashflow forecast to estimate the present value of the expected cashflows attributed to the analogue element of the licence over the relevant period. Details of the proposed methodology for the discounted cashflow forecast are in the following sections.

Apportionment of revenues and common costs between analogue and digital services

55. Broadcasters do not earn revenues separately for provision of the Channel 3 service on analogue, digital terrestrial, cable and satellite. Also, a large proportion of each broadcaster's cost base is common to provision of the service on all platforms. 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. An apportionment of revenue is also necessary for the calculation of PQR payments, as the PQR rate does not apply to revenues earned from the cable and satellite platforms and different weightings are likely to apply to the digital terrestrial and analogue qualifying revenues[4].

56. In the past, this apportionment, for the purposes of valuing licences and calculating PQR payments, was based on the percentage of households in the licensed area with access to digital services. The reason for adopting this basis of apportionment for the Channel 3 licence payments was that regional household digital penetration data was available through the BARB Establishment Survey, which is used as a basis for balancing the BARB panel[5]. However, the ITC acknowledged in the *Qualifying Revenue and Multiplex Revenue: Statement of Principles and Administrative Arrangements (Fourth Edition)* that it would be more appropriate to apportion revenues on the basis of relative viewing shares and that it planned to adopt this method if sufficiently reliable information became available to allow it.

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[4] The current process for calculating and charging PQR payments is set out in the *Qualifying Revenue and Multiplex Revenue: Statement of Principles and Administrative Arrangements (Fourth Edition)*. Ofcom plans to issue a new edition of this document later this year, 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.

[5] Digital penetration data is only one of many factors used to balance the BARB panel.

57. Ofcom recognises that the use of Establishment Survey data to apportion revenue and calculate licence payments has given rise to some issues, including discrepancies between the data on household penetration and Ofcom's own estimates of digital penetration. The relevant data on household penetration is also not available on a timely basis and causes delays of several months in calculating licence payments.

58. Most importantly, Ofcom considers that the proportion of total viewing on a particular platform would be a closer determinant of revenue earned on that platform than the number of households able to access the service via the platform. The viewing data measures viewing by television set, which means that viewing is accurately split between platforms in homes with a primary set that may be digital and second or third sets that may be analogue. Also, data on relative viewing by platform is timely compared with the household penetration data as it is available within one or two weeks of each quarter-end.

59. Ofcom considers that the digital viewing data available through BARB is sufficiently reliable to be considered as a basis for calculating licence payments. Ofcom therefore invites comments on using actual regional viewing data in place of household data. If this change is made, Ofcom would attribute revenues and common costs, in the licence valuations, to the various platforms on the basis of the percentage of the relevant channel's total minutes of viewing on each platform. Ofcom would forecast the proportion of viewing on each platform on a regional basis in order to take account of digital penetration differences in each region.

Question 8: *What is the most appropriate basis for apportioning common revenues and costs between the analogue, digital terrestrial, cable and satellite services given practical considerations and available information?*

Approach to revenue projection

60. Ofcom must determine a value for each regional Channel 3 licence that applies for a review and therefore must develop a separate forecast of advertising revenue for each licence. In Ofcom's view, there are two options for the way to approach this. The most detailed method for doing this would be to develop bottom-up forecasts of the share of total television net advertising revenue (NAR) for each licence. Then, the forecast share for each licence would be applied to a forecast of total television NAR to calculate total advertising revenues for each licence. The more straightforward method would be to forecast total Channel 3 NAR and then to calculate the regional NAR by applying the shares of total Channel 3 NAR that are currently attributed to each region. Ofcom believes that the second option would be preferable because it would be simpler and the outcome would most likely not differ significantly.

61. For either method, Ofcom will need to produce a forecast of total television NAR for the remaining licence period. Ofcom proposes to base the forecast on historic drivers of advertising expenditure, historic growth rates and external forecasts of macro-economic trends that affect advertising expenditure. Ofcom plans to use the most recent data available at the time of the review and will benchmark its own figures against third-party forecasts.

62. Ofcom will need to forecast share of total television advertising revenue either for the individual region or for Channel 3 as a whole, depending on the chosen approach. In order to do this, Ofcom will develop a forecast of Channel 3's or

the individual licence's share of commercial viewing, share of total impacts and the relative price of airtime. Ofcom believes that a forecast at the Channel 3 level would be more robust and would allow for more benchmarking against third-party forecasts.

63. Ofcom invites views as to which approach to forecasting advertising revenue is preferred.

***Question 9:** Which of the two proposed approaches to forecasting advertising revenue is preferable? Please provide reasons.*

64. Channel 3 licensees also earn a small portion of their revenues from selling sponsorship. Ofcom proposes to forecast sponsorship revenue by using as a starting figure the sponsorship revenue in the year prior to application and applying a growth rate in each subsequent year which is equal to the forecast growth in the relevant licence's advertising revenue.

Treatment of licences in common ownership

65. Because many of the Channel 3 licences are held in common ownership[6], Ofcom must consider to what extent the costs and benefits of common ownership should impact the licence valuations. As stated earlier, Ofcom assumes that all licences would be auctioned simultaneously and that the auction would allow contingent bids for multiple licences. Also, Ofcom proposes to assume that alternative bidders would bid for multiple licences in groups that would replicate the current ownership groups, as this is what the market has delivered and is therefore the least arbitrary assumption. Given that a bidder could make its bid contingent upon winning the whole group of licences, it would make sense to take account of the financial implications of common ownership when deciding the amount of the bid. Therefore, Ofcom proposes to project, in the licence valuations, a level of costs that reflects common ownership for the relevant licences. More generally, Ofcom believes that it is appropriate to assume in its projections that the business would operate efficiently, and therefore intends to estimate the costs of an efficient bidder.

66. Ofcom judges that it would not be appropriate to subtract any historic costs to the incumbent of achieving savings from common ownership. An alternative bidder would not incur these costs. The analysis should, however, consider whether an entrant would incur any costs that the incumbent would not need to incur in the future.

***Question 10:** Is Ofcom's proposal to reflect in the licence valuations a level of costs that takes account of common ownership reasonable? Please provide reasons.*

Approach to cost projection

67. Ofcom considers that, in order to determine a value for each licence, it will be 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

[6] Eleven of the sixteen Channel 3 licences are held by ITV plc and two are held by Scottish Media Group.

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.

Treatment of cashflows related to production

68. Ofcom considers that, when deciding the amount to bid for a Channel 3 licence, a potential bidder would only take account of expected cashflows from production to the extent that they relate to the broadcasting licence. Therefore, Ofcom suggests that it will be appropriate to take account of the costs and revenues related to programmes produced for one of the regional services, but not costs and revenues related to programmes produced for external sale or programmes produced and sold on an arm’s length basis to the ITV Network Centre.

69. Specifically, Ofcom proposes that, in relation to regional productions, the costs of production should be included in the licence valuations. This is because the costs to licence holders of producing regional programmes for transmission on their own channels constitute programming costs for the broadcasting service. The corresponding revenues are the revenues earned by the broadcaster for selling advertising and sponsorship during the programmes.

70. Also, Ofcom proposes that any cost associated with producing programmes that are sold to the ITV Network Centre and the corresponding revenues obtained from the sale of the broadcasting rights to the Network Centre should not be reflected in the licence valuations. The reason for this is that Ofcom considers that any transactions between the production arm of a broadcasting licence holder and the ITV Network Centre should be completed on an arm’s length basis and could be completed whether or not the producer held a Channel 3 broadcasting licence. Network programming costs to the broadcaster are represented by each region’s contribution to the network budget.

71. Given that transactions with the Network Centre are completed on an arm’s length basis, Ofcom considers that it is reasonable to assume that the programming currently procured for Channel 3 licensees via the Network Centre would continue to be available on the same terms to a new entrant. The new entrant would either continue this programming or substitute other programming if it offered a superior revenue/cost relationship.

72. Because they do not relate specifically to the broadcasting licence, Ofcom considers that it would not be appropriate to take account in the licence valuations of any costs or revenues related to production of programmes for external sales to third-parties.

***Question 11:** Is Ofcom’s proposed treatment of cashflows related to regional production and production for the ITV Network Centre reasonable, given that the valuation relates to the broadcasting licence specifically?*

Costs of PSB obligations related to the analogue element of the licence

73. Ofcom proposes to take account of the costs of meeting public service broadcasting obligations by reflecting in its forecasts the reduced revenue and increased programming costs that result from these obligations. However, because there is no alternative available to broadcasters to provide an analogue service without PSB obligations, Ofcom considers that it will not be appropriate to reflect as a cost of holding the licence the additional revenue that could be earned if the programming obligations did not exist.

74. When forecasting the revenues and programming costs for each licence, it will be necessary for Ofcom to take a view as to the impact of any changes in future obligations that are expected as a result of Ofcom's review of public service broadcasting. For example, any decrease in obligations would be assumed to imply an increase in advertising revenue and/or a decrease in programming costs.

Question 12: *Is the proposed methodology for taking account of the costs of PSB obligations related to the analogue service appropriate?*

Costs of entry

75. 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. At a minimum, Ofcom proposes to include, at the start of the licence period, an allowance for the cost of assets required to operate the business or to meet the requirements of the licence. A corresponding figure for closing assets would be included at the end of the licence period. 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 balance sheet. However, Ofcom recognises that the net book value may understate the cost to a new entrant of acquiring the asset. Therefore, Ofcom proposes to consider submissions from licensees on their views as to the value of modern equivalent assets that would be required to operate the business.

Question 13: *Is Ofcom's proposal to include in the valuations an opening and closing allowance for the value of assets required to operate the broadcasting licence appropriate? If so, is the proposal to use net book value as a basis for determining the value of the assets reasonable?*

76. In Ofcom's view, the opening and closing asset figures should include only fixed assets and net working capital that are required specifically for the broadcasting licence. Ofcom proposes that regional production assets should be included in the valuation, but only to the extent that the licence holder is required by the licence to hold those assets. Otherwise, Ofcom proposes to assume that the regional production assets are not a part of the broadcasting business because the broadcaster would not need to produce its own programmes in order to provide the licensed service. Any other production assets should not be included in the valuations because they do not relate directly to the broadcasting licence.

Question 14: *Is it appropriate to include in the estimate of entry costs the value of regional production assets, only to the extent that they are required by the broadcasting licence?*

77. Ofcom recognises that an alternative bidder could have additional start-up expenses, such as marketing costs to establish a viewer base, which would not be included on the balance sheet. 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.

Question 15: *What other types of costs, if any, should be included in the estimate of entry costs? Please suggest a method for quantifying these costs.*

Viewer migration value associated with analogue licence

78. Ofcom believes that, as analogue viewers migrate to a digital service, the provider of the Channel 3 digital service is likely to inherit a larger share of the new digital audience than it would if it was providing a non-Channel 3 digital service under a digital programme service licence (primarily in the form of Channel 3 viewers migrating from the analogue service to the digital service). The right to broadcast on the analogue spectrum therefore increases the value of the digital element of the licensee's business, either by increasing digital revenues or by saving the marketing costs necessary to acquire the equivalent audience share. However, Ofcom considers that it will be difficult to estimate the size of this effect robustly. Ofcom invites proposals on suitable methodologies.

Question 16: *Is it appropriate to include in the valuations a 'viewer migration value' for the analogue licence as described? If so, what would be a suitable methodology for estimating the value?*

Discount rate

79. 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 television company. 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.

80. Ofcom has considered the possibility that smaller licences that are held separately may carry greater risk, 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.

81. 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 and European television companies. Based on this analysis, Ofcom proposes to use a real, pre-tax discount rate of 12% in the licence valuations.

Annex 6 of this document provides further information on the methodology and assumptions used to arrive at this rate.

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

Question 17: *Is Ofcom's proposal to use a single real, pre-tax discount rate of 12% for all licence valuations reasonable? If not, please provide supporting evidence.*

Section 5

Calculation of financial terms

83. 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. In the past, the ITC 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.

84. As explained in Annex 5, Ofcom intends to introduce two categories of qualifying revenue in the digital replacement licences: analogue qualifying revenue and digital terrestrial qualifying revenue. The PQR rate will be applied to both categories of qualifying revenue. However, Ofcom will assign a weighting to each category, for the purpose of calculating licence payments, and the weightings will be based on each category's impact on the licence valuation. For example, if Ofcom determines that the net valuation of the digital terrestrial element of the licence is zero or negative, digital terrestrial qualifying revenue will continue to have a zero-weighting.

85. Ofcom believes that there would continue to be advantages to recovering a high proportion of the licence fees through a PQR, and it may even make sense to recover 100% of the licence fees in this manner. This 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. This is particularly important given the high degree of uncertainty associated with forecasting over the next ten years. Also, because the PQR rate is not applied to revenue from cable and satellite services and will most likely be applied to a low or zero-weighting of revenues from the digital terrestrial service, PQR payments will decline as digital penetration increases. Therefore, Ofcom considers that recovering a higher portion of the licence fees through the PQR would be aligned with the objective of promoting digital switchover.

86. Ofcom recognises that there are also arguments in favour of a higher annual fixed cash sum. Most importantly, 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. Also, a higher fixed cash sum would give licensees more certainty about their future payments.

87. 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. However, Ofcom must make the final determination regarding the structure of the payments, taking into account any representation made on behalf of the licence holder.

88. Ofcom invites views on the appropriate split between the PQR and cash sum.

***Question 18:** Should Ofcom reconsider the 75/25% split between the PQR and annual cash sum? If so, what would be an appropriate split?*

Section 6

Administrative details

Application process

89. Each licensee wishing to apply for a review of its financial terms must submit the following to Ofcom:

- A formal letter of application requesting a review under Section 225 of the Act
- A cheque for the application fee of £30,000 per licence
- Financial information in the required format with a supporting statement
- An auditor's letter verifying the financial information submitted

90. The official application date will be the date that Ofcom receives the formal letter of application, accompanied by the application fee and the additional information outlined below.

Required information

91. In the past, the ITC required licensees to submit detailed ten-year business plans, apportioned between the analogue and digital businesses, supported by written commentary to inform the licence valuations. Licensees were also required to submit several forecast scenarios based on changes to their assumptions about key drivers. 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 undue burden on licensees.

92. 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.

93. Ofcom proposes to require the following minimum set of information (dates refer to licensees that apply on 31 December 2004):

- The licensee's results for its 2003 financial year (the "2003 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 2003. For those licensees with an accounting reference period in 2003 other than 12 months, the 2003 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 2004 financial year (the "2004 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. The 2004 Actual

Statements should be based on the licensee's best estimate of the actual results for the year based at the time of the application. Given the concurrence of the earliest application date and the licensees' accounting reference date, licensees applying on 31 December are additionally invited to provide updated versions of the 2004 statements, together with an explanation of the main changes from the initial estimates, or are required to confirm that there are no significant changes by 31 January. The 2004 Actual Statements should be capable of reconciliation to the licensee's statutory accounts for 2004 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 2005 financial year (the "2005 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 2004 Actual Statements and the 2005 Forecast Statements.

- Forecast results for the years 2006 to 2014 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 2005 Forecast 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.

94. 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. The exact form of the templates is to be decided but it is likely that the templates will, for example, require licensees to separate costs that are specific to a delivery platform, e.g. transmission costs. Ofcom will endeavour to ensure that the required level of detail is not excessive. For example, Ofcom is considering the possibility that licensees might not be required to apportion common revenues or costs between the analogue and digital services. Further, Ofcom expects that licensees will not be required to provide forecasts based on alternative scenarios.

95. 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 viewing share, share of total impacts, price premium, total revenue and the share that is expected to be attributable to each licence.

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

97. 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.

98. Ofcom intends to conclude the reviews as quickly as possible after receiving applications from licensees and no later than the end of June 2005. Ofcom considers that, in order to ensure that its determination of new terms is a fair and accurate reflection of the value of the licence, it should take into account available information that has a material bearing on the valuation until the time the review is concluded.

Question 19: *Is the proposed set of information required from licensees reasonable?*

Information that Ofcom will provide

99. 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, particularly for the early years of the valuation, 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 television NAR and digital penetration closer to the earliest possible application date of 31 December 2004. Ofcom expects to provide this information by early-November.

Question 20: *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 31 December 2004?*

Timetable for notification and licensees' decisions

100. Ofcom expects to send a written notification of the determination of new financial terms by the end of June 2005 to any licensee applying for a review on 31 December 2004. The notification will include the following information, as required by Section 228(2) of the Act:

- the determination made by Ofcom;
- the modifications of the applicant's licence that are required to give effect to the determination;
- a date by which the applicant must notify Ofcom whether or not he accepts the determination and modifications; and,
- a subsequent date by which the applicant's licence will cease to have effect if he does not accept the new terms.

101. Ofcom proposes to notify the relevant licensees of the new terms on a strictly confidential basis approximately two days prior to announcing its decision. Also, Ofcom proposes that each licensee will be required to notify Ofcom in writing of its decision to accept or reject the new terms within four weeks of the offer date. Any failure to respond by the deadline will be considered to be a rejection of the offer.

Section 7
Responding to this consultation

How to respond

102. Ofcom invites written views and comments on the issues raised in this document, to be made by 5pm on 6 August 2004.

103. 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 2), 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.

104. Please send your response to david.brown@ofcom.org.uk.

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

David Brown
Competition and Markets
3rd Floor
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 7981 3333

106. 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.

107. 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 could explain why you hold your views, and how Ofcom's proposals would impact on you.

Further information

108. If you have any questions about the issues raised in this consultation, or need advice on the appropriate form of response, please contact David Brown on 020 7981 3718.

Confidentiality

109. 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 this is acceptable).

110. 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.

111. Ofcom reserves its power to disclose certain confidential information where this is necessary to fulfil its functions, although in practice it would do so only in limited circumstances.

112. Please also note that copyright in responses will be assumed to be assigned to Ofcom unless specifically retained.

Next steps

113. Following the end of the consultation period, Ofcom intends to publish a statement on the results, including Ofcom's decision on the final methodology for the reviews, in September 2004. 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

114. Ofcom is keen to make responding to consultations easy, and has published some consultation principles (see Annex 1) which it seeks to follow, including on the length of consultations.

115. This consultation is shorter than Ofcom's standard ten-week period in order to allow licensees sufficient time to prepare their applications for reviews after the final methodology document is published and prior to the earliest possible application date of 31 December 2004.

116. 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.

117. If you would like to discuss these issues, or Ofcom's consultation processes more generally, you can alternatively contact Philip Rutnam, Partner, Competition and Strategic Resources, who is Ofcom's consultation champion:

Philip Rutnam
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA
Tel: 020 7981 3585
Fax: 020 7981 3333
E-mail: philip.rutnam@ofcom.org.uk

Annex 1
Ofcom's consultation principles

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

Before the consultation

1. 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

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

3. 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.

4. We will normally allow ten weeks for responses, other than on dispute resolution.

5. 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.

6. 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

7. 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 2

Consultation response cover sheet

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, unless we are asked not to.

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.

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 confirm on the response cover sheet that Ofcom can publish their responses upon receipt.

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.

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, 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)?

Yes ☐ No ☐

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. If I have sent my response by email, Ofcom can disregard any standard email text about not disclosing email contents and attachments.

Ofcom can publish my response: on receipt ☐ once the consultation ends ☐

Name

Signed (if hard copy)

Annex 3

Consultation questions

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: *Given practical considerations, is Ofcom's proposal to estimate the bid of the incumbent by estimating the value of the licence to the second-highest bidder reasonable? If not, please suggest an alternative approach.*

Question 3: *Is Ofcom's proposed methodology for estimating the value of the right to reserved capacity on a digital terrestrial multiplex reasonable?*

Question 4: *Does the right to an appropriate degree of prominence on EPGs have material value? If so, what would be an appropriate method for valuing this right in practice?*

Question 5: *Is it reasonable to assume that the must-carry obligation has minimal value?*

Question 6: *Are Ofcom's proposals for taking account in the licence valuations of obligations related to digital switchover appropriate?*

Question 7: *Is the proposed methodology for valuing the PSB obligations on the digital terrestrial service appropriate?*

Question 8: *What is the most appropriate basis for apportioning common revenues and costs between the analogue, digital terrestrial, cable and satellite services given practical considerations and available information?*

Question 9: *Which of the two proposed approaches to forecasting advertising revenue is preferable? Please provide reasons.*

Question 10: *Is Ofcom's proposal to reflect in the licence valuations a level of costs that takes account of common ownership reasonable? Please provide reasons.*

Question 11: *Is Ofcom's proposed treatment of cashflows related to regional production and production for the ITV Network Centre reasonable, given that the valuation relates to the broadcasting licence specifically?*

Question 12: *Is the proposed methodology for taking account of the costs of PSB obligations related to the analogue service appropriate?*

Question 13: *Is Ofcom's proposal to include in the valuations an opening and closing allowance for the value of assets required to operate the broadcasting licence appropriate? If so, is the proposal to use net book value as a basis for determining the value of the assets reasonable?*

Question 14: *Is it appropriate to include in the estimate of entry costs the value of regional production assets, only to the extent that they are required by the broadcasting licence?*

Question 15: *What other types of costs, if any, should be included in the estimate of entry costs? Please suggest a method for quantifying these costs.*

Question 16: *Is it appropriate to include in the valuations a 'viewer migration value' for the analogue licence as described? If so, what would be a suitable methodology for estimating the value?*

Question 17: *Is Ofcom's proposal to use a single real, pre-tax discount rate of 12% for all licence valuations reasonable? If not, please provide supporting evidence.*

Question 18: *Should Ofcom reconsider the 75/25% split between the PQR and annual cash sum? If so, what would be an appropriate split?*

Question 19: *Is the proposed set of information required from licensees reasonable?*

Question 20: *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 31 December 2004?*

Annex 4

Licensees' current payment terms

Licensee	Percentage of Qualifying Revenue	Fixed Annual Cash Sum Payable in 2004 (£m's)
Anglia	17%	3.63
Border	2%	0.08
Carlton	20%	17.85
Central	17%	7.99
Granada	15%	4.28
HTV	7%	2.32
LWT	17%	5.18
Meridian	23%	12.90
Tyne Tees	16%	2.24
Westcountry	13%	1.29
Yorkshire	22%	8.52
GMTV	23%	4.52
Channel	0%	0.001
Ulster	5%	0.61
Scottish	11%	1.80
Grampian	6%	0.11

Annex 5

Implementation of the definition of qualifying revenue

1. Ofcom intends to introduce two categories of qualifying revenue in the digital replacement licences: analogue qualifying revenue and digital terrestrial qualifying revenue. The existing PQR rate will be applied to both categories of qualifying revenue. However, Ofcom will assign a weighting to each category, for the purpose of calculating licence payments, and the weightings will be based on each category's impact on the most recent licence valuation. The weighting that will attach to digital revenues when the digital replacement licences are issued will be zero. The implication of this approach is that licence payments will not change as a result of the issuance of digital replacement licences.

2. If Ofcom believes, at the time of a review of the financial terms of a licence, that the digital terrestrial service is contributing a net positive value to the licence, a non-zero weighting may be introduced to digital terrestrial qualifying revenue. However, Ofcom's preliminary view is that the value of the digital terrestrial element of the licence will most likely be minimal and could possibly be negative.

3. Ofcom intends that the calculation of licence payments will work as in the following example:

Digital licence provisions

PQR rate payable for licence:	20%
Weighting applied to analogue qualifying revenue:	100%
Weighting applied to digital terrestrial qualifying revenue:	0%

Revenue of licence holder

Total revenue derived from advertising and sponsorship:	£100

Apportionment of revenue by platform

Satellite	30%
Cable	10%
Digital terrestrial	10%
Analogue	50%

Calculation of qualifying revenue

Digital terrestrial qualifying revenue	£100 x 10% = £10
Analogue qualifying revenue	£100 x 50% = £50
Total qualifying revenue	£60

Calculation of PQR payment amount

PQR payment =
PQR rate ((digital terrestrial QR x weighting of digital terrestrial QR) + (analogue QR x weighting of analogue QR))

In this example, the PQR payment would equal:
20% ((£10 x 0%) + (£50 x 100%)) = £10

Annex 6
Cost of capital calculation

Summary

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 television company. In order to be consistent with the proposed circumstances of the hypothetical auction, Ofcom's proposed discount rate is intended to reflect the opportunity cost of investment faced by a hypothetical entrant that is assumed to be an existing television company. Ofcom has considered calculating discount rates on a licence-by-licence or ownership-group basis. However, Ofcom is of the view that, to the extent that there are material differences between licences or groups of licences that may impact the discount rate (e.g. smaller licensees may have a higher proportion of fixed costs), they would be prohibitively difficult to estimate in a robust manner.

2. Ofcom has calculated a real, pre-tax rate of 12%, which is meant to reflect the weighted average cost of capital (WACC) of a hypothetical entrant. The calculation is based on data and estimates relating to the existing licensees and other European broadcasters and reflects a combination of Ofcom's own assumptions and equity analysts' estimates.

Introduction

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.

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.

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.

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

Estimating discount rates

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

   - the recently merged ITV;
   - Carlton and Granada;
   - other UK media/broadcasting companies; and
   - specific and generic European broadcasters as modelled by financial analysts

8. 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

9. 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. The nominal risk free rate for 10-year gilts in the first four months of 2004, i.e. January to April, averaged at 4.85%. The difference between this and the corresponding real rate implies an inflation rate of approximately 2.8%. The implied inflation rate is calculated on a geometric basis: (1+nominal rate)/(1+real rate) –1. In the interests of being conservative, Ofcom proposes to use a rounded value of 5%.

Equity risk premium

10. 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.

11. Ofcom has used a value of 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. The value of 5% is higher than the value typically used by other regulators and practitioners. However, Ofcom's view is that 5% falls within a reasonable range of estimates and Ofcom favours a higher estimate given the uncertainty in the industry.

Equity beta

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

13. Ofcom has given equal weight to a number of beta estimates, as shown in the table below.

Estimate	Data	Source	Average value at 10% gearing
ITV PLC	Daily data, Feb – June 2004	Ofcom estimate	0.87
Carlton & Granada PLC	Daily data, Jan – Dec 2003	The Brattle Group	1.66
ITV/generic European broadcaster	Various	Four different equity analysts	1.23
Average			**1.25**

14. In the light of the above estimates, Ofcom has used in its calculation a value of 1.25 for equity beta. This is consistent with an estimate of 1.23 calculated by The Brattle Group for the UK's FTSE Media and Entertainment Index against the FTSE All Share Index.

Optimal gearing

15. 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.

16. Ofcom is minded to base its estimate on the optimal gearing values used by sector analysts in recent (2004) reports. Based on such figures, a value of 10% is appropriate.

Debt premium

17. 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. The promised yield on outstanding ITV bonds in the first three months of 2004 was between 5.6 and 5.7%. Given Ofcom's assumed risk-free rate (see above), this corresponds to a debt premium of about 1%, which is in line with the values used by sector analysts.

Conclusion

18. 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 TV advertising market. Ofcom's estimate for a nominal post-tax WACC is 10.5%. This translates into a real, pre-tax WACC of 11.9%, which Ofcom proposes to round to 12%. A summary of the components of the WACC calculation follows:

Summary of calculation

Variable	Estimate
Risk-free	5.00%
Equity risk premium	5.00%
Equity beta	1.25
Cost of equity (nominal, post-tax)	**11.25%**
Debt premium	1.00%
Cost of debt (nominal, pre-tax)	6.00%
Corporate tax rate	30%
Cost of debt (nominal, post-tax)	**4.20%**
Gearing (D/{D+E})	10%
WACC (nominal, post-tax)	10.5%
WACC (nominal, pre-tax)	15.1%
WACC (real, pre-tax)	**11.9%**

19. For comparison, the average real, pre-tax rate used in the analysts' reports that Ofcom has reviewed[7] is just below 9%, with a minimum of about 8.5% and a maximum of about 9.75%. The single biggest factor behind the difference between analysts' rates and Ofcom's proposed rate is Ofcom's use of a value of 5% for the equity risk premium. As mentioned earlier, Ofcom favours the use of a higher estimate than that typically used by other regulators and practitioners.

[7] Analysts typically use nominal, post-tax discount rates in their analysis. For comparison purposes, Ofcom has translated these rates into real, pre-tax rates using the current rate of inflation.