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Critical Review of Ofcom's Impact Assessment of Licensing Policy for VHF Band III, Sub- band 3

Prepared for Digital One

NERA

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NON-CONFIDENTIAL VERSION

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Contents

1.	Introduction	1
2.	Stage One: Definition of the Issue	3
3.	Stage Two: Definition of Policy Objectives	3
4.	Stage Three: Identification of Options	5
5.	Stage Four: Identification of Impacts on Stakeholders	6
6.	Stage Five: Identification of Impacts on Competition	9
7.	Stage Six: Assessment of Impacts and Choice of Best Option	10
8.	Summary	12

1. Introduction

1.1. Background

This report, which has been prepared by NERA Economic Consulting (NERA), was commissioned by Digital One. It examines the extent to which Ofcom's recent consultation document on radio licensing policy for VHF Band III,¹ constitutes an impact assessment as defined by Ofcom in its guidelines "Better Policy Making, Ofcom's approach to Impact Assessment", issued 21 July 2005.² NERA has focused on the economic aspects of the impact assessment and has not dealt with issues of technical feasibility.

A number of Ofcom's findings in its recent consultation document are based on two past consultation documents and the stakeholder responses to them.³ To a limited extent, Ofcom also rely on the findings of a report prepared by Analysis, DotEcon and Mason (the ADM report).⁴ These various documents identify a number of policy options, assess the likely economic benefits for stakeholders, and, where possible, quantify them.

NERA has already reviewed the ADM report and Ofcom's initial impact assessment (which formed part of the 2003 consultation) in a separate report, which was submitted to Ofcom by Digital One earlier this year.⁵ Ofcom then commissioned a response to NERA's paper,⁶ to which NERA has now responded in a separate report to Digital One.⁷

NERA has assumed that Ofcom, when preparing its impact assessment, would have been subject to the guidelines that it issued in July 2005. While we recognise that the consultation process regarding the licensing policy for VHF Band III started before these guidelines were issued, we note that they are heavily based upon, and do not differ substantially from, the guidelines provided by the Cabinet Office in their document "Better Policy Making Guide: a Guide to Regulatory Impact Assessments". Moreover, Ofcom adopted its guidelines on 1 August 2005, a date which precedes the publication of this latest impact assessment.

¹ Ofcom, "Radio- Licensing Policy for VHF Band III, Sub-band", 19 October 2005. NERA has used the confidential version of the document provided by Ofcom to Digital One.

² Ofcom writes that "Ofcom is required under section 7 of the Communications Act to carry out an assessment of the likely impact of implementing a proposal where it appears to Ofcom that the proposal is important. This document constitutes an impact assessment for this purpose." In addition, Ofcom writes in the foreword that it has "returned to first principles to consider what [it] should do"(paragraph 2.14 "Radio- Licensing Policy for VHF Band III, Sub-band", Ofcom consultation document, 19 October 2005)

³ VHF Band III and 1.5GHz Band Consultation , October 2003 (http://www.ofcom.org.uk/consult/condocs/ra_rau/) and Radio Review Phase One Consultation, December 2004 (http://www.ofcom.org.uk/consult/condocs/radio_review/radio_review2/)

⁴ "Assessment of options for allocating available spectrum within VHF Band III and L-Band: Final Report", prepared for Ofcom by Analysis, DotEcon and Mason, December 2004 (available online: <http://www.dotecon.com/publications/>)

⁵ NERA, "Analysis of Ofcom's Impact Assessment of the Allocation of Available Spectrum within VHF Band III and L-Band", Report prepared for Digital One, February 2005.

⁶ "Response to Digital One comments on Band III report", prepared for Ofcom by Analysis, 2 June 2005

⁷ NERA, "Response to Analysis' Response to Digital One's Comments on Band III Report", October 2005.

1.2. Scope of an Impact Assessment

Impact assessments of a given policy are designed to identify all the costs and benefits that accrue to affected stakeholders. They therefore need to take account of the wider impacts of policy options and their knock-on effects across the communications sector. This helps to ensure that objective, reasoned decisions can be taken that maximise the interests of UK citizens and minimise the risk of unintended consequences.

Ofcom outline six main stages of an impact assessment:

1. Defining the issue that is under consideration and identifying the citizen or consumer interest;
2. Defining the policy objective;
3. Identifying the options;
4. Identifying the impacts on different types of stakeholder;
5. Identifying any impacts on competition; and
6. Assessing the impacts and choosing the best option

Each stage of the impact assessment builds upon the analysis and findings of previous stages so that the options relate to the policy objectives; the impacts of each policy option are considered – even if only qualitatively – and the choice of the best option involves assessing the impacts of each policy option.

1.3. Structure of Report

NERA has used the different stages of an impact assessment as the titles of the following sections of this report. In each section, NERA has reviewed the extent to which the consultation document has fully met the objectives of an impact assessment as set out in the relevant part of Ofcom's guidelines. In addition, NERA has assessed the extent to which the outputs from each of the stages relate to each other.

In the final section of the report, NERA provides a summary of the extent to which Ofcom's consultation document represents a complete impact assessment.

2. Stage One: Definition of the Issue

Ofcom sets out its definition of the issue to be addressed in Section 3 of its consultation document.⁸ Ofcom defines the issue as being how best to allocate and assign the spectrum in sub-band 3 of VHF Band III (that is, the frequency range 209.2-217.5MHz) and the associated guard bands. The latest information available to Ofcom is that four blocks of Band III spectrum may now be available for release.

Additionally, Ofcom considers what should happen to existing users of this spectrum, whether co-existence would be possible and, if not, whether they should be moved elsewhere. At the same time, it notes that any policy options or proposals would also be subject to international agreements.

3. Stage Two: Definition of Policy Objectives

It is necessary to identify Ofcom's policy objectives in order to determine the extent to which later stages of the impact assessment have been correctly carried out.

Ofcom's overarching role is "to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate, by promoting competition".⁹ Ofcom also has a general preference for avoiding regulatory intervention where possible unless policy objectives would not be achieved otherwise and the intervention is proportional. Furthermore, it is Ofcom's intention to release and liberalise spectrum as quickly as possible.¹⁰ Nevertheless, Ofcom recognises that it should consider whether the market would best achieve its policy objectives and that there are two main ways in which the market can fail:

- § By not delivering the types of broadcasting to which consumers may want to listen or have the option of listening;
- § By not taking account of the positive externalities of broadcasting and supplying less than may be socially optimal.¹¹

Ofcom's goals fall under two broad categories. Firstly, under its radio broadcasting policy objectives, Ofcom aims to secure "a wide range of commercial radio services to enhance choice and competition by licensing new digital services and by encouraging the growth of digital radio more generally." Secondly, under its spectrum policy objectives, Ofcom aims to promote market-based allocation and assignment of spectrum as quickly as possible and where optimal. The objectives of these two policies may be conflicting and Ofcom may have to exercise a certain degree of discretion to ensure that its overall role is fulfilled.

⁸ "Radio- Licensing Policy for VHF Band III, Sub-band", Ofcom consultation document, 19 October 2005

⁹ "Better Policy Making, Ofcom's approach to Impact Assessment", issued by Ofcom 21 July 2005

¹⁰ "Radio- Licensing Policy for VHF Band III, Sub-band", Ofcom consultation document, 19 October 2005, paragraph 4.28

¹¹ Ibid, paragraph 4.35

As the consultation process progressed, Ofcom narrowed down its specific policy objectives for the allocation of this spectrum and focused on the following:

1. Securing wider access to local digital radio services in areas that presently do not have coverage from local services on the DAB platform;¹²
2. Securing additional national sound services on the DAB platform that contribute to the choice and diversity for listeners and are widely available;¹³
3. Providing additional capacity for radio services that are presently broadcast using only analogue technology, to secure a migration path to digital broadcasting;¹⁴ and
4. Providing additional capacity for local digital radio services per se, including in areas already served by local digital radio multiplexes.¹⁵

Ofcom also has a duty to “secure in carrying out its function the availability throughout the UK of a wide range of television and radio services, which taken as a whole are both of high quality and calculated to appeal to a variety of tastes and interests.”¹⁶

It can be seen that, while these are largely public policy objectives, there is still a need to determine the most efficient and most economic way of achieving them.

¹² Ibid, paragraph 6.20

¹³ Ibid, paragraph 6.30

¹⁴ Ibid, paragraph 6.65

¹⁵ Ibid, paragraph 6.89

¹⁶ Ibid, paragraph 6.149

4. Stage Three: Identification of Options

During the consultation process, Ofcom identified a number of different allocation options. These include allowing licence exempt usage versus licensed usage and setting different parameters for licences including geographical scope and spectrum masks.¹⁷ In the event that there would be policy objectives that would not be achieved without intervention, and that the benefits would be greater than the cost of doing so, Ofcom maintained its discretion to intervene to correct market failure in the least costly manner.

Ofcom looked at a number of service options including private mobile radio (PMR), public access mobile radio (PAMR), terrestrial digital audio broadcasting (DAB) radio, and portable and mobile multimedia services over DAB and digital video technologies. The ADM report did not identify any options additional to those in the 2003 consultation since it was Ofcom that defined the parameters of the ADM study. Ofcom identified the possibility of sharing of spectrum between different uses such as PMR/PAMR and T-DAB subject to technical feasibility.

Other options related to whether licensing conditions such as whether licences should be issued under the Broadcasting Act as well as the Wireless Telegraphy Act (i.e. whether licences should be usage neutral) and what the limit of non-programme related data content should be. Another licensing option was the requirement of a minimum coverage area. In its 2005 consultation Ofcom also discussed the option of allowing the spectrum to be used licence-exempt.¹⁸

As the consultation process progressed, the options were narrowed down to the number of blocks that should be allocated to national and local on a basis compatible with the technical configuration for T-DAB.¹⁹ Ofcom argued that, since only four blocks of spectrum are expected to be available in T-DAB compatible form, “the options are to use one, two, three or all four of these blocks to complete the coverage of local multiplexes.”²⁰

However, as NERA argued in its first report, Ofcom has not identified, addressed or evaluated all allocation options. Examples of additional options would include varying the time at which new spectrum would be released or allocated to different uses.

¹⁷ Ibid, paragraph 6.4

¹⁸ Ibid, paragraph 6.2

¹⁹ Ibid, paragraph 5.32

²⁰ Ibid, paragraph 6.120

5. Stage Four: Identification of Impacts on Stakeholders

In NERA's first report, it was argued that Ofcom had not identified all stakeholders and, as a result, had not given full consideration to the likely impacts of policy options. NERA notes that, in this latest consultation document, Ofcom has given more complete attention to existing digital radio multiplexes. However, some issues still remain.

5.1. Determination of Likely Policy Outcomes

It does not appear that Ofcom has looked at the likely outcome of its policy options in sufficient detail. Specifically, although Ofcom recognises the importance of determining the financial viability of new entrants to the market,²¹ Ofcom does not appear to do this.

In addition, Ofcom does not make it clear in its impact assessment how different licensing options would affect the likely outcomes. This means that Ofcom's use of both ADM's estimates (which seem to assume that the whole spectrum block will be used either for broadcasting or for multimedia services and not for a mix of the two) and Ofcom's own estimates of the economic and wider benefits may be misleading.²² This is because the licensing framework may limit the amount of spectrum that can be used for different services. Even if the decision is not an economic one, it is not clear that Ofcom has considered how likely it is that its public policy objectives will be achieved. Also it is not clear that the benefits anticipated by Ofcom will necessarily materialise since the likely development of the market has not been fully considered.

While the purpose of the ADM study was not to predict how the market would allocate the spectrum, it did nevertheless estimate the economic value of different allocations. Ofcom appears to assume that its proposal of allocating the fourth block for national use will result in the achievement of its policy objective of securing national sound services on the DAB platform. However, this may not be the case.

For example, Ofcom has assumed that entry to the digital broadcasting and multiplex market will be profitable and that this will result in more competition and greater choice and benefits for listeners. However, as we discuss in the rest of this section, it is quite possible that there is insufficient demand for two national multiplexes. Therefore, irrespective of the licence conditions, Ofcom's proposals may not result in increased competition and the benefits that would accompany it.

5.2. Impact on Existing Multiplexes

One of NERA's main arguments from its first report was that Ofcom did not sufficiently take account of the impact of policy options on all stakeholders. In particular, NERA concluded that Ofcom had not given sufficient consideration to the effect of more spectrum being available for national digital radio multiplexes on the incumbent operator, Digital One.

²¹ Ibid, paragraph 6.116

²² See "Response to Analysys' Response to Digital One's Comments on Band III Report", NERA, October 2005

[CONFIDENTIAL INFORMATION REMOVED]²³

[CONFIDENTIAL INFORMATION REMOVED]²⁴

[CONFIDENTIAL INFORMATION REMOVED]²⁵

[CONFIDENTIAL INFORMATION REMOVED]

5.3. Impact on Listener Choice

Ofcom argues that any new radio stations entering the national commercial market will have to satisfy licensing conditions set by Ofcom. Ofcom also argues that it could ensure new entrants would increase choice for listeners if the multiplex licence is issued under the Broadcasting Act since Ofcom will be able to set conditions on the content and geographical coverage of radio stations operating on that multiplex.²⁶

However, Ofcom's own research shows that the benefits of increased choice are uncertain. In particular, Ofcom concludes that there was no widespread consensus among respondents over whether greater choice would increase how much they valued digital radio.²⁷ A confidential response to the consultation process also concluded that the benefits of more digital radio stations may be limited.²⁸

Nevertheless, there may not necessarily be entrants and Ofcom's predicted benefits may not materialise. It does not appear that Ofcom has given sufficient consideration to the likely financial feasibility of entrants to the market and therefore the outcome Ofcom predicts may not materialise.

²³ [CONFIDENTIAL INFORMATION REMOVED]

²⁴ [CONFIDENTIAL INFORMATION REMOVED]

²⁵ [CONFIDENTIAL INFORMATION REMOVED]

²⁶ Ibid, paragraph 6.149-150

²⁷ Ibid, paragraph 6.56

²⁸ Ibid, paragraph 6.57

5.4. Impact in the longer term

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²⁹ [CONFIDENTIAL INFORMATION REMOVED]

³⁰ [CONFIDENTIAL INFORMATION REMOVED]

³¹ [CONFIDENTIAL INFORMATION REMOVED]

³² [CONFIDENTIAL INFORMATION REMOVED]

5.5. Other Impacts not Considered by Ofcom

While Ofcom recognises that the timing of the release of new spectrum will have an effect on existing businesses, it does not analyse or quantify the impact of varying the timing. This is important since varying the timing of spectrum release may have important economic implications.³³

For example, it would be possible to delay the release of the fourth block of spectrum for national use. This would enable Digital One to make a sufficient return on the investment it made in developing digital radio technology, developing the T-DAB radio market and increasing demand for digital radio more generally. By allowing the market to develop further, that is by allowing demand for digital radio services in general to increase, Ofcom could help to ensure that there would be entry to the national commercial multiplex market and that this entry would increase the amount of competition in the market. Moreover, the prospect of a future entrant could provide Digital One with the incentive to innovate more and lower costs so that it will be better placed to compete once a competitor enters the market. Therefore, some of the benefits of competition might be enjoyed by consumers in advance of competition actually occurring.

Not only would such a delay be likely to increase benefits, it would also send a strong signal to future investors of Ofcom's regulatory commitment. In the longer term, this would have implications not just for the digital radio market but for other markets regulated by Ofcom.

5.6. Longer Term Impact not Fully Considered by Ofcom

Ofcom has still not given due consideration to the likely longer term implications of its decision and the signal that this policy could send to future investors. When Digital One was awarded the national commercial digital radio licence, it was on the understanding that it would be the sole licence holder for the duration of the licence. Indeed, the Radio Authority (one of Ofcom's legacy regulators) advertised it as being the only one to be issued.³⁴

Permitting a second national digital multiplex runs contrary to this understanding and may create the perception of a lack of regulatory commitment. This in turn increases the perception of regulatory risk and may act as a disincentive to future investment in the communications industry.

6. Stage Five: Identification of Impacts on Competition

By releasing spectrum for an additional national multiplex, Ofcom argues that there will be significant effects on competition.

³³ Although one respondent to the consultation process noted that "delay [to introducing a second national multiplex] could lead to stagnation of the market and younger audiences by-passing the T-DAB platform altogether." ("Radio-Licensing Policy for VHF Band III, Sub-band", Ofcom consultation document, 19 October 2005, paragraph 6.49)

³⁴ See "News Release: Radio Authority Advertises First and Only National Commercial Digital Multiplex Licence", 23 March 1998, <http://www.ofcom.org.uk/static/archive/rau/newsroom/news-release/98/pr25.htm>

For example, Ofcom argues that there may be a price premium on carriage on the current national multiplex and that competition would be beneficial since for spectrum consumers (including digital radio stations, data providers, listeners and advertisers) since a second national multiplex could erode that price.³⁵

However, the effects on competition identified by Ofcom, are subject to entry to the market being economically viable for new multiplex providers. Ofcom does not appear to have analysed in any detail whether such entry will be viable. A full impact assessment ought to require such an analysis for otherwise the benefits are merely conjectural.

7. Stage Six: Assessment of Impacts and Choice of Best Option

The decision to allocate three of the spectrum blocks to local commercial digital multiplexes was a public policy one and not one based on an economic assessment of the impacts.³⁶ In other words, Ofcom's decision was not based on the economic value of different options to stakeholders. Ofcom considered that allocating three blocks to local coverage would allow listeners in practically all parts of the UK to access local digital radio and would provide an appropriate degree of granularity without preventing Ofcom from meeting its objective to increase national digital multiplex capacity.

Similarly, the decision to allocate the fourth block of spectrum for national use that would be compatible with the technical configuration for T-DAB was not based on economic considerations. However, although Ofcom's decisions over the best way to allocate the spectrum blocks seem to be largely based on public policy objectives, there is still a role for economic analysis in determining whether these objectives are being achieved in the most economically efficient way.

Ofcom claims that it "has considered the opportunity costs associated with a regulatory intervention in this case in as much detail as the information available allows."³⁷ However, by not giving sufficient weight to economic considerations, Ofcom is not in a position to conclude that its policy proposals will actually result in its stated public policy objectives being achieved. Furthermore, this may be to the detriment of other policy objectives. For example, Ofcom did not determine whether any firms would be able to provide local digital multiplexes profitably in areas that do not presently have coverage from local services on the DAB platform. This means that it is possible that Ofcom's objective of securing wider access

³⁵ "Radio- Licensing Policy for VHF Band III, Sub-band", Ofcom consultation document, 19 October 2005, paragraph 6.155

³⁶ Ibid, paragraph 6.131

³⁷ Ibid, paragraph 6.96

to local digital radio services in these areas may not be achieved. If that is so, the spectrum involved might have been more beneficially used for other purposes.

8. Summary

Given that each stage of an impact assessment builds upon the preceding stages, it is important that an impact assessment completes each stage in the fullest way possible. However, critical analysis of the Ofcom impact assessment shows that Ofcom has not done this and that therefore the conclusions reached may not necessarily be sound.

Although Ofcom may have made policy recommendations on the basis of public policy considerations – that is, by not placing much importance on the relative economic value but rather, on the social value of different options – NERA concludes that Ofcom has not conducted sufficient economic analysis to determine whether its objectives would be met regardless of the relative values of these objectives.

In addition, NERA remains unconvinced that Ofcom has given due consideration to the impact of the policy options on existing stakeholders or to the longer term implications. Namely, Ofcom has not considered signals provided to future investors.

More importantly, by not conducting a full economic analysis, Ofcom has assumed that the scenarios it predicts will arise. This has two important implications.

- § Firstly, it means that Ofcom has not considered whether its predicted outcomes would actually happen and what the implications would be if the predicted outcomes failed to materialise.
- § Secondly, it means that Ofcom has not sufficiently considered the need for identifying alternative policy options.

The combination of the above effects means that the impacts of both Ofcom's chosen option and other options have not been fully assessed and evaluated. As a consequence Ofcom may not have chosen the best option.

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