Renewal of the Independent National Radio licences

Methodology for review of financial terms

Consultation

Publication date: 9 July 2010

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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 (further) 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. All three INR licensees are currently providing such a service, and thus 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"). This consultation is primarily concerned with the process we are required to undergo in order to set these financial terms.

1.4 Each of the three INR licences has an expiry date between September 2011 and December 2012. Consequently, the timetable for each licence to undergo the process of renewal potentially is different. In this consultation document we set out the renewal timetable for all three licences.

1.5 We propose 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, but taking account of developments, as set out in this document. Now, as in 2006, our overriding objective is to establish a methodology which enables us to determine financial terms that are fair and reasonable within the context of the current market environment, and ensure that the tax payer gets a proper return for the use of the scarce analogue spectrum.

1.6 We propose 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 also propose to apply a discount rate of 11.8% to the valuations.

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

1.8 Chief among these uncertainties is the potential duration of the renewed licence periods in practice[1] – we propose that for each of the two AM INR licences, the appropriate period for valuation purposes is the period from a key date associated with the renewal application[2] to the end of 2015, and for the FM licence, the

[1] Noting that we propose they will formally be renewed for seven years from the date of their renewal
[2] Which depends when the application is made, in some cases will be the relevant date, and is set out in section 3 below

appropriate period is from the anticipated date of renewal of the licence to the end of 2015.

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 In this report, the Government laid out an ambition to deliver a 'Digital Radio Upgrade' programme by the end of 2015, under which all national and local radio services carried on the DAB platform would cease continuing to also broadcast on FM or AM. The Government also stated its wish that this 'Upgrade' would occur when 50% of radio listening is to digital services, and when national DAB coverage is comparable to FM coverage, and local DAB reaches 90% of the population and all major roads (although these criteria are not included in the legislation). The current Government confirmed that these criteria still apply with the publication of its Digital Radio Action Plan[3].

2.3 As part of this proposal, the Government further stated that "we also recognise that the investment needed to achieve the Digital Radio Upgrade timetable will on the whole be made by the existing radio companies. We are also aware that our timetable will mean that many new licences will run only for three or four years. For these reasons, we propose to grant Ofcom new powers to extend the licence period of all national and local licences, broadcasting on DAB, for up to a further seven years."

2.4 Consequently, 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[4] 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).

2.5 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.

2.6 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”).

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[3] http://www.culture.gov.uk/publications/7227.aspx

[4] Section 103B of the Broadcasting Act 1990, as inserted by section 31 of the Digital Economy Act 2010

2.7 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.[5] 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.

2.8 This consultation document 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

2.9 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'.

2.10 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 already 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	30 Sep 2011	30 Sep 2010	30 June 2010
Absolute Radio	30 Apr 2012	30 Apr 2011	30 Jan 2011
Talk Sport	31 Dec 2012	31 Dec 2011	30 Sept 2011

2.11 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.[6]

2.12 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'.

2.13 As can be seen from the table above, the 'relevant date' in respect of the licence held by Classic FM is 30 September 2010. 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 this consultation 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.

[5] Under section 98 of the Broadcasting Act 1990
[6] See section 103A (8) of the Broadcasting Act 1990

2.14 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.

2.15 Given their later expiry dates, the same timetable constraints do not apply to the licences held by each of Absolute Radio and Talk Sport, and therefore these licences will be renewed on or before their respective 'relevant dates', subject to the grounds for their renewal being met and depending on when the licensees apply for renewal and determination of their financial terms.

2.16 However, it is open to both Absolute Radio and Talk Sport 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.

2.17 As noted above, a licence is renewed from the date of renewal, not from the expiry date of the current licence. This means that any revised financial terms will apply from the date of renewal (i.e. in the case of the licences held by Absolute Radio and Talk Sport, from not later than one year prior to the expiry of the existing licence,[7] and in the case of the licence held by Classic FM, from January 2011 at the latest).

2.18 The table below sets out the renewal timetable for all three licences, and includes details of how long the financial terms Ofcom determine will be open for the relevant licensees to accept.

Date	Event
30 June 2010	Application deadline for Classic FM Deadline for Absolute Radio and Talk Sport to indicate interest in having reviews processed concurrently with Classic FM
13 August 2010	Close of consultation period
September 2010	Publication of statement on methodology
October 2010 (depends on date of statement)	Deadline for Classic FM to provide initial financial submissions in support of its application for renewal (and accompanying review of financial terms). De facto deadline for Absolute Radio and Talk Sport to apply for renewal and provide financial submissions if they wish to have financial terms reviews processed concurrently with Classic FM

[7] Depending on when they apply. The renewal date could be earlier if the financial terms are accepted before the relevant date

January 2011	Ofcom expects to offer revised terms to Classic FM and other licensees who were processed at the same time. Deadline for Classic FM and any other licensees processed concurrently to accept terms is 30 days from the date of the determination. Revised terms take effect from the date upon which the licence is renewed (i.e. on acceptance of the terms)
30 January 2011	Statutory deadline for Absolute Radio to submit application for licence renewal and review of financial terms and initial financial submissions – unless they have already had a review concurrent with Classic FM. De facto deadline for Talk Sport to submit application for review of financial terms and initial financial submissions if they wish to have review processed concurrently with Absolute Radio.
30 April 2011	Ofcom expects to offer revised terms to Absolute Radio and Talk Sport if they applied for a review by Absolute Radio's application deadline. Deadline for Absolute Radio and any other licensees processed concurrently to accept terms is 30 days from the date of the determination. Revised terms take effect from the date upon which the renewal is accepted
30 September 2011	Expiry date for Classic FM licence if no renewal is granted Statutory deadline for Talk Sport to submit application for licence renewal and review of financial terms and initial financial submissions – unless they have already had a review concurrent with Classic FM or Absolute Radio.
31 December 2011	Ofcom expects to offer revised terms to Talk Sport if it applied for a review by its application deadline. Deadline for Talk Sport to accept terms is 30 days from the date of the

	determination. Revised terms take effect from the date upon which the renewal is accepted
30 April 2012	Expiry date for Absolute Radio licence is no renewal is applied for or granted
31 December 2012	Expiry date for Talk Sport licence if no renewal is applied for or granted.

Impact assessment

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

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

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

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

Section 3

Approach to the review of financial terms

Introduction

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

3.2 We propose that the methodology used by Ofcom in 2006[8] remains broadly appropriate, with some modifications that are set out in this section. We propose to apply it on that basis, and subject to those modifications. We provide an overview of the methodology in this section and invite views.

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[9].

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 being granted afresh for the period of the (further) renewal on an application made in accordance with section 98 of the 1990 Act (which established the process for the original auction of the national licences), instead of being renewed.

3.6 Under the 1990 Act the procedure Ofcom must follow in connection with considering applications for national licences is described in section 99. This sets out certain thresholds an applicant must meet before Ofcom may consider its Cash Bid under section 100 of 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

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

of the PQR payments and Cash Bid. The definition of qualifying revenue is set out in section 102 of the 1990 Act and Ofcom is 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, Ofcom has taken the view that to ensure a consistent approach to setting both the PQR and the Cash Bid, it is appropriate to conduct a single economic valuation according to common principles. This valuation is intended to meet the requirements of the Act in relation to determining the Cash Bid, and also to provide a robust basis for informing Ofcom's decision as to the appropriate level of the PQR, taking into account both the objectives and the uncertainties discussed in this document.

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.

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 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, the purpose of the statutory provisions relating to the auction of national sound broadcasting licences can be seen from the following statement made to the House of Commons during the passage of the Bill that became the 1990 Act, [10] by the then Home Secretary, David Waddington MP. He said the purpose is to:

".. ensure[s] that the tax payer gets a proper return for the use of the valuable and scarce national resources constituted by broadcasting rights and, in particular, the use of the frequency spectrum"

This, it appears to us, translates into a duty on Ofcom to secure such a return.

3.18 These provisions and purposes have not changed since 2006, notwithstanding the changes made by the 2010 Act. Our duties to further the interests of citizens and consumers and to secure the range, diversity and quality of national radio services, and the specific requirements as to their contents, 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 if we receive applications for further licence renewal under section 103B of the 1990 Act. In particular, to:

3.19.1 establish a methodology and process enabling Ofcom to determine financial terms for the further renewals that are fair and reasonable within the context of the current market environment and would continue to be reasonable for the further renewed period of the licence(s); and

3.19.2 ensure the tax payer gets a proper return for the use of scarce analogue spectrum.

3.20 This will ensure that each of what appear to us to be four key duties continue to be met.

The market environment

3.21 The 2006 reviews resulted in a reduction in the amounts payable for the independent national radio licences[11]. 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

[10] On 18 December 1989,

[11] 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

considered to be the principal right attached to the licence – the privileged access to scarce analogue spectrum – was in decline.

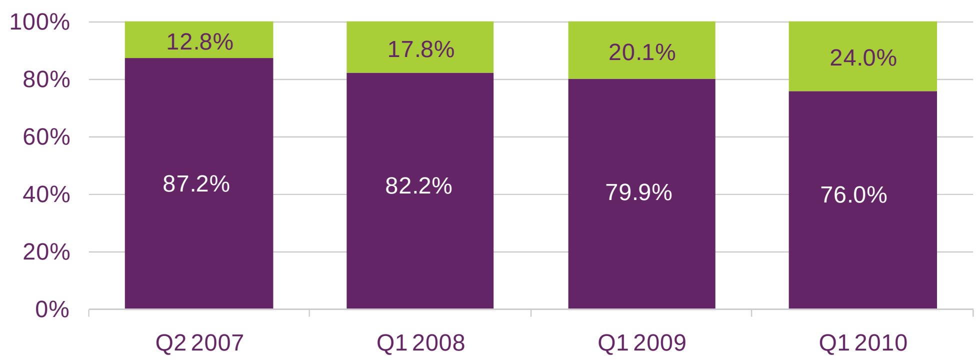
3.22 For the two AM licences considered, we set the PQR at zero and the Cash Bid at £100,000. For the FM licence we set the PQR at 6% and the Cash Bid at £50,000. The differential between the terms set for the FM licence and the AM licences reflected the difference in the quality of each medium, the 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 being granted afresh in an auction. 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 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. This was up by 20% over the year, and by 88% in three years. DAB digital radio was the most widely used means of listening to digital radio services, accounting for 63% of all digital listener hours in Q1 2010; DTV was the second most popular choice (4%) with streaming over the internet ranking third (3%).

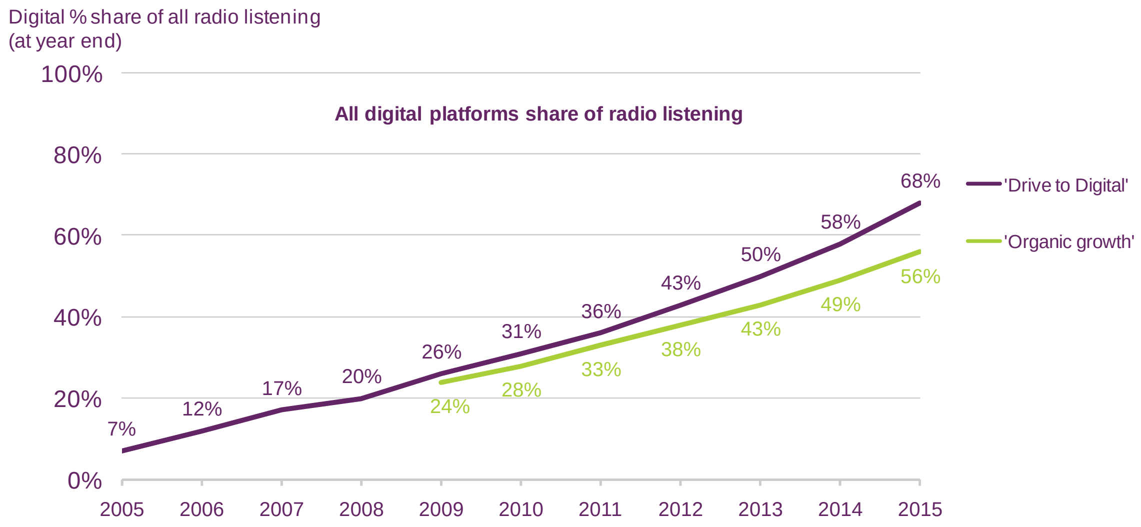
Figure 1: Distribution of listening hours across analogue and digital platforms



Source: RAJAR Ipsos MORI/ RSMB, Q1 2010
Note: New digital radio listening share survey begun in Q2 2007 by RAJAR Ipsos MORI/ RSMB

3.25 The previous government's *Digital Britain* report set out the last available public domain projections for digital radio listening. Figure 2 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. As shown above, by Q1 2010 digital platforms had gained a 24% 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.

Figure 2: The projected proportion of digital radio listener hours, according to the previous government's *Digital Britain* report.

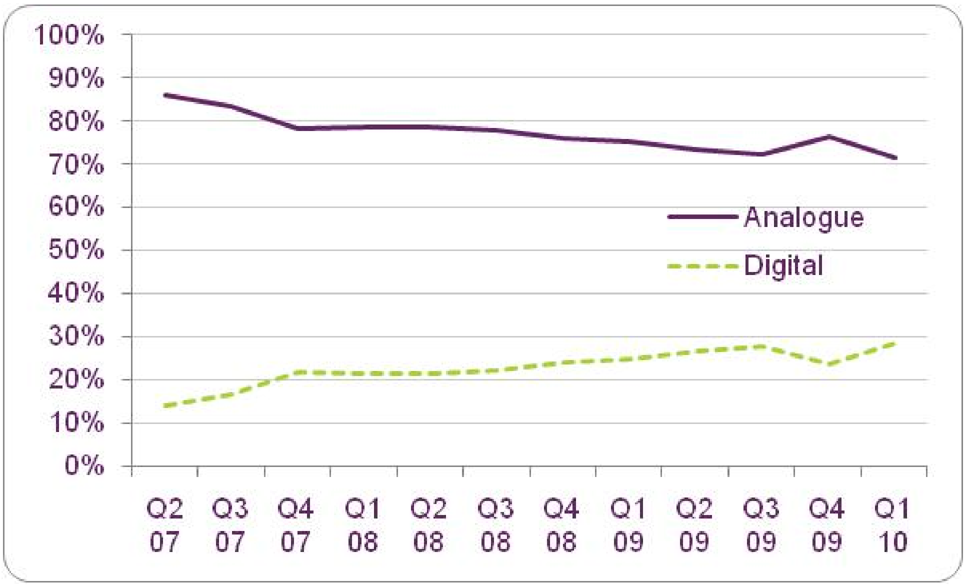


Source: Rajar, Digital Britain, Value Partners analysis[12]

Trends in listening to the INR services[13]

3.26 Since the second quarter of 2007, the total number of weekly listening hours to Classic FM has fallen by 11%, from 42m to 37m. Over the same period, the proportion of listening to digital platforms has doubled from 14% to 28%, as illustrated in Figure 3.

Figure 3: Classic FM – proportion of listening to analogue (FM) and digital

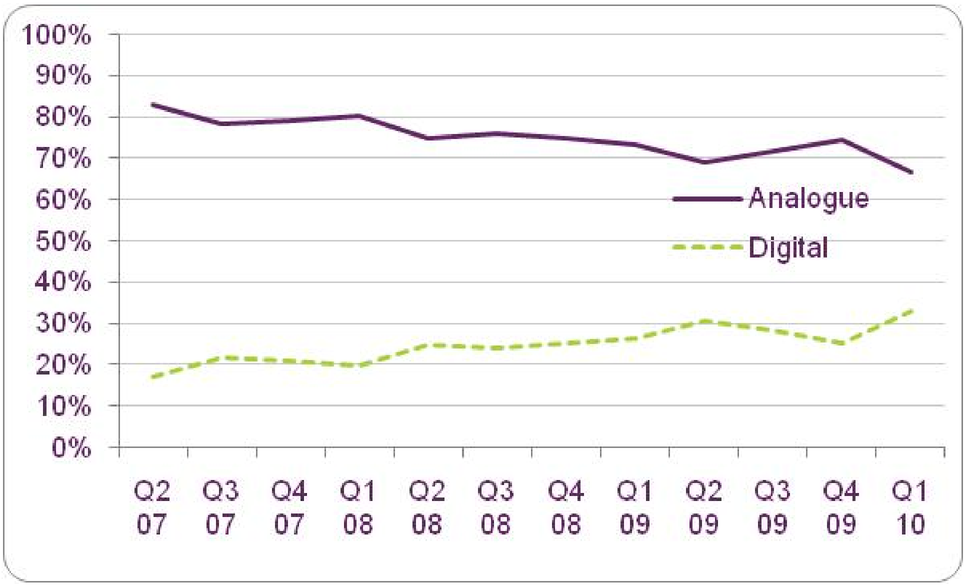


[12] Information in this document taken from the Government's "Digital Britain Final Report" (or any other Crown source) is subject to Crown Copyright

[13] All listening data are sourced from RAJAR.

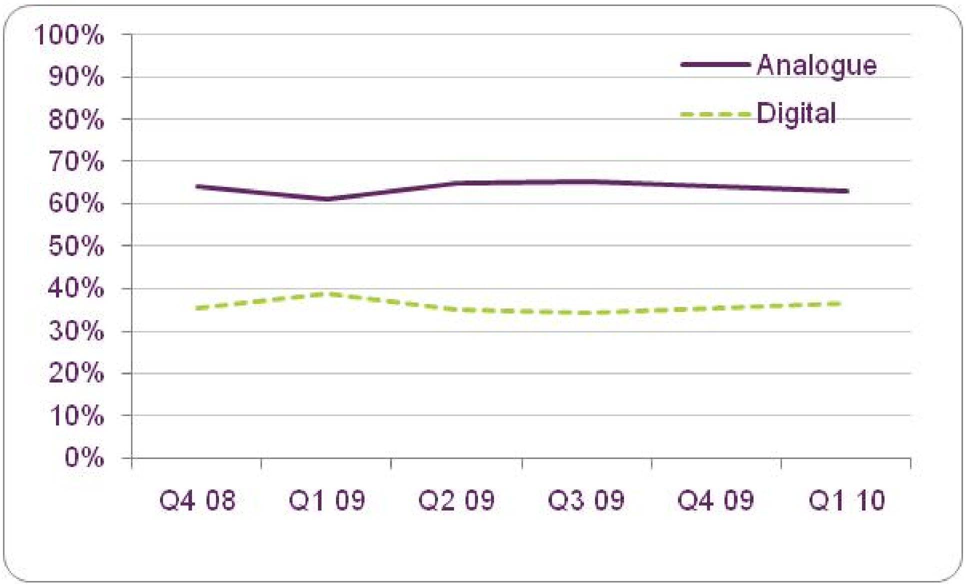
3.27 Since the second quarter of 2007, total listening to TalkSport has fallen by 15%, although this largely reflects a fall in listening in the first quarter of 2010. Like Classic FM, the proportion of listening represented by digital platforms has doubled over the same period, rising from 17% to 33%, as illustrated in Figure 4.

Figure 4: TalkSport – proportion of listening to analogue (AM) and digital



3.28 Since the last quarter of 2008 (the quarter after Absolute Radio launched), total listening to Absolute Radio has increased by around 4%. The proportion of Absolute Radio's listening represented by digital platforms has remained steady, at around 36% of listening, as shown in Figure 5.

Figure 5: Absolute Radio – proportion of listening to analogue and digital

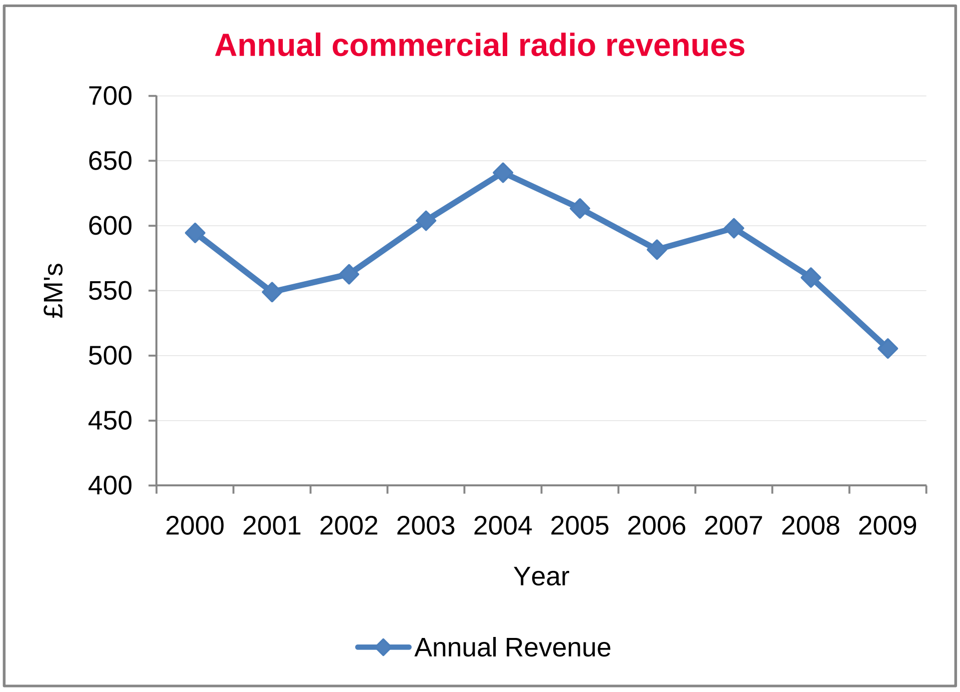


Note: Analogue includes AM and FM listening, since Absolute Radio is simulcast on AM nationally and on FM in London.

Changes in the UK radio advertising market

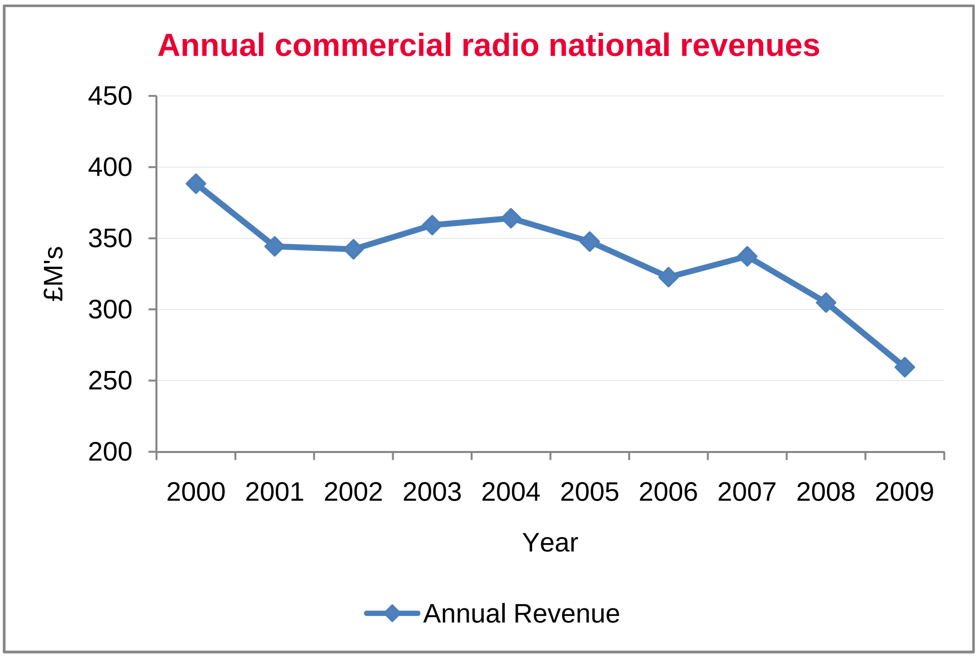
3.29 Since the financial terms attached to the INR licences were last reviewed in 2006, annual revenues for commercial radio have fallen by 13%. Over the same period, national revenues have also fallen, but by a greater degree - nearly 20%. This is illustrated in the following two charts:

Figure 6: Annual Commercial Radio Revenues



Source: RAB (Note: data from 2003 are Q4 MAT)

Figure 7: Annual commercial radio national revenues



Source: RAB (Note: data from 2003 are Q4 MAT)

3.30 Commercial radio's share of all display advertising has fallen fractionally since 2006, from 6% to 5.9%.

Question 1 *What other features of the market environment do you believe Ofcom should consider when deciding on the PQR payable and determining the amount that, in its opinion, would have been the Cash Bid for the licence if offered in a competitive tender process ('a hypothetical auction')?*

Regulatory developments

3.31 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.

3.32 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,[14] 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. [15]

3.33 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.[16]

3.34 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.

3.35 On 7 July 2010 the Communications Minister Ed Vaizey announced the Government's 'Digital Radio Action Plan', saying that[17]

3.36 "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"[18].

[14] which can include further renewed national licences
[15] The 2010 Act inserts these provisions into the 1990 Act as sections 97A and 97B
[16] The 2010 Act inserts these provisions into the 1990 Act as section 105A
[17] http://www.culture.gov.uk/news/media_releases/7225.aspx
[18] http://www.culture.gov.uk/images/publications/digitalradioactionplan_vs1.pdf, page 2

3.37 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.

3.38 In response to the previous Government's *Digital Britain* report published in June 2009, Ofcom consulted on a new set of policy proposals designed to adapt the regulation of commercial radio to changes taking place in the wider media market. The statement following this consultation can be found at http://www.ofcom.org.uk/consult/condocs/radio/statement/.

3.39 These changes were proposed in the context of the previous Government's strategic goal of a three-tier structure for commercial radio set out in the *Digital Britain* report, which included the facilitation, at a UK-wide level, of new commercial radio stations to create an improved consumer proposition.

3.40 In pursuance of this goal of encouraging new UK-wide services, delivered on digital platforms, it is now possible for existing 'regional' FM stations to request to have their localness obligations removed from their licences, thus 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.

Question 2 *What other developments do you believe Ofcom should consider when deciding on the PQR payable and determining the amount that, in its opinion, would have been the Cash Bid for the licence if offered in a competitive tender process ('a hypothetical auction')?*

Valuation methodology

3.41 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 proposes to use a similar approach to any review that is triggered by an application for renewal. Below, we set out our proposed methodology and identify those areas where there are changes from the approach taken in the last review.

3.42 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

3.43 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.

3.44 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.)

3.45 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.

3.46 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

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

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

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

3.50 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.

3.51 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

3.52 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.

3.53 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.

3.54 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 take up this right, and deliver a DAB simulcast.

3.55 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.

3.56 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.

3.57 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.

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

Question 3 *Do you agree that the overall valuation methodology, as set out above, remains appropriate for reviews that Ofcom may be required to undertake to inform our decision about the PQR and Cash Bid? If you do not, then please explain why you think it is inappropriate and what justifications exist for suggested alternatives.*

Dealing with uncertainties for the purposes of the review

3.59 Valuation of licences on a forward looking basis involves taking account of a number of uncertainties. In the February 2006 statement, we highlighted this as follows:

However, it is important to recognise the very wide range of uncertainties that Ofcom faces in arriving at its determination. The uncertainties include, but are not limited to, the following:

- *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.*

The requirement for Ofcom to consider the outcome of a hypothetical single round sealed bid auction adds a further layer of complexity. Neither the exact circumstances of the auction, the identity of bidders, their business plans nor their bidding strategies can be predicted with certainty.

Ofcom is unable to eliminate these uncertainties. Therefore, in order to fulfil its statutory duty to determine the financial terms, it is necessary for Ofcom to make a series of assumptions on many issues.

Ofcom believes that the methodology outlined in this statement is compatible with both Ofcom's objectives and statutory duties. Ofcom recognises that there may be alternative approaches to individual elements of the valuation methodology but considers that, taken as a whole, the methodology should provide a fair and reasonable result, which Ofcom can use to inform its estimate of the Cash Bid (the fixed payment) and determination of a PQR (being the Percentage of Qualifying Revenue which must be paid.)

Source: Paragraphs 1.4 – 1.7 of the February 2006 statement

3.60 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.

3.61 The announcement of the Government's Digital Radio Action Plan confirms 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"[19].

3.62 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.

3.63 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.

3.64 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.

3.65 Ofcom's view will therefore be informed by a number of sources, including:

- 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

[19] http://www.culture.gov.uk/news/media_releases/7225.aspx

- evidence required to be provided by stakeholders to Ofcom, including consideration of pre-existing business plans and forward looking projections which are relevant

***Question 4** Do you agree with Ofcom's approach to dealing with the uncertainties outlined above? If not, please explain why and what alternative approaches would be available?*

***Question 5** How do you think Ofcom should estimate future trends related to listening hours? In particular, how should we estimate future trends in the proportion of listening represented by analogue and digital platforms?*

***Question 6** How do you think Ofcom should estimate future trends in radio advertising revenues?*

Duration of the renewed licence period

3.66 In the 2006 reviews, Ofcom was required to consider the value of a four year extension to an eight year licence. In contrast, further renewals are for a period of up to seven years from the date of the renewal. Ofcom proposes further to renew the relevant national licences for the maximum (formal) duration of seven years from that date (but subject to the duration variation provisions introduced by the 2010 Act outlined in this document).

3.67 Whilst we could further renew the relevant national licences for a shorter period, we consider that there are sufficiently compelling reasons for adopting the maximum further renewal period and no such reasons for a shorter one. The licence duration variation provisions in the 2010 Act and referred to elsewhere in this document mean there is little need to adopt a different (shorter) period in the interests of flexibility. A seven year further renewal period also, we consider, offers 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. We invite comments on whether this proposed period for the further renewals is appropriate and, if not, what is and why.

3.68 On the face of things, therefore, seven years is the period of the (further) renewal by reference to which Ofcom is required[20] to determine the Cash Bid amount. If the renewed licence was expected to endure for seven years, then Ofcom considers that the appropriate period for the discounted cashflow valuation would be a period of seven years. However, the 2010 Act also contains specific provisions which mean that the renewed licences could be terminated early. There are two such provisions.

3.69 Firstly, as set out above, if the Secretary of State has not announced a date for digital switchover (or has rescinded such an announcement) then he or she may set a "termination date" on which certain analogue licences (including, potentially, the further renewed INR licences) must expire (effectively on two years' notice). The termination date cannot be before 31 December 2015.

3.70 Secondly, and again as set out above, if the Secretary of State announced a date for digital switchover then the renewed INR licences could be terminated with two years' notice. In theory, this notice could be given at any time. However, the date for digital switchover is defined in legislation *as "a date after which it will cease to be*

[20] By virtue of section 103A(7) of the 1990 Act

appropriate for [a] service to continue to be provided in analogue form." This means the Secretary of State would need grounds for deciding that it will be appropriate for switchover to occur, and so his or her discretion (and the time at which it may be exercised) is constrained thereby. The Government's policy criteria which it would expect to be met before announcing a switch off date for analogue are referred to below.

3.71 We believe that, in the event of an auction, any potential bidder would want to take account of the possible duration of the licence in practice when considering the amount that they would be prepared to bid.

3.72 Although the further licence renewal is proposed for a (maximum) seven year period, the presence of explicit revocation provisions means that a bidder might not expect that the licence would necessarily run to its full duration. There are a variety of different durations which might be possible depending upon the actions of the Secretary of State, which in turn would likely be influenced by external events. It might be desirable for a bidder to consider the likelihood of a range of different end dates, assign an appropriate percentage probability to each possible outcome and weight them accordingly. However, there is relatively little evidence available to Ofcom to determine what the reasonable weightings should be.

3.73 In the first early termination scenario set out in 3.69 above, the earliest date that the Secretary of State could terminate the licences is 31 December 2015. If this were the only early termination scenario created by the 2010 Act, the licensees would be certain that the licence would operate at least until 31 December 2015.

3.74 The second early termination scenario set out in 3.70 above is also at the Secretary Of State's discretion but is inextricably linked to the setting of a date for digital switchover. In theory, it is possible that the Secretary of State could seek to set a switchover date before 31 December 2015. However, we believe that a bidder for the licence would not assign a high probability to such an outcome. Rather, we believe that bidders would generally consider that 31 December 2015 would probably be the earliest possible date on which digital switchover could occur.

3.75 Our view for this is based upon the policy set out in the Government's Digital Radio Action Plan, published on 7 July 2010. This sets out two preconditions for digital switchover:

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

3.76 We note that although it is plausible that these conditions might be met in future, they have not been met at the present time.

3.77 It therefore seems unlikely that the Government would give two years' notice of termination prior to the end of 2013, although since this is a policy decision for Government, such an outcome could not be entirely discounted if the criteria for switchover were met.

3.78 It is possible that a potential bidder might view a December 2015 end date as being earlier than they would expect the actual end date to be. They might therefore expect the licence to endure beyond December 2015.

3.79 Another uncertainty is the precise start date of the further renewed licences. The further renewed Classic FM licence will, at the earliest, run from a date as soon as reasonably practicable after the relevant date Ofcom has set in relation to it. The other two further renewed licences could run from dates much earlier than their relevant dates if their licensees apply early for renewal as set out in this document, Ofcom determines the financial terms and the licensees accept them before the relevant date (within the time given for acceptance).

3.80 Ofcom acknowledges that there are a number of different possible views that a bidder could take about the likely duration of the licence in practice. However, it is difficult to assign weightings and probabilities to these views in an objective way. Nevertheless we think that it is important to value the licences on as consistent a basis as possible, which so far as possible fairly reflects a reasonable view of what the licence duration may be in practice taking into account the uncertainties set out above.

3.81 Ofcom therefore proposes that the duration of the licence in practice for the purposes of establishing the Cash Bid[21] of the incumbent for the two AM licences will be the period between the a key date associated with the application (as set out below)[22] and 31 December 2015. In the unique case of Classic FM, where the renewal will take place later than the relevant date, the duration of the licence will be the period between 31 January 2011 and 31 December 2015. For clarity, these periods are set out below:

- For Classic FM, the duration of the licence for the purposes of establishing the Cash Bid will be the period between 31 January 2011 and 31 December 2015.

- If Absolute Radio and/or Talk Sport choose to apply and have their application processed alongside Classic FM, then the duration of the licence for the purposes of establishing the Cash Bid will be the period between 31 January 2011 and 31 December 2015.

- If Absolute Radio applies for a renewal by 30 January 2011, in line with the process by which its terms are set by reference to its own relevant date, then the duration of the licence for the purposes of establishing the Cash Bid will be the period between 30 April 2011 and 31 December 2015.

- If Talk Sport chooses to apply and has its application processed alongside Absolute Radio in line with the latter's relevant date then the duration of the licence for the purposes of establishing the Cash Bid will be the period between 30 April 2011 and 31 December 2015.

- If Talk Sport applies for a renewal by 30 September 2011, in line with the process by which its terms are set by reference to its own relevant date, then the duration of the licence for the purposes of establishing the Cash Bid will be the period between 30 December 2011 and 31 December 2015.

[21] That is, how we propose to treat the way bidders would regard and bid for all the licences where, legally, the period of the licences' (further) renewal is seven years but they are subject to the possibilities of early termination outlined.

[22] Which depends when the application is made and, in some cases but not all, will be the relevant date in relation to one of the licences

3.82 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.

3.83 Calculation of the PQR and Cash Bid payable by the licensees will be based upon the anticipated amounts of Qualifying Revenue over the same period. This will match the expected recovery of value from the licensee to the period of the discounted cashflow analysis.

3.84 In proposing this approach, we note that should the licences in practice extend beyond 31 December 2015, the Cash Bid will be payable throughout the (up to) seven year licence period. We also propose that we set the PQR so that the same percentage be payable throughout that (up to) seven year period. This means that if the licence is not subject to early curtailment, and runs beyond 31 December 2015, there will be some recovery of the value associated with this through the application of the PQR and Cash Bid during that period.

3.85 We consider that the overall proposed approach on the duration of the further renewed licences fairly and properly balances the different uncertainties, and their possible effects. And, does so in a way that is consistent with our statutory duties and our objectives here, both as set out above. In particular, that of determining fair and reasonable financial terms whilst ensuring the tax payer gets a proper return for the use of scarce analogue spectrum. The approach to the duration of the licences might result in a lower valuation than might otherwise be made, but it is consistent with the Government's policy approach to digital switchover and the dates on which the further renewed licences might end (as far as they can presently be identified). And, the ongoing effect of the licence conditions about the payment of the PQR and Cash Bid mitigates against the risk that our approach to the duration of the licences will result in a lower valuation than might otherwise be made, and maintain the return for the tax payer in relevant circumstances.

Question 7 *Do you agree with Ofcom that the appropriate period to use for the duration of the licence in practice is, for the AM licences, the period from the key date associated with the application (as set out above) to 31 December 2015 and, for the Classic FM licence, the period from the anticipated renewal date (being 31 January 2011) to 31 December 2015. Please explain why.*

Question 8 *Do you agree that it is appropriate that the same PQR, as well as the Cash Bid, should endure for the full duration of the licence? If not, then how do you propose that Ofcom should mitigate the risk that the licences have enduring value beyond the 31 December 2015 cut off date?*

Discount rate

3.86 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 proposed discount rate is intended to reflect the opportunity cost of investment faced by a hypothetical entrant that is assumed to be an existing media company.

3.87 Ofcom has calculated a nominal, pre-tax rate of 11.8%, which is meant to reflect the weighted average cost of capital (WACC) of a hypothetical entrant. The calculation is based on a consideration of data and estimates relating to UK and European broadcasters.

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

Question 9 *Do you agree that a nominal, pre-tax discount rate of 11.8% is appropriate? If not, then please set out what other considerations Ofcom should have taken into account in determining the discount rate.*

Cut-off date

3.89 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.

3.90 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

Responding to this consultation

A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 13 August 2010**. This five week period is shorter than our standard ten week consultation period. However, we consider this is appropriate given that:

- the consultation is primarily of interest to a limited number of stakeholders who are aware of the issues involved;
- there are factors which require the project to be concluded within a short period: there is a need to complete the project with an expedited timetable because of the recent passage of the 2010 Act and the need further to renew the Classic FM licence as soon as reasonably practicable after the relevant date that applies to it; and
- the proposals contained in this document are generally consistent with those we previously consulted on and used when Ofcom last conducted such reviews in 2006.

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

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

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

Neil Stock
Head of Broadcast Licensing
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA

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

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

Further information

A1.6 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Neil Stock, Head of Broadcast Licensing, on 020 7981 3000.

Confidentiality

A1.7 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

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

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

Next steps

A1.10 Following the end of the consultation period, Ofcom intends to publish a statement on its methodology during September 2010.

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

Ofcom's consultation processes

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

A1.13 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk . We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.

A1.14 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is Ofcom's consultation champion:

Vicki Nash
Ofcom
Sutherland House
149 St. Vincent Street
Glasgow G2 5NW

Tel: 0141 229 7401
Fax: 0141 229 7433

Email vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

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

Before the consultation

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

During the consultation

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

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

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

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

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

After the consultation

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

Annex 3

Consultation response cover sheet

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

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

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

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

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

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

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

Nothing	☐	Name/contact details/job title	☐
Whole response	☐	Organisation	☐
Part of the response	☐	If there is no separate annex, which parts?	

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

DECLARATION

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

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

Name | Signed (if hard copy)

Annex 4

Summary of consultation questions

Question 1 *What other features of the market environment do you believe Ofcom should consider when deciding on the PQR payable and determining the amount that, in its opinion, would have been the Cash Bid for the licence if offered in a competitive tender process (‘a hypothetical auction’)?*

Question 2 *What other developments do you believe Ofcom should consider when deciding on the PQR payable and determining the amount that, in its opinion, would have been the Cash Bid for the licence if offered in a competitive tender process (‘a hypothetical auction’)?.*

Question 3 *Do you agree that the overall valuation methodology, as set out above, remains appropriate for reviews that Ofcom may be required to undertake to inform our decision about the PQR and Cash Bid? If you do not, then please explain why you think it is inappropriate and what justifications exist for suggested alternatives.*

Question 4 *Do you agree with Ofcom’s approach to dealing with the uncertainties outlined above? If not, please explain why and what alternative approaches would be available?*

Question 5 *How do you think Ofcom should estimate future trends related to listening hours? In particular, how should we estimate future trends in the proportion of listening represented by analogue and digital platforms?*

Question 6 *How do you think Ofcom should estimate future trends in radio advertising revenues?*

Question 7 *Do you agree with Ofcom that the appropriate period to use for the duration of the licence in practice is, for the AM licences, the period from the key date associated with the application (as set out in section 3 above) to 31 December 2015 and, for the Classic FM licence, the period from the anticipated renewal date (being 31 January 2011) to 31 December 2015. Please explain why.*

Question 8 *Do you agree that it is appropriate that the same PQR, as well as the Cash Bid, should endure for the full duration of the licence? If not, then how do you propose that Ofcom should mitigate the risk that the licences have enduring value beyond the 31 December 2015 cut off date?*

Question 9 *Do you agree that a nominal, pre-tax discount rate of 11.8% is appropriate? If not, then please set out what other considerations Ofcom should have taken into account in determining the discount rate.*

Annex 5

Discount rate

Summary

A5.1 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.

A5.2 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.

A5.3 Ofcom has calculated a nominal, pre-tax rate of 11.8%, which is meant to reflect the weighted average cost of capital (WACC) of a hypothetical entrant.

Introduction

A5.4 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 a class of investor is equal to the rate of return that investors could expect to earn on other investments of equivalent risk.

A5.5 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.

A5.6 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.

A5.7 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

A5.8 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 is proposing to apply a single discount rate in its NPV analysis for each of the licences. In theory, it may be desirable to make assumptions regarding the financial/operational leverage and debt premia of generic bidders for each relevant licence. However, in practice, any such assumptions are likely to be difficult to calculate.

A5.9 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. Where possible, Ofcom has used data on existing broadcasters to support its calculations, but the lack of UK listed companies with radio operations makes this harder in some areas, for example in the estimation of an equity beta. Our approach in this area is outlined in paragraphs A5.13 to A5.18.

Risk free rate

A5.10 Ofcom proposes 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"[23] (the 'Television Statement'). That statement set out the methodology for the review of television licences in the same way that this consultation is considering the review of financial terms for the national radio licences.

A5.11 This risk free rate was sourced from Annex 8 of Ofcom's statement "A new pricing framework for Openreach " (the "Openreach statement")[24]. This statement used estimates of yields on nominal gilts as a proxy for the real risk free rate. We are also proposing in this consultation to use a forward looking inflation rate of 2.5%, consistent with the Openreach and Television statements[25].

Equity risk premium

A5.12 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. Ofcom has used a value of 5% for this calculation in line with the equity risk premium used in Annex 8 of the Openreach statement and Annex 1 of the Television Statement.

Equity beta

A5.13 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*[26].

[23] http://www.ofcom.org.uk/consult/condocs/review_c3_c5_licences/statement/Statement.pdf
[24] http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/annexes.pdf
[25] See paragraph 6.55 of Annex 6 of the Openreach statement
[26] http://www.ofcom.org.uk/telecoms/ioi/g_a_regime/sce/ori/beta/

A5.14 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 the 2006 consultation Ofcom "carried out an analysis of the equity betas of a number of players in the UK media sector within the last 1-2 years, with particular weight put on companies with significant operations in the radio sector"[27].

A5.15 In 2010, UTV is the only UK listed company with significant radio assets. However, 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 have considered a number of beta estimates from UK and European broadcasters. These are shown in the table below and are based on unadjusted two year daily rates against the relevant index.

	Country	Beta
NRJ	France	0.30
UTV	UK	0.50
RTL	Luxembour	0.54
M6	France	0.67
Mediaset	Italy	0.73
Antena 3	Spain	0.81
Telecinco	Spain	0.87
Sky	UK	0.87
TF1	France	0.93
ITV	UK	0.93
MTG	Sweden	1.12

Source: Bloomberg, beta as at 31 May 2010

A5.16 We also note that the equity beta for the FTSE 350 Media Index against the FTSE All share index was 0.86 as at 31 May 2010.

A5.17 At this stage we are inclined to give most weight to those companies involved in operating radio stations and whose shares are relatively liquid. This could mean excluding UTV, NRJ and RTL on liquidity grounds[28] and M6, Mediaset, Sky, TF1 and ITV since they do not operate radio stations. Given that none of the remaining companies (Antena 3, Telecinco and MTG) are UK based, and the uncertainty around what a UK beta might be, we are left with few, if any, reliable indicators as to the equity beta of a new entrant in the UK radio market. We note that the FTSE 350 Media Index has a beta just below 1 (i.e. 0.86), and we therefore propose to adopt a market average equity beta of 1. Given the tendency for equity betas to mean revert over a long period of time, we feel this is a reasonable estimate when the evidence is very limited. We welcome stakeholders' comments on our approach in this area.

A5.18 In our 2006 consultation[29], we said that "In estimating a beta where no market data is available, firm size might be a qualitative factor to be taken into account". We went on to say that this would only be relevant if Ofcom believed that the second highest bidder would be a smaller company than the ones included in its sample of media companies. As in that statement, Ofcom is not aware of any reason to think

[27] http://www.ofcom.org.uk/consult/condocs/methodology/main2.pdf, paragraph A6.16
[28] These companies have relatively low average daily volumes traded and/or a low free float which makes the shares relatively illiquid.
[29] http://www.ofcom.org.uk/consult/condocs/methodology/statement.pdf, paragraphs 5.77 to 5.80

that the parent companies of second highest bidders would necessarily be any smaller than these firms – indeed, it is very plausible that the bidder might be a large multinational firm. We have therefore not specifically added a small company premium, but consider that the relatively high equity beta we have proposed of 1.0 should reflect any increase in systematic risk involved in operating a radio licence.

Optimal gearing

A5.19 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.

A5.20 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).

A5.21 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.

A5.22 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 assume 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[30] and also the same as we used in the Television Statement.

Debt premium

A5.23 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%.

A5.24 For the purposes of a hypothetical new entrant, Ofcom is minded to use a debt premium figure of 4%. This reflects the relatively high cost of borrowing for media companies at the moment, and is in line with ITV's current debt premium.

Conclusion

A5.25 Ofcom has estimated a single discount rate to be used in the licence valuations, being a nominal pre tax WACC of 11.8%. A summary of the components of the WACC calculation follows:

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

	Consulation estimate
Nominal risk free rate	4.5%
Equity risk premium	5.0%
Equity beta	1.00
Cost of equity (nominal, post tax)	9.5%
Debt premium	4.0%
Cost of debt (nominal, pre tax)	8.5%
Corporate tax rate	28.0%
Cost of debt (nominal, post tax)	6.1%
Gearing	30.0%
WACC (nominal, post tax)	8.5%
WACC (nominal, pre tax)	11.8%

A5.26 We have also considered the pre tax discount rates published in the statutory accounts of some UK broadcasting companies with radio operations. Although these discount rates are fairly out of date, it is useful to sense-check our estimates. These are summarised below:

	Date of accounts	Pre tax discount rate
Global Radio Ltd	March 2009	9.2%
UTV plc	December 2009	13.2%
GMG	March 2010	10.5% - 13%

Source:

Global Radio: Annual report, March 2009, page 13
UTV: Annual report, December 2009, page 84
GMG: Annual report, March 2010, page 57

These discount rates appear to lie in a range of 9 – 13%, and based on this we consider that our pre tax rate of 11.8% is a reasonable estimate of the discount rate applicable to a hypothetical new entrant.