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Renewal of the Channel 3 and Channel 5 licences

Proposed methodology for a review of the financial terms of the Channel 3 and Channel 5 licences

CONSULTATION:

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Contents

Section

Annex

1. Overview

This document forms part of the process to renew the Channel 3 and Channel 5 public service broadcasting licences, which are due to expire on 31 December 2024. As part of the process to renew these licences, we are required to set the financial terms payable by the licensees. This consultation sets out the methodology we propose to use to determine the financial terms for the Channel 3 and Channel 5 licences for the period 1 January 2025 to 31 December 2034. We propose to apply largely the same methodology we used when the licences were last renewed in 2014.

In March, the Government published the draft Media Bill, which proposes changes to the regulatory framework for public service broadcasting. The timing of the draft Bill and the final form of any measures it would introduce remain uncertain. The impact such measures may have on licence valuations for the purpose of setting financial terms is also uncertain. In this document we set out the approach we are minded to take regarding the Media Bill.

We welcome comments from stakeholders on the proposed methodology set out in this document by 28 July 2023. Subsequently, we will seek data and information from current licensees that will allow us to determine financial terms. This will include licensees' views on the value a new entrant would place on the licences following our methodology set out in this document.

Once this information has been received we will review it and, where necessary, seek further evidence in order to arrive at what we consider to be a fair and reasonable determination of financial terms for the next licence period. We must notify the licensees of our determination in accordance with the Communications Act 2003 and if they accept the terms, we must subsequently issue the renewed licence as soon as reasonably practicable.

2. Approach to the review

Licence renewal

2.1 The UK has two fully commercially owned and funded public service television channels, known as Channel 3 and Channel 5. These channels are an important part of the public service broadcasting ("PSB") system, alongside the BBC, Channel 4 and S4C.

2.2 There are 15 national and regional Channel 3 licences and one UK-wide breakfast licence. STV plc ("STV") provides the Channel 3 service in Central and Northern Scotland, while ITV plc ("ITV") provides the service in England, Wales, Northern Ireland, Southern Scotland, and the Channel Islands, alongside the breakfast service, GMTV. The Channel 5 licence covers the entirety of the UK. It is held by Channel 5 Broadcasting Limited, which is a subsidiary of Paramount Global. The current Channel 3 and Channel 5 licences are due to expire on 31 December 2024.

2.3 As part of the relicensing process, Ofcom has a statutory duty to submit a section 229 report to the Secretary of State for Culture, Media, and Sport in anticipation of a new licensing round for the Channel 3 and Channel 5 services.[1] We submitted our report in June 2022 ("2022 report"), in which we assessed the ability of the Channel 3 and Channel 5 licensees to contribute to the fulfilment of the PSB purposes, at a commercially sustainable cost, over the next ten-year licence period.

2.4 Overall, we found the licensees (ITV, STV and Paramount Global) could continue to contribute to PSB purposes. We said that the current licence obligations are the minimum contributions to PSB that we expect for audiences, and the licensees have a good record in delivering them. We also said that that the commercial sustainability of the licensees over the next licence period would be strengthened if the Government's proposed reforms to the regulatory framework relating to new prominence and availability rules for PSBs' online services, were to be introduced. These proposals have now been published in draft.

2.5 On 29 March 2023, the Secretary of State confirmed to us that she does not intend to prevent the renewal of the Channel 3 and Channel 5 licences, nor use her order-making powers to amend the public service remit and/or other statutory requirements attached to the licences.[2] Therefore, we can proceed with the licence renewal process.

2.6 The existing licence holders have a statutory right to apply for renewal of their licences for another ten-year period (from 1 January 2025 to 31 December 2034). Licensees had until 30 April 2023 to apply for renewal of their licences, and each licensee applied before the deadline. As part of the licence renewal process, we must determine the financial terms on which the licences will be renewed. Licensees must accept the financial terms to renew their licences. We must notify the licensees of our determination in accordance with

[1] Ofcom, 29 June 2022, 2022 report.

[2] DCMS, 29 March 2023, Letter to Ofcom on the renewal of the Channel 3 and Channel 5 licences.

section 216 of the Communications Act 2003 ("2003 Act") and if they accept the terms, we must subsequently issue the renewed licence as soon as reasonably practicable

2.7 This document sets out the proposed methodology we are minded to use to determine the financial terms of the Channel 3 and Channel 5 licences. We have broadly followed the same approach as the methodology used for the previous determination of financial terms of the Channel 3 and Channel 5 licences in 2014,[3] but includes some updates to reflect current uncertainties. We welcome comments on our proposed methodology by 28 July 2023.

Ofcom's statutory task

2.8 Section 217 of the Communications Act 2003 sets out the statutory framework we must follow to determine the financial terms on which the licences will be renewed following an application made by a licensee. For the next ten-year licence period, we must determine two elements:

i) **The cash bid to be paid for the licence**: this is a fixed annual cash amount which increases by inflation each year;[4] and

ii) **The percentage of qualifying revenue ("PQR")** payable for each year of the licence.[5] The PQR can vary from year to year.

2.9 In respect of the cash bid, we are required to determine the amount that, in our opinion, would have been the cash bid of the incumbent licence holder were the licence being granted afresh in a competitive tender, instead of being renewed.[6] This means that, in practice, to determine the cash bid we need to consider the outcome of a hypothetical auction of the Channel 3 and Channel 5 licences.

2.10 If the licences were actually being granted afresh in a competitive tender, section 15 of the Broadcasting Act 1990 ("1990 Act") would require us to set out, in a notice inviting licence applications, the PQR payable by the winning bidder. Under a competitive tender, the PQR would therefore be determined before cash bids are made. However, our statutory task under section 217 of the 2003 Act is to determine both the cash bid and PQR payable by the incumbent licence holder in the next licence period. No guidance is given in the 2003 Act on how we should set the PQR for the purposes of determining financial terms or the relative sizes of the PQR payments and cash bid.

2.11 In a competitive tender, we would therefore have a level of discretion in setting the PQR that we would not have in respect of the cash bid. However, for the purposes of determining financial terms, we consider that to ensure a consistent approach to setting

[3] Ofcom, 7 February 2014, Determination of financial terms for the Channel 3 and Channel 5 licences.
[4] The cash bid increases by the RPI each year under section 19 of the 1990 Act.
[5] According to the 2003 Act, the cash bid should be determined for each calendar year and the PQR for each accounting period. Since the licensees each have December year ends for accounting purposes, these differences are not relevant in practice.
[6] Section 217(2) of the 2003 Act. The competitive tender would be carried out in accordance with section 15 of the 1990 Act.

both the PQR and the cash bid it is appropriate to conduct a single valuation according to common principles. This valuation is intended to meet the requirements of the 2003 Act in relation to determining the amount that, in our opinion, would have been the cash bid of the incumbent licence holder, and to provide a robust basis for informing our decision as to the appropriate level of the PQR, considering both the objectives and the uncertainties discussed in this document.

Valuation methodology

2.12 The objectives of the methodology are to set fair and reasonable terms such that they recover, as far as possible, the combined value of the rights and obligations to the licence holder over the duration of the licence, based on a methodology which is consistent with our statutory duties.

2.13 To determine financial terms, we are minded to use a methodology consistent with that set out in our 2013 statement ("2013 methodology statement").[7] This methodology informed our determination of the financial terms in 2014. The methodology was established to inform our decision when setting the PQR and cash bid for each licence and our statutory task today is comparable to previous reviews.

2.14 We set out the methodology in the following sections. We also comment on how we are minded to take account of uncertainties around the Media Bill and our review of some of the rules in our Code on the Scheduling of Television Advertising ("COSTA").

Circumstances of the hypothetical auction

2.15 The hypothetical auction will assess the value of the Channel 3 and Channel 5 licences by replicating the circumstances set out below:

- 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.
- Each licence would be offered individually on a non-contingent, standalone basis in a single round, sealed-bid auction.[8] This means that we will value each of the Channel 3 licences separately, on a standalone basis.
- 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.

2.16 To determine the amount of the second-highest bid in an auction, we will estimate the net present value ("NPV") of the rights and obligations associated with the licence from the

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[7] Ofcom, 27 July 2013, 2013 methodology statement.
[8] The 2004 methodology statement explained that the statutory framework makes it infeasible to assume there is a multiple contingent bid auction. See paragraphs 3.4 to 3.13 of that statement.

point of view of a new entrant, taking account of potential start-up costs. To win the auction, the incumbent would need to bid slightly more than the new entrant. If no new entrant was expected to bid, the incumbent would only need to submit a nominal bid to win the auction.

Overarching principles

2.17 In principle, we consider that the value of a licence to any potential bidder will 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 a Channel 3 or Channel 5 licence).

2.18 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 a bidder could make as a result of holding the licence. We consider that alternative bidders with the highest valuations are likely to be existing television companies, either from the UK or abroad. These are likely to have lower costs of entry and greater revenue synergies than companies without television interests, which could allow them to extract more value from a Channel 3 or Channel 5 licence, making it more likely that they would be the second highest bidder.

2.19 In relation to the next best alternative for each of the Channel 3 and Channel 5 licences, we will take the following approach, consistent with the 2013 methodology statement.

2.20 The Channel 5 licence requires that the service is made available for broadcast on the digital terrestrial television ("DTT") platform, satellite and cable platforms.[9] For the Channel 5 licence, we consider the next best alternative in the counterfactual would be to operate a national non-PSB channel on these platforms.

2.21 As with Channel 5, the Channel 3 licences require that the services are made available for broadcast on the DTT, satellite and cable platforms. Consistent with the 2013 methodology statement, we consider that the most appropriate counterfactual for the purposes of assessing the benefits and costs associated with each Channel 3 licence is that of operating a non-PSB service in each licence area.[10] Given we are valuing each licence on a standalone basis, this approach will allow us to identify the incremental costs and benefits that arise directly as a consequence of holding each Channel 3 licence. We consider that this is likely

[9] DTT is provided by Freeview. Satellite platforms include Sky and Freesat, and cable is provided by Virgin Media.

[10] Ofcom, 23 July 2013, 2013 methodology statement. Paragraphs 3.13 and 3.14 discuss alternative counterfactuals and explain why this is the most appropriate for the purpose of this exercise. One alternative counterfactual considered was that of operating a national commercial channel. However, this was considered a poor counterfactual as the size of licence areas would not be comparable, making it difficult to assess which incremental costs and benefits arise because of holding the Channel 3 licence, and which arise due to differences in the size of the licence area. Another counterfactual might be for the new entrant to not operate any channel. In this case, the benefit of holding the Channel 3 licence would effectively be equal to the entire profit generated from the licence, as all profits would be incremental to the counterfactual of not operating any licence. We concluded that the most appropriate counterfactual to assess the costs of benefits associated with each Channel 3 licence was that of holding and operating an equivalent commercial licence in each licence area.

to represent the value that a hypothetical bidder would place on each individual Channel 3 licence if they were being auctioned in the way described above.

2.22 Under these counterfactuals, costs and benefits will only be included in the valuation to the extent that they arise as a direct consequence of holding a Channel 3 or Channel 5 licence compared to operating an equivalent non-PSB licence in the same licence area.

2.23 While we will adopt these counterfactuals for the purposes of assessing which costs and benefits to include in the valuation, for practical reasons, in the case of Channel 3, we may quantify the cost or benefit at a more aggregate level and apportion this amount to individual licences. For example, when estimating the value of the right to appropriate electronic programme guide ("EPG") prominence for each individual Channel 3 licence, we may first estimate the value of this right to Channel 3 as a whole and apportion this total value to licences on an appropriate basis. [11]

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

- In general, if a right similar to one associated with the licence could be acquired in the market (e.g. a prominent EPG position), the value of the right would be equal to the cost savings to the licence holder from not having to pay for the right. However, if the right could not be acquired in the market, then the value would equal the total financial benefit to the licensee of having the right (e.g. the higher revenues associated with a prominent EPG position).
- The cost of an obligation imposed on a licensee would be equal to the extra cost associated with meeting the obligation, compared to the cost that would be incurred without the obligation.

2.25 We will assume that a new entrant would hold the Channel 3 and Channel 5 licences for the duration of the next licence period (rather than ceasing the broadcast of the PSB service during the licence period and triggering a licence revocation process) and value the licences on this basis.

2.26 In general, where rights and obligations remain in place throughout the next licence period, we will take account of market trends and other evidence to inform the valuation. For example, the value of rights associated with the Channel 3 and Channel 5 licences may be expected to reduce over time in line with linear viewing trends. Where there is uncertainty around the introduction of additional costs and benefits (such as the Media Bill, as discussed in paragraphs 2.86 – 2.90), this uncertainty will be reflected in the valuation.

The rights and obligations associated with the licence

2.27 Channel 3 and Channel 5 licensees must comply with obligations such as programming and production quotas. Some of these may represent opportunity costs where costs are higher, or revenues lower, than would be the case if the licensees were not subject to these

[11] For example, an allocation based on share of revenue or transmission costs.

obligations. Licensees also incur some direct costs from holding these licences, such as higher Ofcom licence fees and contributions to the National Television Archive.

2.28 The current PSB framework also grants benefits to Channel 3 and Channel 5 licensees. The principal benefits are the right to reserved capacity on the DTT platform (Freeview) and the right to appropriate prominence within EPGs for the main Channel 3 and Channel 5 services. These benefits are valuable as they secure the wide availability of these channels and encourage greater viewing in a way that may be harder, or more costly, to achieve, without such regulatory interventions. As a result, revenues are higher, and some costs are lower, than they would be otherwise.

2.29 Table 1 summarises the rights and obligations associated with the Channel 3 and Channel 5 licences that a new entrant might take account of when considering a bid for the licences.

Table 1: Rights and obligations associated with the Channel 3 and Channel 5 licences

	Channel 3	Channel 5
Rights		
Right to appropriate prominence on EPGs	✓	✓
Reserved capacity on PSB Multiplex 2	✓	
Reserved capacity on PSB Multiplex 2 and commercial Multiplex A		✓
Option to apply for reserved HD capacity on PSB Multiplex B	✓	✓
PSB programming obligations		
News	✓	✓
Current affairs	✓	✓
Regional and national programming (news & non-news)	✓	
Original programming	✓	✓
Proportion of programmes by spend and hours made outside M25	✓[12]	✓
25% (of qualifying hours) allocated to independent productions	✓	✓
Subtitling, audio description (“AD”), and signing[13]	✓	✓
Other obligations and direct costs		
Extra restrictions on advertising minutage	✓	✓
Code of Practice for commissioning from independent producers	✓	✓
Ensure approved networking arrangements are in force	✓	
Contributions to the National Television Archive	✓	✓
Higher Ofcom fees	✓	✓
Regulatory oversight costs	✓	✓

[12] Except the national breakfast licence.
[13] Channel 3 licensees have higher subtitling and AD requirements than other broadcasters, while Channel 5 has the same requirements.

Valuing the rights associated with the licences

General Approach

2.30 In general, 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 (where market information is available). This reflects the view that an entrant would not pay more for the rights via a licence payment than it would need to pay for equivalent rights elsewhere.

2.31 We will take account of the rights included in Table 1, as explained below, but where licensees present evidence indicating the existence of other incremental benefits of holding Channel 3 or Channel 5 licences that a new entrant would enjoy, we will consider incorporating these into the valuation.

Right to appropriate prominence on regulated EPGs

2.32 Channel 3 and Channel 5 licences carry with them the right to an appropriate degree of prominence on regulated EPGs.[14] A channel with high EPG prominence is likely to attract higher audiences and advertising revenues than a channel with low EPG prominence. In 2019 we revised our Code of Practice on Electronic Programme Guides to ensure that regulated EPG providers grant Channel 3 the third EPG slot and Channel 5 the fifth EPG slot.[15]

2.33 Prior to this change, a new entrant may not have assumed they would be granted a particular slot, as there were alternative ways to interpret the right to appropriate prominence on EPGs. This could have dampened the value a new entrant would associate with this right, as it would be uncertain of the EPG position it would occupy if it won the licence. This change clarifies that a new entrant winning a Channel 3 or Channel 5 licence would be positioned in slot three and five on relevant, regulated EPGs, meaning this right may be more valuable than the last time we set financial terms.[16]

2.34 Consistent with our 2013 methodology statement, we consider that a new entrant would attach a value to the right to appropriate EPG prominence but recognise that it is difficult to estimate a precise value as it depends on several assumptions, especially given that front page EPG slots are rarely traded.[17] In the absence of market data, the value could depend on how EPG position three or five compared with an entrant's expectations of the EPG position it would occupy without the licence, and the audience and revenue uplift associated with such an improved EPG position.

[14] Section 310 of the 2003 Act.
[15] Ofcom, 4 July 2019, Review of prominence for public service broadcasting.
[16] Ofcom, 23 July 2013, 2013 methodology statement. Paragraphs 3.50 to 3.58 discusses the right to appropriate prominence.
[17] This is reflected in the wide valuation range we estimated for this right in our 2022 report, when considering the value to existing licensees. See for example Figure 2.4 of that report.

2.35 The value of EPG prominence will likely decline over the next licence period as viewers continue to move away from linear viewing to other forms of viewing like subscription video-on-demand (SVOD). We will reflect this in our licence valuation.

2.36 Our valuation will be informed by several sources of information, including:

- Actual prices paid for EPG positions on different platforms;
- Previous reports commissioned by us, for example the 2018 Report on the UK Market in EPG Positions[18] and the 2013 report by FEH Media Insight;[19]
- Approaches we have taken in previous work on valuing EPG movements, including our 2022 report and competition assessments;[20] and
- Information by licensees as part of this renewal process.

2.37 Since the right to appropriate prominence applies to all regulated EPG providers, our valuation will take into account the benefit of this right across all platforms, (DTT, cable and satellite).[21]

Reserved capacity on DTT – Channel 3

2.38 Channel 3 licence holders have the right to reserved capacity on PSB Multiplex 2, the licence for which they jointly own alongside Channel 4. This means that Channel 3 licence holders only need to pay their share of the multiplex costs to secure carriage rather than the market rate they would be charged on a commercial multiplex.

2.39 An additional benefit associated with reserved capacity on a PSB multiplex is that it covers around 98.5% of the UK population, rather than the 90% achieved by commercial multiplexes. This means that Channel 3 licence holders can generate viewing and advertising revenue from a larger coverage area than would be the case without the benefit.

2.40 The Channel 3 licence holders must reserve capacity on Multiplex 2 for the Channel 5 service, for which they receive a carriage fee from the Channel 5 licence holder.

2.41 Consistent with the 2013 methodology statement, the value of this benefit will be based on the costs of replicating the rights in the market, less the costs of operating Multiplex 2. Although there is only a limited market for carriage on PSB multiplexes (compared to a commercial multiplex), as Channel 5 pays for carriage on Multiplex 2, this provides a reference point for the valuation. We will therefore estimate the value of this benefit across Channel 3 as a whole as follows (apportioning the value to individual licensees as appropriate):

- the cost of carriage on Multiplex 2, proxied by the price paid by Channel 5, multiplied by the number of streams on Multiplex 2 available to a new Channel 3 entrant,

[18] Expert Media Partners, July 2018, Report on the UK Market in EPG Positions.
[19] FEH Media Insight, 29 April 2013, An analysis of the audience impact of page one EPG prominence.
[20] For example, our November 2021 BBC Three television channel competition assessment and Review of rules for prominence of BBC Three.
[21] A list of regulated EPG providers is published on our website. Ofcom has a statutory duty to review the EPG code from time to time under section 310 of the 2003 Act.

- less the Channel 3 entrant's share of Multiplex 2 running costs.

2.42 We recognise that the price of carriage on Multiplex 2, the number of video streams and the running costs of Multiplex 2 could change over the licence period and we will consider data or evidence from licensees on these points as part of our determination.

2.43 The 2013 methodology statement also said a bidder may enjoy a 'cross promotional' benefit as it could launch a portfolio of channels on DTT more quickly (by virtue of the reserved capacity associated with Channel 3 licences) compared to a non-PSB counterfactual (where it may have to acquire additional DTT video streams without the benefit of reserved capacity). We said any benefit would only accrue for as long as a new entrant was unable to acquire additional DTT video streams in a non-PSB counterfactual.

2.44 While in principle we still think such a benefit could arise, we recognise that, given we assume the second highest bidder is likely to be an existing television company, it may already have a portfolio of channels, and as such the value of any cross promotional benefit could be limited, as it would enjoy this with or without a Channel 3 licence. Consistent with the 2013 methodology statement, we will consider evidence supporting the possibility that a new Channel 3 licence holder could launch services on multiple DTT streams quicker than in the counterfactual, and the value of any cross promotional benefit that may arise as a result. As viewing on DTT is expected to decline over the next licence period, the value of any 'cross promotional' benefit will also reduce.

Reserved capacity on DTT – Channel 5

2.45 The Channel 5 licence holder has the right to reserved capacity on Multiplex 2 for its main channel. Multiplex 2 is a PSB multiplex which has a higher coverage of the UK (98.5%) compared to commercial multiplexes (90%).

2.46 The Channel 5 licence holder also has reserved capacity on Multiplex A.[22] Multiplex A is a commercial multiplex and has lower coverage than a PSB multiplex.

2.47 Unlike Channel 3 licensees, the Channel 5 licensee is required to agree commercial carriage fees with the operators of Multiplex 2 and Multiplex A. This means that the value of the right to reserved capacity is lower for the Channel 5 licence than for the Channel 3 licences, but the right to reserved capacity does deliver long term security of carriage for the Channel 5 licence holder which we will take account of in the valuation.

2.48 Consistent with the 2013 methodology statement, we will value this benefit by estimating the reduced contracting costs that Channel 5 and multiplex operators benefit from by not having to go to market to either acquire equivalent capacity (in the case of the Channel 5 licence) or sell capacity (in the case of multiplex operators). We expect the gains from any reduced contracting costs would be shared between the parties. This could be estimated

[22] The Television Multiplex Services (Reservation of Digital Capacity) Order 2008 provides that where there is capacity reserved for Channel 5 on Multiplex 2, the licence for Multiplex A should have conditions requiring the provision to Channel 5 of capacity equivalent to 50% of its capacity, less the capacity required to broadcast Channel 5 in standard definition.

by applying an appropriate percentage to the price paid by Channel 5 for carriage on Multiplex 2 and Multiplex A.

2.49 Consistent with our approach to Channel 3, we will also consider evidence supporting the possibility that a new Channel 5 licence holder could launch services on multiple DTT streams quicker than in the counterfactual, and the value of any cross promotional benefit that may arise as a result. However, as noted above, given we assume the second highest bidder is likely to be an existing television company which may already have a portfolio of channels, the value of any cross promotional benefit could be limited.

Option to apply for reserved HD capacity on DTT

2.50 A Channel 3 or Channel 5 licence holder has the option to apply to broadcast in high definition (HD) on DTT Multiplex B. Channel 3 licensees are only eligible if at least 13 of the licensees make an application (so a new entrant that owned fewer than 13 Channel 3 licences could not apply alone). If any Channel 3 or Channel 5 licence holder ceases to hold a relevant licence, we can give a notice terminating their use of the capacity on Multiplex B – this means that capacity on Multiplex B is likely to be available to a new entrant to apply for if it won a Channel 3 or Channel 5 licence.

2.51 In the 2013 methodology statement we said a licence holder would only apply to broadcast in HD on multiplex B if it had a positive NPV over the licensing period.

2.52 However even if the NPV was positive, it does not follow that the bidder would include the entirety of the positive NPV in its licence valuation. This is because it would be valuing the option, not the resulting value if it exercised that option. Similarly, even if the NPV was negative, the option may still have some value.

2.53 In the 2013 methodology statement we said the NPV of exercising the option will inform the value of the option. An option which, when exercised, gives the potential for a high NPV will be worth more than an option which gives the potential for a low or negative NPV. To the extent that the NPV of exercising the option is limited, we do not consider a new entrant would place a significant value on the option, and we note that in our 2022 report, the value associated with HD broadcasting was relatively low.[23]

2.54 Consistent with the 2013 methodology statement, the value we put on the option will be informed by data from licensees on the NPV of operating an HD channel on DTT over the next licence period.

[23] For example, Table 2.2 of the 2022 report indicates that the benefit of broadcasting in HD on DTT to ITV is relatively low, around 2% of the total value of benefits associated with its Channel 3 licences.

Valuing the costs and obligations associated with the licences

General approach

2.55 The valuation of the licence should reflect the incremental costs of the licence given the obligations it imposes. Channel 3 and Channel 5 licensees must comply with obligations such as programming and production quotas. Some of these may represent opportunity costs where costs are higher, or revenues lower, than would be the case if the licensees were not subject to these obligations. The licensees also incur some direct costs from holding PSB licences, such as higher Ofcom licence fees and contributions to the National Television Archive.

2.56 We will take account of the obligations included in Table 1, and we set out below our approach to some of these. Where licensees present evidence indicating the additional costs of these obligations, or the existence of other incremental costs of holding Channel 3 or Channel 5 licences that a new entrant would incur, we will consider incorporating these into the valuation.

Cost of meeting PSB programming obligations

2.57 Each PSB programming obligation will be considered separately. Consistent with the 2013 methodology statement, the opportunity cost calculation will include the increased programming cost and, where evidence is available, the reduction in advertising revenue received from showing PSB programming compared to a commercial schedule.

2.58 It is likely to be easier to estimate the additional costs imposed by PSB programming obligations compared to a commercial schedule for a new entrant. This is because estimates of revenue foregone are more likely to rely on assumptions about the new entrant business plan, and how revenue estimates compare between the 'PSB' and 'commercial' schedule.

2.59 We consider the additional costs could be estimated by taking the cost of the PSB programming obligations (e.g. news) and subtracting the cost of programming a new entrant would incur by operating a commercial schedule in those same programming slots.

2.60 Some opportunity costs may apply to the launch period, and where this is the case, they will be included in the valuation. Capital costs will also be included to the extent they are incurred as a result of the obligation to provide PSB programming and would not be incurred, or would be lower, under an alternative commercial schedule.

Other obligations and direct costs

2.61 The 2013 methodology statement specifically set out our approach to some other obligations and direct costs. Our approach to these is summarised below.

Extra restrictions on advertising minutage

2.62 COSTA sets limits on the amount of advertising for commercial PSB channels (Channel 3, Channel 5 and Channel 4) and all other commercial broadcasters. The effect of the current rules is to reduce the maximum number of advertising impacts that are available for sale on Channel 3 and Channel 5 services compared to a non-PSB alternative.[24]

2.63 It is possible that these rules could represent an opportunity cost to a new entrant where the restrictions on minutage resulted in lower revenue compared to a non-PSB counterfactual. However, this would depend on the relationship between advertising minutage, commercial impacts and the price per commercial impact, which makes any impact difficult to estimate, as we have previously noted.[25] Even if the revenue impact of COSTA is hard to measure, we recognise that the rules could impose some costs on a new entrant via reduced flexibility when scheduling adverts and responding to changes in demand.

2.64 Consistent with the 2013 methodology document, we will include an opportunity cost associated with COSTA where this is supported by data or evidence which would allow us to quantify the size of this cost from the point of view of a new entrant bidding for a Channel 3 or Channel 5 licence. We noted in that document that a new entrant would not necessarily consider that the opportunity cost would be equal to the benefit (in terms of additional revenue) an incumbent would enjoy if it could broadcast more advertising minutes, but such a calculation might provide a helpful reference point.[26]

2.65 We recently consulted on potential changes to COSTA.[27] We consider the potential impact of changes to the rules in paragraphs 2.91 – 2.95 when we discuss uncertainties facing the new entrant.

Code of Practice for commissioning from independent producers

2.66 Public service broadcasters, including the Channel 3 and Channel 5 licensees, are required to have in place Codes of Practice for commissioning from independent producers which secure the seven statutory objectives and have been approved by Ofcom.[28] In the 2013 methodology statement, we did not consider that this requirement was likely to represent a significant additional cost.[29] Similarly, in our 2022 report, we did not consider this requirement imposed a significant cost on incumbent licensees and did not include an opportunity cost in that report.

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[24] For example, COSTA restricts the maximum average number of minutes of advertising per hour to 7 minutes on commercial PSB channels and 9 minutes on other commercial channels.
[25] See for example paragraphs A2.118 to A2.122 of our 2022 report.
[26] Ofcom, 23 July 2023, 2013 methodology statement, paragraph 3.79.
[27] Ofcom, 19 April 2023, Quantity and scheduling of television advertising on public service channels.
[28] Under section 285 of the 2003 Act, the statutory objectives include securing sufficient clarity about the categories of rights that are being sold, sufficient transparency about the amounts being paid in respect of each category of rights, and satisfactory arrangements about the duration and exclusivity of these rights.
[29] Ofcom, 23 July 2013, 2013 methodology statement, paragraph 3.84.

2.67 We therefore do not intend to include a cost associated with the requirement to have in place codes of practice for commissioning from independent producers. However, consistent with the 2013 methodology statement, we will consider any data or evidence presented by licensees that demonstrate that the Code of Practice represents an additional cost to a new entrant and that allows us to quantify the amount of the cost.

Direct costs

2.68 A new entrant could also incur direct costs associated with the Channel 3 and Channel 5 licences, such as the following:

- **Contributions to the National Television Archive**: Channel 3 and Channel 5 licence holders (alongside other commercial public service broadcasters) must contribute to the costs of the National Television Archive.[30] We will include an estimate of these contributions in the valuation.
- **Higher Ofcom licence fees**: Ofcom licence fees are higher for Channel 3 and Channel 5 licence holders compared to a non-PSB channel generating the same amount of revenue. We will include an estimate of the impact of this higher tariff, from the point of view of a new entrant, in the licence valuation. This may require making assumptions about the revenue a new entrant could generate by operating a commercial licence, which could be proxied by considering the revenue of current non-PSB commercial channels.
- **Regulatory oversight costs:** In the 2013 methodology statement, we said additional staff may be required to manage the regulatory relationship that would not be required in a non-PSB counterfactual. We will include a reasonable allowance for such costs in the valuation, based on the data or evidence provided by licensees. Since we are valuing each Channel 3 licence on a standalone basis, a reasonable allowance for regulatory oversight costs will be included in the valuation of each Channel 3 licence.[31]

2.69 Consistent with the 2013 methodology statement, we will take these into account in our valuation.

Start-up costs

2.70 Consistent with the 2013 methodology statement, we will take into account any start-up costs that a new entrant would incur which would be associated with the additional costs described in this section. This could include, for example, pre-launch capital and operating expenditure for news studios associated with obligations to provide news, or regulatory oversight costs that may need to be incurred in a dry running phase prior to launch. In

[30] Section 185 of the 1990 Act.

[31] That is, under our methodology, each licence may have to incur regulatory oversight costs, while if they were in common ownership, these costs may only need to be incurred once across several licences.

general, we will not include start-up costs such as marketing spend as a new entrant would need to incur these in both the PSB and non-PSB scenarios.

Dealing with uncertainties for the purposes of the review

2.71 Valuing Channel 3 and 5 licences over a ten-year licence period is difficult and involves taking account of a number of uncertainties, including:

- Future trends in the proportion of viewing on different platforms (which could affect the value of rights associated with Channel 3 and Channel 5 licences);
- Future trends in television advertising revenue and programming costs;
- Future trends in the proportion of homes that are DTT homes (relevant for setting the PQR);
- The duration of DTT multiplex licences; and
- Changes to regulations which could affect rights and obligations associated with Channel 3 and Channel 5 licences (such as the introduction of the Media Bill and our COSTA consultation).

2.72 The requirement for us 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. We are unable to eliminate these uncertainties.

2.73 Therefore, to fulfil our statutory duty to determine the financial terms, it is necessary for us to make a series of assumptions to achieve a fair and reasonable outcome for the licence valuation.

2.74 In general, our view will be informed by several sources, such as:

- Evidence presented by licensees, such as forward-looking financial projections and pre-existing business plans. We would expect these to take account of current market conditions (e.g. in relation to advertising revenues) and the extent to which these are expected to be temporary or persistent;
- Market reports and externally generated analysis of cost, revenue and viewing trends;
- Public policy developments and statements; and
- Findings from our work and research in relevant and related fields.

2.75 We consider it is appropriate to take account of a range of possible outcomes before judging what would be a reasonable overall assessment. However, we will be cautious about incorporating opportunity costs or benefits that depend upon uncertain external factors, and we will consider carefully what a new entrant would reasonably incorporate into their forward-looking assessment when considering a bid for the licence.

2.76 Below we set out our approach to dealing with the specific uncertainties identified above.

Future trends in the proportion of viewing on different platforms

2.77 Trends in the proportion of viewing on different platforms could affect the value of rights associated with the licences, such as those associated with EPG and DTT. For example, where the proportion of viewing on DTT is expected to decline in future, this could affect the price for carriage on DTT multiplexes and the value associated with a prominent EPG position on the DTT platform. These trends could also affect how the value of rights and cost of obligations are apportioned between Channel 3 licences (where this is based on share of viewing or revenue).

2.78 We will use forecasts submitted by licensees and place weight on forecasts that have been prepared and utilised for business planning purposes. Where these are not available, or only available for a limited period, we will use forecasts based on projecting forward historical trends. We will also take account of any developments that would affect the proportion of viewing on different platforms in future, and the subsequent impact on rights and obligations for Channel 3 and Channel 5 licences, where this is supported by evidence.

Future trends in television advertising revenue and programming costs

2.79 Advertising revenue forecasts potentially have two roles in the determination process. First, they may feed into our assessment of the value of a number of rights and obligations associated with the Channel 3 and Channel 5 licences (such as EPG prominence and opportunity costs associated with programming obligations). Second, if we set a positive PQR, this will be applied to revenues associated with DTT, which will in turn depend, in part, on total advertising revenues for each licence.

2.80 Forecasts of programming costs are relevant to the estimate of the opportunity cost of PSB programming.

2.81 We will use licensee's forward looking financial projections where we can (for example, five-year business plans, where available). Where these do not run to the end of the licence period, we will use forecasts based on projecting forward historical trends. We will consider data or evidence by licensees where they adopt different assumptions, including any developments that could affect future trends in advertising revenue and programming costs.

Future trends in the proportion of homes that are DTT homes

2.82 As explained below, any PQR we determine will apply to revenues associated with DTT only. If we decide to set a positive PQR, it will be necessary to forecast revenues associated with DTT. This will be done by multiplying total revenue associated with the Channel 3 or Channel 5 licences by the proportion of homes that are DTT homes.

2.83 We will consider forecasts from licensees on the proportion of homes that are DTT homes. We will also consider trends in the proportion of homes that are DTT from BARB Establish Surveys before coming to an overall view.

The duration of DTT multiplex licences

2.84 We recently renewed the Multiplex 2 and Multiplex A licences until 2034. We can, after consultation and with the agreement of the Secretary of State, revoke multiplex licences for spectrum management reasons, though we must give a notice period of five years and revocation cannot take effect earlier than 31 December 2030.[32]

2.85 We recognise the new entrant's expectations for the possibility of revocation could affect the value ascribed to the rights associated with DTT and EPG in the later years of the next licence period. We consider a new entrant would take account of any public policy statements on the future of DTT to inform its view of the likelihood of revocation happening before the end of the next licence period. To date, we have not indicated that revocation is likely, so we consider a new entrant would place a relatively low weight on this possibility for the purposes of the licence valuation.

Changes to regulations which could affect rights and obligations associated with the licences

Media Bill

2.86 On 29 March 2023, the government published a draft Media Bill which proposes changes to the legal framework for PSB. The draft simplifies the PSB remit, allows it to be delivered over a broader range of media, and includes provisions for additional benefits and obligations for public service broadcasters that a new entrant could factor into its valuation:

- Provisions that would allow Ofcom to designate 'internet programme services' that make a significant contribution to the public service remit. These could include online services provided by public service broadcasters, such as ITVX, STV Player and My5. Where such services are designated, they would then benefit from prominence and availability requirements on popular connected TV platforms. Under the draft Bill, Ofcom is required to consult on and publish a code of practice on compliance with 'appropriate prominence' requirements, and guidance on how public service broadcasters and platforms may meet specified statutory agreement objectives.
- Changes to the listed events regime so that the category of free to air "qualifying services" which must be offered the opportunity to acquire broadcasting rights for live coverage of events such as the Olympics, FIFA World Cup finals and Wimbledon tennis is expressly limited to services provided by PSBs.
- Changes to programming quotas which would allow PSBs to deliver some obligations using their on-demand programme services, where they form part of designated PSB internet programme services, as well as their main licensed channels.

2.87 Some of these proposed changes could affect the opportunity costs of delivering some of the PSBs' content obligations, and the value of potential future benefits, in particular the value of online prominence and availability obligations could be significant.[33] However,

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[32] As set out in the Television Services (Renewal of Multiplex Licences) Order 2021.

[33] Ofcom, 29 June 2022, 2022 report. On page 4 we said that reforms to the prominence and availability rules would be important to strengthen the future sustainable delivery of the PSB licence obligations.

even if the new entrant knew with certainty how the future framework will work, estimating a value for these benefits is difficult at this stage in the Bill process.[34]

2.88 The final form of the legal framework will not be certain until the Media Bill has made its way through the legislative process and gained Royal Assent, secondary legislation is in place and Ofcom has consulted on and published codes of practice and guidance relating to compliance with the new framework.

2.89 There is, therefore, uncertainty about the value a new entrant would place on any future benefits stemming from the draft Media Bill, and at what point during the next licence period any benefit is likely to start. We think a new entrant would be cautious when ascribing a value to new benefits and obligations.

2.90 For the purposes of the licence valuations, we will take account of information we may receive from current licensees when considering how a new entrant would value new benefits or obligations associated with the Media Bill, and how it would reflect any uncertainty over timings. Additionally, for online prominence, we will consider other sources, including:

- Actual prices paid for prominence on platforms such as connected TVs, where such evidence is available to us.
- Estimates of the uplift in revenues associated with different levels of prominence. [35]
- Reports commissioned by Ofcom or other parties.

Proposed changes to the COSTA rules

2.91 As set out above, our COSTA rules set limits on the amount of advertising that can be shown on commercial PSB channels and other commercial channels.

2.92 We published a consultation on the future of these rules in April 2023 which proposed the removal of the current stricter rules that apply to the PSB channels and replace them with either:

a) full harmonisation of the rules between PSB and non-PSB channels; or

b) partial harmonisation, while retaining the limit on the number of internal breaks permitted in programmes on PSB channels. Under this option, all PSB and non-PSB channels would be subject to the same advertising minutage limits, but PSB channels would continue to have fewer internal breaks in programmes. We said this is our preferred option at this stage.

2.93 We also said that, subject to responses to the consultation, we may also consider maintaining the status quo.

[34] Ofcom, 29 June 2022, 2022 report, paragraph 4.39.

[35] For example, ITV includes some indicative estimates from Mediatique in its submission informing our 2022 report. See, for example, paragraphs 4.37 to 4.41 of that report.

2.94 In our consultation we said that we aimed to publish our decision in Q2 2023/24, which would be ahead of our determination of the financial terms for the Channel 3 and Channel 5 licences. Where this is the case, we will reflect our decision in our analysis.

2.95 If we decide to fully harmonise the rules between PSB and non-PSB channels, then from the point of view of a new entrant, there would be no difference in the amount of advertising they could broadcast under a Channel 3 or Channel 5 licence compared to a commercial alternative. In this case, we would not include any opportunity cost associated with advertising minutage in the valuation. Where different rules continue to apply to PSB and commercial channels (whether in relation to the amount of advertising or number of breaks that can be shown), this could in theory give rise to an opportunity cost, and we will consider evidence from licensees where this enables us to evaluate this for inclusion in the valuation.

Discount rate

2.96 To be consistent with the proposed circumstances of the hypothetical auction, the discount rate is intended to reflect the opportunity cost of investment in a television channel faced by a hypothetical entrant that is assumed to be an existing television company. We set out the methodology for estimating the discount rate in Annex 1.

2.97 We have estimated a pre-tax nominal discount rate of 12.8%, as explained in Annex 1. We will also consider sensitivities around this discount rate, and the resulting impact on our valuation, where included in information we may receive from current licensees.

Cut-off date

2.98 Consistent with previous reviews, we consider it is necessary for us to be able to take account of any information relevant to setting financial terms that is or becomes available up to the date of the determination.

Setting financial terms

2.99 We will calculate financial terms which allow for the recovery of the combined NPV of the rights and obligations associated with the licence. However, as explained above, no guidance is given in the 2003 Act as to how we should set the PQR or indeed the relative sizes of the PQR and cash bid.

2.100 In terms of setting the PQR, we will use the definition of qualifying revenue set out in our 2004 statement of principles document.[36] In that document, revenues from the provision of the service on digital terrestrial will constitute qualifying revenue. Revenue from the provision of the service on cable and satellite fall outside the definition of qualifying

[36] Ofcom, 16 December 2004, Qualifying Revenue and Multiplex Revenue: Statement of Principles and Administrative Arrangements under the Broadcasting Act 1990, the Broadcasting Act 1996 and the Communications Act 2003, paragraph 1.10.

revenue. Therefore, any PQR we determine will apply to revenues apportioned to DTT only.

2.101 In terms of the relative sizes of any PQR payments and cash bid, recovering more of the licence value from PQR would align the payments with licensees' revenues, offer some protection against the risk of revenue downturns and mitigate some of the risk of forecasting error. Therefore, consistent with the 2013 methodology statement, the PQR will be calculated to recover as close to 95% of the value of the licence as possible, without exceeding this proportion and consistent with setting the PQR as an integer. The cash bid would then be set to recover the balance of the value of the licence.

2.102 When converting the NPV of the licence into PQR and/or cash bids, we intend to use the discount rate set out above, but we may consider the risk associated with the PQR and cash bid payments (and adjust the discount rate accordingly) where this could have a significant impact on the size and profile of payments.[37]

2.103 Where our review indicates that a new entrant would assign a relatively small value to the licence, we may, for administrative convenience, recover the value of the licence solely through the cash bid, with the PQR set to zero. This would also give licensees certainty about future payments.

2.104 If our review indicates that a hypothetical new entrant would not be prepared to bid for the licence based on our assessment of the value of the rights and obligations associated with the licence, we will conclude that the incumbent licence holders could retain their licences in a hypothetical auction for a nominal cash bid. In previous reviews we have set this nominal cash bid at £10,000 (as shown in Table 2 below).

Outcomes of previous reviews

2.105 The table below shows the outcomes of previous reviews of financial terms.

[37] For example, when turning a lump sum value into a stream of payments for Annual Licence Fees for mobile operators, we considered that the appropriate discount rate would sit between the cost of debt and the cost of capital, depending on how much risk in the value of the licence was borne by government. See for example Annex 2 of Annual Licence Fees for UK Broadband's 3.4 GHz and 3.6 GHz spectrum.

Table 2: Financial terms determined for each Channel 3 and Channel 5 licence

	Prior to 2005		2005-2009		2010-2014		2015-2024	
	PQR	Cash bid	PQR	Cash bid	PQR	Cash bid	PQR	Cash bid
Channel 3 regions								
Anglia (East of England)	17%	£3,631k	10%	£180k	0%	£10k	0%	£10k
Border (Borders)	2%	£79k	0%	£10k	Did not apply		0%	£10k
Central (East, West and South Midlands)	17%	£7,994k	11%	£900k	0%	£10k	0%	£10k
Channel (Channel Islands)	0%	£1k	Did not apply		Did not apply		0%	£10k
Granada (North-West England and Isle of Man)	15%	£4,278k	9%	£240k	0%	£10k	0%	£10k
London (London Weekday)	20%	£17,849k	26%	£1,120k	0%	£10k	0%	£10k
LWT (London Weekend)	17%	£5,176k	21%	£720k	0%	£10k	0%	£10k
Meridian (South and South-East England)	23%	£12,897k	14%	£320k	0%	£10k	0%	£10k
STV Central (Central Scotland)	11%	£1,800k	0%	£10k	Did not apply		0%	£10k
STV North (North of Scotland)	6%	£111k	6%	£60k	Did not apply		0%	£10k
Tyne Tees (North-East England)	16%	£2,239k	0%	£10k	Did not apply		0%	£10k
Ulster (Northern Ireland)	5%	£611k	5%	£120k	0%	£10k	0%	£10k
Wales	7%	£2,323k	0%	£10k	Did not apply		0%	£10k
Westcountry (South-West and West of England)	13%	£1,289k	0%	£10k	Did not apply		0%	£10k
Yorkshire (Yorkshire and Lincolnshire)	22%	£8,524k	3%	£240k	0%	£10k	0%	£10k
Channel 3 breakfast licence	23%	£4,523k	30%	£230k	Did not apply		0%	£10k
Channel 5	8%	£4,318k	8%	£680k	0%	£10k	0%	£10k

Note: Where a licensee did not apply for a review, its existing financial terms continued to apply. The cash bids are as at the renewal date and increase by the Retail Price Index ("RPI") each year. The PQR to 2014 applied to analogue revenues only. From 2015 the PQR applied to DTT revenues.

2.106 The table shows that over time the PQR and cash bid associated with the Channel 3 and Channel 5 licences have reduced, and that each licensee has been making nominal financial payments since the 2010 review.

2.107 The large reductions in financial terms in the years leading to 2010 were due to the reduced value of broadcasting on analogue, reflecting the switch to digital television. Following digital switchover, our reviews have indicated that a new entrant would not be prepared to make financial payments as well as deliver PSB programming in return for the rights attached to the licences. As a result, we have concluded that the incumbents could retain their licences in a hypothetical auction for a nominal cash bid of £10,000.

Consultation

2.108 We are minded to adopt the methodology we have set out in this document to determine the financial terms for the Channel 3 and Channel 5 licences, subject to any comments we receive. These should be sent to us by no later than 5pm on 28 July 2023. See Annex 2 for further details.

> Question 1: Do you have any comments on the methodology Ofcom proposes to use to determine the financial terms? Where you disagree with any of our proposals, please explain why.

A1. Discount rate

A1.1 The discount rate is intended to reflect the opportunity cost of investment faced by a hypothetical entrant that is assumed to be an existing television company. We have estimated a pre-tax nominal discount rate of 12.8% to reflect the weighted average cost of capital ("WACC") of a hypothetical entrant. We have estimated a nominal rate as we will ask licensees to prepare forecasts to inform our valuation in nominal terms. We will consider whether it is appropriate to update our discount rate estimate for the statement, especially for parameters we have estimated using short averaging periods, such as the risk-free rate ("RFR") and cost of debt.

Estimating discount rates

A1.2 The discount rate applied to the forecast cash flows in a NPV analysis should reflect the opportunity cost to the relevant capital providers, weighted to their relative contribution to the company's total capital base. This is approximated by calculating the firm's WACC.

A1.3 The WACC combines the cost of funding from debt (Kd) and equity (Ke), each weighted by their relative share of enterprise value (i.e. the sum of the value of debt and equity). The value of debt relative to enterprise value (gearing) is denoted by g in the formula below and the rate of corporation tax is denoted by t. The pre-tax WACC is obtained by scaling the post-tax cost of equity by 1/(1-t), the cost of debt already being pre-tax:

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

A1.4 We have estimated the cost of equity using the Capital Asset Pricing Model ("CAPM"), where the cost of equity is a function of the RFR, the expected return on the equity market as a whole above the RFR (i.e. the equity risk premium, or "ERP") and the systematic risk of the company (i.e. equity beta, βequity):

$$Ke = RFR + ERP * \beta\text{equity}$$

A1.5 We have estimated the cost of debt by considering the cost of new debt issued for the period of the licence for a firm with an investment grade rating.

A1.6 There are several parameters that we must estimate to calculate the WACC for a hypothetical entrant. Some parameters reflect economy-wide factors that affect all firms, in particular the expected market return ("EMR"), which represents the sum of RFR and ERP), the RFR and the corporate tax rate.

A1.7 We considered some of these economy-wide factors as part of the March 2021 Wholesale Fixed Telecoms Market Review ("WFMTR").[38] Consistent with a view that long-run market returns are relatively stable[39], we have adopted the same EMR of 6.7% (expressed in CPI-

[38] Ofcom, 18 March 2021, Promoting investment and competition in fibre networks – Wholesale Fixed Telecoms Market Review 2021-26 ("WFTMR"), Annex 20.

[39] Ofcom, 18 March 2021, WFTMR, Annex 20, paragraph A20.55.

real terms) as used in the WFTMR. To convert this to a nominal EMR we use the Bank of England's long run Consumer Prices Index ("CPI") target of 2%,[40] which is intended to reflect expected CPI inflation over the licence period.

A1.8 We have estimated the RFR using the yields on 10-year index-linked gilts, to match the duration of the next licence period.[41]

A1.9 We have estimated the RFR using a one-month average of these gilt yields.[42] We consider a short-run average better reflects the current market environment i.e. the rates a new entrant would face when financing its bid. We have used a real (RPI-based) RFR of 0.1%, consistent with the average yield on these gilts in April 2023. To convert this to a nominal RFR we use an RPI rate of 3%, which combines the Bank of England's long run CPI target of 2% and an estimate of the RPI-CPI wedge of 1%, based on the latest OBR publication.[43]

A1.10 We have used a corporate tax rate of 25%, consistent with current tax rates.[44]

A1.11 Other parameters that influence the WACC calculation are firm-specific, such as gearing, equity and asset betas, and the cost of debt. We set out our estimate of these below and, where possible, we have used data on existing broadcasters to support our calculations.

Asset beta, equity beta and gearing

A1.12 The value of a company's equity beta measures the movements in returns from its shares relative to the movement in the return from a relevant equity market. The equity beta includes the effect of capital structure on the systematic risk of the company, so an asset beta is often calculated to remove financial leverage effects from the equity beta to more easily compare the betas of different companies (which may have different gearing).[45]

A1.13 In the 2013 methodology statement, we used a gearing of 30% and an equity beta of 1.4. The equity beta was informed by our estimates of the equity betas for ITV, STV, UTV and BSkyB.[46] We put most weight on ITV's equity beta as BSkyB was not a free to air broadcaster and STV and UTV were thinly traded (so their betas may be unreliable).[47] Our gearing estimate was informed by ITV's gearing over time.

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[40] HM Treasury, 17 November 2022, Monetary Policy Remit: Autumn Statement 2022.

[41] This approach is consistent with 'recommendation 3' of the UKRN cost of capital guidance published in March 2023 which says the RFR should be estimated with a maturity which matches the assumed investment horizon (which in this case is the 10 year licence period).

[42] Bank Of England, Yield Curves. Archive yield curve data – Daily, as at 30 April 2023.

[43] We have used the OBR's data from its Economic and fiscal outlook (March 2023) and the average implied RPI-CPI wedge of between 0.9pp and 1.2pp in the first three years of the licence to assume a wedge of 1% to calculate RPI.

[44] The gov.uk website says, "At the Spring Budget 2021, the government announced that the Corporation Tax main rate for non-ring fence profits would increase to 25% for profits above £250,000". See Corporation Tax rates.

[45] Assets betas are calculated using the following formula. Our calculations assume a debt beta of 0.1, consistent with the 2021 WFTMR, but this does not materially affect the WACC calculation.

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

[46] Ofcom, 23 July 2013, 2013 methodology statement, Table A1.2.

[47] Thinly traded means that the shares are bought and sold in low volumes and not traded as frequently as the average market portfolio. This means resulting betas can be unreliable.

A1.14 Since the last review, UTV has been acquired by ITV, BSkyB has been acquired by Comcast and STV remains relatively thinly traded, leaving ITV as the only remaining benchmark from the companies we previously considered.

A1.15 We have considered whether more recent evidence would support a change to the beta and gearing assumptions used in the 2013 methodology statement. Our approach, as set out above, is to assume the new entrant is an existing television company. In May 2014, Channel 5 was acquired by Viacom (now Paramount Global), a US listed media company. We have considered the beta and gearing for ITV and Paramount Global as these are listed, frequently traded, companies which hold Channel 3 and Channel 5 licences. The table below shows 2-year and 5-year beta and gearing estimates for these companies.

Table A1: Beta and gearing estimates

	2-year			5-year		
	Equity beta	Asset beta	Gearing	Equity beta	Asset beta	Gearing
ITV	1.73	1.36	23%	1.38	1.11	21%
Paramount Global	1.23	0.67	49%	1.16	0.67	46%

Source: Bloomberg. Betas calculated using daily data as at 30 April 2023 against the FTSE All Share Index for ITV and the S&P 500 for Paramount Global. Gearing estimated using Bloomberg's definitions of short and long term debt, which from 1 January 2019 includes operating leases per IFRS 16.

A1.16 We consider the asset beta for ITV is likely to better approximate the asset beta facing a hypothetical new entrant considering bidding for a Channel 3 or Channel 5 licence as the Channel 3 licences are likely to represent a larger proportion of ITV's business than the Channel 5 licence for Paramount Global.[48] Consistent with our approach in WFTMR, we also put more weight on 5-year betas as they tend to be less volatile than shorter averaging periods. On this basis, we have used an asset beta of 1.11, equal to ITV's 5-year asset beta.

A1.17 To estimate a forward-looking equity beta, we need to consider the forward-looking gearing associated with the hypothetical entrant. The data in Table A1 would support gearing estimates of 20%-50%. Placing more weight on ITV for the reasons above, we have used a rate of 25%, towards the bottom of this range.

A1.18 An asset beta of 1.11 is equivalent to an equity beta of 1.45 using our forward-looking gearing of 25%[49], which is slightly higher than the equity beta we used in the 2013 methodology statement.

[48] For example, Channel 5 Broadcasting Limited's revenue was £388m in 2021, around 2% of Paramount Global's revenue in the same year. In comparison, ITV plc's Media & Entertainment division (which is made up of streaming and broadcast, activities, including Channel 3) represented 66% of ITV Plc's revenue in 2021.

[49] Using the formula β equity = (β asset - β debt * g)/1-g gives (1.11 – 0.10*25%)/75% = 1.45.

Cost of debt

A1.19 ITV and Paramount Global have corporate bonds rated at BBB- by S&P. We think it is reasonable to assume the debt of a new entrant would also be BBB- rated. We consider that bonds with a 10-year maturity would be consistent with the duration of the licence.

A1.20 In April 2023, yields on 10-year BBB-rated bonds ranged from 5.2% to 5.6% and averaged 5.4%.[50] As we assume the debt of a hypothetical entrant would be BBB- rated, its cost of debt is likely to be higher than average yields on a BBB index.[51] On this basis, we consider 5.6% would be a reasonable estimate of the cost of debt of a hypothetical entrant considering bidding for the licence.

Estimated WACC

A1.21 Applying the parameters discussed above, we have estimated a pre-tax nominal WACC of 12.8%. A summary of the WACC calculation and related assumptions is shown in Table A2 below.

[50] Source: Bloomberg.
[51] A BBB index includes bonds rated BBB+, BBB and BBB-. A BBB- bond is likely to have a higher cost of debt than a BBB or a BBB+ bond.

Table A2: WACC parameters

WACC component	Estimate	Source
Real (RPI-based) RFR	0.1%	Ofcom estimate based on index-linked gilt yields
RPI inflation forecast	3.0%	CPI + assumed RPI-CPI wedge of 1%
Nominal RFR	3.1%	= (1+ real (RPI-based) RFR)*(1+RPI inflation)-1
Real (CPI based) EMR	6.7%	WFTMR
CPI inflation forecast	2.0%	Bank of England long run target
Nominal EMR	8.8%	= (1+real EMR)*(1+CPI inflation)-1
Nominal ERP	5.7%	= Nominal EMR – Nominal RFR
Debt beta (β debt)	0.1	WFTMR
Asset beta (β asset)	1.11	Based on ITV's 5-year asset beta
Gearing (forward looking) (g)	25%	Ofcom estimate
Equity beta (β equity)	1.45	= (βa - βd*g)/(1-g)
Cost of equity (post-tax) (Ke)	11.4%	= Nominal RFR + Nominal ERP *βe
Cost of equity (pre-tax)	15.2%	= Ke / (1-t)
Corporate tax rate (t)	25%	HMRC
Cost of debt (pre-tax) (Kd)	5.6%	Ofcom estimate based on yields on BBB bonds
WACC (pre-tax nominal)	12.8%	=(Ke*(1-g))/(1-t)+(Kd*g)

A2. Responding to this consultation

How to respond

A2.1 Ofcom would like to receive views and comments on the issues raised in this document, by 5pm on 28 July 2023.

A2.2 You can download a response form from our website. You can return this by email or post to the address provided in the response form.

A2.3 If your response is a large file, or has supporting charts, tables or other data, please email it to commercialrelicensing@ofcom.org.uk, as an attachment in Microsoft Word format, together with the cover sheet.

A2.4 Responses may alternatively be posted to the address below, marked with the title of the consultation:

C3/C5 Relicensing Team
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA

A2.5 We welcome responses in formats other than print, for example an audio recording or a British Sign Language video. To respond in BSL:

- send us a recording of you signing your response. This should be no longer than 5 minutes. Suitable file formats are DVDs, wmv or QuickTime files; or
- upload a video of you signing your response directly to YouTube (or another hosting site) and send us the link.

A2.6 We will publish a transcript of any audio or video responses we receive (unless your response is confidential)

A2.7 We do not need a paper copy of your response as well as an electronic version. We will acknowledge receipt of a response submitted to us by email.

A2.8 You do not have to answer all the questions in the consultation if you do not have a view; a short response on just one point is fine. We also welcome joint responses.

A2.9 It would be helpful if your response could include direct answers to the questions asked in the consultation document. The questions are listed at Annex 5. It would also help if you could explain why you hold your views, and what you think the effect of Ofcom's proposals would be.

A2.10 If you want to discuss the issues and questions raised in this consultation, please contact the C3/C5 relicensing team by email to commercialrelicensing@ofcom.org.uk.

Confidentiality

A2.11 Consultations are more effective if we publish the responses before the consultation period closes. In particular, this can help people and organisations with limited resources or familiarity with the issues to respond in a more informed way. So, in the interests of transparency and good regulatory practice, and because we believe it is important that everyone who is interested in an issue can see other respondents' views, we usually publish responses on the Ofcom website at regular intervals during and after the consultation period.

A2.12 If you think your response should be kept confidential, please specify which part(s) this applies to, and explain why. Please send any confidential sections as a separate annex. If you want your name, address, other contact details or job title to remain confidential, please provide them only in the cover sheet, so that we don't have to edit your response.

A2.13 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and try to respect it. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A2.14 To fulfil our pre-disclosure duty, we may share a copy of your response with the relevant government department before we publish it on our website. This is the Department for Business and Trade for postal matters, the Department for Culture, Media and Sport (DCMS) for broadcasting and media matters, and the Department for Science, Innovation and Technology for online safety, telecoms and spectrum and Ofcom sponsorship.

A2.15 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's intellectual property rights are explained further in our Terms of Use.

Next steps

A2.16 Following this consultation period, Ofcom plans to publish our methodology statement by October 2023.

A2.17 If you wish, you can register to receive mail updates alerting you to new Ofcom publications.

Ofcom's consultation processes

A2.18 Ofcom aims to make responding to a consultation as easy as possible. For more information, please see our consultation principles in Annex 3.

A2.19 If you have any comments or suggestions on how we manage our consultations, please email us at consult@ofcom.org.uk. We particularly welcome ideas on how Ofcom could more effectively seek the views of groups or individuals, such as small businesses and residential consumers, who are less likely to give their opinions through a formal consultation.

A2.20 If you would like to discuss these issues, or Ofcom's consultation processes more generally, please contact the corporation secretary:

Corporation Secretary
Ofcom
Riverside House
2a Southwark Bridge Road
London SE1 9HA
Email: corporationsecretary@ofcom.org.uk

A3. Ofcom's consultation principles

Ofcom has seven principles that it follows for every public written consultation:

Before the consultation

A3.1 Wherever possible, we will hold informal talks with people and organisations before announcing a big consultation, to find out whether we are thinking along the right lines. 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

A3.2 We will be clear about whom we are consulting, why, on what questions and for how long.

A3.3 We will make the consultation document as short and simple as possible, with an overview of no more than two pages. We will try to make it as easy as possible for people to give us a written response.

A3.4 We will consult for up to ten weeks, depending on the potential impact of our proposals.

A3.5 A person within Ofcom will be in charge of making sure we follow our own guidelines and aim to reach the largest possible number of people and organisations who may be interested in the outcome of our decisions. Ofcom's Consultation Champion is the main person to contact if you have views on the way we run our consultations.

A3.6 If we are not able to follow any of these seven principles, we will explain why.

After the consultation

A3.7 We think it is important that everyone who is interested in an issue can see other people's views, so we usually publish the responses on our website at regular intervals during and after the consultation period. After the consultation we will make our decisions and publish a statement explaining what we are going to do, and why, showing how respondents' views helped to shape these decisions.

A4. Consultation coversheet

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 aims to publish responses at regular intervals during and after the consultation period. 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)

A5. Consultation question

A5.1 We invite views from stakeholders on the following question:

> Question 1: Do you have any comments on the methodology Ofcom proposes to use to determine the financial terms? Where you disagree with any of our proposals, please explain why.