Renewal of the Channel 3 and Channel 5 licences

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

Statement

19 September 2023

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Section

1. Overview

1.1 This document forms part of the process to renew the Channel 3 and Channel 5 public service broadcasting ("PSB") licences,[1] 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 document sets out the methodology we will use to determine the financial terms for the Channel 3 and Channel 5 licences over the next ten-year licence period, which runs from 1 January 2025 to 31 December 2034.

What we have decided in brief

- Subject to a small number of changes to take account of comments received from stakeholders in response to the methodology consultation ("Consultation"), the methodology we have adopted to determine the financial terms is consistent with that used for our determination when we last renewed the Channel 3 and Channel 5 licences in 2014.
- The methodology will allow us to set financial terms that are fair and reasonable within the context of the current market environment and will continue to be reasonable for the next licence period.
- This means taking account of reasonably foreseeable changes in the market and regulatory environment that could impact the financial terms for each licence. This includes uncertainties such as proposed changes to the legal framework for PSB, currently set out in the draft Media Bill.
- Our methodology also reflects Ofcom's decision on the rules in the Code on the Scheduling of Television Advertising ("COSTA") that apply to public service broadcasters.

The Channel 3 and Channel 5 relicensing process

1.2 The UK has two commercially owned public service television channels, known as Channel 3 and Channel 5. These channels are an important part of the PSB ecology, alongside the BBC, Channel 4 and S4C. Each broadcaster plays a unique role in ensuring that the system has something for everyone, so that together they can meet the needs and interests of different audiences right across the UK.

1.3 The Channel 3 licences are held by subsidiaries of ITV and STV,[2] and the Channel 5 licence is held by Channel 5 Broadcasting Limited (a subsidiary of Paramount Global). As public service broadcasters, they must meet the public service remit by providing high quality and diverse programming. The Channel 3 and Channel 5 licences include specific obligations relating to programming and production quotas. The Channel 3 and Channel 5 licensees are also required to comply with stricter rules on the quantity and scheduling of television

[1] There are 15 national and regional Channel 3 licences and one UK-wide breakfast licence. There is one Channel 5 licence which covers the entirety of the UK.
[2] STV plc ("STV") provides Channel 3 in Central and Northern Scotland, while ITV plc ("ITV") provides Channel 3 in England, Wales, Northern Ireland, Southern Scotland, and the Channel Islands, alongside the UK-wide breakfast service, GMTV.

advertising.[3] In return, the licence holders receive benefits including prominence within electronic programme guides ("EPGs") and privileged access to digital terrestrial television ("DTT").

1.4 The current licensees have the right to apply to Ofcom to renew their licences for the next ten-year licence period. As part of the relicensing process, on 29 June 2022 Ofcom provided the Secretary of State ("SoS") with a report ("2022 Report") in accordance with section 229 of the Communications Act 2003 (the "2003 Act"), in anticipation of a new licensing round for the Channel 3 and Channel 5 services. This set out our opinion on the ability of the licensees to contribute to the fulfilment of the purposes of PSB, at a commercially sustainable cost, over the next ten-year licence period.

1.5 In the 2022 Report we said that overall, the current PSB obligations could be commercially sustainable and that the Channel 3 and Channel 5 licensees could continue to deliver the PSB obligations over the next ten years. However, we recognised that sustainability of the licences may come under more pressure over the course of the next licence period as broadcasters continue to implement digital first strategies and linear viewing and advertising revenue move to other platforms. We highlighted that the licensees' sustainability should be strengthened by the Government's proposed reforms (which were published in its white paper, Up Next and subsequently incorporated in the draft Media Bill in March 2023) to establish new prominence and availability regulation for public service media[4] online services. We remain of the view that regulatory change to move to a modernised PSM system, such as the proposed reforms in the Media Bill, should help mitigate the decline in the value of existing licence benefits. Regulatory reform will be key to broadcasters being able to build on their current successes, and to ensuring the commercial sustainability of the obligations in the Channel 3 and Channel 5 licences over the next licensing period and thereby protecting the benefits to audiences that those obligations deliver.

1.6 Following the submission of our 2022 Report, the SoS confirmed 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.

1.7 The current Channel 3 and Channel 5 licence holders have now submitted their applications for licence renewal. On this basis, we are continuing with the renewal process.

Setting the financial terms

1.8 Before we can renew a licence, we must first determine the financial terms on which the licence will be renewed. Our objective is 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.

1.9 We received five responses to our Consultation on our methodology.[5] In setting out our final methodology we explain how we have taken stakeholders' views into account.

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[3] Ofcom, 28 April 2022, Code on the Scheduling of Television Advertising.

[4] In our 2020 document, Small Screen: Big Debate, the Future of Public Service Media, we said that a new Public Service Media ("PSM") framework is required to deliver the objectives of public service in an increasingly online world. Such a framework must be based on a broader concept, which recognises, supports and encourages the delivery of PSM across a range of broadcast and online services, see section 2.

[5] We received responses from each of the licensees, ITV, STV and Paramount Global as well as from Sky and News Broadcasting.

Next steps

1.10 We will seek data and information from current licensees that will allow us to apply this methodology and determine financial terms. This will include licensees' views on the value a new entrant would place on the licences, following the methodology set out in this document. Once this information has been received, we will review it and where necessary, seek further evidence to arrive at what we consider to be a fair and reasonable determination of financial terms for the next licence period.

1.11 We must notify the licensees of our determination in accordance with the 2003 Act and if they accept the terms, we must subsequently issue the renewed licence as soon as reasonably practicable.

1.12 We will aim to determine the financial terms in early 2024.

2. Approach to the review

2.1 In this section we explain Ofcom's statutory obligation to determine the financial terms of the Channel 3 and Channel 5 licences.

Ofcom's statutory task

2.2 Section 217 of the 2003 Act 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;[6] and

ii) **The percentage of qualifying revenue ("PQR")** payable for each year of the licence.[7] The PQR can vary from year to year.

2.3 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.[8] 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.

2.4 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.

2.5 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 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.

[6] The cash bid increases by the RPI each year under section 19 of the 1990 Act.
[7] 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.
[8] Section 217(2) of the 2003 Act. The competitive tender would be carried out in accordance with section 15 of the 1990 Act.

3. Methodology

3.1 In this section we set out the methodology we will use to determine financial terms and explain how we will take account of uncertainties around the Media Bill and our latest decision on the rules in COSTA. We also summarise and respond to stakeholder comments in response to our Consultation in the areas we received them.[9] The licensees broadly agreed with our approach for setting the methodology.

Valuation methodology

3.2 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.

3.3 In our Consultation we proposed to use a methodology consistent with that set out in our 2013 statement ("2013 methodology statement"),[10] which informed our determination of financial terms in 2014.

3.4 In response to our Consultation, ITV, STV and Paramount Global agreed with our proposal to use a methodology consistent with previous reviews.[11] However, Sky considered our current approach was "not fit for purpose" and suggested we conduct a 'bottom-up' review of our methodology to determine the value an incumbent licence holder would bid in a competitive tender to secure the licence.[12]

3.5 In preparing the Consultation we reconsidered what methodology would be appropriate to enable us to set the financial terms for the next 10-year licence period. We remain of the view that our statutory task today is comparable to previous reviews and therefore it is appropriate to adopt the same methodology, subject to a small number of changes, used to determine the financial terms in 2014. Where new developments could be relevant to our determination, such as the draft Media Bill, the methodology allows us to take these into account, as explained further below.

Circumstances of the hypothetical auction

3.6 The Consultation proposed that the hypothetical auction would 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.[13] We noted that the 2004 statement ("2004

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[9] We received consultation responses from ITV, News Broadcasting, Paramount Global, Sky and STV.
[10] Ofcom, 27 July 2013, 2013 methodology statement.
[11] Responses to Consultation: STV, p. 1; Paramount Global.
[12] Sky's response to Consultation, p. 2.
[13] See 2004 methodology statement paragraphs 3.4 to 3.13.

methodology statement") explained that the statutory framework makes it infeasible to assume there is a multiple contingent bid auction. 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.

3.7 Sky said that, while our 2004 methodology statement said the statutory framework makes it infeasible to assume there is a multiple contingent bid auction, it left open the possibility of taking account of the value of holding multiple Channel 3 licences over time.[14]

3.8 We agree that, although we will value each Channel 3 licence on a standalone basis, bidders could factor in the possibility of holding multiple licences during the licence period. We consider this could reduce the standalone costs a bidder would include in its valuation. In practice, how we take account of standalone costs is to assume some costs associated with holding the licences, such as regulatory oversight costs, may need to be incurred by each licensee. Where a bidder assumes it could hold multiple licences over the course of the licence period, these standalone costs would reduce over time, and we will reflect this possibility in our valuation.

3.9 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 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

3.10 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).

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 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.

3.12 ITV agreed with our proposal that the alternative bidders for the Channel 3 licences are likely to be other broadcasters.[15]

3.13 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.

[14] Sky's response to Consultation, p. 3.
[15] ITV's response to Consultation, p. 1.

Counterfactual for Channel 5

3.14 The Channel 5 licence requires that the service is made available for broadcast on the DTT platform, satellite and cable platforms.[16] For the Channel 5 licence, we consider the next best alternative to operating with the licence would be to operate a national non-PSB channel on these platforms.

Counterfactual for Channel 3

3.15 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, in our Consultation we proposed that, for the purposes of assessing the benefits and costs associated with each Channel 3 licence, a bidder would consider the next best alternative to be that of operating a non-PSB service on these platforms in each licence area. We noted that in our 2013 methodology statement we also discussed alternative counterfactuals of operating a national commercial channel and for the new entrant not to operate any channel.[17]

3.16 Sky disagreed with our Channel 3 counterfactual and said that counterfactuals comprising either a national non-PSB channel or an 'all or nothing' approach (which we assume means the counterfactual is for the new entrant to do nothing) had greater credibility and were more likely to give a realistic valuation of the licences.[18] Sky also said that our licence valuation "must reflect the value of the Channel 3 licences as a single branded channel".

3.17 We recognise that determining the next best alternative for individual Channel 3 licences is not straightforward. However, given that Channel 3 licences are regional and we are valuing each licence on a standalone basis, we consider our proposed approach of assuming a hypothetical bidder would operate an equivalent non-PSB channel if its bid was not successful 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 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.

3.18 However, we will generally quantify costs and benefits at a more aggregate level and apportion this amount to individual Channel 3 licences, i.e. compare the additional costs and benefits from operating Channel 3 overall to a counterfactual of a national non-PSB service. For example, when estimating the value of the right to reserved DTT capacity and appropriate electronic programme guide ("EPG") prominence for each individual Channel 3 licence, we will first estimate the value of these rights to Channel 3 as a whole and apportion this total value to individual licences on an appropriate basis.[19] Similarly, when considering the additional cost of obligations such as regional news, we will compare the cost of regional news to the cost of alternative non-PSB programming (where the regional cost of alternative non-PSB programming represents a share of the national non-PSB cost). In practice therefore, our approach does reflect the value of the rights and obligations associated with the Channel 3 licences as a single branded channel.

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

[17] Footnote 10 of our Consultation refers to paragraphs 3.13 to 3.14 of our 2013 methodology statement where these counterfactuals were discussed.

[18] Sky response to Consultation, p. 2.

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

3.19 We do not consider that assuming the entrant would not operate any channel without the Channel 3 licence would represent the value a hypothetical bidder would place on each licence. In this scenario the benefit of holding the Channel 3 licence would effectively be equal to the entire profit generated from providing a regional service, as all profits would be incremental relative to the counterfactual of not operating any licence. We consider this would overestimate the additional profits that could be made from holding the licence, as some of those profits could be made without the licence – i.e. by operating a commercial alternative.

Valuing the costs and benefits of the licences

3.20 Under the counterfactuals listed above, 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.

3.21 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.

3.22 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.

3.23 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 draft Media Bill, as discussed in paragraphs 3.93 – 3.99), this uncertainty will be reflected in the valuation.

The rights and obligations associated with the licences

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

3.25 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.

3.26 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	✓[20]	✓
25% (of qualifying hours) allocated to independent productions	✓	✓
Subtitling, audio description ("AD"), and signing[21]	✓	✓
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	✓	✓

Valuing the rights associated with the licences

General Approach

3.27 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.

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

3.28 We will take account of the rights included in Table 1, as explained below, but if there is evidence of other incremental benefits of holding the 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

3.29 Channel 3 and Channel 5 licences carry with them the right to an appropriate degree of prominence on regulated EPGs.[22] 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.[23]

3.30 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.[24]

3.31 News Broadcasting considered that our decision to define linear prominence by slot position had made this right potentially more valuable since the last licence renewal.[25]

3.32 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.[26] 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.

3.33 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), broadcaster video-on-demand (BVOD) and other online services (for example, YouTube). We will reflect this in our licence valuation.

3.34 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[27] and the 2013 report by FEH Media Insight;[28]

[22] Section 310 of the 2003 Act.
[23] Ofcom, 4 July 2019, Review of prominence for public service broadcasting.
[24] Ofcom, 23 July 2013, 2013 methodology statement. Paragraphs 3.50 to 3.58 discusses the right to appropriate prominence.
[25] News Broadcasting response to Consultation, p 2.
[26] 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.
[27] Expert Media Partners, July 2018, Report on the UK Market in EPG Positions.
[28] FEH Media Insight, 29 April 2013, An analysis of the audience impact of page one EPG prominence.

- Approaches we have taken in previous work on valuing EPG movements, including our 2022 Report and competition assessments;[29] and
- Information by licensees as part of this renewal process.

3.35 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).[30]

Reserved capacity on DTT – Channel 3

3.36 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.

3.37 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.

3.38 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.

3.39 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, we proposed in our Consultation that this would provide a reference point for the valuation.

3.40 ITV said [✂].[31]

3.41 [✂] We will factor in a lower fee for carriage on Multiplex 2 where supported by evidence, e.g. evidence of reductions in commercial carriage fees since the agreement with Channel 5 was made, or internal forecasts of future fees from Channel 5 for carriage on Multiplex 2.

3.42 We will therefore base our estimate of the value of this benefit across Channel 3 as a whole as follows (apportioning the value to individual licensees as appropriate):

- the value of reserved capacity on Multiplex 2, proxied by the price paid by Channel 5 (adjusted [✂], as appropriate), multiplied by the number of streams on Multiplex 2 available to a new Channel 3 entrant,
- less the Channel 3 entrant's share of Multiplex 2 running costs.

3.43 In addition to the price of carriage on Multiplex 2, we recognise that 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.

3.44 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

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[29] For example, our November 2021 BBC Three television channel competition assessment and Review of rules for prominence of BBC Three.
[30] 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.
[31] ITV's response to Consultation, p. 1.

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.

3.45 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.

3.46 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

3.47 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%).

3.48 The Channel 5 licence holder also has reserved capacity on Multiplex A.[32] Multiplex A is a commercial multiplex and has lower coverage than a PSB multiplex.

3.49 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.

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

3.51 As per 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

3.52 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

[32] 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.

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.

3.53 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.[33]

3.54 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.

Valuing the costs and obligations associated with the licences

General approach

3.55 The valuation of a 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.

3.56 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

3.57 Each PSB programming obligation will be considered separately. Consistent with the 2013 methodology statement, the opportunity cost calculation will include the increased cost and where evidence is available, the reduced advertising revenue, associated with meeting the PSB programming obligation, compared to the costs and revenues of a commercial schedule in those programming slots.

3.58 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.

3.59 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

[33] 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.

would incur by operating a commercial schedule in those same programming slots. Not every PSB obligation will necessarily have an opportunity cost.

3.60 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

3.61 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

3.62 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.[34]

3.63 In April 2023 we consulted on proposed changes to COSTA[35]. We have now published our decision not to remove the stricter advertising minutage rules that apply only to PSB channels. As a result, we do not intend to change our approach to valuing the opportunity cost of complying with COSTA and our approach will be consistent with the 2013 methodology document. We consider the broader impact of this decision on the methodology in paragraphs 3.100 – 3.101 when we discuss uncertainties facing the new entrant.

3.64 It is possible that COSTA 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.[36] 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.

3.65 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.[37]

Code of Practice for commissioning from independent producers

3.66 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 have

[34] 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.
[35] Ofcom, 19 April 2023, Quantity and scheduling of television advertising on public service channels.
[36] See for example paragraphs A2.118 to A2.122 of our 2022 Report.
[37] Ofcom, 23 July 2023, 2013 methodology statement, paragraph 3.79.

been approved by Ofcom.[38] In the 2013 methodology statement, we did not consider that this requirement was likely to represent a significant additional cost.[39] 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.

3.67 In our Consultation we said we did not intend to include a cost associated with the requirement to have in place Codes of Practice for commissioning from independent producers.

3.68 ITV disagreed that there are no costs associated with this obligation. It argued that [✂] and that non-PSBs do not apply such terms.[40]

3.69 The obligation associated with the Channel 3 and Channel 5 licences is to publish a Code of Practice that secure the seven statutory objectives and which we have approved by reference to our guidance.[41] As explained in the 2022 Report, we do not consider that this obligation imposes a significant cost.[42] While a requirement to publish a Code of Practice could reduce the flexibility a Channel 3 or Channel 5 licensee has when negotiating commissions (as the starting point for negotiations would be publicly available), it is not clear this would impose a significant cost as the current Codes of Practice, which may be similar to those a new entrant would have, are high level and do not preclude specific outcomes or deals being made. In our 2022 Report we highlighted that licensees can propose changes to Codes of Practice for our approval, so even where the obligation did impose material costs, these could be addressed or mitigated by licensees proposing suitable changes to their Codes of Practice.

3.70 In addition, as explained in the 2013 methodology statement, we would expect the outcome of negotiations with producers to reflect the conditions in which those negotiations are made. If, due to the Code of Practice, a PSB broadcaster has less flexibility in negotiating than a non-PSB alternative and it felt that this represented an additional cost, we would expect this cost to be reflected in the agreed contract (for example via a lower price, or in other contractual conditions).

3.71 For these reasons, we do not intend to include a cost associated with this obligation in our valuation. 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

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

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[38] 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.

[39] Ofcom, 23 July 2013, 2013 methodology statement, paragraph 3.84.

[40] ITV's response to Consultation, p. 1-2.

[41] Ofcom, 2007, Guidance for Public service Broadcasters in drawing up Codes of Practice for commissioning from independent producers.

[42] See paragraphs A2.34 to A2.57 of the 2022 Report.

- **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.[43] 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.[44] As stated above, we consider bidders could factor in the possibility of holding multiple licences during the licence period which would reduce the standalone costs a bidder would factor into its valuation. We will reflect this possibility in our valuation.

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

Start-up costs

3.74 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 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

3.75 In the Consultation we said that valuing Channel 3 and Channel 5 licences over a ten-year licence period is complex as it 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);

[43] Section 185 of the 1990 Act.

[44] 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.

- 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 regulation which could affect rights and obligations associated with Channel 3 and Channel 5 licences (such as the enactment of the Media Bill and any changes we may make to COSTA following a further review).

3.76 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.

3.77 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.

3.78 In the Consultation we said that 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.

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

3.80 ITV, STV and Paramount Global agreed that our approach to dealing with legal and regulatory uncertainties was sensible.[45] Sky also supported our proposal to look at alternative sources of evidence for the purposes of the licence valuations.[46]

3.81 Therefore, we will adopt this approach in our determination. In the section below we explain our approach to dealing with the specific uncertainties identified above.

Future trends in the proportion of viewing on different platforms

3.82 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).

[45] Responses to Consultation: ITV, p. 2; STV, p.1; and Paramount Global.
[46] Sky's response to Consultation, p. 5.

3.83 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

3.84 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.

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

3.86 We will use licensees' 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

3.87 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.

3.88 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 Establishment Surveys before coming to an overall view.

The duration of DTT multiplex licences

3.89 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.[47]

3.90 In our Consultation we considered that a hypothetical new entrant would place a relatively low weight on the possibility of revocation as we have not indicated that it is likely.

3.91 ITV said [✂].[48] ITV added [✂]. [49]

3.92 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

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[47] As set out in the Television Services (Renewal of Multiplex Licences) Order 2021.
[48] ITV's response to Consultation, p. 2.
[49] ITV's response to Consultation, p. 2.

licence period and therefore we may need to reflect this uncertainty in the valuation. 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. We also recognise that the benefit of the right associated with reserved DTT capacity could fall over time as DTT viewing reduces. Our valuation will be informed by submissions from licensees and other sources of evidence, where available, as set out above.

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

Media Bill

3.93 On 29 March 2023, the Government published a draft Media Bill which proposes changes to the legal framework for broadcasting. The draft simplifies the public service 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. The public service broadcasters could ask Ofcom to designate their online services. This could potentially include ITVX, STV player, My5, Channel 4, and S4C Clic.[50] If Ofcom determines these services meet the designation criteria, the public service broadcasters 'must offer' these services to the connected TV platforms that fall in scope of the Bill provisions. As a corollary, these platforms 'must carry' and give appropriate prominence to the public service broadcasters' services. These requirements are subject to both parties agreeing terms. Under the draft Bill, Ofcom is also 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.

3.94 In the Consultation we said that 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.[51] Sky agreed that the Media Bill could provide licence holders with several significant benefits.

[50] As a UK Public Service, the BBC's internet programme service (BBC iPlayer) would be automatically designated under the draft Bill.

[51] 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.

3.95 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. At this point in time, there remains some uncertainty on the timing of the Media Bill's introduction to parliament and how long it could take to pass through parliamentary scrutiny.

3.96 In the Consultation we proposed a new entrant would be cautious when ascribing value to the benefits and obligations that may arise from the Media Bill for two reasons. First, 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.[52] Second, the new entrant would be uncertain at what point in the licence period the benefit would start.

3.97 Sky said that a new entrant was unlikely to be cautious when ascribing a value to new benefits and obligations introduced by the Media Bill.[53] It also considers that the Government's publication of a draft Bill and the SoS' letter on licence renewal suggests a level of certainty in the benefits which will arise during the next licence period.

3.98 Whilst we agree that a new entrant would not completely disregard the potential new benefits and obligations proposed by the Media Bill, we continue to consider that a new entrant would be cautious when ascribing value to these for the reasons given above.

3.99 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.[54]
- Reports commissioned by Ofcom or other parties.

COSTA rules

3.100 In our decision published today, we have said that we will review our position on COSTA as part of our consideration of other changes to move to a PSM system over the coming few years, such as those flowing from the implementation of the Media Bill.[55]

3.101 While there is a possibility that the rules could change at some point during the next licence period, we consider a new entrant would place a low weight on this possibility for the purpose of licence valuation given we do not know what the outcome of our review would be or when any changes would come into effect.

[52] Ofcom, 29 June 2022, 2022 Report, paragraph 4.39.
[53] Sky's response to Consultation, p. 3.
[54] For example, ITV included some indicative estimates from Mediatique in its submission informing our 2022 Report. See, for example, paragraphs 4.37 to 4.41 of that report.
[55] Ofcom, 19 September 2023. COSTA statement, overview and paragraph 3.3.

Discount rate

3.102 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.

3.103 In the Consultation we proposed to use a pre-tax nominal discount rate of 12.8%. Based on more recent data, we have revised this to 12.5%, as set out in Annex 1.

3.104 As per the Consultation, 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

3.105 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

3.106 We will calculate financial terms which allow for the recovery of the combined NPV of the rights and obligations associated with the licence. 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.

3.107 In terms of setting the PQR, we will use the definition of qualifying revenue set out in our 2004 statement of principles document.[56] In that document, revenues from the provision of the service on DTT constitute qualifying revenue. Revenue from the provision of the service on cable and satellite fall outside the definition of qualifying revenue. Therefore, any PQR we determine will apply to revenues apportioned to DTT only.

3.108 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.

3.109 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.[57]

3.110 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

[56] 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.

[57] 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.

through the cash bid, with the PQR set to zero. This would also give licensees certainty about future payments.

3.111 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).

3.112 ITV said we should review whether £10,000 represents a nominal fee given the significant annual cost this fee represents across multiple licences and the "unattractive nature of the licences in their current form to any new entrant".[58] STV suggested we set the financial terms at a nominal level as the cost of providing the PSB obligations for the STV licences is higher than the value of the benefits during the next licence period.[59] Sky and News Broadcasting were concerned that the fees will be set at a nominal level.[60]

3.113 Where we conclude a nominal cash bid is appropriate because a hypothetical new entrant would not be prepared to bid on the licences, we have previously based the cash bid on the outcome of franchise auctions in the 1990s where there were no competing bids. In the 1991 franchise auctions, three Channel 3 incumbent licensees won the auction uncontested, with winning cash bids of £2,000 (two licences) and £52,000.[61] This indicated that a cash bid in an uncontested auction could be in the low thousands, which we have previously assumed to be £10,000. As well as previously setting the nominal cash bid for Channel 3 and Channel 5 licences at £10,000 we have also used this as the nominal cash bid in other licence renewals such as the renewal of the Independent National Radio licences.[62]

3.114 In 2022, Ofcom auctioned the additional service radio licence and the incumbent, Inrix won the auction uncontested with a cash bid of £1,000. This provides another reference point when considering the magnitude of a nominal cash.

3.115 To the extent we need to determine a nominal cash bid, we will continue to place weight on the outcome of actual licence auctions and the cash bids of incumbent licensees that retained their licences uncontested.

3.116 News Broadcasting was also concerned about the impact on competition in the broadcasting sector if the cost of the licence is set too low, (i.e. setting PQR at 0%, and £10k nominal fee).[63] It also did not consider the obligations associated with the licences would prevent licensees from running a viable business given the value of rights associated with the licences.

3.117 While Channel 3 and Channel 5 licensees could have an unfair advantage if the value of benefits associated with holding the licences was significantly greater than the cost of PSB obligations, the licence renewal process safeguards against this risk. There are two elements to the licence renewal process that consider the balance of the rights and obligations of the licences. The first is the 2022 Report which considers the commercial sustainability of the Channel 3 and Channel 5 licences to the existing licensees, by reference to the rights and

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[58] ITV's response to Consultation, p. 2.
[59] STV's response to Consultation, p.2.
[60] Responses to Consultation: Sky, p. 2; News Broadcasting, p.1.
[61] ITC Annual Report & Accounts, 1991, Page 12
[62] Renewal of the Independent National Radio licences – determination of financial terms, April 2021.
[63] News Broadcasting's response to Consultation, p.1.

obligations of the licences. If our assessment identified a significant difference between the value of rights and cost of obligations we could, in our report to the SoS, propose changes to some obligations, to help align the balance between the rights and obligations. Our 2022 Report did not consider this was necessary.

3.118 The second is the process of setting financial terms. To the extent the value of benefits exceeds the cost of obligations over the next licence period, setting financial terms can help ensure licensees do not unduly benefit. However, the statutory test for setting financial terms is to determine how much an incumbent would bid in a hypothetical auction to retain its licence. Our established methodology is that the incumbent's bid would be informed by how a hypothetical new entrant would balance the rights and obligations associated with the licence (which could differ from the value the incumbents place on the licences). Where a hypothetical new entrant would not be prepared to make financial payments as well as incur costs associated with PSB programming and other licence obligations in return for the benefits directly associated with the licences, it would not bid and the incumbent could retain its licence by making a nominal bid. The results from actual auctions have resulted in incumbents retaining their licences by making a nominal bid, so our methodology is consistent with such outcomes.

Outcomes of previous reviews

3.119 Table 2 below shows the outcomes of previous reviews of financial terms.

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.

3.120 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.

3.121 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.

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. In our Consultation we estimated a pre-tax nominal discount rate of 12.8% to reflect the weighted average cost of capital ("WACC") of a hypothetical entrant.

A1.2 We received no responses related to our estimate of a discount rate.

A1.3 In the Consultation we said we would consider whether it is appropriate to update our discount rate estimate for the statement. We have updated the following parameters for more recent data:

- Increased the risk-free rate ("RFR") from 0.1% to 0.9%;
- Increased the cost of debt from 5.6% to 6.3%; and
- Reduced the asset beta from 1.11 to 1.09.

A1.4 These changes result in an updated pre-tax nominal discount rate of 12.5%. We have estimated a nominal rate as we will ask licensees to prepare forecasts to inform our valuation in nominal terms.

Estimating discount rates

A1.5 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.

A1.6 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:

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

A1.7 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):

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

A1.8 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.

A1.9 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.

A1.10 We considered some of these economy-wide factors as part of the March 2021 Wholesale Fixed Telecoms Market Review ("WFMTR").[64] As per our Consultation, and consistent with a view that long-run market returns are relatively stable[65], we have adopted the same EMR of 6.7% (expressed in CPI-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%,[66] which is intended to reflect expected CPI inflation over the licence period.

A1.11 We have estimated the RFR using the yields on 10-year index-linked gilts, to match the duration of the next licence period.[67]

A1.12 We have estimated the RFR using a one-month average of these gilt yields.[68] 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 0.9%, consistent with the average yield on these gilts in August 2023.[69] 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.[70]

A1.13 We have used a corporate tax rate of 25%, consistent with current tax rates.[71]

A1.14 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

A1.15 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).[72]

A1.16 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

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[64] Ofcom, 18 March 2021, Promoting investment and competition in fibre networks – Wholesale Fixed Telecoms Market Review 2021-26 ("WFTMR"), Annex 20.
[65] Ofcom, 18 March 2021, WFTMR, Annex 20, paragraph A20.55.
[66] HM Treasury, 17 November 2022, Monetary Policy Remit: Autumn Statement 2022.
[67] 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).
[68] Bank Of England, Yield Curves. Archive yield curve data – Daily, as at 31 August 2023.
[69] In our Consultation we used a real (RPI-based) RFR of 0.1%, which was the average yield on these gilts in April 2023.
[70] We have used the OBR's data from its Economic and fiscal outlook (March 2023) and the average implied RPI-CPI wedge of between 0.9 percentage points and 1.2 percentage points in the first three years of the licence to assume a wedge of 1% to calculate RPI.
[71] 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.
[72] 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.

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

BSkyB.[73] 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).[74] Our gearing estimate was informed by ITV's gearing over time.

A1.17 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.

A1.18 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. These betas are calculated using data up to 31 August 2023, compared to data to 30 April 2023 in the Consultation.

Table A1: Beta and gearing estimates

	2-year			5-year		
	Equity beta	Asset beta	Gearing	Equity beta	Asset beta	Gearing
ITV	1.69	1.29	25%	1.39	1.09	23%
Paramount Global	1.29	0.66	53%	1.17	0.65	48%

Source: Ofcom analysis of data reported by S&P Capital IQ. Betas calculated using daily data as at 31 August 2023 against the FTSE All Share Index for ITV and the S&P 500 for Paramount Global. Gearing estimated using short and long term debt, including operating leases.

A1.19 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.[75] 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 1.09, equal to ITV's 5-year asset beta.[76]

A1.20 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.

A1.21 An asset beta of 1.09 is equivalent to an equity beta of 1.42 using our forward-looking gearing of 25%[77], which is slightly higher than the equity beta we used in the 2013 methodology statement.

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

[74] 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.

[75] 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.

[76] In our Consultation we used an asset beta of 1.11 which was ITV's 5-year asset beta as at 30 April 2023.

[77] Using the formula β equity = (β asset - β debt * g)/1-g gives (1.09 – 0.10*25%)/75% = 1.42.

Cost of debt

A1.22 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.

A1.23 In August 2023, yields on 10-year BBB-rated bonds ranged from 5.9% to 6.3% and averaged 6.1%.[78] 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.[79] On this basis, we consider 6.3% would be a reasonable estimate of the cost of debt of a hypothetical entrant considering bidding for the licence.[80]

Estimated WACC

A1.24 Applying the parameters discussed above, we have estimated a pre-tax nominal WACC of 12.5%. A summary of the WACC calculation and related assumptions is shown in Table A2 below.

[78] Source: Bloomberg.

[79] 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.

[80] In our Consultation we estimated a cost of debt of 5.6%, based on data from April 2023.

Table A2: WACC parameters

WACC component	Estimate	Source
Real (RPI-based) RFR	0.9%	Ofcom estimate based on index-linked gilt yields
RPI inflation forecast	3.0%	CPI + assumed RPI-CPI wedge of 1%
Nominal RFR	3.9%	= (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	4.9%	= Nominal EMR – Nominal RFR
Debt beta (β debt)	0.1	WFTMR
Asset beta (β asset)	1.09	Based on ITV's 5-year asset beta
Gearing (forward looking) (g)	25%	Ofcom estimate
Equity beta (β equity)	1.42	= (βa - βd*g)/(1-g)
Cost of equity (post-tax) (Ke)	10.9%	= Nominal RFR + Nominal ERP *βe
Cost of equity (pre-tax)	14.5%	= Ke / (1-t)
Corporate tax rate (t)	25%	HMRC
Cost of debt (pre-tax) (Kd)	6.3%	Ofcom estimate based on yields on BBB bonds
WACC (pre-tax nominal)	12.5%	=(Ke*(1-g))/(1-t)+(Kd*g)