Renewal of the Independent National Radio licences

Methodology for review of financial terms

Statement

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Section 1

Executive summary

1.1 The Digital Economy Act 2010 ("the 2010 Act") includes provisions which allow for a national analogue ("INR") licence to be renewed for a period of not more than seven years, beginning with the date of renewal. These new statutory provisions represent a second opportunity for the three INR licensees to apply for licence renewal, and thus avoid having to apply for a new licence in an auction. All three licences were previously renewed in 1999/2000 (for an eight-year period).

1.2 Licence renewal is a statutory incentive for the holder of an analogue licence to provide a digital service. Specifically, an INR licence is eligible to be renewed only if its holder is providing a digital simulcast service (which all three INR licensees do on the national DAB radio multiplex, so they are eligible to apply for a renewal).

1.3 As part of the process of INR licence renewal, Ofcom is required to set new financial terms for each licence. These so-called 'additional payments' 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 (further) renewal period rather than renewed (the "Cash Bid"), and a percentage of qualifying revenue ("PQR").

1.4 In July, we issued a consultation on the approach that we should take to the reviews of financial terms. The last time such reviews were undertaken was in 2006 and in the consultation we set out that overall we considered that the approach taken then remains appropriate subject to a small number of adjustments. We received three responses to the consultation, which the respondents said were confidential. This statement sets out Ofcom's methodology having considered the responses received and gives details of the renewal timetable for all three licences.

1.5 We have decided to apply the same methodology for setting the additional payments for each licence which we used in 2006 when the financial terms of each licence were last set, taking account of developments and making modifications as set out in this document. Now, as in 2006, our overriding objective is to adopt a methodology which enables us to determine financial terms that are fair and reasonable within the context of the current market environment, in line with our powers and duties.

1.6 We have decided that the overall valuation methodology, to help us set a Cash Bid and PQR for each licence, will involve valuing each licence as a whole in order to determine the amount of the second-highest bid in a hypothetical auction. We have decided to apply a discount rate of 12.8% to the valuations.

1.7 A particular uncertainty related to the valuation of these licences is the potential duration of the renewed licence periods in practice[1] – we have decided that for each of the two AM INR licences, the appropriate period for valuation purposes is the period from their 'relevant date' to the end of 2015, and for the FM licence, the appropriate period is from the anticipated date of renewal of the licence to the end of 2015.

[1] Noting that we propose they will formally be renewed for seven years from the date of their renewal

Section 2

Legal framework

2.1 Between 8 April and 8 June 2010, provisions of the Digital Economy Act 2010 (“the 2010 Act”) came into force. Amongst other things, this new legislation makes significant changes to the Broadcasting Act 1990 (“the 1990 Act”) and creates the statutory framework to support the policy proposals which the previous Government put forward in its Digital Britain report in June 2009.

2.2 The 2010 Act includes provisions which allow for a national analogue ("INR") licence to be renewed for a (further) period of not more than seven years, beginning with the date of renewal. These new statutory provisions[2] represent a second opportunity for the three INR licensees to apply for licence renewal, and thus avoid having to apply for a new licence in an auction. All three licences were previously renewed in 1999/2000 (for an eight-year period).

2.3 Under the legislation, 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 The financial terms attached to these licences were last reviewed by Ofcom in 2006, following applications from each licensee for a four-year extension of their licences under section 253 of the Communications Act 2003(“the 2003 Act”).

2.5 What the legislation requires Ofcom to do in respect of the financial terms, on granting a licence renewal application, is determine an amount to be payable to OFCOM (which is then passed on to the Treasury) equal to 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.[3] It also requires Ofcom to specify the percentage of qualifying revenue for each accounting period that will be payable by the applicant during the licence renewal period.

2.6 This statement is about the process and timetable for national analogue licence renewal applications and the accompanying reviews of the financial terms.

Timetable for the renewal applications and financial terms reviews

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

[2] Section 103B of the Broadcasting Act 1990, as inserted by section 31 of the Digital Economy Act 2010
[3] Under section 98 of the Broadcasting Act 1990

2.8 The 'relevant date' is defined (in statute) as the date by which, if the licence was not (further) 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 determined that the 'relevant date' for each of the three INR licences is one year prior to the expiry of the current licence, as follows:

Service	Expiry date	Relevant date	Application deadline
Classic FM[4]	30 Sep 2011	30 Sep 2010	30 June 2010
Absolute Radio[5]	30 Apr 2012	30 Apr 2011	30 Jan 2011
Talk Sport[6]	31 Dec 2012	31 Dec 2011	30 Sept 2011

2.9 It is important to note that 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 relevant 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.[7]

2.10 The reason that the legislation sets the application deadline as three months prior to the 'relevant date' is so as to allow Ofcom up to 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'.

2.11 As can be seen from the table above, the 'relevant date' in respect of the licence held by Classic FM is 30 September 2010 and the deadline for a renewal application was 30 June 2010[8]. However, because the Digital Economy Act was only passed in April, it was not possible for Ofcom to commence work on the licence renewal process until after this date. As the consultation concluded by this statement forms an important and necessary part of the process, it is not reasonably practicable for Ofcom to make a determination about revised financial terms for Classic FM by the 'relevant date' of 30 September 2010, and it is not reasonably practicable to renew the licence by that date.

2.12 As indicated, the legislation explicitly allows for this scenario, but is clear that, in this event, Ofcom should make its determination as to financial terms and, if those terms are agreed, renew a licence, as soon as reasonably practicable after the relevant date. Accordingly, we intend to announce terms for the licence held by Classic FM and, if agreed, renew that licence, by the end of January 2011 at the latest.

2.13 Given their later expiry dates, the same timetable constraints do not apply to the licences held by each of Absolute Radio and talkSport. In light of the consultation responses we have amended slightly our proposals in respect of these licences. We have decided that these licences will be valued from and renewed on their respective 'relevant dates', subject to the grounds for their renewal being met. We explain briefly as follows and further in section 3 of this statement.

2.14 In our consultation we proposed giving the two AM licences a choice between applying to have their terms assessed alongside Classic (and accepting renewed

[4] The relevant licence is held by Classic FM Ltd
[5] Licence held by TIML Radio Ltd
[6] Licence held by talkSport Ltd
[7] See section 103A (8) of the Broadcasting Act 1990
[8] Ofcom received appropriate applications by this date

terms at the same time) or waiting to apply next year (in accordance with their statutory deadlines) and we would assess terms then. Paragraph 2.18 of the consultation included a table setting out the proposed renewal timetable for all three licences.

2.15 One respondent suggested a third option whereby it could apply for a review of its terms alongside Classic but that we would value the licence starting from its relevant date. The licensee would then accept terms at the same time as Classic and those terms would apply from a renewal period starting from its relevant date.

2.16 As set out in section 3 of this statement, we agree with the points raised by the respondent and have amended our proposal accordingly. That is, the AM licences can opt to have their terms considered alongside Classic with the licences being valued from their relevant dates. If the financial terms are accepted then they will apply from the relevant date. All licensees will have 30 days to accept or reject the terms once offered.

2.17 It is therefore 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 they choose not to, that will not delay the determination of the financial terms for the Classic FM licence.

2.18 The tables below set out the renewal timetables for all three licences depending on whether they apply alongside another licence or apply later in line with their own statutory deadlines. If no renewal is applied for or granted, the licences will expire as per the table in paragraph 2.10.

2.19 Classic's timetable is as set out below as per paragraphs 2.13 and 2.14.

Classic	Timetable followed
	Classic 's
Application deadline	30 June 2010
Provision of data	October 2010
Determination of terms	January 2011
Terms applied from	On acceptance[9]

2.20 Absolute Radio could opt to have its terms reviewed at the same time as Classic FM, or it could decide to wait until its statutory deadline in January and have its terms determined in April.

Absolute	Timetable followed	
	Classic's	Absolute's
Application deadline	-	30 January 2011
Provision of data	October 2010	TBC
Determination of terms	January 2011	April 2011
Terms applied from	Relevant date	Relevant date

2.21 talkSport could opt to have its terms reviewed at the same time as Classic FM or Absolute (if Absolute follows its own timetable) or it could decide to wait until its statutory deadline in September 2011 and have its terms determined in December 2011.

[9] In statutory terms, the renewal period will start on "the date of renewal," but we envisage this will be on or very shortly after the Classic licensee's acceptance of the new terms

talkSport	Timetable followed		
	Classic's	Absolute's	talkSport's
Application deadline	-	30 January 2011	30 September
Provision of data	October 2010	TBC	TBC
Determination of terms	January 2011	April 2011	December 2011
Terms applied from	Relevant date	Relevant date	Relevant date

Section 3

Approach to the review of financial terms

Introduction

3.1 This section sets out our approach towards setting the PQR and determining the cash bid in any review of financial terms triggered by an application for renewal received by 30 June 2010. The same methodology will also apply to any applications for renewal received subsequent to 30 June 2010.

3.2 We consider that the methodology used by Ofcom in 2006[10] remains broadly appropriate, with some modifications that are set out in this section. We provide an overview of the methodology in this section.

3.3 There have been a number of regulatory and market developments since the last time the financial terms were reviewed in 2006. These will impact the outcome of any review we undertake.

Ofcom's statutory task

3.4 Section 103B (and certain parts of section 103A) of the 1990 Act set out the statutory framework for re-determining the licence payments under a further renewed INR licence following an application for such renewal made by the licensee. Ofcom must determine two elements which comprise the additional payments payable by licence holders during the further renewed period. These are 1) a fixed annual cash amount ("Cash Bid"), which rises in line with RPI and 2) the Percentage of Qualifying Revenue ("PQR") to be payable for each year of the (further) renewed licence[11].

3.5 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 to be granted 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.

3.6 Under the 1990 Act part of 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 the Act. Section 100 indicates that the award of 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.

3.7 Under section 98 of the 1990 Act, Ofcom must set out the PQR in the notice inviting licence applications. The PQR would therefore be determined before Cash Bids are made. No guidance is given in the Act as to how Ofcom should set the PQR nor, indeed, as to the relative proportions of licence payments which should be comprised of the PQR payments and Cash Bid. The definition of qualifying revenue is set out in

[10] See the document at the web address in paragraph 3.9 below
[11] Different percentages may be determined for different accounting periods.

section 102 of the 1990 Act and Ofcom is required to determine a percentage of it which shall be payable to the Treasury.

3.8 Ofcom therefore has a greater level of discretion in relation to setting the PQR compared to the determination of the Cash Bid. However, in the context of broadcasting licence renewals, Ofcom has taken the view that to ensure a consistent approach to setting both the PQR and the Cash Bid, it is appropriate for us to conduct a single economic valuation of the further renewed licence 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 in the context of the further renewal, taking into account both the objectives and the uncertainties discussed in this document.

3.9 As in 2006, Ofcom will set the relative weighting of the PQR and Cash Bid in its determination. We note that respondents to the consultation in 2005/6 specified a preference towards terms which recover a high proportion of the total value of the licence through the PQR element of the payments. We will consider whether the relative weighting set in 2006 is also appropriate for the further renewed licences (as to which see further below).

Ofcom's objectives

3.10 For the purposes of the 2006 reviews, we established a methodology to value each licence so that we could decide on the PQR and determine the Cash Bid. That methodology was presented in a statement published in February 2006 (the "February 2006 statement.") It can be viewed in full at the following address:

http://www.ofcom.org.uk/consult/condocs/methodology/statement.pdf

3.11 In that statement, we set out our objectives for the review as follows:

Ofcom's overriding objective is to determine financial terms for the licence extensions, through determining a fair and reasonable value based on a methodology which is consistent with its statutory obligations

Source: Paragraph 1.3 of the February 2006 statement

3.12 The statement went on to describe that the terms for the extension should ensure that the tax payer gets a proper return for the use of scarce analogue spectrum and that the process should enable Ofcom to set terms that were reasonable within the context of the current market environment and would continue to be reasonable for the extended period of the licence.

3.13 These objectives were set against the following statutory backdrop.

3.14 First, Ofcom's principal general duty when carrying out our functions is to further the interests of citizens in relation to communications matters and to further consumers' interests in relevant markets, where appropriate by promoting competition. This is set out in section 3(1) of the 2003 Act.

3.15 Second, under section 3(2) of the 2003 Act, amongst the things Ofcom has to secure by virtue of its principal duty above, is the optimal use for wireless telegraphy of the electro-magnetic spectrum and the availability throughout the United Kingdom of a wide range of radio services which (taken as a whole) are both of high quality and calculated to appeal to a variety of tastes and interests.

3.16 Third, under section 85(2) of the 1990 Act, we have to do all we can to secure the provision within the United Kingdom of a diversity of national radio services each catering for tastes and interests different from those catered for by the others and of which:

3.16.1 one is a service the greater part of which consists in the broadcasting of spoken material, and

3.16.2 another is a service which consists, wholly or mainly, in the broadcasting of music which, in the opinion of OFCOM, is not pop music.

3.17 Fourth, also relevant, as part of the background to the statutory scheme in which we perform our duties is the following statement made to the House of Commons during the passage of the Bill that became the 1990 Act,[12] by the then Home Secretary, David Waddington MP. He said of [what became] the 1990 Act's provisions relating to the auction of licences

"….Our proposal that Channel 3, Channel 5 and certain other licences should be allocated by competitive tender has two main objectives. First, we want to establish a fairer and more objective system for awarding franchises than the present one, which has few defenders, but at the same time to ensure high standards and diversity. Secondly, we have a clear duty, which some campaigners gloss over far too quickly, to ensure that the taxpayer 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"

3.18 The relevant provisions have not changed since 2006, notwithstanding the changes made by the 2010 Act. Our duties are met by the services currently provided by the INR licensees. They would continue to be met were their licences further renewed, in line with their entitlements to such renewal.

3.19 So, it appears to us to remain appropriate that, for present purposes, we should seek to pursue the same objectives as in 2006 in relation to further licence renewal under section 103B of the 1990 Act.

3.20 This will ensure we continue to meet our duties.

The market environment

3.21 The 2006 reviews resulted in a reduction in the amounts payable for the independent national radio licences[13]. This reflected a number of changes in the market environment since the previous reviews in 1999/2000, including the view that the growth of digital forms of distribution meant that the value associated with what was considered to be the principal right attached to the licence – the privileged access to scarce analogue spectrum – was in decline.

3.22 For the two AM licences considered, we set the PQR at zero and the Cash Bid at £100,000. For the FM licence we set the PQR at 6% and the Cash Bid at £50,000. The differential between the terms set for the FM licence and the AM licences

[12] On 18 December 1989
[13] A document setting out the revised terms and the background to Ofcom's determination is available at http://www.ofcom.org.uk/consult/condocs/methodology/financialterms/financialterms.pdf

reflected the difference in the quality of each medium, the different earnings potential and differences in the cost base.

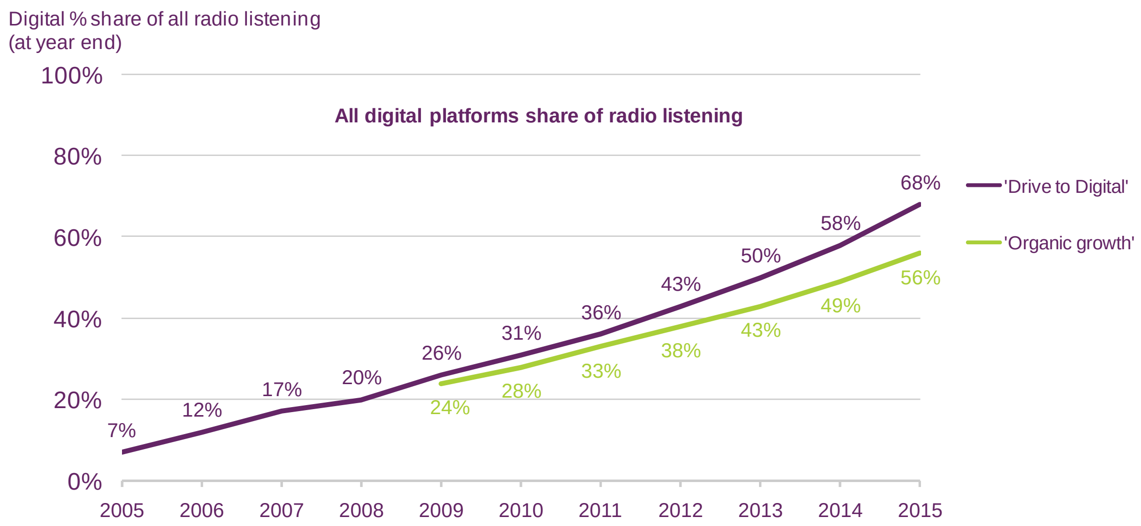
3.23 Since the 2006 reviews, there have been a number of changes to the market environment which will impact the value of the licence and will have a bearing on our decision about the PQR payable and the amount that, in Ofcom's opinion, would be the Cash Bid for the licence if it were to be granted in an auction (instead of being renewed). Three such developments are the further advance of digital broadcasting, trends in listening to the INR services, and the changes in the UK radio advertising market.

Development of digital listening

3.24 In our consultation we set out that in the three months to the end of March 2010, around 24% of all radio listening hours were to services delivered over a digital distribution platform. In the three months to June 2010 this increased to 24.6%. DAB digital radio was the most widely used means of listening to digital radio services in the three months to June 2010, accounting for 64% of all digital listener hours in Q1 2010; DTV was the second most popular choice (17%) with streaming over the internet ranking third (12%)[14].

3.25 In our consultation we said that the previous government's *Digital Britain* report set out the last available public domain projections for digital radio listening. Figure 1 shows the projected rise in digital radio listening under two scenarios: 'organic growth' and a 'concerted drive to digital'. Both suggest that a majority of listening hours will come through a digital radio platform by 2015. By June 2010 digital platforms had gained a 24.6% share of all radio listening hours according to the RAJAR listening survey, which is broadly in line with the 'organic growth' outlined on the forecast chart, although digital listening will need to increase to 28% by the end of 2010 in order to keep up with this scenario from the forecast.

Figure 1: The projected proportion of digital radio listener hours, according to the previous government's *Digital Britain* report.



[14] Unspecified listening made up the remainder (8%)

Source: Rajar, Digital Britain, Value Partners analysis[15]

Trends in listening to the INR services[16]

3.26 In our consultation we set out the recent listening trends to Classic FM, talkSport and Absolute. We have updated these figures to include the most recent Rajar data.

3.27 Since the second quarter of 2007, the total number of weekly listening hours to Classic FM has fallen by 7%, from 42m to 39m. Over the same period, the proportion of listening to digital platforms has increased from 11% to 28%.

3.28 Since the second quarter of 2007, total listening to talkSport has fallen by 9%. Similar to Classic FM, the proportion of listening represented by digital platforms has increased over the same period from 13% to 27%.

3.29 Since the last quarter of 2008 (the quarter after Absolute Radio launched), total listening to Absolute Radio has increased by around 11%. The proportion of Absolute Radio's listening represented by digital platforms has remained steady since Q4 2008, at approximately 32%

Changes in the UK radio advertising market

3.30 In our consultation we said that between 2006, when the financial terms attached to the INR licences were last reviewed, and 2009 annual revenues for commercial radio fell by 13%. Over the same period, national advertising revenues fell by nearly 20%[17].

3.31 The advertising market as a whole is expected to show increases in 2010, with television advertising doing particularly well. For example, the Advertising Association's Q1 2010 Expenditure report, published in June, was forecasting total advertising spend to increase by 3.3% in 2010, with television advertising growing the most[18]. Indeed, ITV plc's June 2010 interim report suggests that the television market grew by 15% in the first 6 months of the year.

3.32 According to the RAB, radio advertising in Q1 2010 was up 7% on the same quarter last year, with national advertising up 15%. There are signs that this national advertising performance has continued in 2010, with UTV's June 2010 interim financial statements showing talkSport's revenues up 23% on the same period last year, with the football World Cup providing a boost. UTV said that it was expecting its British radio stations to increase revenue by 10% in the third quarter of 2010, with talkSport's revenues up 15%[19].

3.33 Advertising revenues generally are expected to increase again in 2011, but at lower rates than 2010. For example, the Advertising Association's Q1 2010 Expenditure report was forecasting total advertising spend to increase by 2.4% in 2011.

[15] Information in this document taken from the Government's "Digital Britain Final Report" (or any other Crown source) is subject to Crown Copyright
[16] All listening data are sourced from RAJAR.
[17] Source: RAB
[18] http://expenditurereport.warc.com/FreeTopLineData.aspx
[19] http://www.utvmedia.com/reports.asp?sub=iv&sublk=rpt

Respondents views on the market environment

3.34 We asked what other features of the market environment Ofcom should consider when reviewing the financial terms.

3.35 Respondents broadly agreed that the principle developments related to trends in listening and changes to the advertising market.

3.36 One respondent argued that Ofcom should consider licence specific factors when reviewing the licences, for example factors relating to transmission or rights contracts. Because we will value each licence individually, we believe that this offers sufficient scope to take account of licence-specific factors.

3.37 Each of the respondents pointed out that advertising spend from the COI (Central Office of Information), the largest radio advertiser, has reduced this year and this reduction is expected to be permanent. We recognise that the COI issued a press release in August stating that “the new Government has made it clear that this reduction in spend should be expected to continue into the future”[20]. We would anticipate that a potential bidder for these licences would take this into account when preparing financial forecasts. We deal in more detail in paragraphs 3.90 to 3.104 below with specific submissions the respondents made and with the way we have decided to take market environment factors into account.

Regulatory developments

3.38 There have also been a number of regulatory developments that have occurred since 2006 which might have impacted the value of the licences and will have a bearing on our decision about the PQR payable and the amount that, in Ofcom’s opinion, would be the Cash Bid for the licence if offered at auction.

3.39 In particular, the 2010 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,[21] 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[22].

3.40 The 2010 Act also provides for the possible termination of relevant renewed licences, including further renewed national licences, in the event that digital switchover does not occur (either because no switchover date is nominated, or a nominated date is withdrawn and not replaced). In those circumstances, the Secretary of State may give notice to OFCOM fixing a termination date in relation to specified services (relevant renewed licences). That date may not be before 31 December 2015. On receipt of such a notice Ofcom must amend the duration of all relevant renewed licences that would otherwise end after the specified termination date so that they end on or before that date, again provided we give the relevant licensee two years’ notice[23].

3.41 The effect of these statutory provisions is to make the duration of a renewed INR licence uncertain, in that it may be terminated with two years' notice.

[20] http://coi.gov.uk/press.php?release=342
[21] which can include further renewed national licences
[22] The 2010 Act inserts these provisions into the 1990 Act as sections 97A and 97B
[23] The 2010 Act inserts these provisions into the 1990 Act as section 105A

3.42 On 7 July 2010 the Communications Minister Ed Vaizey announced the Government's 'Digital Radio Action Plan', saying that[24]

"The Digital Radio Action Plan I am publishing today sets out our clear commitment to make progress towards digital radio switchover. But I am not setting a date. The industry believes 2015 is an achievable target date and we will work to support that ambition. And when the weight of public opinion is behind it, with more than half of all radio listening digital, then we can take the decision on when the country will be ready for switchover. This Action Plan says that a decision on switchover can only be made once 50% of all listening is to digital, national DAB coverage is comparable to FM, and local DAB reaches 90% of the population and all major roads"[25].

3.43 On 14 September 2010 the Consumer Expert Group (CEG) published its recommendations to Government on digital radio switchover[26]. CEG Chair Leen Petré said "Any switchover to digital radio must only happen when listeners are ready and when the industry has delivered what consumers need". The report recommends that "the target date for a digital switchover should be revised upwards as 2015 is realistically far too early for the necessary preparations to be put in place for consumers. Any target date set should be looked upon as secondary to consumer issues such as willingness to adopt the technology, voluntary take-up and digital radio reception as an instigator for switchover"[27].

3.44 In response to the report Ed Vaizey MP said that "consumers should lead the way to switchover and this is the key principle that drives the Government's digital radio action plan, this report will make a valuable contribution as we implement our plans over the coming months"[28].

3.45 The 2010 Act also makes changes to the statutory framework relating to the regulation of localness in commercial radio. Amongst other things, and speaking broadly, the new provisions allow for local stations to provide their required locally-made programmes from within a wider area beyond that which they are licensed to serve.

3.46 Ofcom has adopted new policies on localness regulation as a result (see http://www.ofcom.org.uk/consult/condocs/radio/statement/).

3.47 In particular, it is now possible for existing 'regional' FM stations to request to have their localness obligations removed from their licences, allowing them to share the same programmes across a number of regions, provided that in return they provide a version of their programme service across the UK on DAB. This new policy is designed to foster competition and choice in UK-wide services, and encourage a greater range and diversity of content for consumers.

3.48 In our consultation we asked what other regulatory developments Ofcom should consider when reviewing the financial terms.

3.49 Respondents agreed that the major regulatory developments since the 2006 review are the introduction of the Digital Economy Act 2010 and the publication of the Digital Radio Action Plan. Respondents thought that the revocation provisions introduced by the Digital Economy Act would mean that a potential bidder for these licences would

[24] http://www.culture.gov.uk/news/media_releases/7225.aspx
[25] http://www.culture.gov.uk/images/publications/digitalradioactionplan_vs1.pdf, page 2
[26] http://www.culture.gov.uk/news/news_stories/7421.aspx
[27] http://www.culture.gov.uk/images/publications/CEG_Digital_radio_switchover.pdf, page 8
[28] http://www.culture.gov.uk/news/news_stories/7421.aspx

be uncertain over the actual length of the licence. We explain how we will take account of this in paragraphs 3.104 to 3.120.

Valuation methodology

3.50 The methodology set out in the 2006 statement was established to inform Ofcom's decision when deciding on the PQR and determining the annual Cash Bid sum for each licence. Ofcom has decided to use a similar approach to any review that is triggered by an application for renewal. Below, we set out our methodology and identify those areas where there are changes from the approach taken in the last review.

3.51 As was the case during the 2006 reviews, the aim of the methodology is to set fair and reasonable terms such that they recover, so far as possible, the combined value of the rights and obligations over the duration of the licence.

Overarching principles

3.52 We consider that each licence should be valued as a whole, taking into account the rights and obligations associated with holding the licence. Where possible, we also consider that the valuation should seek to take into account any significant consequential effect that the presence of one right or obligation has on another.

3.53 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).

3.54 We consider that, notwithstanding respondents' submissions to the contrary, 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. It seems to us a reasonable assumption that such bidders would have lower costs of entry than other alternative bidders, and therefore would bid more for the licence.

3.55 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. If the right could not be replicated elsewhere then the value would equal the total financial benefit to the licensee of having the right. Similarly, the cost of an obligation would be equal to the extra cost associated with meeting the obligation, net of any benefit to the licensee.

Circumstances of the hypothetical auction

3.56 The hypothetical auction to assess the overall value of the licence would replicate circumstances as set out below.

3.57 The auction would be designed, within the framework of the legislation, to recover the maximum possible value consistent with Ofcom's statutory duties and, in particular, with the requirement that the successful bidder is also able to fulfil programming and other obligations associated with the licence.

3.58 In line with the statutory framework, each licence would be offered individually on a non contingent basis in a single round, sealed bid auction.

3.59 The amount the incumbent would bid in a competitive auction would be the minimum required to beat the second-highest bidder, and as such would not necessarily represent the maximum amount the incumbent would be willing to pay. The difference between the value of the licence to the incumbent and the value of the licence to the second-highest bidder should equal approximately the cost of entry.

3.60 In order to determine the amount of the second-highest bid in an auction, Ofcom would estimate the net present value of the licence (efficiently operated) as represented by the expected value to the incumbent and then adjust this value to reflect the additional costs (e.g. start-up costs) that a new entrant might incur.

Valuation of analogue and digital rights

3.61 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. The analogue element of the licence should be valued 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 analogue spectrum.

3.62 In order to forecast cashflows for the analogue service, expected costs and revenues that are common to simulcasts across multiple platforms will be allocated across services on the basis of the hours of listening expected to be achieved on each platform. Start-up costs will also be apportioned across different platforms to reflect their value to each. Ofcom does not consider that a new entrant would necessarily replicate all existing assets owned by the incumbent license and may consider that leasing an asset for the duration of the licence would be preferable to purchasing it.

3.63 The only digital right associated with the holding of the licence is the right to reserved capacity on the national DAB multiplex. Licensees have an obligation to deliver a digital simulcast, which they do on this multiplex.

3.64 Until recently there was a relatively large amount of capacity available on the national DAB multiplex, and while it is close to full capacity at present, we believe there would be opportunities to purchase multiplex capacity if an operator wanted to launch a national DAB service. The entitlement of the licence holders to the right to reserved capacity on the multiplex does not, therefore, appear to have any significant value since capacity is available on the open market.

3.65 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 will be excluded from the valuation of the analogue licence since it will be assumed to indicate that the decision to simulcast on DAB can be justified on a commercial basis, distinct from ownership of the analogue licence.

3.66 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. In such circumstances, the net losses associated with the DAB simulcast will be taken into account in the valuation.

3.67 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.

Respondent's views on the valuation of analogue and digital rights

Analogue rights

3.68 Two respondents said that allocating shared costs via hours of listening was inappropriate. One of these respondents said that this was because most costs were incurred in relation to providing the national analogue service. The same respondent also said that allocation of revenue via hours of listening was also inappropriate and should take into account differences in platform specific CPTs (costs per thousand).

3.69 Ofcom considered the question of how to apportion revenues and costs across platforms at some length in section 5 of the 2006 Statement[29]. There is no 'correct' method of apportioning revenues and costs across platforms but we need to select a method that is objective, transparent and practicable.

3.70 The underlying approach to these reviews is to assess the incremental value of a licence to a new entrant which does not currently own the national analogue licence. Because Ofcom cannot directly observe the additional profits which are available as a result of owning the analogue licence and because those observations which can be made may not always be appropriate to apply to the incumbents, it is difficult to estimate the value of these additional profits and Ofcom must therefore find an alternative means of estimating the value of the national analogue licence to a non-holder of the licence. Ofcom considers that an apportionment approach on the basis of listener hours would provide a conservative estimate of the value of the licence to the incumbent and would also reflect the changing importance of the platform mix over time.

3.71 Since our approach is based on easily observable data on listening hours, it is also transparent and practicable. Ofcom considers that a similar allocation approach should be applied to both costs and revenues. The implication of the approach suggested by one of the respondents from 3.68 is that we should allocate the majority of costs to the national analogue licence but only a minority of revenues. Ofcom considers that adopting an apportionment approach which seeks to differentiate the incremental effects on costs from the incremental impact on revenues is unlikely to provide an answer which is fair or reasonable and is likely to understate the value of an analogue licence.

3.72 Ofcom will therefore proceed with the valuation on the basis set out in paragraph 3.62 above.

[29] http://stakeholders.ofcom.org.uk/binaries/consultations/methodology/statement/statement.pdf

3.73 One respondent said that the analogue licences contain obligations to provide election broadcasts and that digital carriage contracts entered into by the INRs with Digital One require them to devote airtime to DAB, and that these represent costs associated with the analogue licence. To the extent that licensees can demonstrate that these obligations impose a material cost, and can quantify that cost, we will consider how a new entrant might take this into account.

Costs of entry

3.74 All respondents said that the costs of entry for a potential bidder could be significant and included several examples of the factors a bidder may take into account. The entry costs suggested by the respondents appear to fall into two categories:

3.74.1 Pre-launch costs. This category includes costs such as capital expenditure and ‘dry running’ costs prior to launch. It would also include marketing and promotional expenditure incurred prior to launch.

3.74.2 Post-launch revenue and cost effects. Respondents suggested that a new entrant would not be able to achieve the same revenues as the incumbents for a variety of reasons, for example one respondent said that since the station would not have audience figures for several months, revenue would be slow to build up while another added that the entrant would face continuing competition from the incumbent licence holder, which would continue to broadcast on digital platforms.

In relation to costs, one respondent said that the continued presence of the incumbent would increase costs in relation to programming inputs such as rights and talent.

3.75 In principle Ofcom agrees that ‘costs of entry’ could include not only pre-launch expenditure on items such as assets and marketing, but also factors which would affect the performance of a new entrant compared to the incumbent subsequent to launch. Ofcom will make an allowance in the valuation for the reasonable costs of entry of a new entrant and will consider submissions from licensees on their views as to the value and scope of these costs, placing particular weight on submissions which provide evidence in support of the likely scale of such costs.

3.76 As to whether and how a new entrant would reflect the possible impact of the continued presence of the incumbent on either the cost of programming inputs (such as rights and talent) or audience and revenue delivery, it is possible it may do so. But, in the absence of evidence, any allowance Ofcom could make for this would be wholly speculative.

3.77 We keep in mind that we are adopting a valuation methodology that, taken as a whole, provides a fair and reasonable result in line with our duties and takes a reasonable view of the way uncertainties might be taken into account in the valuation exercise. So, Ofcom will only include costs of entry in the valuation to the extent that Ofcom considers they would reasonably be expected to be incurred by a new entrant and considers that the allowance made for entry costs must be evaluated within the overall scheme of the business plan and that it is therefore necessary for Ofcom to consider the reasonableness of the scope or magnitude of such costs in conjunction with the overall costs and revenues that are estimated in the valuation. We would consider if and how a new entrant would reflect the possible impact of the continued presence of the incumbent if licensees submit evidence, for example of their experience of such an effect from competitors, as part of their submissions.

3.78 Two respondents said that while a new entrant may consider that leasing an asset for the duration of the licence would be preferable to purchasing it, in practice this would be difficult because of the limited term associated with the licences. The respondents said that the entrant would find it necessary to replicate the vast majority of existing assets owned by the incumbent. We recognise that, in practice, there may be practical issues relating to the leasing of some categories of assets. However, we do not consider that it follows that a new entrant would therefore assume that it would have to purchase all assets from new. For example, a new entrant that was unable to lease the required assets might instead assume that it could acquire some assets from the departing incumbent for a negotiated price. We will take account of licensee's views to determine a reasonable basis for determining the costs that a new entrant might face. It is possible that lease costs provide a good proxy for these costs, regardless of whether the assets would be leased in practice.

Digital obligations

3.79 In relation to the obligation to deliver a DAB simulcast, one respondent asked whether, if the analysis suggests that the digital platform is loss making in the early part of the licence period (including a share of set up costs), then the net losses of digital will be taken into account in the valuation of the analogue licence for that period, regardless of the profitability or otherwise of the digital platform in later years.

3.80 As set out in paragraphs 3.65 and 3.66 above, where annual costs apportioned to DAB exceed the revenues apportioned to DAB, these net losses will be taken into account in the valuation. 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 otherwise have been the case; that is, if the decision to simulcast during the licence period was being made on a commercial basis. The apportionment of shared revenues and costs to DAB will be based on the proportion of digital listening which takes place on DAB for each licence.

3.81 One respondent also asked whether Ofcom would include a listener migration value in its review. We did not include such a value in our last review. In our 2006 statement we said that while the opportunity to own a national analogue service could also provide longer term benefits for the service on digital platforms, it appeared unlikely that a new entrant would calculate such a value specifically and that any such value was unlikely to be transparent in the near term. For the same reasons, we will not include a listener migration value in the current review.

Dealing with uncertainties for the purposes of the review

3.82 Valuation of licences on a forward looking basis involves taking account of a number of uncertainties. We referred in our consultation document to the way we highlighted this in paragraphs 1.4 – 1.7 of our February 2006 statement. We said the uncertainties included:

- *future trends in radio advertising revenues;*
- *the likely size and speed of structural change in the industry including that associated with digital switchover; and*
- *future decisions on digital switchover.*

3.83 The uncertainties outlined in the February 2006 statement are still uncertainties now, with arguably new uncertainties as a result of the Digital Economy Act 2010.

3.84 The announcement of the Government's Digital Radio Action Plan confirmed the Government's support for digital switchover and sets out the criteria that would need to be met before a decision on switchover could be taken. While the Government has not set a switchover date, it has said that "the industry believes 2015 is an achievable target date and we will work to support that ambition"[30].

3.85 We consider that this Action Plan is relevant when considering future trends in the amount of digital listening since it represents an ambition on behalf of the industry and Government to increase the amount of digital listening in the next few years.

3.86 As with all such uncertainties, Ofcom will need to form a reasonable view of the way in which such factors should be taken into account in the valuation exercise so as to achieve a fair and reasonable outcome for the licence valuation, consistent with Ofcom's statutory duties.

3.87 Furthermore, in order to determine a value for those elements of the licence which are explicitly modelled, Ofcom will need to project revenues and costs forward and will also need to determine how to project future listening hours.

3.88 Ofcom's view will therefore be informed by a number of sources, which might include:

- market reports and externally generated analysis of cost, revenue and technological trends;
- public policy developments and statements;
- findings from Ofcom's work and research in relevant and related fields;
- 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 projections which are relevant

Respondent's views on dealing with uncertainties

3.89 In our consultation we asked whether stakeholders agreed with Ofcom's approach to dealing with uncertainties outlined above. If not, we asked what alternative approaches would be available. In particular we asked how we should estimate future trends in listening hours and radio advertising revenues.

3.90 Respondents broadly agreed with our approach to dealing with uncertainties but made specific suggestions in relation to future trends in listening and advertising.

3.91 All respondents thought that the Digital Britain forecasts from paragraph 3.25 should be used to project the proportion of listening attributable to digital platforms, making adjustments to reflect the current levels of digital listening achieved by the incumbents. Of the two scenarios presented in this chart, one respondent thought we

30 http://www.culture.gov.uk/news/media_releases/7225.aspx

should use the "organic growth" scenario as a starting point; another respondent thought we should use the "drive to digital" scenario.

3.92 As the most recent publicly available forecast of digital listening, it seems reasonable to base projections of digital listening on this forecast from the Digital Britain report. As we said in paragraph 3.25, digital listening across the radio industry as a whole is broadly in line with the "organic growth" scenario. We recognise however that the INRs have a higher proportion of digital listening than the industry average. We are minded to use the digital Britain 'organic growth' forecasts as our base forecast given that this most closely agrees with where the industry currently is, adjusting for the current levels of digital listening that the INRs achieve. However, we will consider sensitivities around this forecast, including the "drive to digital" scenario, and consider any alternative suggestions from licensees in their submissions.

3.93 Two respondents thought it was reasonable to assume that each INR's share of total listening would continue to decline as digital take-up grows, more national stations launch and competition increases from non-linear streaming services such as Spotify. From paragraphs 3.27 to 3.29 above it is clear that listening to INR services has fallen in recent years and we recognise that there are several factors putting pressure on the audiences of INR stations, for example, as digital take up increases, listening to BBC and commercial services only available on digital would be expected to increase and this could reduce listening to INR stations.

3.94 In respect of future advertising trends, respondents suggested that we should not rely on a single source, such as the Advertising Association forecasts, but consider a range of data. One respondent suggested that we consider "top down" and "bottom up" forecasts of radio advertising revenues. This would enable consideration of macro factors, such as GDP and total advertising, and licence-specific factors such as reliance on COI spend or the potential impact of the 2012 Olympics.

3.95 One respondent suggested that for market forecasts of revenue Ofcom should give weight to recent independent forecasts, and for licence specific revenue forecasts, weight should be given to the submissions from licensees. Another respondent asked what forecasts of advertising revenue we would have regard to.

3.96 Two respondents said that we should take into account structural changes to the advertising market such as consolidation in the number of advertising buying points and national sales houses, and the importance of annual share deals to advertising revenue performance.

3.97 One respondent said that Ofcom should ensure that its assumptions are sufficiently prudent while another said that a cautious outlook needs to be maintained.

3.98 Ofcom has considered these points carefully and concluded that forward looking projections used by the existing licensees would provide a strong indicator of the future anticipated listening and advertising revenues that could be generated by a licence, taking into account many of the features that are associated with the licence, the way advertising is bought and sold and current expectations about future outcomes.

3.99 Where possible, Ofcom will seek to utilise such forecasts from applicants in determining the licence valuation and will place particular emphasis on forecasts that are prepared and utilised for business planning purposes, such as internal business plans.

3.100 To the extent that these are not available we will have regard to the short term Advertising Association (AA) forecasts of radio advertising revenue, recognising that these only extend two years[31]. If applicants decide to use a range of advertising forecast information instead of, or in addition to, these AA forecasts, they should narrate how the forecast is constructed and where it diverges from the AA forecasts, provide suitable explanations.

3.101 As with the 2006 reviews, we will require applicants to submit top down and bottom up forecasts of advertising revenue over the period to December 2015, providing explanations in relation to any areas where the results of the two approaches appear to diverge. We will also seek to cross check these forecasts against external forecasts, for example the Advertising Association forecasts, in order take a reasonable view of the amount of advertising that a bidder could expect to generate on the licensed service.

3.102 Ofcom does not consider it would be appropriate to take a view of future forecasts which are systematically prudent or cautious; rather, it is appropriate for Ofcom to take into account a range of possible outcomes before judging what would be a reasonable overall assessment. This also means that Ofcom will be careful about incorporating new sources of income or expenditure that depend upon uncertain external factors and we will need to consider carefully what a new entrant would reasonably incorporate into their forward looking assessment when considering a bid for the licence.

3.103 Taken together, Ofcom considers that these approaches mean that the forecasts of listening and advertising revenues utilised in its valuation will be capable of offering a reasonable reflection of future expectations.

Renewed licence duration and renewal dates

3.104 In our consultation we proposed to renew the relevant national licences for the maximum (formal) duration of seven years from the date of renewal (subject to the duration variation (termination) provisions introduced by the 2010 Act outlined in this document).

3.105 We said that whilst we could renew the relevant national licences for a shorter period, we considered that there were sufficiently compelling reasons for adopting the maximum further renewal period and no such reasons for a shorter one. The licence duration variation (termination) provisions in the 2010 Act and referred to elsewhere in this document meant there was little need to adopt a different (shorter) period in the interests of flexibility. We also considered that a seven year renewal period offered the best prospects for viability of the relevant stations and of maximising the incentives for the licensees to provide DAB services in a way that is consistent with the statute. None of the responses received to the consultation disagreed with this proposal and we have therefore decided to renew the licences for seven years from the date of renewal.

3.106 In our consultation we proposed that, for the two AM INR licences, the appropriate licence period for valuation purposes was the period from a key date associated with the relevant renewal application to the end of 2015. For the FM (Classic) licence, that period is from the anticipated date of renewal of the licence to the end of 2015. (See paragraphs 1.8 and 3.81 – 3.83 of the consultation document).

[31] The RAB also includes this data on its website at http://www2.rab.co.uk/rab2009/showContent.aspx?id=355

3.107 The key date for the AM licences would depend on when the licensees' renewal applications were made. For the talkSport licence it could be 31 January 2011, 30 April 2011 or 31 December 2011. For the Absolute licence it could be 31 January 2011 or 30 April 2011.

3.108 We further proposed that each of the AM licensees could choose when to seek a review of their financial terms, doing so either in relation to an earlier key date alongside other licensees or waiting until the latest possible time to apply. We said we would aim to offer revised financial terms by whatever was the key date in the particular case, and give the licensee 30 days to accept them. The renewal of the licence would then take place on the licensee's acceptance of the revised terms. (See also paragraphs 2.16 – 2.18 of the consultation document)

3.109 The effect of these proposals would be that the AM INR licensees could seek revised financial terms at an earlier stage and have them apply from an earlier date, resulting in a shorter incremental duration for their licence. Or, they could seek those terms later and have them apply later, giving a longer incremental licence duration.

Respondents' views on licence duration and renewal dates

3.110 One respondent said of our proposals relating to licence duration, key dates and relevant dates that licensees should benefit from greater flexibility. Ofcom's current proposal is to restrict an INR licence's renewal date to within 30 days of the date on which Ofcom sets out proposed financial terms – even if that date is well ahead of the relevant date.

3.111 Instead, Ofcom should revert to an approach similar to that in 2006 when the INR licences were extended. So, we should allow the AM licences to apply alongside Classic but value the (further) renewed licence by reference to the period between the licence's relevant date and 31 December 2015. We should then allow the applicants to accept terms (in or around February 2011) that will apply to a renewal period starting from the relevant date, which is the latest date from which we can renew the licence.

3.112 The respondent's arguments for adopting this approach include:

- It reflects the circumstances of the hypothetical auction. Ofcom's decision to set a relevant date a year in advance of the INR expiry dates reflects the likelihood that an auction would occur well ahead of a licence start date, due to the time required for the new entrant to prepare for launch
- It would allow each applicant to enjoy the maximum incremental duration of their licence
- It will ensure consistent treatment across all three INR licensees
- It allows Ofcom to undertake a single valuation exercise
- It could help applicants share certain costs with other applicants who are applying at the same time
- Ofcom followed a similar approach in 2006 when the licences were extended by 4 years (in which Ofcom chose to employ a much longer gap between the time of application and periods of valuation (up to 2 and a half years) than would apply now (a maximum of 8 – 11 months, in which significant changes in relevant evidence and assumptions are unlikely to occur)

3.113 We have considered again how to deal with this issue, in the context of the relevant statutory provisions for licence renewal and the responses received to our consultation.

3.114 An INR licence may be (further) renewed once for not more than 7 years beginning with the date of renewal. It is clear the renewal could be before the Relevant Date (itself well before the licence expiry date): the 1990 Act requires Ofcom in most cases formally to renew licences 'not later than the relevant date'.

3.115 Therefore we have discretion about when the renewal should occur. In considering how to exercise this, we have to consider (and have considered) the need to set financial terms for the (further) licence renewals by determining a fair and reasonable value based on a methodology which is consistent with our statutory obligations.

3.116 In doing that, it appears to us to be appropriate – in terms of a fair and reasonable valuation and our obligations and objectives – to match the periods by reference to which the (further) renewed licence is valued and for which it is (likely in practice to be) renewed. There is a clear logical connection between those periods.

3.117 It also seems reasonable to argue, as one respondent has, that the hypothetical auction by reference to which Ofcom must value the licences here would likely take place a significant time before a (hypothetical) licence were due to start (and bidders would value it and bid accordingly). So, if an applicant applied for a renewal 8-11 months before his relevant date (as would be the case for talkSport, which has the latest relevant date), and we valued the licence in advance of and by reference to that date, this would not be inconsistent with what is required of us. This is also similar to what we did in the 2006 exercise to value the INR licences for the purpose of their four-year extensions when there were gaps of up to two and a half years between the time of application and periods of valuation

3.118 In a change to our consultation proposal we are therefore minded to allow the AM licences to apply for a review alongside Classic FM, if they wish, and we will carry out the valuation starting from their respective relevant dates. The licensees will still have 30 days to accept or reject the terms in or around February 2011, but those terms would apply to a renewal period starting from their relevant dates[32].

3.119 If licensees choose to take up this option, there will be a gap between the time of the review and the beginning of the licence renewal period. Our February 2006 statement referred to the risk this involved that a major extraneous event could occur which would materially affect the valuation of the licence had it been assessed at the latter date. However, we consider that the risk of such an event occurring as part of this review appears less than in 2006 because the period between the time of application and the period of valuation is a maximum of 11 months compared to two and a half years in 2006.

3.120 These timings are set out based on our assessment that the earliest likely end date for the licences is 31 December 2015. However, if information comes to light at any point before Ofcom's determination in any relevant case which suggests that an earlier or later end date for the licences is probable, then an adjustment may be made in this regard.

Enduring Cash Bid and PQR

[32] Alternatively, the two AM licensees, Absolute and talkSport, may apply at later dates as set out in section 2 above, in which case we would also value the further renewed licence from their relevant date(s) and from which date(s) the renewed licence period would run.

3.121 In our consultation we set out that there are statutory revocation provisions associated with these licences which mean that a bidder might not expect the licences to run to their full duration. For example, the Secretary of State could set a digital switchover date for radio (see paragraphs 3.39 to 3.40). To take account of this uncertainty we proposed to value the licences by reference to a period up to December 2015 on the basis that this is the earliest possible date that digital switchover (DSO) could occur (and that hypothetical bidders for the licence would bid on that basis).

3.122 Even though we will value the licences by reference to a period up to 2015, the licences may nonetheless continue beyond 2015 if DSO has not occurred. In the consultation we said that if the licences continued beyond 2015 then the annual cash bid would continue to be paid (as the law requires) and we proposed that we would set the PQR so that the same percentage would be payable over the whole 7 year period.

3.123 We said this would mean that, if the licence is not ended early, there will be some recovery of the value associated with it through the application of the PQR and Cash Bid during that period. We suggested this would fairly and properly balance the different uncertainties in play, and their possible effects.

Respondents' views on enduring Cash Bid and PQR

3.124 One respondent noted that Ofcom proposes to base its valuation of the licence on the period up to December 2015, with no residual value beyond that point. It agreed with that approach, but said it begs the question of whether it is appropriate to charge the same fees beyond December 2015, since such payments will not have been included in the valuation.

3.125 The respondent said that the value of the analogue licence will continue to decline over time and therefore it may not be appropriate to set the same PQR for pre- and post- December 2015, and Ofcom should therefore consider setting a declining scale of payments beyond December 2015, if the licences remain in force.

3.126 A second respondent said it disagrees that the Cash Bid and PQR payments should endure beyond 31 December 2015. It argued that there is a contradiction between their doing so and valuing the licence only as far as that date.

3.127 It also said the value associated with an INR licence will be significantly reduced after 2015, since a licensee is likely to derive the majority of its listening hours from digital platforms within its licence renewal term. It also said that ending the additional payments at the end of 2015 will ensure the INR licensees do not experience a disincentive towards continued analogue broadcasting after 2015.

3.128 A third respondent said it does not agree Ofcom's proposal is appropriate, given that the respondent has already met the digital listening threshold of over 50%. It said it would be bearing the burden of dual transmission costs for any period of the (further) renewed licence beyond December 2015, so its terms after that date should be at a peppercorn rate only, or it will in effect be penalised by the slower digital take-up of the rest of the radio industry.

3.129 Again, we have considered these responses carefully. We are required to include in an INR licence conditions requiring the annual payment of a licensee's Cash Bid sum (plus annual RPI increase) and PQR(s) throughout the relevant licence period[33]. Once set, we cannot change those conditions[34].

3.130 So, where we determine a Cash Bid sum to be payable here, it is payable throughout the formal seven year renewal period. We may not remove the need to pay it after a certain time, like 31 December 2015 here, nor reduce it to a peppercorn rate.

3.131 The same applies in relation to PQR payments, but with one difference. Though we must set them at the start of the renewal period and may not change them, we can set different percentages for different accounting periods within a renewed licence period and a nil percentage may be set.[35] So, we could, for example, set different PQRs for accounting periods after 31 December 2015, and these could even be nil.

3.132 Having considered the consultation responses we have decided to modify our position. We will value the renewed licences by reference to the period to 31 December 2015. We reserve our right to set different PQR rates, and to consider the appropriate split of PQR and cash bid, so as to recover what we have determined to be the value of each licence, at the time of determination. This will give us greater scope to set annual charges that reflect the licences' ongoing value.

3.133 One respondent raised several other points related to additional payments. It said that no other analogue licences have Cash Bid and PQR payments associated with them. It said this reflects the declining value and scarcity associated with opportunities to provide national analogue radio services, and provides a clear precedent that it would be inappropriate to maintain the INR licence payments after 2015.

3.134 It also said that INR licensees would continue to provide significant continuing annual licence fees to Ofcom, in any event.

3.135 Further, it requested that the financial sanctions Ofcom can levy on an INR licensee in the event it hands its licence back be removed or set at zero from 1 January 2016.

3.136 We have considered these other points as follows. It is not relevant in the analysis of Cash Bid and PQR payments that these are not payable in respect of radio licences other than those for INR services. That is because other licences are subject to different statutory provisions that do not require those payments.

3.137 A similar point applies to the submission about the payment of annual licence fees. They are required under different statutory provisions and licence conditions and are set in order to recover Ofcom's functions relating to the regulation of broadcasting. Additional payments for INR licences are required on top of them, and are paid by Ofcom to HM Treasury.

3.138 In response to the request that the financial sanctions Ofcom can levy on an INR licensee in the event it hands its licence back be removed or set at zero from 1 January 2016, where Ofcom may, or is required to, levy a financial sanction in connection with the ending of an INR licence we cannot in advance restrict our ability to do so. It would be a matter to be dealt with at the relevant time.

Discount rate

[33] see sections 102(1), 103A(6) and 103A(9) of the 1990 Act
[34] see section 86(6) of the same Act
[35] Section 103A(7A) of the 1990 Act

3.139 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 would be an existing media company. In order to be consistent with the proposed circumstances of the hypothetical auction, Ofcom's 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.

3.140 In our consultation we calculated a nominal, pre-tax rate of 11.8%, which was meant to reflect the weighted average cost of capital (WACC) of a hypothetical entrant. The calculation was based on a consideration of data and estimates relating to UK and European broadcasters.

3.141 Following the responses received to the consultation, and the additional evidence we sourced as a result of the responses, we have:

- revised our beta estimate from 1.0 to a range of 1.0 to 1.4, with a midpoint of 1.2
- Reduced the gearing ratio from 30% to 25%
- Reduced the corporate tax rate from 28% to 26%

3.142 These changes have increased our nominal pre tax WACC from 11.8% to 12.8%. Full details of how we have calculated our discount rate are provided in Annex 1.

Cut-off date

3.143 As in the 2006 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. Applicants will have the opportunity to withdraw an application prior to a determination being made, for example, in light of information that becomes available after the date of application but before the determination of new financial terms by Ofcom. In cases where Ofcom is satisfied that a valid withdrawal has been made, the licensee may reapply within the same review period.

3.144 Once a determination of financial terms has been made by Ofcom, if the licensee wishes to accept the terms it must provide written acceptance to Ofcom within 30 days of the determination being made. Once Ofcom has made its determination, there is no further opportunity for a review of the financial terms, although the licensee has the option of declining the renewal offered if it so wishes. So, if licensees apply based on the accelerated timetable referred to in this document, they must confirm that they are aware that no mechanism exists for Ofcom to re-assess the valuation or modify the terms which would apply to the further renewal once determined, and those, once set, therefore, are final.

Annex 1

Discount rate

Summary

A1.1 Ofcom's view is that the value of the winning bid in a hypothetical auction can be approximated by the valuation of the second-highest bidder and that the second-highest bidder would be an existing media company. In order to be consistent with the proposed circumstances of the hypothetical auction, Ofcom's proposed discount rate is intended to reflect the opportunity cost of investment faced by a hypothetical entrant that is assumed to be an existing media company.

A1.2 Ofcom has previously considered calculating discount rates on a licence-by-licence basis. However, consistent with the approach taken in the 2006 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.

A1.3 Ofcom has calculated a nominal, pre-tax rate of 12.8% which is meant to reflect the weighted average cost of capital (WACC) of a hypothetical entrant.

Introduction

A1.4 The discount rate applied to the forecast cash flows in an NPV analysis should reflect the opportunity cost to all the relevant capital providers, weighted to their relative contribution to the company's total capital base. This is approximated by calculating the firm's Weighted Average Cost of Capital (WACC). The opportunity cost that is borne by investors is equal to the rate of return that they could expect to earn on other investments of equivalent risk.

A1.5 A number of different asset pricing models exist for calculating the cost of capital. The most commonly used is the Capital Asset Pricing Model (CAPM), which measures market risk via a single beta coefficient measured relative to a market portfolio. There are also multifactor models which measure market risk using multiple risk coefficients estimated relative to different factors.

A1.6 Ofcom's preferred approach is to use the CAPM. The CAPM has a clear theoretical foundation and its implementation is simple and well established relative to that of other asset pricing models. This results in the continued wide use of the CAPM by the UK's economic regulators, and its wide use amongst practitioners.

A1.7 Under the CAPM the WACC is calculated according to the following formulae:

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

Estimating discount rates

A1.8 Some of the parameters that influence the WACC calculation, specifically gearing ratios, equity betas, and debt premia may vary on a firm-by-firm, and hence potentially on a licence-by-licence, basis. However, Ofcom has decided 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.

A1.9 When Ofcom undertook the 2006 reviews, several UK companies with significant radio interests were listed on the stock exchange, such as GCap Media plc, Emap plc and Chrysalis Group plc. In 2010, UTV Media plc is the only UK listed company with significant radio assets and this represents the most relevant data available to Ofcom for the purposes of establishing a discount rate for a hypothetical new entrant.

A1.10 One respondent to the consultation said that it did not accept that it was appropriate to use a discount rate which is derived from companies which operate portfolios of well established, profitable and cash generative radio stations or other media assets. It said that it does not follow that any investment made by such a company into a new area of activity, such as launching a new national radio station, would be of equal risk to its existing operations. The respondent argued that a new entrant would take into account the increased risks and uncertainties of launching a new national radio station and so employ a relatively high discount rate.

A1.11 We consider that the best approach to estimating the discount rate for the second-highest bidder in a hypothetical auction for these radio licences is to have regard to companies already operating in this industry. We would highlight that this is an estimate, and calculating a discount rate requires us to use our regulatory judgement in order to arrive at a figure which is, in our opinion, reasonable and based on observable evidence.

Risk free rate

A1.12 No consultation responses disagreed with the risk free rate proposed in the consultation. Ofcom has decided to use the 4.5% nominal risk free rate (2.0% real) in line with the figure used in its recent statement “Reviews of the financial terms for the Channel 3 and Channel 5 Licences”[36] (the ‘Television Statement’). That statement set out the methodology for the review of television licences in the same way that this statement sets out the methodology for the review of the INRs.

A1.13 This risk free rate was sourced from Annex 8 of Ofcom’s statement “A new pricing framework for Openreach” (the “Openreach statement”)[37]. This statement used estimates of yields on nominal gilts as a proxy for the real risk free rate. We have also decided to use a forward looking inflation rate of 2.5%, consistent with the Openreach and Television statements[38].

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[36] http://www.ofcom.org.uk/consult/condocs/review_c3_c5_licences/statement/Statement.pdf
[37] http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/annexes.pdf
[38] See paragraph 6.55 of Annex 6 of the Openreach statement

Equity risk premium

A1.14 The equity risk premium is the difference between the overall return on equities and the nominal risk free rate. Its value in the UK reflects the risk of investing in UK equities generally. No consultation responses disagreed with the equity risk premium proposed in the consultation. Ofcom has decided to use a value of 5% in line with the equity risk premium used in Annex 8 of the Openreach statement and Annex 1 of the Television Statement.

Equity beta

A1.15 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. For a detailed discussion of issues relating to beta estimation, see, for example, *Issues in Beta Estimation for UK Mobile Operators, The Brattle Group, July 2002*[39]*.*

A1.16 In our consultation we explained that when Ofcom undertook the 2006 reviews, several UK companies with significant radio interests were listed on the stock exchange, such as GCap Media plc, Emap plc and Chrysalis Group plc. However, in 2010, UTV Media is the only UK listed company with significant radio assets. In our consultation we said that in the Television Statement we put little weight on UTV's beta since its shares are relatively thinly traded and consequently may not be a reliable estimator of its equity beta. As a result we considered a number of 2-year beta estimates from UK and European broadcasters. However, we were left with few, if any, reliable indicators as to the equity beta of a bidder for an INR licence. We proposed to adopt a market average equity beta of 1 and said that, given the tendency for equity betas to mean revert over a long period of time, we felt this was a reasonable estimate when the evidence is very limited.

A1.17 Two respondents commented on the equity beta and disagreed with our proposal, although they recognised the difficulties in determining an equity beta where evidence is limited. One respondent said that radio companies have traditionally exhibited above average betas, in excess of 1. The respondent also suggested analysing betas over a five year period rather than two years. This point was echoed by another respondent. Both respondents thought that we should use betas based on UTV Media (though another said we should not because UTV operates spread of businesses not specific to operation of an INR licence).

A1.18 One of the respondents also said that we should include a 'small company premium' in our analysis of the discount rate. It argued that potential bidders were likely to be of similar size to incumbent operators, rather than, say, a large multinational and that a small company risk premium should therefore be included.

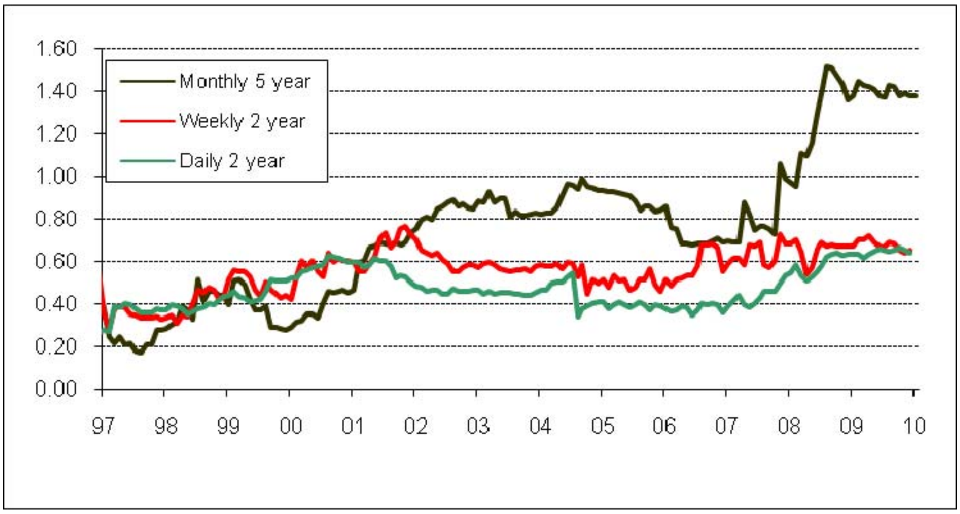
A1.19 We have considered the points raised by the respondents on the equity beta and have reviewed our estimates as set out below.

A1.20 Figure 2 shows UTV's equity betas over two and five years using daily, weekly and monthly data. It shows that the five year monthly beta has been above 1 for the last couple of years while the daily and weekly two year betas have been below 1. It is not immediately clear from this chart which beta estimate is the most appropriate to use. Attaching more weight to the monthly five year estimates would lead to a beta

[39] http://www.ofcom.org.uk/telecoms/ioi/g_a_regime/sce/ori/beta/

estimate of above 1 while putting more weight on the daily and weekly two year estimate would lead to an estimate of below 1.

Figure 2: UTV equity betas 1997-2010



Source: Bloomberg

A1.21 We also reviewed the two year and five year equity betas for GCap Media, Chrysalis and Emap whilst they were listed companies and had significant radio assets. This analysis indicated that five year monthly betas were usually higher than two year betas, and were typically above 1.

A1.22 In our consultation we considered two year beta estimates for a range of different broadcasters but concluded that these did not provide reliable indicators of the appropriate beta to use for a hypothetical new entrant to the UK radio sector. Taking into account the responses received to the consultation we agree that where the shares of a company such as UTV are relatively thinly traded and the company itself is very reliant on advertising revenue, five year equity betas may be more appropriate than two year equity betas. This is because a five year analysis provides more data points for calculating the beta and may better reflect the cyclical nature of the advertising market. We also agree that as the only listed company with radio operations, UTV is the best source of information available to us to inform our assessment of the equity beta.

A1.23 We therefore place significant weight on UTV Media's five year equity beta estimates.

A1.24 Taking into account the evidence available to us, we consider that a reasonable range for our estimate of the equity beta is 1.0 to 1.4, where the upper end of the range is informed by the five year data, and the lower end of the range is informed by our previous market average estimate. We will use the midpoint of the range, i.e. 1.2, in our calculation of the discount rate.

A1.25 It is Ofcom's view that basing the equity beta (and debt premium) on evidence relating to existing radio operators takes into account the fact that operators of radio stations may be subject to greater volatility than the market as a whole. We do not consider there is good reason to think that the parent companies of second-highest bidders would necessarily be smaller than the current operators of the INR licences.

Consequently we do not consider it is necessary or appropriate to include a small company risk premium in our estimate of the discount rate.

Optimal gearing

A1.26 Under the standard Capital Asset Pricing Model a firm can potentially lower its overall cost of capital by increasing its gearing. This is because debt is generally cheaper than equity as a result of tax advantages to debt.

A1.27 Our approach to gearing is to assume an optimal level of gearing, which is that at which the cost of capital is minimised and the value of the firm is maximised. Since the cost of debt is lower than the cost of equity, this suggests that the optimal rate would favour debt financing. However, if the level of debt gets too high the risk of financial distress increases very quickly, and equity investors recognise that their claim on the assets of a firm in financial distress comes after the claims of debt holders. Therefore, equity holders will be wary of high levels of gearing, particularly in firms where there are limited fixed assets (which could be liquidated in the event of distress).

A1.28 We would expect investors in a radio licence, which would have relatively few assets to sell in the event of financial distress, to want lower levels of gearing than those of a company like BT, where substantial valuable fixed asset investments might help to insulate investors from the risk of losing their investment. As a point of reference, we assume the optimal gearing rate to be 35% for BT Group, which was based on BT's long-run average gearing up until the last few years.

A1.29 On the basis that investors should want a gearing rate that maximises the benefit from cheaper debt financing, but without jeopardising the financial viability of the firm, we assumed in our consultation an optimal gearing level of 30%. This is the same as the rate we used for Sky in our recent Pay TV phase three consultation document[40] and also the same as we used in the Television Statement.

A1.30 All respondents thought this gearing ratio was too high. The reasons given for this were:

- It is inappropriate to compare a start up national radio station to a large, established, profitable broadcaster like Sky. Sky's ability to raise leverage does not translate to a radio broadcaster
- It would not be possible in the current climate to raise debt financing against the launch of a new business which would not be backed by any other assets other than the licence itself

A1.31 One respondent suggest a gearing ratio of 20%, another suggested 0%-10%.

A1.32 We agree with the view expressed by respondents that radio companies are likely to be less able to raise debt funding than a very large media company such as Sky. We have also considered the current gearing level of UTV Media, recognising that some of this debt would have been raised prior to current market conditions. We are required however to use our regulatory judgement to estimate an optimal gearing ratio for a hypothetical new entrant considering bidding for these licences in an auction. Taking into account the points raised by respondents and their effect on

[40] http://www.ofcom.org.uk/consult/condocs/third_paytv/annex10.pdf, paragraphs 2.44-2.46

our original proposals and our rationale for them, we have decided to reduce the optimal gearing ratio from the 30% proposed in our consultation to 25%.

Debt premium

A1.33 The cost of corporate debt is made up of a risk free component and a company specific risk premium. ITV's most recently issued debt now trades at around 4% above equivalent government gilts, while the same figure for recently issued Sky debt is around 1.5%.

A1.34 In our consultation Ofcom proposed using a debt premium of 4%, reflecting the relatively high cost of borrowing for media companies at the moment. No consultation responses disagreed with this proposal and we have decided to use an estimate of 4%.

Corporate tax rate

A1.35 The current main rate of corporation tax is 28% but the Government's 2010 budget set out that the tax rate would be 27% from 1 April 2011, reducing to 24% by 1 April 2014[41]. This means that the rate of corporation tax facing our new entrant would be 28% at the start of the licence period, and 24% at the end. We have taken this into account in our estimate of the discount rate by assuming an average tax rate of 26%.

Conclusion

A1.36 In our consultation we estimated a single discount rate to be used in the licence valuations, being a real pre-tax WACC of 11.8%. All respondents thought this should be higher, with suggestions ranging from 15%-18.9%[42]. Taking into account the responses received to the consultation, and the additional evidence we sourced as a result of the responses, we have

- revised our beta estimate from 1.0 to a range of 1.0 to 1.4, with a midpoint of 1.2
- Reduced the gearing ratio from 30% to 25%
- Reduced the corporate tax rate from 28% to 26%

A1.37 These changes have increased our nominal pre tax WACC from 11.8% to 12.8%. A summary of the components of the WACC calculation follows.

[41] See http://www.hmrc.gov.uk/rates/corp.htm and http://www.hmrc.gov.uk/budget2010/bn02.pdf

[42] One respondent also said that, in practice, offering a return of 11.8% on capital to fund a venture like a national commercial radio would not secure any funding, and that private equity investors would be looking for a return of 25 to 30%

	Statement
Nominal risk free rate	4.5%
Equity risk premium	5.0%
Equity beta	1.20
Cost of equity (nominal, post tax)	10.5%
Debt premium	4.0%
Cost of debt (nominal, pre tax)	8.5%
Corporate tax rate	26.0%
Cost of debt (nominal, post tax)	6.3%
Gearing	25.0%
WACC (nominal, post tax)	8.5%
WACC (nominal, pre tax)	12.8%

Annex 2

Glossary

Cash bid: a fixed annual cash amount to be paid for the licence alongside the PQR. It represents the amount Ofcom determines the licence holder would have bid were the licence to be granted for the period of the (further) renewal on an application made in accordance with section 98 of the 1990 Act (i.e. in an auction), instead of being renewed. It is increased each year in line with the retail price index.

PQR: Percentage of Qualifying Revenue. A percentage that is applied to the year's qualifying revenue in order to determine the amount of the variable payment due for that year in regard to the licence.

Qualifying Revenue: revenue related to the operation of the licence as defined in section 102 of the Broadcasting Act 1990, for example advertising and sponsorship revenue.

RAJAR: Radio Joint Audience Research. Rajar is the company that carries out radio audience measurement for the radio industry. It is jointly owned by the Radiocentre and the BBC.

WACC: Weighted Average Cost of Capital. The rate that a company is expected to pay on average to all its security holders to finance its assets