Methodology for determining the financial terms for the Channel 3 and Channel 5 licences

Consultation

Publication date: 21 February 2013

Closing Date for Responses: 2 May 2013

Contents

Section 1

Executive summary

1.1 The Channel 3 and Channel 5 broadcast licences are due to expire on 31 December 2014. Under the provisions of the Communications Act 2003 (the "Act"), the licensees may apply to renew their licence(s) for a further period of 10 years. In line with section 229 of the Act, Ofcom submitted a report to the Secretary of State for Culture, Media and Sport on matters which are relevant to Channel 3 and Channel 5 licence renewal. This was published in May 2012.[1]

1.2 On 21 November 2012, the Secretary of State advised that she did not intend to block the renewal. Ofcom is therefore continuing with the renewal process of Channel 3 and Channel 5 broadcast licences for a period of 10 years, commencing on the expiry of the existing term, from 1 January 2015.

1.3 In order to obtain a licence renewal, the holders of Channel 3 and Channel 5 licences must submit an application to Ofcom within the period set out in the Act. If Ofcom decides to renew their licences it must determine the financial terms on which the licences are to be renewed. The determination must comprise two different types of payment. The first is a percentage of the licensee's qualifying revenue and the second is a fixed annual cash payment. To assess the amount of the annual cash payment, Ofcom is required to determine the amount which, in its opinion, would have been the cash bid of the licence holder were the licence being granted afresh in a competitive auction process (under section 15 of the Broadcasting Act 1990 (the "1990 Act")).

1.4 This consultation sets out Ofcom's proposed approach to determining the financial terms for the Channel 3 and Channel 5 licences should the licences be renewed. Ofcom has previously determined the financial terms of Channel 3 and Channel 5 in 2010 and 2005.

1.5 Ofcom's objectives for these reviews were to determine a fair and reasonable value for each licence (in accordance with the statutory requirements) and to set new financial terms according to a fair and objective process. Subject to a small number of adjustments which we set out in this consultation, we suggest that the approach followed in our previous reviews remains appropriate in setting out the financial terms on which Channel 3 and Channel 5 licences may be renewed. To the extent possible, the process should allow Ofcom to set terms that are reasonable within the context of the current market environment and that will continue to be reasonable for the period of the renewed licences. This means that we need to take into account changes in the market and regulatory environment that will impact the financial terms for each licence.

1.6 This consultation invites views from stakeholders about our proposed approach. The consultation is open for ten weeks, until 5pm on 2 May 2013.

[1] http://stakeholders.ofcom.org.uk/broadcasting/tv/c3-c5-licensing

Section 2

Legal framework

2.1 On 21 November 2012, the Secretary of State advised Ofcom that she did not intend to block the renewal of Channel 3 and Channel 5 broadcast licences. Ofcom is therefore continuing with the renewal process of the licences for a period of 10 years, commencing on the expiry of the existing licences (from 1 January 2015).

2.2 Under section 216 of the Communications Act 2003 (the "Act") the holders of Channel 3 and Channel 5 licences may apply to Ofcom for a 10 year renewal of their existing licences. Applications for renewal must be made within the period set out under the Act. Licensees have been notified that the closing date for the on-going process is 15 March 2013.

2.3 Section 216(4) of the Act states that on receipt of an application Ofcom must decide whether to renew the licence and must notify the applicant accordingly. Pursuant to section 216(4A)(b), if Ofcom decides to renew a licence it must determine in accordance with section 217 the financial terms on which the licence will be renewed.

2.4 Under section 217 of the Act Ofcom must determine two elements:

2.4.1 a fixed annual cash amount (the "cash bid") to be paid for the licence in respect of the first complete calendar year falling within the renewal period;[2] and

2.4.2 a percentage of qualifying revenue (the "PQR") payable for each accounting period of the licence holder falling within the renewal period.

2.5 The Act does not set out any process that Ofcom must follow in order to determine the PQR. As regards the annual cash bid, however, section 217(2) of the Act requires Ofcom to determine the amount that, in its opinion, would have been the cash bid of the licence holder were the licence being granted afresh in a competitive tender process under section 15 of the Broadcasting Act 1990 (the "1990 Act"). This means that as regards the cash bid element of the financial terms Ofcom is required, in practice, to reproduce the effects of a hypothetical auction of the licences.

2.6 Subject to the Channel 3 and Channel 5 licences being renewed, the proposed new financial terms will apply from the expiry of the current licence (31 December 2014) for a 10 year period. The period under review is from 1 January 2015 to 31 December 2024.

2.7 The financial terms attached to the Channel 3 and Channel 5 licences were last reviewed by Ofcom in 2010 ("the 2010 Review"). Ofcom published a statement on the methodology ("the 2010 Statement")[3] and a determination ("the 2010

[2] The Act requires for a cash amount to be paid in the first calendar year falling within the renewal period and in respect of each subsequent years that amount increased by the appropriate percentage (the RPI percentage increase as defined in section 19 of the 1990 Act).

[3] Statement published 3 March 2010 http://stakeholders.ofcom.org.uk/binaries/consultations/review_c3_c5_licences/statement/Statement.pdf

Determination").[4] Ofcom also reviewed the financial terms in 2005 ("the 2005 Review"), publishing a statement in 2004 ("the 2004 Statement")[5] and a determination in 2005 ("the 2005 Determination").[6]

Impact assessment

2.8 It is a statutory requirement that Ofcom should carry out a determination of financial terms for each Channel 3 and Channel 5 licence for which a renewal application is made. A separate impact assessment on this statutory requirement is not therefore necessary or appropriate.

2.9 However, the purpose of this document is to consult on a proposed approach to determining financial terms within the statutory framework. We have therefore set out in this document those factors which we propose to take into account and have sought, in Section 3 in particular, to assess their likely impact. 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.

2.10 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.

2.11 It is not apparent to us that the proposals set out in this document will have any impact on equality issues, including race, disability and gender equality issues, as well as equality in Northern Ireland.

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[4] Determination published on 1 October 2010 http://stakeholders.ofcom.org.uk/binaries/consultations/review_c3_c5_licences/statement/determination.pdf

[5] Statement published on 13 October 2044: http://stakeholders.ofcom.org.uk/binaries/consultations/channel3_consultation/statement/c3mstatement.pdf

[6] Determination published 29 June 2005: http://stakeholders.ofcom.org.uk/binaries/consultations/channel3_consultation/statement/ch3ch5fin.pdf

Section 3

Approach to the review

Introduction

3.1 This section sets out our proposed approach towards setting the PQR and determining the cash bid for each Channel 3 or Channel 5 licence holder that applies for a renewal of its licence.

3.2 For the reasons set out below, we propose that the methodology used by Ofcom in 2005 and 2010 remains appropriate, subject to the modifications set out in this section. This section provides an overview of our proposed methodology and invites views and comments on our proposal.

Ofcom's statutory task

3.3 Section 217 of the Act sets out the statutory framework for determining financial terms following an application made by a licensee and Ofcom's decision to renew the licence. For the 10-year period of renewal Ofcom must determine two elements:

3.3.1 a fixed annual cash amount (the "cash bid") to be paid for the licence. That amount must be equal to the amount the licence holder would have bid were the licence being granted afresh in a competitive tender under section 15 of the 1990 Act; and

3.3.2 the percentage of qualifying revenue ("PQR") as determined by Ofcom to be payable for each year of the licence.[7] The PQR can vary from year to year.

3.4 In the context of a competitive tender (under section 15 of the 1990 Act), Ofcom must set out, in its notice inviting licence applications, the PQR that would be payable by an applicant if he were granted the licence. The PQR would therefore be determined before bids are made for the cash bid element. No guidance is given in the Act as to how Ofcom should set the PQR or indeed the relative sizes of the PQR payments and cash sum. The definition of qualifying revenue is set out in section 19(2) of the 1990 Act and Ofcom is simply required to determine a percentage of it which shall be payable to HM Treasury.

3.5 As regards the amount of the cash bid, however, section 217(2) requires Ofcom to reach its decision in accordance with section 15 of the 1990 Act. To assess this amount Ofcom must in effect carry out a hypothetical auction of the licence as though it were being granted afresh.

3.6 Ofcom therefore has a level of discretion in relation to setting the PQR that it does not have in respect of the cash bid. However, 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 valuation according to common principles. This valuation is intended to meet the requirements of the Act in relation to determining the amount that, in Ofcom's opinion, would have been the cash bid, and also to

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[7] The Act says that the cash bid should be determined for each calendar year and the PQR for each accounting year. Since the Channel 3 and Channel 5 licensees each have December year ends for accounting purposes, these differences are not relevant in practice.

provide a robust basis for informing Ofcom's decision as to the appropriate level of the PQR, taking into account both the objectives and the uncertainties discussed in this document.

Valuation methodology

3.7 The methodology set out in the 2004 Statement and 2010 Statement was established to inform Ofcom's decision when deciding on the PQR and determining the annual cash sum for each licence. Ofcom proposes to use a similar approach to any determination required following an application for licence renewal. This is because Ofcom's statutory task is identical whether it is required to determine financial terms following an application to renew the licences (as is the case here) or whether it is reviewing the financial terms following a request from the licensees (as was the case in the 2005 and 2010 reviews). Below, we set out our proposed methodology and identify those areas where there are changes from the approach taken in the last reviews.

3.8 As was the case during the 2005 and 2010 reviews, the aim of the proposed methodology is to set fair and reasonable terms such that they recover, so far as possible, the combined value of the rights and obligations to the licence holder over the duration of the licence, whether that be five years as was the case in the 2010 review, or 10 years as was the case in the 2005 review and is the case with the forthcoming determination.

Q1: Do you agree that the overall valuation methodology remains appropriate for the determination of the PQR and cash bid element of the renewed licences? If you do not, please explain why you view that methodology as inappropriate and what justifications exist for suggested alternatives.

Overarching principles

3.9 Each licence should be valued as a whole, although for the purposes of explanation and analysis we separately consider the rights and obligations associated with the licences. Although rights and obligations are considered separately, where possible the valuation should also seek to take into account any significant consequential effect that the presence of one right or obligation has on another.

3.10 In principle, 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 (ie: if they did not hold the licence).

3.11 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 television companies.

3.12 Our approach to valuing the licence is as follows:

3.12.1 In general, we consider that 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 costs savings to the licence holder from not having to obtain the right elsewhere.However, if the right could not be replicated elsewhere, then the value would equal the total financial benefit to the licensee of having the right.

3.12.2 Similarly, the costs of an obligation would be equal to the extra cost associated with meeting the obligation.

Circumstances of the hypothetical auction

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

3.14 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.

3.15 Each licence would be offered individually on a non-contingent standalone basis in a single round, sealed-bid auction. This is because, as explained in the October 2004 statement[8], for the purposes of conducting a hypothetical auction, we consider that the statutory framework makes it infeasible to assume that there is a multiple contingent bid auction.

3.16 The amount the incumbent would bid in a competitive auction would be the minimum required to beat the second-highest bidder, and as such would not necessarily represent the maximum amount the incumbent would be willing to pay.

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

Outcomes of previous reviews

3.18 Table 1 sets out the financial terms associated with each licence in the period prior to the 2005 Review, following the 2005 Review and following the 2010 Review.

Table 1: Financial terms determined for each Channel 3 and Channel 5 licence

	Prior to 2005		2005-2009		2010-2014	
	PQR	Cash bid (in 2004)	PQR	Cash bid (in 2005)	PQR	Cash bid (in 2010)
Channel 3 regions						
Anglia	17%	£3,631k	10%	£180k	0%	£10k
Border	2%	£79k	0%	£10k	Did not apply	
Carlton	20%	£17,849k	26%	£1,120k	0%	£10k
Central	17%	£7,994k	11%	£900k	0%	£10k
Channel	0%	£1k	Did not apply		Did not apply	
GMTV	23%	£4,523k	30%	£230k	Did not apply	
Grampian	6%	£111k	6%	£60k	Did not apply	
Granada	15%	£4,278k	9%	£240k	0%	£10k
HTV	7%	£2,323k	0%	£10k	Did not apply	
LWT	17%	£5,176k	21%	£720k	0%	£10k
Meridian	23%	£12,897k	14%	£320k	0%	£10k
Scottish	11%	£1,800k	0%	£10k	Did not apply	
Tyne Tees	16%	£2,239k	0%	£10k	Did not apply	

[8] 2004 Statement, paragraphs 3.4 to 3.13.

	Prior to 2005		2005-2009		2010-2014	
	PQR	Cash bid (in 2004)	PQR	Cash bid (in 2005)	PQR	Cash bid (in 2010)
UTV	5%	£611k	5%	£120k	0%	£10k
Westcountry	13%	£1,289k	0%	£10k	Did not apply	
Yorkshire	22%	£8,524k	3%	£240k	0%	£10k
Channel 5	8%	£4,318k	8%	£680k	0%	£10k

Note: Where a licence did not apply for a review, its existing terms continued to apply. The cash bid increases by RPI each year. The PQR in these periods applied to analogue revenues only.

3.19 The 2005 Determination led to a reduction in the financial terms associated with each licence. This was driven by the value of the right to broadcast on analogue reducing as the penetration of digital television increased and changes that Ofcom had made to licensees' PSB obligations.[9] The 2005 Determination noted that historically the value of the rights associated with the licences, in particularly the right to broadcast on analogue, outweighed the costs of the obligations associated with the licences such that licensees were prepared to make additional payments to HM Treasury. However, the 2005 Determination also noted that as digital switchover approached completion, the benefit associated with broadcasting on analogue would reduce and as a result it was possible that the value of the rights associated with the licence would be offset in full by the costs of the obligations associated with the licence such that a new entrant might be unwilling to pay more than a nominal sum for the licence.[10] For some licences we set nominal terms of £10,000, recognising that a hypothetical 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.

3.20 By the time of the 2010 Determination, analogue viewing had reduced further as digital switchover neared completion, and we concluded that a hypothetical new entrant would not be prepared to make financial payments as well as deliver PSB programming in return for the rights attached to any of the licences that had applied for a review. As a result, we considered that the incumbent licence holders could retain their licences in a hypothetical auction for a nominal amount of £10,000 per annum for each licence (the same nominal amount as was set for some licences in the 2005 Review).

3.21 The outcome of these reviews is that most licences are currently making nominal financial payments.

Digital switchover

3.22 Since the 2010 Determination digital switchover has completed[11]. This means that in the next licence period, licence holders will no longer enjoy the right to broadcast on analogue and the profits previously associated with that right. Analogue cashflows will therefore no longer be included in the valuation.

The rights and obligations associated with the licences

3.23 Table 2 sets out the rights and obligations associated with the Channel 3 and Channel 5 licences and any other regulations that a new entrant might take into account when considering a bid for one of the Channel 3 or Channel 5 licences.

[9] 2005 Determination, paragraph 3.4,
[10] 2005 Determination, paragraph 3.19
[11] http://media.ofcom.org.uk/2012/10/24/end-of-an-analogue-era-paves-way-for-4g-mobile/

Table 2: Rights and obligations associated with the Channel 3 and Channel 5 licences

	Channel 3	Channel 5
Rights		
Reserved capacity on PSB multiplex 2 (half the multiplex)	✓	
Reserved capacity on PSB multiplex 2 for Channel 5 (sufficient to broadcast in SD) and commercial multiplex A (50% of the capacity, less capacity used for Five on Multiplex 2)		✓
Option to apply for reserved HD capacity on DTT (PSB multiplex B)	✓	✓
Right to appropriate prominence on EPGs	✓	✓
PSB programming Obligations		
Public Service Broadcasting Obligations		
- regional news (in and outside peak)	✓	
- Other regional content	✓	
- National and international news (in and outside peak)	✓	✓
- Originations (in and outside peak)	✓	✓
- Current affairs (in and outside peak)	✓	✓
- Independent production	✓	✓
- Production outside London	✓	✓
Other regulations		
Extra restrictions on advertising minutage	✓	✓

Q2: Are there any other rights, obligations or regulations associated with the Channel 3 and Channel 5 licences that we should consider, or any other factors that may affect the valuation? If so, please explain how we should take them into account and provide any relevant data or analysis to support your suggestion.

Valuing the rights associated with the licences

General approach

3.24 In general, we consider that 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 costs savings to the licence holder from not having to obtain the right elsewhere. However, if the right could not be replicated elsewhere, then the value would equal the total financial benefit to the licensee of having the right. Where a forecast cashflow is used then it may be relevant to apportion costs and revenues to broadcast platforms (e.g. DTT, Satellite, Cable) based on the share of viewing.

3.25 Digital satellite and cable services are not part of the licensed service. They are therefore not included in the valuation.

3.26 The cashflows associated with an associated business are not included in the valuation of the licence as they do not arise as a result of owning the licence. Likewise, the costs of production facilities that do not arise as a necessary consequence of holding the licence would be excluded from the valuation.

Reserved capacity on DTT

3.27 Channel 3 licence holders have the right to reserved capacity on Multiplex 2 as well as joint ownership of the multiplex 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 on a commercial multiplex. An additional benefit associated with reserved capacity on a PSB multiplex is that they cover 98.5% of the UK population, rather than the 90% achieved by commercial multiplexes.

3.28 For Channel 3 licences, the value of the standard definition digital terrestrial television ("DTT") rights will be based on the costs of replicating those rights through purchase in the market, less the costs associated with operating Multiplex 2. Although there is a market for carriage on commercial multiplexes, there is only a limited market for carriage on PSB multiplexes. Therefore we propose to proxy the cost of carriage on a PSB multiplex. We propose to do this as follows:

3.28.1 In July 2010 Ofcom determined the price that Five needed to pay Digital 3 and 4 Ltd (the holder of PSB Multiplex 2) for carriage on that multiplex ("the 2010 Price Determination").[12]

3.28.2 The 2010 Price Determination was at a premium to the then market rate of carriage on a commercial multiplex. We propose to calculate this premium and apply it to the current market value of a carriage on a commercial multiplex in order to estimate the current market value of carriage on a PSB multiplex.

3.29 Capacity is reserved for Channel 5 on Multiplex 2 and on Multiplex A. Unlike the Channel 3 licence holders, however, Channel 5 is required to agree commercial carriage fees with the multiplex operators. 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 into account in the valuation.

3.30 For both Channel 3 and Channel 5 licences the cashflows associated with broadcasting on DTT are therefore not included in the valuation.

Option to apply to broadcast in HD on DTT

3.31 The option to apply to broadcast in high definition using DTT capacity is available only as a consequence of holding the licence. We consider that a new entrant applying for a licence renewal would only take up the option of applying to broadcast a DTT HD service if it had a positive net present value (NPV) over the full licensing period (here 10 years). If the HD service was expected to have a negative NPV, the entrant would not take up the option. As in the 2010 Review, Ofcom will examine the existing business plans for licensees' HD operations when considering what value to attach to this option.

Right to appropriate prominence on EPGs

3.32 The Channel 3 and Channel 5 licences carry with them the right to an appropriate degree of prominence on electronic programme guides (EPGs).

3.33 Ofcom considers that this right is likely to carry some value but that estimating that value is difficult and there are reasons why the right may have different values to existing broadcasters compared to the value that would be conferred on a new entrant. In the 2010 Review we said that a new entrant would not necessarily

[12] Determination between Digital 3 and 4 Limited and Channel 5 Broadcasting on charges payable for services on DTT multiplex *2*, 28 July 2010. http://stakeholders.ofcom.org.uk/binaries/enforcement/competition-bulletins/closed-cases/all-closed-cases/754344/determinationd34.pdf

assume that they would be granted a particular channel number, since there may be alternative ways of interpreting the right to due prominence on the EPG.[13]

3.34 In our report to the Secretary of State published in May 2012, we said that "*the size of this benefit is difficult to quantify*" but that, based on a consideration of the available evidence, "*the value of the right to appropriate prominence to ITV plc is likely to range from £5m to £40m per annum*"[14]. This was an estimate of the possible value to one of the incumbent Channel 3 licence holders (ITV plc) and we invite views on what evidence exists that could help quantify the value of this right to a new entrant for both the Channel 3 and Channel 5 licences.

Q3: Do you agree with Ofcom's proposed approach to valuing the rights associated with the Channel 3 and Channel 5 licences as outlined above? If not, please explain why and what alternative approaches would be available (providing any relevant data to support your alternative view). In particular, how should we value the right to appropriate EPG prominence to a new entrant (please provide relevant data to support your response)?

Cost of meeting PSB programming obligations

3.35 The valuation of the licence should also reflect the incremental costs that the licence implies as a result of the obligations it imposes. The primary cost is the cost of meeting the PSB programming obligations listed in Table 2. The cost of meeting PSB obligations is equal to the additional costs associated with providing such programming (compared with the costs of alternative commercial programming). The cost of meeting PSB obligations may also include the opportunity costs of lost advertising revenue if the PSB programming attracts less advertising spend than alternative commercial programming. We propose to take the opportunity cost of lost advertising revenue into account where stakeholders are able to present data or evidence to support the incremental revenues that could be generated by alternative commercial programming.

3.36 As in the 2005 and 2010 reviews, the expected cost of PSB obligations would be forecast and considered separately. The PSB cost calculation will include both the increased programming cost and, where evidence is available, the reduction in advertising revenue received as a result of showing PSB programming that attract less advertising revenue than might otherwise be received.

3.37 In the 2010 Review we said that the valuation would reflect the net cost to the licence of any PSB obligations relating to digital switchover, where these are incurred. Following completion of digital switchover we do not consider that any costs relating to digital switchover will be relevant in the next licence period.

Q4: Do you agree with this approach to assessing the opportunity cost associated with PSB programming obligations? If not, please explain why and what alternative approaches would be available (providing any relevant data to support your alternative view).

[13] 2010 Statement on the methodology, paragraph 3.75.
[14] http://stakeholders.ofcom.org.uk/binaries/broadcast/tv-ops/c3_c5_licensing.pdf, paragraphs 6.73 and 6.74. An estimate for Five was not published in the non-confidential version of this document.

Other regulations

Extra restrictions on advertising minutage

3.38 The amount of advertising UK television broadcasters are allowed to show is determined by Ofcom , based on European legislation, the AVMS Directive, and implemented by Ofcom's Code on the Scheduling of Television Advertising (COSTA). The COSTA sets limits on the amount of advertising for PSB channels (including Channel 3 and Channel 5) and all other commercial broadcasters. Ofcom's December 2011 Statement on "*Regulating the quantity of advertising on television*"[15] provided a summary of the COSTA rules:

Table 3: Summary of COSTA rules

	PSB	Non PSB
Maximum average number of minutes of advertising per hour for hours broadcast	7mins/hour	9mins/hour
Maximum number of minutes of adverts in any single hour	12mins/hour	12mins/hour
Maximum average number of minutes per hour in peak (6pm – 11pm)	8mins/hour	Rule does not apply
Teleshopping allowance	Included in advertising allowance and only allowed midnight – 6pm	3mins/hour in addition to advertising. Can be any time of day.

Source: Regulating the quantity of advertising on television, Figure 1

3.39 The effect of the COSTA rules is to reduce the maximum number of advertising impacts that are available for sale on a Channel 3 or Channel 5 licence compared to a non-PSB alternative.

3.40 We consider that a new entrant is likely to consider in the round any impact on revenue of holding a Channel 3 or Channel 5 licence. In particular, we consider that a new entrant would take into account the restrictions on advertising minutage at the same time as the right to appropriate EPG prominence. This is because the right to appropriate EPG prominence and restrictions on advertising minutage both affect the number of advertising impacts available for sale, albeit in different directions – appropriate EPG prominence increasing the number of impacts (via a higher audience share) and the advertising restrictions reducing the number of impacts (via limiting how much advertising can be shown in any hour).

3.41 We invite views on what data or evidence exists to indicate the extent of the impact the COSTA rules could have on the number of advertising impacts a Channel 3 or 5 licence holder can sell (and what revenue impact this might have), compared to a non-PSB alternative. To the extent that data or evidence is available, we propose to take into account the restrictions on advertising minutage when considering the impact of the right to appropriate EPG prominence. However, we also invite views on what alternative approaches might be available.

Q5: Do you agree that we should take into account the extra restrictions on advertising that apply to PSB licence holders alongside the right to appropriate EPG prominence? If not, what alternative approaches are available? What data or evidence exists to indicate the effect on advertising impacts or revenue of the advertising minutage restrictions on the Channel 3 or Channel 5 licences?

[15] http://stakeholders.ofcom.org.uk/binaries/broadcast/Advertising_minutage.pdf

Consultation on PSB obligations

3.42 Ofcom is currently consulting on proposals to amend the PSB obligations applicable to Channel 3 and Channel 5 licences. As in previous reviews, Ofcom will take into account any information relevant to determining the licence payments that is or becomes available up to the date of determination. Accordingly, we will seek to reflect any regulatory changes that are announced in a statement following the consultation on PSB obligations.

Dealing with uncertainties for the purposes of the review

3.43 Valuation of licences on a forward looking basis involves taking account of a number of uncertainties, including the following:

3.43.1 Future trends in television advertising revenues and programming costs.

3.43.2 Future trends in the proportion of homes that are DTT homes (relevant for setting the PQR).

3.43.3 The regulatory environment, including the long term path of PSB obligations and the implementation of administered incentive pricing (AIP).

3.44 Replicating 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.

3.45 Ofcom is unable to eliminate these uncertainties. Therefore, in order to fulfil its statutory duty to determine the financial terms applicable to each licence, it is necessary for Ofcom to make a series of assumptions on many issues. Ofcom recognises that there may be alternative approaches to individual elements of the valuation methodology. However, Ofcom believes that, when considered together as part of a coherent methodology, the overall approach provides a fair and reasonable basis for Ofcom to determine the financial terms for each licence.

3.46 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.

3.47 Furthermore, in order to determine a value for those elements of the licence which are explicitly modelled, Ofcom may need to project revenues and costs forward.

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

- evidence presented by stakeholders, such as forward looking financial projections;
- evidence to be provided by stakeholders to Ofcom, including consideration of the relevant part of pre-existing business plans and forward looking projections;
- market reports and externally generated analysis of cost, revenue and technological trends;

- public policy developments and statements; and
- findings from Ofcom's work and research in relevant and related fields;

3.49 Below we consider the particular uncertainties identified in paragraph 3.43.

Future trends in television advertising revenues and programming costs

3.50 For the first three years of the renewed licence period (up to the end of 2017) we propose to put particular weight on licensees forward looking financial projections, since existing five year plans will run until the end of 2017. For the remainder of the renewed licence period we seek views from stakeholders on how advertising revenues and programming costs could be forecast.

Future trends in the proportion of homes that are DTT homes

3.51 As explained below, any PQR determined by Ofcom will apply to revenues associated with DTT only. Therefore, should Ofcom 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 licence by the proportion of homes that are DTT homes. We invite views from stakeholders on how the proportion of homes that are DTT homes could be forecast in the period 2015 to 2024.

Future costs associated with PSB obligations

3.52 In respect of the future costs associated with public service broadcasting obligations Ofcom will take a cautious view about future changes in PSB obligations. However, we will assume that neither the regulator nor licensee will engage in economically irrational behaviour; the valuation will therefore assume that PSB obligations will not be maintained at a level that makes holding the licence no longer commercially viable. We noted at paragraph 3.42 that Ofcom is separately consulting on changes to PSB obligations.

Introduction of AIP

3.53 In its 2012/13 annual plan Ofcom said it "w*ill undertake analytical work to enable it to consult on the implementation of administered incentive pricing (AIP) assessing the potential level of fees, the potential impact of these fees on broadcasting output and the appropriate timetable over which they should be introduced*".[2] Ofcom intends to publish a consultation on AIP in the first half of March 2013 that will set out its detailed proposals for AIP.

3.54 Our methodology will be able to take into account Ofcom's proposals on AIP to the extent that they would affect the valuation that a hypothetical new entrant would place on a Channel 3 or Channel 5 licence. We consider that a new entrant would only factor in future AIP fees into its bid to the extent that PSB licence holders and non-PSB licence holders would face different costs as a result of the introduction of AIP (and the entrant was able to quantify that difference). If the new entrant expected that in future both PSB and non-PSB licence holders were likely to face the same level of costs associated with AIP, then we do not consider that it would include any costs associated with AIP in its bid. This is because the introduction of AIP would not give rise to any material incremental cost or benefit associated with holding a

[2] http://www.ofcom.org.uk/files/2012/03/Annual_Plan_2012-13.pdf, paragraph 4.23

Channel 3 or Channel 5 licence, i.e. the level of costs associated with AIP would be effectively the same for holders of PSB licences and non-PSB licences.

Q6: 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? Please provide any relevant data or analysis that could assist Ofcom.

Setting financial terms

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

3.56 In terms of setting the PQR, Ofcom defines qualifying revenue in its 2004 document "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"[16]. It says "*the service provided on both analogue and digital terrestrial will constitute the licensed service and revenues from provision of the service on both platforms will comprise qualifying revenue. Revenue from the provision of a service on cable and satellite will continue to fall outside the definition of qualifying revenue*".[17] Following completion of digital switchover there are no revenues associated with analogue so any PQR determined by Ofcom will apply to revenues associated with DTT only.

3.57 In terms of the relative sizes of the PQR payments and cash sum, Ofcom said in the 2005 Determination that it "*considered that the PQR should be calculated to recover as close to 95% of the value of the licence as possible, without exceeding this proportion whilst being consistent with setting the PQR as an integer" and "the level of the cash bid was then set to recover the balance of the value of the licence".*[18] Where our review indicates that a licence has significant value we consider that this remains a reasonable basis on which to set the PQR and cash bid. However, where our review indicates that a licence has a small value we may, for administrative convenience, recover the value of the licence solely through the cash bid, with the PQR being set to zero.

3.58 As with the 2005 and 2010 Determinations, if our review indicates that a hypothetical new entrant would not be prepared to make payments as well as deliver PSB programming in return for the rights attached to the licences, we would conclude that the incumbent licence holders could retain their licences in a hypothetical auction for a nominal amount.

Discount rate

3.59 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 television 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 television company.

[16] http://stakeholders.ofcom.org.uk/binaries/broadcast/other-codes/qualifying_revenue.pdf
[17] At paragraph 1.10.
[18] 2005 Determination, paragraph 2.12.

3.60 Ofcom has calculated a real, pre-tax rate of 9.2%, which is meant to reflect the weighted average cost of capital (WACC) of a hypothetical entrant. The calculation is largely based on data and estimates relating to the existing licensees.

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

Q7: Do you agree that a real, pre-tax discount rate of 9.2% is appropriate? If not, then please set out what other considerations Ofcom should have in determining the discount rate.

Cut-off date

3.62 As in the 2005 and 2010 reviews, Ofcom considers that it is necessary for it to be able to take into account any information relevant to deciding the revised licence payments that is or becomes available up to the date of determination.

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 2 May 2013**.

A1.2 Ofcom strongly prefers to receive responses using the online web form at http://stakeholders.ofcom.org.uk/consultations/c3-c5-finance/howtorespond/form , 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 andy.causby@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.

A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.

Andy Causby
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 7981 3333

A1.5 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.

A1.6 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

A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Andy Causby on 020 7981 4155.

Confidentiality

A1.8 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.

A1.9 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.

A1.10 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

A1.11 Following the end of the consultation period, Ofcom intends to publish a statement on its methodology in June 2013.

A1.12 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

A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.

A1.14 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.

A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Graham Howell, Secretary to the Corporation, who is Ofcom's consultation champion:

Graham Howell
Ofcom
Riverside House
2a Southwark Bridge Road
London SE1 9HA

Tel: 020 7981 3601

Email Graham.Howell@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 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: Methodology for determining the financial terms for the Channel 3 and Channel 5 licences

To (Ofcom contact): Andy Causby

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

Q1. Do you agree that the overall valuation methodology remains appropriate for the determination of the PQR and cash bid element of the renewed licences? If you do not, please explain why you view that methodology as inappropriate and what justifications exist for suggested alternatives.

Q2: Are there any other rights, obligations or regulations associated with the Channel 3 and Channel 5 licences that we should consider, or any other factors that may affect the valuation? If so, please explain how we should take them into account and provide any relevant data or analysis to support your suggestion.

Q3: Do you agree with Ofcom's proposed approach to valuing the rights associated with the Channel 3 and Channel 5 licences as outlined above? If not, please explain why and what alternative approaches would be available (providing any relevant data to support your alternative view). In particular, how should we value the right to appropriate EPG prominence to a new entrant (please provide relevant data to support your response)?

Q4: Do you agree with this approach to assessing the opportunity cost associated with PSB programming obligations? If not, please explain why and what alternative approaches would be available (providing any relevant data to support your alternative view).

Q5: Do you agree that we should take into account the extra restrictions on advertising that apply to PSB licence holders alongside the right to appropriate EPG prominence? If not, what alternative approaches are available? What data or evidence exists to indicate the effect on advertising impacts or revenue of the advertising minutage restrictions on the Channel 3 or Channel 5 licences?

Q6: 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? Please provide any relevant data or analysis that could assist Ofcom.

Q7: Do you agree that a real, pre-tax discount rate of 9.2% is appropriate? If not, then please set out what other considerations Ofcom should have 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 television 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 television company.

A5.2 Ofcom has previously considered calculating discount rates on a licence-by-licence basis. However, consistent with the approach taken in the 2005 Review and the 2010 Review, we consider that to the extent that there are material differences between licences that may impact the discount rate (e.g. smaller 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 real, pre-tax rate of 9.2%, which is meant to reflect the weighted average cost of capital (WACC) of a hypothetical entrant. The calculation is based on data and estimates relating to the existing licensees.

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 Capital Asset Pricing Model (CAPM) measures market risk via a single beta coefficient measured relative to a market portfolio. In addition, there are other models, for example, 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 all 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. The most relevant data available to Ofcom to support its calculations relates to some of the existing licensees: ITV, STV and UTV.

A5.9 Data is unavailable on a licence-by-licence basis. Any adjustments made to this data to reflect licence-by-licence variations would be highly subjective. Ofcom has therefore based its analysis on country-wide indicators, erring on the side of conservative (i.e. high) estimates where appropriate in order to reflect any regional or national variations.

Risk free rate

A5.10 Ofcom proposes to use a 4.3% nominal risk free rate (1.3% real). This is based on estimates of yields on nominal gilts and forward interest rates as a proxy for the real risk free rate.

A5.11 We estimated a real risk free rate of 1.4% in the WBA charge control statement in July 2011[19]. We updated our analysis of the risk free rate estimates in December 2012. This is shown in the table below.

Table A5.1 Average yields on five and ten year gilts (real terms)

Average period	Ten year gilts (%)	Five year gilts (%)
6 December 2012	-0.7	-1.4
1 month	-0.6	-1.4
3 months	-0.6	-1.4
1 year	-0.2	-1.0
3 years	0.1	-0.7
5 years	0.6	0.2
10 years	1.2	1.0

Source: Ofcom based on Bank of England on 6 December 2012

A5.12 The average yields on both five and ten year gilts have continued to fall, however we believe that a degree of caution is required when interpreting the current data, this is because of the high level of uncertainty which has persisted. In addition, the effects of quantitative easing and a flight to safety still remain.

A5.13 Although we note that estimates of the real risk free rate have continued to fall, we have also considered the implications of this for the equity risk premium (ERP). If we believe that the risk free rate has fallen because equities have become more risky or because investors are becoming more risk averse, then we would expect an increase in the ERP to reflect this.

A5.14 We consider that there is a relationship between the risk free rate and the ERP. Therefore, we are reluctant to make a significant change in the risk-free rate without

[19] See paragraph 6.50 of the WBA charge control statement: http://stakeholders.ofcom.org.uk/binaries/consultations/823069/statement/statement.pdf

considering an increase in the ERP, something which is not supported by current evidence.

A5.15 We have therefore reduced our estimate of the risk free rate from 1.4% to 1.3% to reflect the continued downward trend in estimates of the risk free rate.

A5.16 For the purposes of calculating a real WACC, we have assumed an inflation rate of 3%, which is in line with the Treasury's medium term RPI forecasts.[20] The inflation assumption in the cash flow modelling to assess the value of each licence should be consistent with this figure.

Equity risk premium

A5.17 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 proposes to use a value of 5% for this calculation.

A5.18 This reflects recent work by Professors Dimson, Marsh and Staunton (DMS) from the London Business School, which tracks the average premium that investors have earned from equities (as opposed to bonds or gilts) over time.[21] The latest historical ERP evidence reported by DMS, in the 2012 sourcebook, showed that the historic premium of equities over bonds for the UK was 5%. In addition, in the 2012 report, DMS suggested a long-run arithmetic mean premium for the world index of around 4.5%-5%.

Equity beta

A5.19 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*[22]*.*

A5.20 A number of beta estimates are shown below based on unadjusted two year daily rates[23] against the FTSE All share index.

Table A5.2: Equity betas for television broadcasters

	Dec-10	Jun-11	Dec-11	Jun-12	Dec-12
ITV	1.27	1.34	1.33	1.35	1.40
STV	0.45	0.70	0.51	0.33	0.24
UTV	0.69	0.40	0.49	0.48	0.46
BSkyB	0.62	0.52	0.61	0.50	0.59

A5.21 At this stage we are inclined to give most weight to ITV's equity beta, which has been in a range of 1.27-1.40 in the last 2 years. This is because ITV's shares are relatively liquid and provide a reasonably robust beta estimate, whereas those of UTV and STV are more thinly traded, and therefore may be an unreliable estimator of those companies' equity betas. We also consider that, as a free to air

[20] http://www.hm-treasury.gov.uk/d/201211forcomp.pdf, page 18.
[21] Dimson, Marsh and Staunton "Credit Suisse Global Investment Returns Sourcebook 2011" Credit Suisse Research Institute. See paragraph 6.79-6.96 WBA Statement.
[22] http://www.ofcom.org.uk/telecoms/ioi/g_a_regime/sce/ori/beta/
[23] Estimates are taken at the end of the month.

broadcaster, the equity beta of ITV is more relevant to the Channel 3 and 5 licences for which we are required to determine financial terms than the BSKyB equity beta.

A5.22 We propose to adopt a point estimate of 1.40 from the above range, giving more weight to the most recent observation of ITV's equity beta. We welcome stakeholders' comments on our approach in this area.

Optimal gearing

A5.23 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.

A5.24 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).

A5.25 We would expect investors in a Channel 3 or 5 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.

A5.26 In the 2010 Review, we used an optimal gearing level of 30%. This was estimated 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. This was not dissimilar to ITV's average gearing over the 2 years to June 2009.

A5.27 More recent estimates of ITV's gearing show that it has fallen substantially. However, for the reasons set out in the 2010 Review, we propose to continue to use an optimal gearing level of 30% to calculate the WACC for a hypothetical operator, however we would welcome stakeholder comments on this.

A5.28 Our estimates of ITV's recent gearing levels are show below:

Table A5.3: ITV's recent gearing levels

	Dec 2011	Dec 2010	Dec 2009	Simple average
Net debt £m	120	418	858	
Market cap	2,650	2,724	2,036	
Gearing	4.3%	13.3%	29.6%	15.8%

Debt premium

A5.29 The cost of corporate debt is made up of a risk free component and a company specific risk premium. ITV's recently issued debt maturing in 2017 has traded at around 3.5%-4.5% above equivalent government gilts over the past 6 months, while the same figure for Sky's 2017 debt is around 1.5-1.75%.

A5.30 For the purposes of a hypothetical new entrant, Ofcom is minded to use a debt premium figure of 4%, the mid-point of ITV's recently issued debt. This is because we consider that, as a free to air broadcaster, the debt premium of ITV is more relevant to the Channel 3 and 5 licences for which we are required to determine financial terms.

Conclusion

A5.31 Ofcom has estimated a single discount rate to be used in the licence valuations, being a real pre tax WACC of 9.2%. A summary of the components of the WACC calculation follows:

Table A5.4: WACC calculation

Variable	Consulation estimate
Nominal risk free rate	4.3%
Equity risk premium	5.0%
Equity beta	1.40
Cost of equity (nominal, post tax)	11.3%
Debt premium	4.0%
Cost of debt (nominal, pre tax)	8.3%
Corporate tax rate	21.0%
Cost of debt (nominal, post tax)	6.6%
Gearing	30.0%
WACC (nominal, post tax)	9.8%
WACC (nominal, pre tax)	12.5%
WACC (real, pre tax)	9.2%