Renewal of the Independent National Radio licences

Methodology for review of financial terms

Consultation

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About this document

The UK's three national analogue (FM and AM) commercial radio licences (currently held by Classic FM, TalkSport and Absolute Radio) are all due to expire in 2018. Under the Broadcasting Act 1990 (as amended), all three licences qualify for a further five year renewal. This means that each licensee can apply to extend their licence, rather than having to re-apply for their licence in an open competition.

The licences were originally awarded by an auction process, and the licensees are required to make financial payments to the Treasury. These financial payments consist of a cash bid amount, and a specified proportion of the revenue obtained by the licensee. This latter payment is known as the percentage of qualifying revenue, or PQR. When the licences were first auctioned in the early 1990s, the applicants were required to bid a cash sum. This amount then became payable by the successful bidder as an annual fee. The PQR for each licence was determined by the then regulator, the Radio Authority.

As the licence renewal process means there is no actual auction of the licences (and therefore no cash bids), Ofcom is required to set new financial terms for each licence. These financial terms consist of an amount which, in our opinion, would have been the cash bid of the licence holder if the licence had been auctioned for the renewal period, together with a PQR. This consultation is primarily concerned with the timetable and methodology we propose to follow in order to set these financial terms.

We propose that the methodology used by Ofcom in 2010 for setting the financial terms of the three licences remains broadly appropriate, and will enable us to determine financial terms that are fair and reasonable within the context of the current market environment.

In order to appropriately reflect the uncertainties we face when trying to value the licences, we propose to take account of various information sources, but we are seeking views through this consultation on whether there are alternative ways to deal with the uncertainties.

We are seeking the views of stakeholders by 24 June 2016 and plan to issue a statement towards the end of July.

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Section 1

Executive summary

1.1 Section 103B of the Broadcasting Act 1990 (as amended) (“the 1990 Act”)[1] enables the further renewal of the three independent national radio (‘INR’) licences for a period of five years, beginning with the date of renewal. The three INR licences are held by Classic FM, Absolute Radio and Talksport. This amended legislation represents a third opportunity for the three INR licensees to apply for a licence renewal and thus avoid having to apply for a new licence in an auction process.

1.2 Licence renewal is a statutory incentive for the holder of an analogue licence to provide a digital service on the DAB platform. Specifically, an INR licence is eligible to be renewed only if its holder is providing a DAB simulcast service. All three INR licensees are currently providing such a service, and thus are eligible to apply for a renewal.

1.3 Each of the three INR licences has an expiry date between February 2018 and December 2018. Consequently, the timetable for each licence to undergo the process of renewal is potentially different. In this consultation document we set out the renewal timetable for all three licences.

1.4 As part of the process of INR licence renewal, Ofcom is required to set new financial terms for each licence. These financial terms consist of an amount which, in our opinion, would have been the cash bid of the licence holder were the licence being auctioned for the renewal period rather than renewed (the "cash bid"), and a percentage of qualifying revenue ("PQR"). This consultation is primarily concerned with the methodology we propose to follow in order to set these financial terms.

1.5 We propose that the methodology used by Ofcom in 2010 for setting the financial terms remains broadly appropriate and will enable us to determine financial terms that are fair and reasonable within the context of the current market environment.

1.6 In order to set a cash bid and PQR, we propose to value each licence from the perspective of a new entrant in order to determine the amount of the second-highest bid in a hypothetical auction. We propose to apply a discount rate of 11.0% to the valuations.

1.7 In order to appropriately reflect the uncertainties we face when trying to value the licences, we propose to take account of various information sources, but seek views on whether there are alternative ways to deal with the uncertainties.

1.8 One of the key uncertainties is the potential duration of the renewed licence periods, given that the 2010 Digital Economy Act enables the termination of renewed INR licences with two years notice if the Secretary of State nominates a date for digital switchover. However, we consider that a potential bidder for an INR licence would attach a relatively low weight to the possibility of switchover prior to the expiry date of the renewed licence. This is because: i) the Order[2] allowing further renewal of the licences for five years was made only recently, and ii) the expiry dates of the

[1] This section was originally inserted by section 31 of the Digital Economy Act 2010 and has now been amended by the Legislative Reform (Further Renewal of Radio Licences) Order 2015/2052.
[2] The Legislative Reform (Further Renewal of Radio Licences) Order 2015/2052.

renewed licences[3] and the earliest potential date for switchover based on the government's most recent statement[4] are relatively close together, such that it would be reasonable for a potential bidder to anticipate that the government would be unlikely to announce a switchover date just before the INR licences are in any case due to expire. We therefore propose to determine the financial terms based on a valuation of each licence for the full five-year renewal period.

[3] If each INR licence was renewed for five years they would be likely to expire sometime in 2022 as explained in further detail in section 3 of this document.
[4] In the 2015 consultation on the BBC Charter Review the government indicated that the earliest date for digital switchover could be sometime in 2021.

Section 2

Legal framework

2.1 Section 103B of the 1990 Act (as amended)[5] enables the further renewal of the three INR licences for a period of five years, beginning with the date of renewal. The three INR licences are held by Classic FM, Absolute Radio and Talksport.

2.2 This amended legislation represents a third opportunity for the three INR licensees to apply for a licence renewal, and thus avoid having to apply for a new licence in an auction process. All three licences were previously renewed in 1999/2000 (for an eight-year period); extended in 2006 (for a four year period)[6] and renewed in 2011 (for a seven-year period).

2.3 Under the 1990 Act, where the holder of a national analogue licence applies for renewal, Ofcom must renew the licence if:

- it is satisfied that the licensee would continue to provide its analogue service in accordance with its licensed Format;
- a digital simulcast service is being provided by the licensee; and
- the licensee agrees to the financial terms (also known as 'additional payments') set by Ofcom.

2.4 In relation to the financial terms, the legislation requires us to determine the amount which, in our opinion, would have been the cash bid of the licence holder were the licence (instead of being renewed) to be granted for the (further) renewal period on an application made in accordance with the competitive process for new licences.[7] It also requires Ofcom to specify the PQR for each accounting period that will be payable by the applicant during the licence renewal period.[8]

2.5 This consultation document is about the process and timetable for national analogue licence renewal applications and the methodology for determining the financial terms.

Timetable for the renewal applications and financial terms reviews

2.6 The legislation prescribes a 'window' within which a national analogue licensee is able to apply for a renewal – this 'window' opens three years before the expiry date of the current licence, and closes three months before the 'relevant date'.

2.7 The 'relevant date' is defined in statute as the date by which, if the licence was not renewed, Ofcom would need to publish a notice inviting applications for the licence to enable a fresh licence to be granted from the expiry date of the current one. Ofcom has already determined that the 'relevant date' for each of the three INR licences is one year prior to the expiry of the current licence. The legislation sets the application deadline as three months prior to the 'relevant date' to allow Ofcom up to

[5] This section was originally inserted by section 31 of the Digital Economy Act 2010 and has now been amended by the Legislative reform (Further Renewal of Radio Licences) Order 2015/2052.
[6] Under section 253 of the Communications Act 2003.
[7] Under section 98 of the Broadcasting Act 1990.
[8] The cash bid and PQR are payable to Ofcom but then passed to the Treasury.

three months to reach a decision as to whether or not to renew a licence (this includes offering financial terms). If, for whatever reason, a licence is not renewed it can then be re-advertised by the 'relevant date'.

2.8 Table 2.1 shows the application deadline for each INR licensee.

Table 2.1: Application deadlines

Service	Expiry date	Relevant date	Application deadline
Classic FM	28 Feb 2018	28 Feb 2017	28 Nov 2016
Absolute Radio	30 Apr 2018	30 Apr 2017	30 Jan 2017
Talksport	31 Dec 2018	31 Dec 2017	30 Sep 2017

2.9 The statutorily-prescribed deadline for applying for licence renewal represents the date by which a licensee must have formally applied for renewal. It is not necessarily the date by which a licence must have been renewed. Rather, the legislation says that, if it is not reasonably practicable to renew a licence by the relevant date, the licence should be renewed as soon as is reasonably practicable after that date.[9]

2.10 As can be seen from Table 1, the first 'relevant date' is 28 February 2017, in respect of the licence held by Classic FM. It is open to both Absolute Radio and Talksport to apply for renewal at the same time as Classic FM. This will enable Ofcom to carry out the work to determine the financial terms for all three licences at the same time. But, if one or both of Absolute Radio and Talksport choose not to apply for renewal at the same time as Classic FM, that will not delay the determination of the financial terms for the Classic FM licence.

2.11 As noted above, a licence is renewed from the date of renewal, not from the expiry date of the current licence. This means that any revised financial terms will apply from the date of renewal. Following the statement on the methodology for determining financial terms we will request detailed financial information from licensees to inform our determination of financial terms. Licensees will have 30 days to accept the financial terms determined by Ofcom. Table 2.2 sets out the renewal timetable for all three licences.

Table 2.2: Renewal timetable

Date	**Event**
28 November 2016	Statutory deadline for Classic FM to submit its application for renewal. Deadline for Absolute Radio and Talksport to submit their application for renewal, if they wish to have their financial terms determined at the same time as Classic FM.
30 January 2017	Ofcom expects to offer revised financial terms to Classic FM and any other licensees who have applied to have their financial terms determined at the same time as Classic FM. The deadline for Classic FM to accept terms is 30 days

[9] See section 103A (8) of the Broadcasting Act 1990.

	from the date of the determination. Other licensees who have applied to have their financial terms determined concurrently with Classic FM have until their own relevant date to accept the terms. Revised terms take effect from the date upon which the licence is renewed (i.e. on acceptance of the terms).
30 January 2017	Statutory deadline for Absolute Radio to submit its application for renewal – unless it has already had its financial terms determined alongside Classic FM. Deadline for Talksport to submit its application for renewal if it wishes to have its financial terms determined alongside Absolute Radio.
1 April 2017	Ofcom expects to offer revised terms to Absolute Radio (and Talksport if it applied for a review by Absolute Radio's application deadline). Deadline for Absolute Radio to accept terms is 30 days from the date of the determination. Talksport, if having its financial terms determined concurrently with Absolute Radio, has until its own relevant date (31 December 2017) to accept the terms. Revised terms take effect from the date upon which the renewal is accepted.
30 September 2017	Statutory deadline for Talksport to submit its application for renewal – unless it has already had its financial terms determined alongside Classic FM or Absolute Radio.
2 December 2017	Ofcom expects to offer revised terms to Talksport if it applied for a review by its application deadline. Deadline for Talksport to accept terms is 30 days from the date of the determination. Revised terms take effect from the date upon which the renewal is accepted.
28 February 2018	Licence expiry date for Classic FM licence if no renewal is applied for or granted, or financial terms not accepted.
30 April 2018	Licence expiry date for Absolute Radio licence if no renewal is applied for or granted, or financial terms not accepted.

31 December 2018	Licence expiry date for Talksport licence if no renewal is applied for or granted, or financial terms not accepted.

Impact assessment

2.12 As is set out in this document, the legislation requires that where an application for renewal under section 103B of the Broadcasting Act 1990 is made to it, Ofcom must determine the additional payments in part at least as if the licence in each case were being granted afresh for the period of the (further) renewal on an application made in accordance with section 98 of the same Act (i.e. on the basis of a competitive tender), instead of being renewed. It is a statutory requirement that Ofcom should determine the additional payments on this basis, and a separate impact assessment on the statutory requirement is not therefore necessary or appropriate.

2.13 However, the purpose of this document is to consult on a proposed approach to such a review within the statutory framework. We have therefore set out in this document those factors which we propose to take into account in carrying out a review and have sought, in Section 3 in particular, to assess their likely impact as far as we can. Where there are current uncertainties, we have invited views on what would constitute an appropriate approach for Ofcom to take in considering them. The document as a whole, but Section 3 in particular, therefore constitutes our impact assessment.

2.14 We invite respondents to comment further, if they wish to do so, on the impact of our proposals when responding to this consultation so that we can take their comments into account in reaching a decision.

2.15 Since the proposals in this document do not have any impact on equality issues, no impact assessment in terms of equality including disability equality, racial equality or equality in Northern Ireland is necessary.

Section 3

Approach to the review of financial terms

Introduction

3.1 This section sets out our proposed approach towards setting the PQR and determining the cash bid for each INR licence holder that applies for a renewal of its licence.

3.2 We propose that the methodology used by Ofcom in 2010[10] remains broadly appropriate, with some modifications that are set out in this section. This section provides an overview of the proposed methodology and invites views and comments on our proposal.

Ofcom's statutory task

3.3 Section 103B (and certain parts of section 103A) of the 1990 Act set out the statutory framework for determining financial terms following an application for renewal made by the licensee. For the five year period of renewal Ofcom must determine two elements:

3.3.1 a fixed annual cash amount ("cash bid"), which rises in line with RPI each year.

3.3.2 the PQR to be payable for each year of the (further)renewed licence.[11] The PQR can vary from year to year.

3.4 In respect of the Cash Bid, the Act requires that Ofcom determine the amount that, in its opinion, would have been the Cash Bid of the licence holder were the licence being granted afresh for the period of the (further) renewal on an application made in accordance with section 98 of the 1990 Act (which established the process for the original auction of the national licences), instead of being renewed.

3.5 Under the 1990 Act the procedure Ofcom must follow in connection with considering applications for national licences is described in section 99. This sets out certain thresholds an applicant must meet before Ofcom may consider its Cash Bid under section 100 of Act. Section 100 indicates that the award of a national licence would then be made to the person submitting the highest Cash Bid who has met the section 99 thresholds. On this basis, Ofcom must, for the purposes of the further renewals now being contemplated, consider the results of a hypothetical auction and determine what, in its opinion, was likely to have been the level of Cash Bid for the licence.

3.6 Under section 98 of the 1990 Act, Ofcom must set out, in its notice inviting licence applications, the PQR that would be payable by an applicant if he were granted the licence. The PQR would therefore be determined before bids are made for the cash bid element. No guidance is given in the Act as to how Ofcom should set the PQR or

[10] The consultation and statement on the methodology and the associated determinations of the 2010 review are available here: http://stakeholders.ofcom.org.uk/consultations/renewal-national-licences/?a=0.

[11] The Act says that the cash bid should be determined for the first complete calendar year falling within the period for which the licence is to be renewed and the PQR for each accounting period.

indeed the relative sizes of the PQR payments and cash bid. The definition of qualifying revenue is set out in section 102 of the 1990 Act and Ofcom is simply required to determine a percentage of it which shall be payable to the Treasury.

3.7 Ofcom therefore has a level of discretion in relation to setting the PQR that it does not have in respect of the cash bid. However, we consider that to ensure a consistent approach to setting both the PQR and the cash bid, it is appropriate to conduct a single valuation according to common principles. This valuation is intended to meet the requirements of the Act in relation to determining the cash bid, and also to provide a robust basis for informing Ofcom's decision as to the appropriate level of the PQR, taking into account both the objectives and the uncertainties discussed in this document.

Valuation methodology

3.8 The methodology set out in the 2006[12] and 2010 reviews was established to inform Ofcom's decision when deciding on the PQR and determining the cash bid for each licence. Ofcom proposes to use a similar approach to any review that is triggered by an application for renewal. This is because Ofcom's statutory task is comparable whether it is required to determine financial terms following an application to renew the licences (as is the case here and was the case in 2010) or whether it is reviewing the financial terms for an extension of the licence term (as was case in 2006). Below we set out our proposed methodology and identify those areas where there are changes from the approach taken in the last review.

3.9 As was the case during the 2006 and 2010 reviews, the aim of the proposed methodology here is to set fair and reasonable terms such that they recover, as far as possible, the combined value of the rights and obligations to the licence holder over the duration of the licence, whether that be eight years (as was the case in the 2006 review), seven years (2010 review) or five years (this review), based on a methodology which is consistent with our statutory duties. The methodology should ensure that the taxpayer gets a proper return for the use of the scarce analogue spectrum and the process should enable Ofcom to set terms that are reasonable within the context of the market environment and continue to be reasonable for the renewed period of the licence.

3.10 Those objectives were set in 2006 and 2010 in light of this statutory backdrop:

3.10.1 our duties in section 3(1) of the 2003 Act to further the interests of citizens and consumers;

3.10.2 our duties in sections 3(2) of the 2003 Act and 85(2) of the 1990 Act relating to securing the provision of a range and diversity of radio services;

and

[12] The consultation and statement on the methodology and the associated determinations of the 2006 review are available here: http://stakeholders.ofcom.org.uk/consultations/methodology/?a=0.

3.10.3 the purposes of the provisions of the 1990 Act relating to the auctioning of INR licences.[13]

3.11 These provisions, and the duties they create, have not changed since 2010, and those duties are met by the services currently provided by the INR licensees. They would continue to be met were their licences further renewed. On those bases, the objectives appear to us to remain appropriate.

Overarching principles

3.12 We propose to apply certain overarching principles in orer to secure the objectives of our valuation methodology. We consider that each licence should be valued as a whole, although for the purposes of explanation and analysis we propose to separately consider the rights and obligations associated with holding the licence. Although rights and obligations are considered separately, where possible the valuation should also seek to take into account any significant consequential effect that the presence of one right or obligation has on another.

3.13 In principle, it is our view 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).

3.14 The identity of the potential bidder will have a bearing on the value of the licence to that bidder, as it determines the counterfactual to be considered when estimating the additional profits that bidder could make as a result of holding the licence. Ofcom considers that alternative bidders with the highest valuations are likely to be existing media companies, either from the UK or abroad, that wish to have a presence in the UK national radio market. We consider that other media companies, and in particular other radio companies, would be likely to have lower costs of entry and greater cost and revenue synergies with the new services than companies without prior media interests which would allow them to extract more value from the licence, making it more likely that existing media companies would be the second highest bidder.[14]

3.15 Our approach to valuing the rights and obligations associated with the licence is as follows:

3.15.1 In general, 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. However, if the right could not be replicated elsewhere then the value would equal the total financial benefit to the licensee of having the right.

[13] The purpose of the statutory provisions relating to the auction of INR licences can be seen from the following statement made to the House of Commons in 1989 during the passage of the Bill that became the 1990 Act, by the then Home Secretary, David Waddington MP. He said the purpose is to "ensure that the tax payer gets a proper return for the use of the valuable and scarce national resources constituted by broadcasting rights and, in particular, the use of the frequency spectrum." See Hansard: http://hansard.millbanksystems.com/commons/1989/dec/18/broadcasting-bill

[14] A discussion of the identity of the new entrant is set out in paragraphs 4.14 to 4.21 of Ofcom's February 2006 Statement on the methodology, http://stakeholders.ofcom.org.uk/binaries/consultations/methodology/statement/statement.pdf.

3.15.2 Similarly, the cost of an obligation would be equal to the extra cost associated with meeting the obligation, net of any benefit to the licensee.

Circumstances of the hypothetical auction

3.16 We propose that the hypothetical auction to assess the overall value of the licence would replicate circumstances as set out below.

3.17 The auction would be designed, within the framework of the legislation, to recover the maximum possible value consistent with the requirement that the successful bidder is also able to fulfil programming and other obligations associated with the licence.

3.18 Each licence would be offered individually on a non-contingent standalone basis in a single round, sealed bid auction.

3.19 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.

3.20 In order to determine the amount of the second-highest bid in an auction, Ofcom would estimate the net present value of the rights and obligations associated with the licence from the point of view of a new entrant. In order to win the auction the incumbent would need to bid slightly more than the new entrant.

***Question 1**: Do you agree that the proposed overall valuation methodology (including our objectives) and the proposed overarching principles are appropriate for the determination of the PQR and cash bid element of the renewed licences? If you do not, please explain why you consider that the overall methodology is inappropriate and what justifications exist for suggested alternatives.*

Valuing the rights associated with the licences

3.21 We propose that rights will be valued at the lower of the value of those rights in use and the cost of acquiring those rights in the market. This reflects the view that a licensee would not pay more for the rights via a licence payment than it would need to pay for equivalent rights elsewhere.

3.22 The principal rights associated with the INR licences are i) the right to broadcast radio using analogue spectrum with national coverage (FM for Classic and AM for Absolute Radio and Talksport) and ii) the right to reserved capacity on the Digital One multiplex.

Right to broadcast on analogue spectrum

3.23 We propose to estimate the value of the right to broadcast on analogue spectrum by reference to the cashflows that can only be achieved by acquiring the licence, since there is no other way of acquiring rights to broadcast on national analogue spectrum.

3.24 The underlying approach to this review is to assess the incremental value of a licence to a new entrant which does not currently own the national analogue licence. We cannot directly observe the additional cashflows that would be available to an operator as a result of owning the analogue licence so we need to find a means of estimating the value of the national analogue licence to a new entrant. We consider that such an approach should be objective, transparent and practicable. In order to forecast cashflows for the analogue service, we propose to allocate revenues and costs of the incumbent licence holder that are common to simulcasts across multiple platforms across services on the basis of the hours of listening expected to be achieved on each platform. This approach will reflect the changing importance of the platform mix over time and is based on observable data on listening hours. Where revenues and costs relate wholly to the analogue licence (e.g. analogue transmission costs) they will be directly allocated to the analogue service.

3.25 A new entrant bidding for the analogue licence is also likely to take account of the costs of entry in its valuation. We consider that these entry costs could include i) pre-launch costs such as capital expenditure, marketing and 'dry-running' costs and ii) post launch revenue effects which may mean the new entrant is not able to generate the same revenue as the incumbent from launch. We propose to include an allowance in the valuation for the reasonable cost of entry of a new entrant. As with other cashflows, we propose that start-up costs that would be common across different platforms will be apportioned across those platforms to reflect their relative value to each.

3.26 In relation to capital expenditure, we do not consider that a new entrant would necessarily replicate all existing assets owned by the incumbent licensee and may consider that leasing an asset for the five-year duration of the licence would be preferable to purchasing it.

Right to reserved capacity on the Digital One multiplex

3.27 INR licence holders have the right to reserved capacity on the Digital One multiplex, as well as an obligation to take up this right and deliver a DAB simulcast. The licence holder must agree a commercial fee for the capacity with the multiplex owner.

3.28 We consider that the right to reserved capacity can provide benefits to the contracting parties in the form of reduced transaction costs from not having to go to the market (to either sell capacity in the case of the multiplex owner or acquiring capacity in the case of the licence holder).[15] We will therefore include in the valuation the benefit to the licence holder of its reserved capacity, based on an estimate of the reduced contracting costs to the licence holder.

Cost of meeting obligations associated with the licences

3.29 The principal obligation is the requirement to simulcast the analogue service nationally on DAB. We propose to treat that as follows.

3.30 Where the proportion of revenues associated with the DAB simulcast, as determined through apportionment based on listening hours, is such that it exceeds the costs of providing the DAB service (where costs comprise costs specific to DAB broadcasting plus a share of common costs determined through apportionment based on listening hours), then this amount will be excluded from the valuation of the analogue licence since it will be assumed to indicate that the decision to

[15] This is consistent with the approach taken in the review of financial terms for the Channel 5 licence where Channel 5 has reserved capacity on two DTT multiplexes. See paragraphs 3.45 and 3.46 of the document *Methodology for determiningin the financial terms of the Channel 3 and Channel 5 licences,* 23 July 2013: http://stakeholders.ofcom.org.uk/binaries/consultations/c3-c5-finance/statement/statement.pdf.

simulcast on DAB can be justified on a commercial basis, distinct from ownership of the analogue licence. That is, in the counterfactual, the new entrant would choose to provide a DAB service whether or not it also owned the analogue licence.

3.31 However, if the revenues associated with the DAB simulcast are less than the costs associated with providing the DAB service (calculated in the same way as set out above) then it will be assumed that the decision to simulcast on DAB cannot be justified on a commercial basis and that the decision to simulcast is due to the obligations which result from ownership of the INR licence. That is, in the counterfactual, the new entrant would not choose to provide a DAB service and is only required to do so as a result of holding the analogue licence. In such circumstances, the net cost associated with the DAB simulcast will be taken into account in the valuation.

3.32 Consistent with the 2010 review[16] in the case of start-up costs apportioned to DAB, these will be taken account of in the valuation to the extent that they are higher than, or occur sooner than would have otherwise have been the case. That is, if the decision to simulcast during the licence period was being made on a commercial basis.

3.33 Simulcasts of the service on other platforms (e.g. satellite, DTT or internet) are not part of the licensed service. They are therefore not included in the valuation except to the extent that there is a causal link to profitability. Where costs and revenues for such simulcasts are shared with the licensed service, they will be apportioned on the basis of listening hours.

***Question 2**: Do you agree with our approach to valuing the rights and obligations associated with the INR licences? If not, please explain why not.*

Dealing with uncertainties for the purposes of the review

3.34 Valuation of licences on a forward looking basis involves taking account of a number of uncertainties. These uncertainties include:

- future trends in listening to the INR services;
- future trends in the proportion of listening that is digital;
- future trends in revenue and costs of the INR licences;
- start-up costs of the new entrant; and
- duration of the licence period.

3.35 The requirement for Ofcom to consider the outcome of a hypothetical single round sealed bid auction adds a further layer of complexity. Neither the exact circumstances of the auction, the identity of bidders, their business plans nor their bidding strategies can be predicted with certainty. Ofcom is unable to eliminate these uncertainties. Therefore, in order to fulfil its statutory duty to determine the financial terms, it is necessary for Ofcom to make a series of assumptions on these issues to achieve a fair and reasonable outcome for the licence valuation.

3.36 In general, our view will be informed by a number of sources, including:

[16] Paragraph 3.80, September 2010 methodology statement.

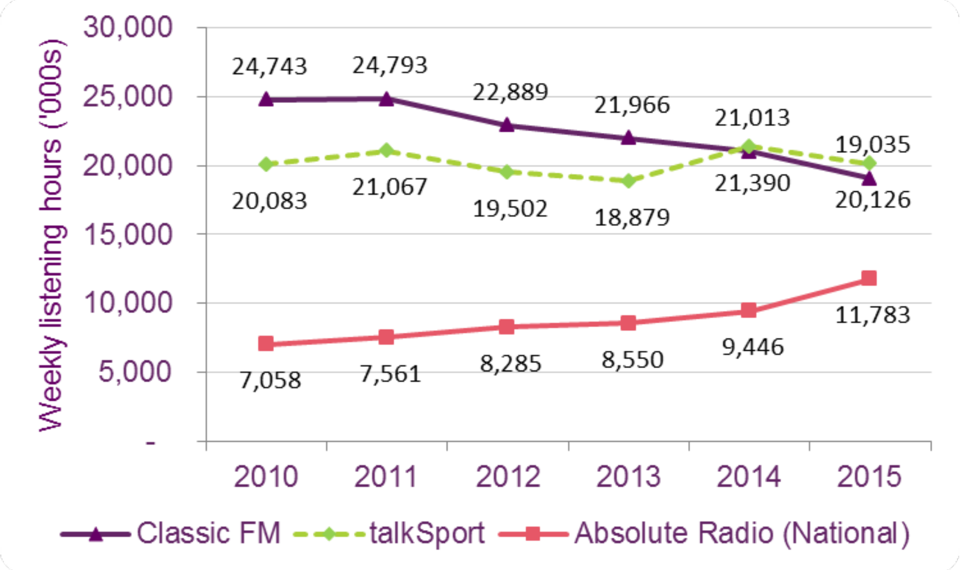
- evidence presented by stakeholders, such as forward looking financial projections; and
- evidence required to be provided by stakeholders to Ofcom, including consideration of pre-existing business plans and forward looking financial projections
- market reports and externally generated analyses of cost, revenue and technological trends;
- public policy developments and statements; and
- findings from Ofcom's work and research in relevant and related fields.

3.37 Below we discuss our proposed approach to dealing with the specific uncertainties identified above.

Future trends in listening to the INR services

3.38 Figure 3.1 shows that weekly listening hours to Classic FM have fallen by 23% since the last review of financial terms in 2010, listening to Talksport has remained steady while listening to Absolute Radio has increased by two-thirds.

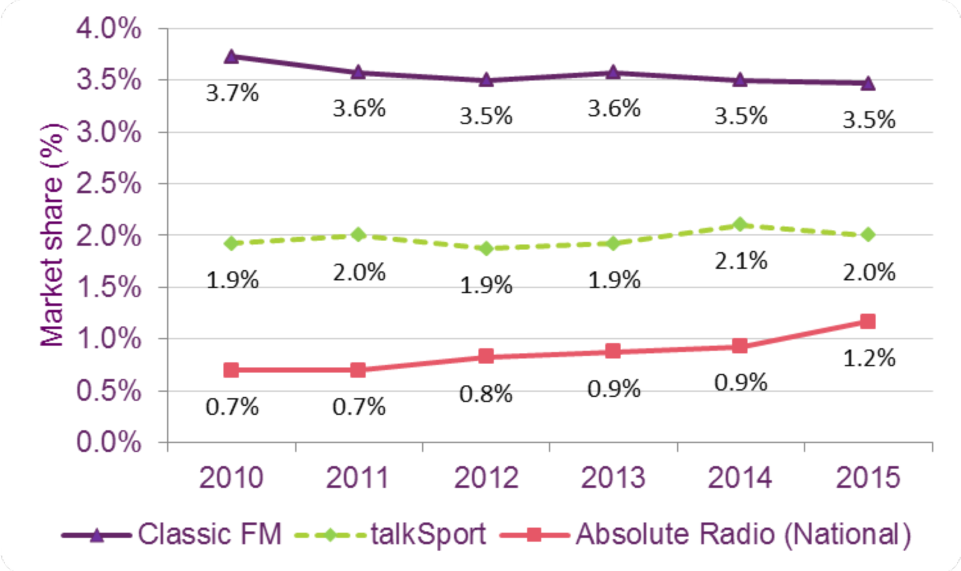
Figure 3.1: Listening hours by INR



Source: Rajar

3.39 Figure 3.2 shows that Classic FM's share of listening hours has fallen slightly since 2010 from around 3.7% to 3.5%; Talksport's share of listening has been steady at around 2% while Absolute Radio's share has increased from 0.7% to 1.2%.

Figure 3.2: Market share by INR



Source: Rajar

3.40 We propose to use listening forecasts from applicants in determining the licence valuation and place particular emphasis on forecasts that have been prepared and utilised for business planning purposes. To the extent these are not available we will consider projecting historic listening trends forward, taking account of factors that could affect this; for example, the launch of a second national digital multiplex on 1 March 2016 could reduce the proportion of total listening to INR services in future.

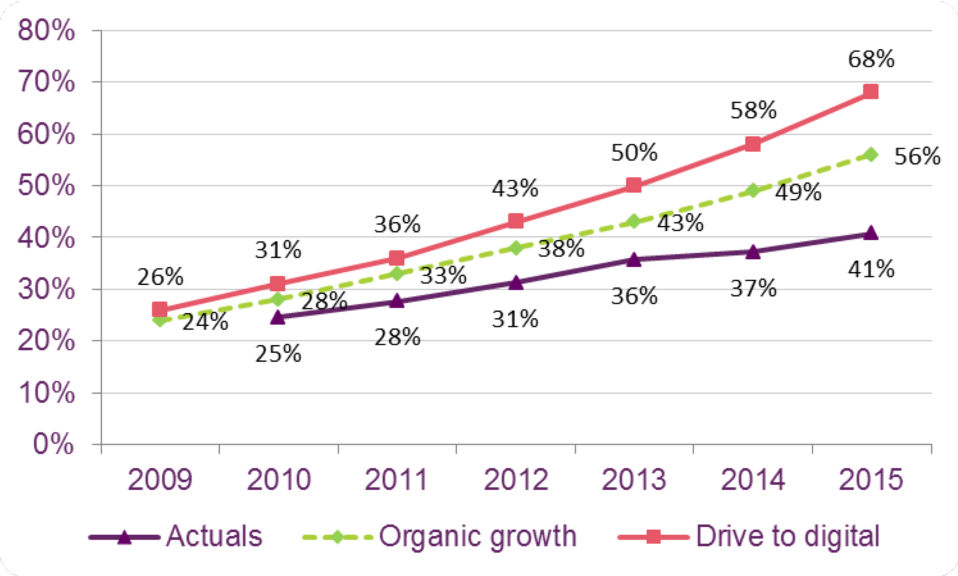
Future trends in the proportion of listening that is digital

3.41 The proportion of total listening that relates to digital has increased since 2010, although at a slower pace than forecast in the government's 2010 'Digital Britain' report.[17] This is illustrated in Figure 3.3. The Quarter 1 2016 RAJAR survey shows that around 44% of all radio listening hours were to services delivered over a digital distribution system. DAB is still the most widely used digital platform, accounting for 70% of all digital listener hours, with the remaining digital listening accounted for by digital television, online streaming and apps.[18]

[17] Available at; http://webarchive.nationalarchives.gov.uk/20100511084737/http:/interactive.bis.gov.uk/digitalbritain/final-report/

[18] RAJAR Q1 2016 data release: http://www.rajar.co.uk/docs/2016_03/DARTS%20Q1%202016%20Charts%201-5%20Clean.pdf

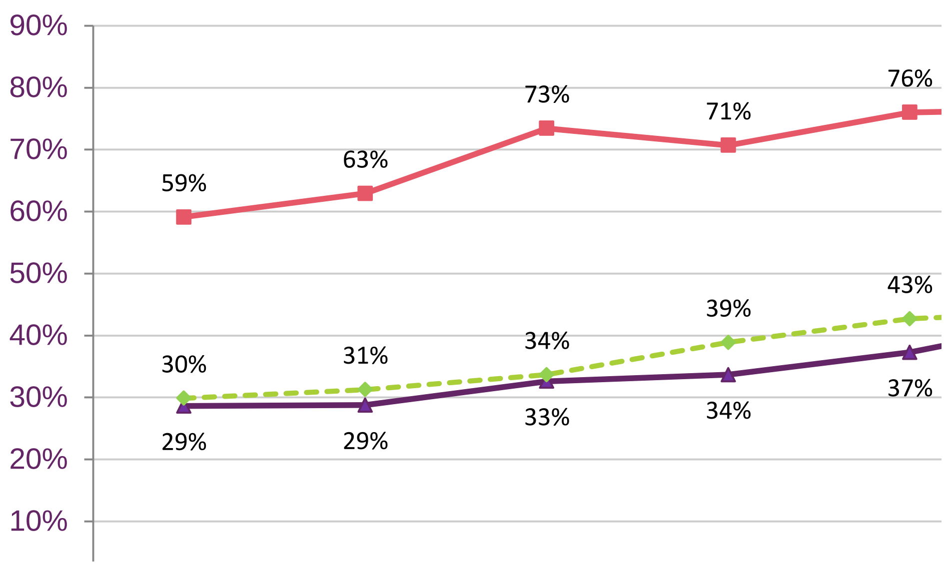
Figure 3.3: Digital listening: actuals versus Digital Britain forecasts



Source: RAJAR, Digital Britain, Value Partners analysis[19]

3.42 Digital listening to the INRs has also increased since 2010 as illustrated in Figure 3.4. Digital listening to Classic FM and Talksport is in line with the national average where around 40% of listening is currently to digital platforms. Digital listening to Absolute Radio is significantly higher, at around 75% of listening.

Figure 3.4: Trends in INR digital listenership



Source: RAJAR

3.43 In the 2010 review we were able to use the Digital Britain forecasts to inform the valuation. We are not aware of any current forecasts of future digital listening, either for the radio industry as a whole or for the INRs specifically. We therefore propose to use forecasts of digital listening from applicants in determining the licence valuation. However, in the absence of specific evidence, such as independent

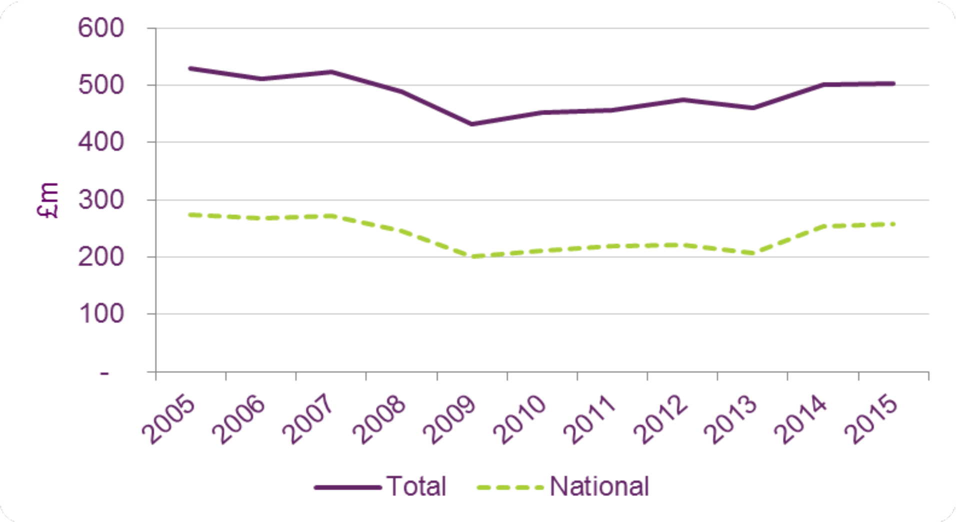
[19] Information in this document taken from the Government's "Digital Britain Final Report" (or any other Crown source) is subject to Crown Copyright.

forecasts or forecasts prepared for business planning purposes, we will place particular emphasis on average growth rates in digital listening since 2010.

Future trends in revenue and costs of the INR licences

3.44 Over the past ten years total commercial advertising radio revenues have trended downwards as advertisers shifted their focus to other platforms. However, in recent years radio revenues have seen marginal annual increases. Over the same ten-year period, national revenues (across all commercial radio stations) have shown a similar trend, as shown in Figure 3.5.

Figure 3.5: Annual Commercial Radio Revenues, £m



Source: Submissions to Ofcom from radio operators

3.45 We propose to use revenue and cost forecasts from applicants in determining the licence valuation and place particular emphasis on forecasts that are prepared and utilised for business planning purposes (e.g. business plans).

3.46 Where these are not available, we will have regard to short term Advertising Association forecasts in relation to revenue, although we recognise that these only extend to two years.[20] As in the 2010 reviews, we propose to require applicants to submit top down and bottom up revenue forecasts over the licence period. We will seek to cross check these against available external forecasts in order to take a reasonable view of the amount of advertising revenue a bidder could expect to generate from the licensed service. In relation to costs we will have regard to external forecasts of inflation and any contractual price increases (e.g. transmission arrangements).

Start-up costs of the new entrant

3.47 In paragraph 3.25, we proposed to include an allowance in the valuation for the reasonable cost of entry of a new entrant, such as i) pre-launch costs such as capital expenditure, marketing and 'dry-running' costs and ii) post launch revenue effects which may mean the new entrant is not able to generate the same revenue

[20] The Radiocentre website includes details of the most recent Advertising Association forecasts, currently extending to Q3 2017. See http://www.radiocentre.org/advertising/factsandfigures/industry-revenue-forecasts/.

as the incumbent from launch. As with other cashflows, we propose that start-up costs common to different platforms will be apportioned across those platforms to reflect their relative value to each.

3.48 We propose to use start-up cost estimates from applicants in determining the licence valuation and will place particular emphasis on costs that are based on evidence from the applicants' own experiences in launching stations. We will also consider evidence from other stakeholders on their experience of the start-up costs associated with a station launch.

Duration of the licence period

3.49 Section 103B of the 1990 Act enables the further renewal of the three INR licences for a period of five years. However, the 1990 Act makes statutory provision for a possible future digital switchover, whereby the Secretary of State can nominate a date on which specified analogue services must cease being provided in analogue form. The legislation further provides that, if a digital switchover date is so nominated, Ofcom must amend the duration of all relevant analogue licences, which would otherwise run beyond the nominated switchover date, so that they do not run beyond that date, provided the licensee is given two years' notice. [21]

3.50 The effect of this statutory provision is to make the duration of a renewed INR licence uncertain, in that it may be terminated with two years' notice. This means that a bidder may not expect the licences to run to their full five-year duration. There are a variety of different durations which might be possible depending upon the actions of the Secretary of State, which in turn would likely be influenced by external events. It might be desirable for a bidder to consider the likelihood of a range of different end dates, assign an appropriate percentage probability to each possible outcome and weight them accordingly. However, there is relatively little evidence available to Ofcom to determine what the reasonable weightings should be.

3.51 The government's Digital Britain report set out a number of preconditions for digital switchover. This set out that a digital switchover date would require the achievement of certain migration criteria such as:

- 50% of radio listening to be digital
- National DAB coverage to be comparable to FM coverage and local DAB to reach 90% of the population and all major roads

3.52 These conditions have not been met at the present time, but local DAB coverage is expected to reach 90% of the population by the end of 2016 as a result of the Local DAB Expansion Plan being completed[22].In addition, extrapolating the digital listening percentages from Figure 3.3, it is possible that the 50% digital listening threshold could be met by the end of 2017.

3.53 The most recent statement by government on the potential for digital switchover was made in the 2015 consultation on the BBC Charter Review. In that document the Government stated that "digital radio listening has reached 40 per cent of all radio listening and nearly 55 per cent of adults listen to digital radio services at least weekly. Supported by the growth of new commercial digital services, the radio

[21] The Digital Economy Act 2010 inserts these provisions into the 1990 Act as sections 97A and 97B
[22] An agreement between Government, the BBC and local radio multiplex operators to extend the coverage of local DAB.

industry expects digital listening to overtake analogue listening at some point in 2017. At that point, Government will need to consider the timetable for a future switch-off of analogue radio services at a date likely to start after 2020".[23]

3.54 This statement from government indicates that the earliest date for digital switchover could be sometime in 2021, around a year before the renewed INR licences expire.[24] We acknowledge that there are a number of different possible views that a bidder could take about the likely duration of the licence in practice, but it is difficult to assign weightings and probabilities to these views in an objective way. Even so, we consider that a potential bidder for an INR licence would attach a relatively low weight to the possibility of switchover prior to the expiry date of the renewed licences because i) the Order[25] allowing a further renewal of the licences for five years was made relatively recently, in December 2015 and ii) the expiry dates of the renewed licences (various dates in 2022) and the potential earliest date for switchover based on the government's most recent statement (sometime in 2021) are relatively close together such that it would be reasonable for a potential bidder to anticipate that the government would be unlikely to announce a switchover date just before the INR licences are in any case due to expire.

3.55 We therefore propose that the valuation of each INR licence for the purposes of determining financial terms will be based on the valuation obtained by assuming a renewed licence endures for the full five year term.

***Question 3**: Do you agree with our proposed approach to dealing with uncertainties for the purposes of the review? In particular, do you agree with our proposed approach to dealing with i) future trends in listening to the INR licences; ii) future trends in the proportion of listening that is digital; iii) future trends in revenue and costs of the INR licences; iv) start-up costs associated with the new entrant and v) the duration of the renewed INR licences? If not, please explain why not. If you disagree with our proposal to base our valuation on an assumption that each INR licence will endure for the full five year term,please also explain how, and on what basis, you consider we should take account of the uncertainty in respect of the duration of the renewed INR licences in our licence valuations?*

Discount rate

3.56 As set out above, our 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 is likely to be an existing media company. In order to be consistent with the proposed circumstances of the hypothetical auction, Ofcom's proposed discount rate is intended to reflect the opportunity cost of investment faced by a hypothetical entrant that is assumed to be an existing media company.

3.57 Ofcom has calculated a nominal, pre-tax rate of 11.0%, which is meant to reflect the weighted average cost of capital (WACC) of a hypothetical entrant. The calculation is based on a consideration of data and estimates relating to UK and European broadcasters.

[23] BBC Charter Review, 16 July 2015, Page 54. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/449830/DCMS_BBC_Consultation_A4__1_.pdf

[24] If each INR licence was renewed for five years from its relevant date (as set out in Table 2.1) they would expire between February 2022 (Classic FM) and December 2022 (Talksport).

[25] The Legislative Reform (Further Renewal of Radio Licences) Order 2015/2052

3.58 Full details of how we have calculated our discount rate are provided in Annex 5.

Question 4: *Do you agree that a nominal, pre-tax discount rate of 11.0% is appropriate? If not, then please set out what other considerations Ofcom should have taken into account in determining the discount rate.*

Cut-off date

3.59 As in the 2006 and 2010 reviews, Ofcom considers that it is necessary for it to be able to take into account any information relevant to deciding the revised licence payments that is, or becomes, available up to the date of determination.

Setting financial terms

3.60 Ofcom will calculate financial terms that will allow for the recovery of the combined net present value of the rights and obligations associated with the licence. However, as explained above, no guidance is given in the Act as to how Ofcom should set the PQR or indeed the relative sizes of the PQR and cash bid.

3.61 Qualifying revenue is defined in section 102 (2) of the 1990 Act 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 in that period of advertisements or other programmes, or in respect of charges made in that period for the reception of programmes included in that service". For the purposes of setting the PQR, we propose to use the guidance relating to qualifying revenue set out in our 2006 statement of principles document.26 In that document, qualifying revenue for INR services is defined by reference to the advertising and sponsorship amounts received in connection with the licensed analogue service. It appears to us that these remain the principal sources of revenue of the services consistent with the definition in the 1990 Act. Where advertising and sponsorship revenue relates to programmes broadcast on multiple platforms, this revenue is apportioned to analogue on the basis of listener hours for the purpose of deriving qualifying revenue.

3.62 In terms of the relative sizes of any PQR payments and cash bid, we propose that the PQR should be calculated to recover as close to 95% of the value of the licence as possible, without exceeding this proportion and consistent with setting the PQR as an integer. The cash bid would then be set to recover the balance of the value of the licence.27 We propose to take this approach because a higher proportion of PQR would align the payments with the licensees' revenues and offer some protection against the risk of revenue downturns and mitigate some of the risk of forecasting error. However, we recognise that setting relatively higher cash bids would give licensees more certainty about future payments. Where our review indicates that a new entrant would assign a relatively small value to the licence, we may, for administrative convenience, recover the value of the licence solely through the cash bid, with the PQR set to zero.

[26] Computation of qualifying revenue and multiplex revenue for radio licensees, 26 October 2006, http://stakeholders.ofcom.org.uk/binaries/broadcast/other-codes/qualifying-revenue-radio-inr.pdf
[27] This is consistent with previous reviews of financial terms for INR licences and Channel 3 and Channel 5 television licences. See for example paragraphs 3.123 to 3.126 of our 23 July 2013 statement *Methodology for determining the financial terms for the Channel 3 and Channel 5 licences*: http://stakeholders.ofcom.org.uk/consultations/c3-c5-finance/?a=0.

3.63 As with the 2010 reviews, if our review indicates that a hypothetical new entrant would not be prepared to bid for the licence based on our assessment of the value of the rights and obligations associated with the licence, we propose to conclude that the incumbent licence holders could retain their licences in a hypothetical auction for a nominal amount.

Question 5: *Do you agree with our proposed approach to setting financial terms? If not, please explain why not and set out what you consider would be an appropriate split between PQR and cash bid.*

Outcomes of previous reviews

3.64 Table 3.1 sets out the financial terms previously determined by Ofcom.

Table 3.1: Financial terms determined for each INR licence[28]

	1991-94 auctions		**1999-01 reviews**		**2006 review**		**2010 review**	
	PQR	Cash bid	PQR	Cash bid	PQR	Cash bid	PQR	Cash bid
Classic FM	4%	£670k	14%	£1000k	6%	£50k	0%	£10k
Absolute Radio	4%	£1,883k	12%	£1000k	0%	£100k	0%	£10k
Talksport	4%	£3,820k	6%	£500k	0%	£100k	0%	£10k

Note: The cash bid increases by RPI each year. The PQR in these periods applied to analogue revenues only

3.65 The table shows that over time the PQR and cash bid associated with the INR licences have reduced and that each licensee is currently making nominal financial payments. This reflects the fact that the profits associated with the right to broadcast nationally on analogue have reduced over time as digital listening has increased and, in more recent reviews, the uncertainty surrounding a date for digital switchover.[29]

[28] Source: 1991-94 auctions and 1999-01 reviews: http://webarchive.nationalarchives.gov.uk/20040104233440/http:/www.ofcom.org.uk/static/archive/rau/newsroom/news-release/99/pr129.htm (Classic FM), http://webarchive.nationalarchives.gov.uk/20040104233440/http:/www.ofcom.org.uk/static/archive/rau/newsroom/news-release/00/pr052.htm (Absolute), http://webarchive.nationalarchives.gov.uk/20040104233440/http:/www.ofcom.org.uk/static/archive/rau/newsroom/news-release/00/pr185.htm (Talksport)
2006 review: http://stakeholders.ofcom.org.uk/binaries/consultations/methodology/summary/financialterms.pdf.
2010 review: http://stakeholders.ofcom.org.uk/consultations/renewal-national-licences/?a=0

[29] The outcome of previous reviews also reflects the length of the licence period. For example, the financial terms determined as part of the 2010 reviews related to licence periods of 4-5 years.

Annex 1

Responding to this consultation

A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on Friday 24 June 2016**. This four week period is shorter than our standard ten week consultation period. However, we consider this is appropriate given that:

- the consultation is primarily of interest to a limited number of stakeholders who are aware of the issues involved and;
- the proposals contained in this document are generally consistent with those we previously consulted on and used when Ofcom last conducted such reviews in 2006 and 2010.

A1.2 Ofcom strongly prefers to receive responses using the online web form at http://stakeholders.ofcom.org.uk/consultations/renewal-independent-national-radio-licences/ as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.

A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email jon.heasman@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.

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

Jon Heasman
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA

A1.4 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.

A1.5 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

A1.6 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Jon Heasman, Radio Licensing Manager, on 020 77834509.

Confidentiality

A1.7 We believe 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. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

A1.8 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A1.9 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at http://www.ofcom.org.uk/about/accoun/disclaimer/

Next steps

A1.10 Following the end of the consultation period, Ofcom intends to publish a statement on its methodology around the end of August 2016.

A1.11 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom's consultation processes

A1.12 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.

A1.13 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, who are less likely to give their opinions through a formal consultation.

A1.14 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Steve Gettings, Secretary to the Corporation, who is Ofcom's consultation champion:

Steve Gettings
Ofcom
Riverside House
2a Southwark Bridge Road
London SE1 9HA

Tel: 020 7981 3601

Email steve.gettings@ofcom.org.uk

Annex 2

Ofcom's consultation principles

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

Before the consultation

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

During the consultation

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

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

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom 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. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

A3.1 Subject to what we say elsewhere in this document about confidentiality, in the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.

A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.

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

A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the ‘Consultations’ section of our website at www.ofcom.org.uk/consult/.

A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don’t have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

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

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

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

Name Signed (if hard copy)

Annex 4

Summary of consultation questions

Question 1. *Do you agree that the proposed overall valuation methodology (including our objectives) and the proposed overarching principles are appropriate for the determination of the PQR and cash bid element of the renewed licences? If you do not, please explain why you consider that the overall methodology is inappropriate and what justifications exist for suggested alternatives.*

Question 2. *Do you agree with our approach to valuing the rights and obligations associated with the INR licences? If not, please explain why not.*

Question 3. *Do you agree with our proposed approach to dealing with uncertainties for the purposes of the review? In particular, do you agree with our proposed approach to dealing with i) future trends in listening to the INR licences; ii) future trends in the proportion of listening that is digital; iii) future trends in revenue and costs of the INR licences; iv) start-up costs associated with the new entrant and v) the duration of the renewed INR licences? If not, please explain why not. If you disagree with our proposal to base our valuation on an assumption that each INR licence will endure for the full five year term, please also explain how, and on what basis, you consider we should take account of the uncertainty in respect of the duration of the renewed INR licences in our the licence valuations?*

Question 4. *Do you agree that a nominal, pre-tax discount rate of 11.0% is appropriate? If not, then please set out what other considerations Ofcom should have taken into account in determining the discount rate.*

Question 5: *Do you agree with our proposed approach to setting financial terms? If not, please explain why not and set out what you consider would be an appropriate split between PQR and cash bid.*

Annex 5

Discount rate

Summary

A5.1 We consider that the value of the winning bid in a hypothetical auction can be approximated by the valuation of the second highest bidder and that the second-highest bidder would be an existing media company. In order to be consistent with the proposed circumstances of the hypothetical auction, Ofcom's proposed discount rate is intended to reflect the opportunity cost of investment faced by a hypothetical entrant that is assumed to be an existing media company.

A5.2 Ofcom has previously considered calculating discount rates on a licence-by-licence basis. However, consistent with the approach taken in the 2006 and 2010 reviews, we consider that to the extent that there are material differences between licences that may impact the discount rate (e.g. some licensees may have a higher proportion of fixed costs), they would be prohibitively difficult to estimate in a robust manner.

A5.3 Ofcom has calculated a pre-tax nominal discount rate of 11.0%, which is meant to reflect the weighted average cost of capital (WACC) of a hypothetical entrant.

A5.4 We are also mindful that the period of the licence is five years from the renewal date. As such, the discount rate will not play as significant a factor as in previous reviews (which had longer licence periods) when assessing the value of the licence award.

Introduction

A5.5 The discount rate applied to the forecast cash flows in an NPV analysis should reflect the opportunity cost to the relevant capital providers, weighted to their relative contribution to the company's total capital base. This is approximated by calculating the firm's 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.

A5.6 The WACC combines the cost of funding from debt and equity according to the gearing, i.e. the value of outstanding debt relative to total financing (i.e. value of debt and equity combined). For gearing, g, and corporate tax rate, t, the pre-tax nominal WACC is defined as follows:

$$WACC = \frac{Ke * (1 - g)}{1 - t} + Kd * g$$

A5.7 In this formula, we calculate the cost of equity, Ke, using the Capital Asset Pricing Model (CAPM), such that the cost of equity is a function of the risk-free rate (RFR), the expected return on the equity market as a whole above the risk-free rate (i.e. the equity risk premium, or ERP) and the systematic risk of the company (i.e. equity beta, βequity): $Ke = RFR + ERP * \beta equity$.

A5.8 Our approach to calculating the cost of debt combines the same RFR assumption as used to estimate the cost of equity and adds to the RFR a debt premium (dp, i.e. the firm's corporate debt rate above benchmark risk-free assets), such that: $Kd = RFR + dp$.

Estimating discount rates

A5.9 There are a number of parameters that we have to estimate in order to calculate a WACC for a hypothetical entrant. Some of these parameters reflect economy-wide factors that affect all firms. We recently considered these economy-wide factors when setting the BT WACC as part of the April 2016 Business Connectivity Market Review Statement (2016 BCMR Statement).[30] For the purposes of this consultation we have adopted the same values for these economy-wide parameters given that the BCMR Statement was published very recently. Specifically we assume a:

- **Real risk free rate (RFR) of 1.0%.** In the 2016 BCMR Statement we said that in setting the real RFR we try to strike a balance between longer term average yields on index-linked gilts and current yields on those gilts. We placed more weight on longer term average yields than on spot rates. We also had regard to other recent regulatory decisions.[31] Combined with our RPI inflation forecast for this consultation of 3.1% (see below), the nominal RFR is 4.1% using the Fisher equation.[32]

- **Real equity risk premium (ERP) of 5.1%.** In the 2016 BCMR Statement we estimated the real ERP by considering i) estimates of the real total market return (TMR) and ii) cross checking the implied real ERP against other evidence.[33] We considered that evidence from historical returns would support a real TMR of 6.1%, which implied a real ERP of 5.1% after subtracting our estimate of the real RFR (1.0%).[34] We considered that a real ERP of 5.1% was supported by evidence on the ERP including i) historical premiums of equities over gilts, ii) forward looking surveys, iii) dividend growth model forecasts from the Bank of England and iv) recent regulatory decisions.[35] Combined with our RPI inflation forecast for this consultation of 3.1% (see below), the nominal ERP is 5.3%.

A5.10 Other parameters that influence the WACC calculation are firm-specific, such as gearing ratios, equity and asset betas, and debt premiums. As in previous reviews, Ofcom is proposing to apply a single discount rate in its NPV analysis for each 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. However, in practice, any such assumptions are likely to be difficult to calculate.

A5.11 The Wireless Group plc is the only UK listed company with significant radio assets. Where possible, Ofcom has used data on existing broadcasters to support its calculations, but the lack of UK listed companies with radio operations makes this harder in some areas, for example in the estimation of an equity beta. Our approach in this area is outlined below.

[30] http://stakeholders.ofcom.org.uk/consultations/bcmr-2015/final-statement/
[31] See paragraphs A30.33 to A30.44 of Annex 30 to the 2016 BCMR Statement.
[32] Nominal RFR = ((1+real RFR) x (1+RPI))-1
[33] See paragraphs A30.45 to A30.72 of Annex 30 to the 2016 BCMR Statement.
[34] See paragraph A30.58 of Annex 30 to the 2016 BCMR Statement.
[35] See paragraphs A30.59 to A30.68 of Annex 30 to the 2016 BCMR Statement.

Inflation

A5.12 Our inflation assumption to be used in the WACC has been informed by RPI forecasts from HM Treasury[36] (HMT) and the Office of Budget Responsibility[37] (OBR) over the renewed licence period of broadly 2017-2022. We consider that it is appropriate to calculate the nominal RFR by reference to RPI because index-linked gilts, which are used to inform our estimate of the real RFR, are linked to RPI. Forecasts from HMT and OBR currently only run to 2020 as shown in Table A5.1.

Table A5.1: RPI inflation forecasts

	2017	2018	2019	2020	Average
OBR	2.4%	3.2%	3.2%	3.2%	3.0%
HMT	2.8%	3.1%	3.1%	3.3%	3.1%

Source: OBR and HMT.

A5.13 Based on these forecasts, RPI is expected to average around 3% to 3.1% over the period to 2020. We propose to use an RPI assumption of 3.1% in the WACC.

Tax rate

A5.14 HMRC's website states that "at Summer Budget 2015, the government announced legislation setting the Corporation Tax main rate (for all profits except ring fenced profits) at 19% for the years starting the 1 April 2017, 2018 and 2019 and at 18% for the year starting 1 April 2020".[38] As the renewed period of each licence will run from 2017 to 2022 we propose to use an average tax rate of 18.5% in the WACC calculation, representing approximately three years of tax at 19% and two years of tax at 18%.

Asset beta, equity beta and gearing

A5.15 The value of a company's equity beta measures the movements in returns (as measured by the sum of dividends and capital appreciation) from its shares relative to the movement in the return from the equity market as a whole.

A5.16 The Wireless Group Plc ('WLG', formerly UTV Plc) is currently the only UK listed company with significant radio assets.[39] However, its shares are relatively thinly traded so we have considered a number of equity and asset beta estimates from UK and European broadcasters. These beta estimates are shown in Table A5.2 below and are based on one and two year daily and five year monthly estimation periods against a home index. Table A5.2 also indicates which companies we understand have radio operations.

[36] Table M3, https://www.gov.uk/government/statistics/forecasts-for-the-uk-economy-may-2016
[37] Page 90, Economic and fiscal outlook - March 2016, available here: http://cdn.budgetresponsibility.org.uk/March2016EFO.pdf
[38] https://www.gov.uk/government/publications/rates-and-allowances-corporation-tax/rates-and-allowances-corporation-tax.
[39] UTV sold its television assets to ITV on 29 February 2016. UTV then changed its name to WLG. According to WLG's 2015 annual report, over 90% of its revenue and almost all of its operating profit related to its radio operations, with the remainder from digital services (web services and a digital agency). https://www.wirelessgroupplc.com/getmedia/62be70e3-033f-4977-a2d2-00edcd285794/Wireless-Annual-Report-2015.pdf?ext=.pdf

A5.17 The equity beta includes the effect of the capital structure on the systematic risk of a company. Therefore when comparing the betas of different companies it is important to unlever the equity beta to calculate an asset beta which removes the financial effects from leverage.[40] We have de-levered the observed equity betas using an average gearing ratio consistent with the time period for estimating the equity beta. For example, a two year equity beta was de-levered to an asset beta using the average two year gearing in the same period. We have assumed a debt beta of 0.1 in our calculations[41]; however we note that using a debt beta of zero does not materially affect the WACC calculation.

Table A5.2: Comparator information from UK and European broadcasters

	Radio	Country	1 Year			2 Year			5 Year		
			β_E	G	β_A	β_E	G	β_A	β_E	G	β_A
Antena 3	✓	Spain	1.10	5.7%	1.04	1.14	6.0%	1.08	1.14	7.9%	1.06
CEME		Czech	0.93	10.4%	0.85	0.85	10.0%	0.78	1.43	10.0%	1.30
ITV		UK	0.96	6.1%	0.91	0.99	5.3%	0.95	1.27	8.9%	1.16
Lagardere	✓	France	0.89	37.1%	0.60	0.90	35.6%	0.61	1.23	37.8%	0.81
Mediaset[42]	✓	Italy	1.29	19.9%	1.05	1.36	21.8%	1.09	1.60	31.3%	1.13
Mediaset[43]	✓	Spain	0.91	0.4%	0.90	0.95	0.4%	0.95	1.11	1.4%	1.10
M6		France	0.66	0.1%	0.66	0.64	0.1%	0.64	1.10	0.1%	1.10
MTG	✓	Sweden	1.07	13.6%	0.94	1.02	10.7%	0.92	1.45	8.2%	1.34
NRJ	✓	France	0.30	2.8%	0.29	0.29	3.3%	0.29	0.35	1.6%	0.35
RTL	✓	Lux	0.70	9.1%	0.65	0.65	8.2%	0.61	0.56	4.7%	0.54
Sky		UK	0.83	30.4%	0.61	0.81	28.5%	0.60	0.66	22.7%	0.53
TF1		France	0.77	0.1%	0.77	0.81	0.1%	0.81	1.38	1.3%	1.36
WLG	✓	UK	0.11	26.4%	0.11	0.21	24.6%	0.18	1.02	28.1%	0.76
Average – all			**0.81**	**12.5%**	**0.72**	**0.82**	**11.9%**	**0.73**	**1.10**	**12.6%**	**0.96**
Average - radio			**0.80**	**14.4%**	**0.70**	**0.82**	**13.8%**	**0.72**	**1.06**	**15.1%**	**0.89**

Note: G = gearing. 1 year and 2 year betas use daily data and 5 year betas use monthly data. Source: Bloomberg, betas calculated as at 31 March 2016. For UK companies betas have been estimated against the FTSE All Share index; for other European companies the FTSE All Europe has been used.

A5.18 We also note that the one, two and five year equity betas for the FTSE 350 Media Index against the FTSE All share index were 0.93 (one and two year) and 0.90 (five year) respectively as at 31 March 2016.

A5.19 We are inclined to give most weight to those companies involved in operating radio stations and whose shares are relatively liquid. This could mean excluding the one and two year daily beta estimates for WLG, NRJ, RTL and Central European Media Enterprises on liquidity grounds[44] and the betas for Metropole Television M6, Sky, TF1 and ITV since they do not operate radio stations. Given that none of the remaining companies (Antena 3, Lagardere, Mediaset, S.p.A, Mediaset España Comunicación, S.A.and Modern Times Group) are UK based, and the uncertainty

[40] Asset betas are calculated using the following formula:

$$\beta\ asset = Gearing * \beta\ debt + (1 - Gearing) * \beta\ equity$$

[41] This is consistent with the debt beta we assumed for BT in the 2016 BCMR Statement.
[42] Mediaset, S.p.A
[43] Mediaset España Comunicación, S.A.
[44] These companies have relatively high bid-ask spreads (greater than 1%) which indicates the shares are relatively illiquid.

around what a UK radio asset beta might be, we are left with few, if any, reliable indicators as to the asset beta of a new entrant in the UK radio market.

A5.20 However, the average data presented in Table A5.2 for one, two and five year betas indicates that an asset beta for a hypothetical entrant would be broadly in the range 0.7 to 1.0, with the lower end of the range associated with one and two year betas, and the upper end of the range associated with five year betas.

A5.21 In the 2010 review we placed particular weight on asset beta for WLG since this is the only listed UK-based radio operator. Since WLG is relatively thinly traded, we put weight on the five year monthly asset beta rather than lower frequency daily betas.[45] Based on current data presented in Table A5.2 this would suggest an asset beta of around 0.8. However, given the fact that the average five year monthly asset beta for other comparators tends to be higher than 0.8[46], we propose to use an asset beta assumption of 0.9, which is slightly above the midpoint of our 0.7-1.0 range but is similar to the average five-year monthly asset beta for those comparators that have radio operations (0.89).

A5.22 In order to estimate an equity beta we need to consider the forward-looking gearing associated with the hypothetical entrant.

A5.23 In the 2016 BCMR Statement we assumed BT's forward looking gearing was 30%. Companies with lower levels of systematic risk can usually support higher levels of gearing than companies with higher levels of systemetic risk. Given that the asset beta associated with the new entrant (0.9) is higher than that associated with BT (around 0.7 in the 2016 BCMR Statement), we would expect the forward-looking gearing of the new entrant to be lower than BT's.

A5.24 This expectation is borne out by the data in Table A5.2 where, with a couple of exceptions, gearing rates of media comparators are below 30% and average around 10%-15%, with companies with radio operations tending to have gearing rates towards the higher end of this range.

A5.25 In the 2010 review we assumed a forward looking gearing assumption of 25%. We consider that the evidence presented in Table A5.2 would support a lower gearing level than this. We therefore propose to use a forward looking gearing assumption of 15%. This is close to the average gearing levels of the media companies presented in Table A5.2 which have radio operations. While we consider a case could be made for a gearing level slightly lower or higher than this, we note that this does not have a significant impact on the WACC calculation.

A5.26 An asset beta of 0.9 is equivalent to an equity beta of 1.0 at our assumed forward-looking gearing rate of 15%. An equity beta of 1.0 is consistent with the equity beta for the FTSE 350 Media Index reported above. We consider that this provides further support that our asset beta and forward looking gearing assumptions provide a reasonable estimate of the equity beta of a hypothetical entrant.

[45] Paragraphs A1.22 to A1.24, 2010 Methodology Statement. For thinly traded shares it may be some time before the impact of a general market movement shows up in the stock price, and monthly betas may therefore be preferred to more frequent daily betas. See for example the 2003 Smithers and Co report called *A study into certain aspects of the cost of capital for regulated utilities in the UK*: http://www.bbk.ac.uk/ems/faculty/wright/pdf/mason%20miles%20wright

[46] Of the remaining 12 comparator companies, nine have an asset beta greater than 0.80.

Debt premium

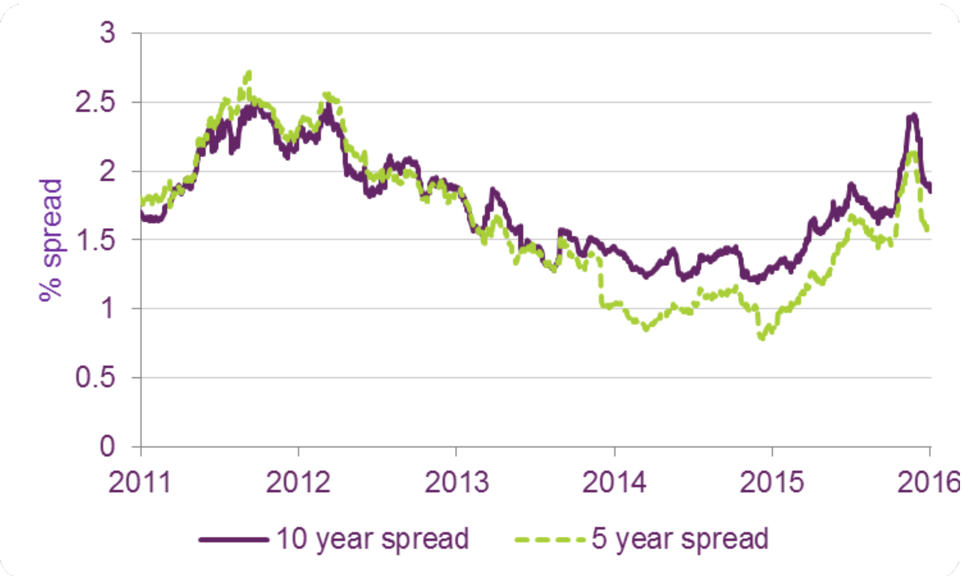
A5.27 The cost of debt is made up of a risk free component and a company specific risk premium. Of the comparator firms listed in Table A5.2, only ITV and Sky have issued rated corporate bonds. The debt of both these companies is rated BBB-.

A5.28 On this basis, we consider it is reasonable to assume that a hypothetical new entrant would be BBB- rated.

A5.29 Of the comparators above, five have listed debt (although only Sky and ITV's debt is rated): ITV, Sky, Modern Times Group, Mediaset Spa, Lagardere. The listed debt of these companies typically has a maturity of between five and ten years. We have therefore considered the debt premium of BBB- debt maturing in five to ten years.

A5.30 We have calculated the difference between yields on a five and ten-year BBB index and a five and ten-year government gilt.[47] The spread for the five and ten year BBB index over the last five years is shown in Figure A5.1. The spread for both five and ten year indexes during this five year period ranged from 0.7% to 2.7% and averaged 1.7%. As we assume that a hypothetical entrant would be BBB- rated, its debt premium is likely to be slightly higher than the average of a BBB index.[48] We have therefore assumed a debt premium of 2.0%, slightly higher than the average debt premium of 1.7% for a BBB index.

Table A5.2: Debt premium for an index of BBB bonds



Source: Bloomberg (period from 1 April 2011 to 31 March 2016)

Conclusion

A5.31 Applying the parameters discussed above, we have estimated a pre-tax nominal WACC of 10.9%. For the purposes of estimating a discount rate to be used in the

[47] Yields on a composite BBB- index are not available in Bloomberg: therefore we have used the Bloomberg composite BBB index in our analysis.
[48] A BBB index includes bonds that are rated BBB+, BBB and BBB-. A BBB- bond is likely to have a higher cost of debt than a BBB or a BBB+ bond.

licence valuations, we have rounded this to 11.0%. A summary of the WACC calculation and related assumptions is shown below in Table A5.3.

Table A5.3: Proposed WACC parameters

WACC component	Consultation estimate	Source
Real RFR	1.0%	Ofcom estimate - BCMR 2016
Real ERP	5.1%	Ofcom estimate - BCMR 2016
RPI inflation	3.1%	Ofcom estimate
Nominal RFR	4.1%	= (1+ real RFR)*(1 + inflation) - 1
Nominal ERP	5.3%	= real ERP*(1 + inflation) - 1
Debt beta (β debt)	0.1	Ofcom estimate
Asset beta (β asset)	0.9	Ofcom estimate
Gearing (forward looking) (g)	15%	Ofcom estimate
Equity Beta (β equity)	1.0	=(β asset - β debt * g)/1-g
Cost of equity (post-tax) (Ke)	9.6%	= Nominal RFR + ERP * βequity
Cost of equity (pre-tax)	11.8%	= Ke / (1-t)
Debt premium (dp)	2.0%	Ofcom estimate
Corporate tax rate (t)	18.5%	Ofcom estimate based on HMRC
Cost of debt (pre-tax)	6.1%	= RFR + dp
WACC (pre-tax nominal)	10.9%	$= \frac{Ke * (1-g)}{1-t} + Kd * g$
Discount rate	11.0%	Ofcom estimate

Source : Ofcom