

Office of the Adjudicator – Broadcast Transmission Services

Statement and guidance on Consultation 3/2009: Principles for the pricing of new Transmission Agreements

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2.0 Background

2.1 Context

On 11 March 2008, the Competition Commission (CC) announced its decision to allow the merger of transmission companies Arqiva and National Grid Wireless (NGW) subject to the agreement of a package of measures (undertakings) to protect the interests of their customers.

Arqiva and NGW overlap in the provision of Managed Transmission Services (MTS) and Network Access (NA) to transmitter sites and associated facilities for terrestrial television and radio broadcasters. In its final report, the CC found that Arqiva and NGW were the only active providers of MTS/NA to the UK television broadcasters. The companies were also the most significant providers of national MTS/NA to UK radio broadcasters with a combined market share of more than 85%. In both cases, prior to merger, the companies had exercised a competitive constraint on each other.

The CC concluded the merger of the two companies would lead to a “substantial lessening” of competition in broadcast transmission services. The CC found the loss of rivalry between Arqiva and NGW may lead to a worsening in the price and non-price factors on which the parties compete in the provision of MTS/NA to television and radio broadcasters.

After consultation by the CC with Arqiva, its customers and other stakeholders, the Commission accepted undertakings from Arqiva on 1 September 2008

[\[http://www.competition-commission.org.uk/inquiries/ref2007/macquarie/pdf/notice_undertakings.pdf\]](http://www.competition-commission.org.uk/inquiries/ref2007/macquarie/pdf/notice_undertakings.pdf).

The Undertakings are intended, amongst other things, to adequately protect existing and new customers over pricing and the terms and conditions of supply of Arqiva's services.

The Undertakings provide for the appointment of an Adjudicator to operate an adjudication scheme as set out in Appendices 1 and 2 of the Undertakings. One of the functions (described in Appendix 1 Para 8) is to issue guidance in relation to the application of specific provisions of the Undertakings.

This guidance relates to Para 8 (i) of Appendix 1 which sets out the function of the Adjudicator to issue guidance on the application of Paragraphs 9-12 of the Undertakings which relate to charges and Terms & Conditions for new Transmission Agreements and for Network Access under Para 13.6 of the Undertakings, the Adjudicator be called upon to resolve disputes arising between Arqiva and its customers in relation to these matters.

2.2 Objectives

Under paragraph 12(ii) of the Adjudication Scheme set out in the Undertakings, the Adjudicator must “*where relevant, take account of (but not be bound by) (a) Ofcom's statutory duties and (b) any relevant guidance or specific advice issued by Ofcom...*”

Ofcom issued its Guidance to the Adjudicator in January 2009. It noted that the Adjudicator has a general duty to achieve consistency with sectoral regulation and, in Section 4, identified three objectives for the Adjudicator:

- protection of customers,

- ensuring incentives for investment and innovation and
- providing incentives for efficiency.

A further objective that runs through the Undertakings is that of transparency e. g. Para 9.5 “*Arqiva shall secure and shall be able to demonstrate to the satisfaction of the Adjudicator that each customer or prospective Customer under Para 9.1 has been provided with sufficient transparency and information regarding the basis for the calculation by Arqiva of charges proposed.....*”

3.0 Consultation responses and the Adjudicator’s comments

3.1 Overview

Eight responses to the Consultation were received. The BBC, Arqiva, Channel 4, Digital 3 & 4, Ericsson and The Local Radio Company submitted responses with consent to allow publication; these are given in Appendix 1. The Radio Centre responded but wished the content to remain confidential and one further respondent did not wish to be identified.

The Adjudicator is grateful to all those who responded.

3.2 Consultation responses

Question 1: do you agree with the principle that capital recovery should be aligned to the useful life of the asset?

There was general agreement with the concept of capital recovery being aligned to the useful life of the equipment.

Arqiva pointed out that the fee they charge is for the provision of a service, that capital recovery is only a part of it and that other factors such as risk, customer licence period and the chance of the assets being stranded would be part of the calculation.

Another respondent believed that the capital recovery period should be set on a contract by contract basis after discussion and agreement with the Customer. A further concern was raised as to the means of establishing the useful life or equipment.

Another submission suggested that the life of the equipment depended greatly on the care that Arqiva took of it and that there should be an incentive for Arqiva to maximise the useful life of the equipment.

Adjudicator’s Comment

The majority of the respondents gave unconditional support for this concept. For the remainder the main concern was transparency.

The Adjudicator proposes to recommend that the useful life of the equipment is the basis for the capital recovery period as a principle but accepts that the principle can be varied to suit individual circumstances. The important thing is that the recovery period and the reasons for its adoption are transparent and are open to discussion between Arqiva and the Customer. The Adjudication rules provide a route for dispute resolution should these discussions reach an impasse.

Question 2: do you agree with the concept of allowing faster recovery where there is an identified risk of there being stranded assets?

Again there was general support for this concept.

Arqiva proposed that, where there is a risk of stranded assets, the recovery be accelerated or there should be a termination fee.

The BBC agreed in principle but felt that the determination of the likelihood of an asset becoming stranded should be carried out in consultation with the Customer.

Both Channel 4 and D 3 & 4 agreed subject to there being guidance to cover the circumstances where recovery has been completed but the equipment continues to be used to service the contract.

TLRC agreed subject to the equipment being available for purchase at reduced or zero value.

Adjudicator's comment

There was general support for the concept and the Adjudicator believes that it is reasonable for Arqiva to be transparent and discuss this risk at the time of contract negotiation. Similarly this would be the time to reach an agreement to cover what happens if the equipment ends up being used for a lesser or greater time than the agreed recovery period.

The TLRC's concern is already covered in the Adjudicator's earlier guidance on transmission equipment valuation.

Question 3: would you propose a different mark-up for maintenance only contracts?

Arqiva wish to make a competitive return in line with the service offered and suggest 15% as a reference point with variation for risk and complexity.

The BBC requested more information in order to answer this question and pointed out that the margin depends on what costs are included, for example, to what extent overhead recovery is included.

Channel 4 and D3 &4 suggested a definition of "a margin of 15% applied to directly attributable costs".

Two respondents wished to see a benchmarking exercise or further evidence and one felt that 15% was high due to the low risk.

TLRC agreed with 15%. They were keen to see new entrants in the maintenance market and wished the Adjudicator to minimise barriers to entry.

Adjudicator's comment

The 15% was based on a very limited benchmark with the intention of getting some workable guidance in place now over a broad range of issues and then doing an in-depth analysis at a later date. The observation from the BBC that it all depends what is included is important and the definition suggested by D3 &4 addresses this. It would also seem inappropriate to impose a specific figure regardless of the service offering.

The Adjudicator is conscious that without a very tight definition of what costs are allowable in calculating the 15%, it will have little meaning. It is also clear that a fixed margin is in appropriate as it ignores factors such as specific risk.

The Adjudicator is minded to offer guidance that does not specify a figure but requires transparency such that the customer can see and discuss the figure and use the Adjudication Process if necessary.

Q4: Do you agree with the rate-card approach to Network Access Charges for Radio?

There was a common theme in the responses pointing out that there was not enough information in the public domain to make an informed decision and a concern that any mechanism should not permit over-recovery of common costs.

Adjudicator's comment

The Adjudicator accepts the concern about lack of data; however the question was aimed at the level of a general principle and was trying to avoid the response being conditioned by whether the respondent would be potentially better or worse off. The issue is whether two identical radio stations on two separate Arqiva sites should pay the same for their facilities or for the charge to be determined by the level of activity (TV etc) on that particular site.

The Adjudicator feels that to discharge his responsibility to ensure FRND treatment, a rate card is the appropriate route. Now that the timetable for analogue radio closedown is on the agenda, it is appropriate to start considering the effect on sharing of common costs post analogue radio. An investigation into the whole area of allocation of common costs is in progress and once this has reported there will be a further consultation on this issue. This will include the way in which the present charges are calculated, the basis of apportionment and the rate card.

Q5: Do you consider maintaining both WACC at 10.4% real and RPI-1 to be appropriate in the short term?

Several respondents pointed out that there was a misprint and that 10.4% is nominal (7.71% real). Arqiva believe that in the current climate the figure may be low but suggest that the present rate should be maintained in the short term. Arqiva believe that the WACC figure only relates to NA and not to MTS and seek confirmation of this.

The BBC accepts the figure for the short term but would like to know when it will be reviewed. They believe it to be high and also would see it as an average figure which should be modified on a case-by-case basis according to such factors as risk.

Both D3 & 4 and Channel 4 believe there is a need to re-evaluate the rate which they believe to be high.

One further respondent believes it is appropriate in the short term whilst another believes it is too high and would also welcome a harsher RPI- regime.

Adjudicator's Comment

WACC represents the average return that Arqiva needs to make in order to service its debt and to meet the return required by its equity providers. In setting WACC the risk free rates for debt and equity are considered and then the appropriate risk provisions added. In setting WACC for NA, no specific risk was included, long term contracts were assumed and an uplift of RPI was allowed.

It is important to note that Arqiva like most companies finances itself to avoid short term fluctuations in interest rate (like a fixed rate mortgage) and therefore WACC will not fluctuate in the short term.

From examining the background to the setting of WACC, the Adjudicator believes that the figure of 10.4% is appropriate in the short term for NA but that it is not appropriate to apply this figure to MTS where the assumptions on contract duration are different and the risk is concentrated in one customer rather than over a spread as in NA. In the existing guidance to Arqiva on NA, an annual increase of RPI is permitted. (As WACC is set, any other RPI-based figure would mean that WACC was exceeded or not met and the two would conflict).

In the main, contracts will be for Transmission Services which are a bundle of NA and MTS. Para 9.4 of the Undertaking requires that the NA charge is passed through without markup. Appendices 11 and 12 of the Undertakings set out the main terms and conditions of a Transmission Services Reference Offer and permit Arqiva to make “an appropriate return” on efficiently incurred costs but also specifies that an RPI-1% factor is applied.

The Adjudicator believes that it is inappropriate to specify what constitutes an “appropriate return” for an individual customer as this will vary from customer to customer. Again the important consideration is transparency and if the customer is unable to reach an agreement through commercial negotiation then the dispute resolution route is available.

Q6 Are there any other aspects of pricing that you feel require guidance?

Arqiva wish the concept of “Service Provision” to be discussed further, particularly in regard to risk.

They would also like further consideration of gain-share mechanisms against the context of the RPI-1 efficiency measure.

The BBC wishes the Adjudicator to ensure that costs are efficiently incurred, that Arqiva has an incentive to provide alternative designs, clarity on common cost allocation and to suggest to Ofcom a review of its 2005 notification.

Another respondent sought clarity on the definition of MTS for each broadcast technology.

A further respondent wished there to be incentives upon Arqiva to optimise its efficiency in design, operation and electricity consumption.

Adjudicator’s Comment

Arqiva contend that they are providing a service and are charging for that service provision. The Adjudicator accepts that principle but notes that it is subject to the terms of the Undertakings which require a degree of transparency and other constraints to reflect the lessening of competition identified by the Competition Commission. As discussed above the pricing of any Transmission Agreement consists of two elements, NA which is already set by Ofcom, and the MTS element. The Undertakings set the principles for bundled MTS and NA. As a bundled contract is customer specific it is appropriate to consider specific risk for the MTS element and reflect this in the pricing.

In Appendices 11 and 12 of the Undertakings provision is made for gain-share mechanisms. Arqiva ask for more discussion on gain-share mechanisms in the context of RPI-1. Though not stated, the Adjudicator infers that this is borne of a concern that there are dual efficiency incentives. The Adjudicator notes that although the RPI factor is specified, the gain-share is mentioned as a principle only and believes that normal commercial discussion should result in a formula acceptable to both parties and also that the dispute resolution route exists if agreement cannot be reached.

A respondent sought clarity on the limits of MTS for each technology. MTS is a defined term in the Undertakings and covers the design, installation, monitoring, operation and maintenance of Transmitter Equipment (which term is also defined in the Undertakings). In system terms, MTS starts at the output of the distribution system at the transmitter site and includes the Programme Input Equipment (PIE), the transmitter and any filter specific to that transmitter and ends at the input to the combiner or antenna feeder system (where there is no combiner) which are part of Network Access. Also included are any systems for monitoring and controlling the Transmitter Equipment and for the management of SI at the transmitter site. Contribution, Multiplexing and distribution are excluded from MTS.

Arqiva's efficiency as a supplier is discussed under Q7 below. Arqiva are obliged under Para 9.5 of the Undertakings to provide alternative designs; albeit that the degree of detail is not defined. There is potential for Arqiva to be requested to provide many detailed designs which has a cost implication and will then lead to a reluctance to do this or an attempt to recover the cost. The Adjudicator believes the best approach is for Arqiva to show the alternatives in outline i.e. enough detail to describe the alternative options and the price implication and permit Arqiva to charge for detailed design work on alternatives. This will ensure that the cost is borne by the Customer requesting the information.

The Ofcom 2005 notification which set out the basis for NA charges falls within the remit of the Adjudicator. The Adjudicator has commissioned an investigation which is the first stage of reviewing the allocation of common costs and will, in due course lead to a review of WACC etc.

Q7 Are there any other related issues that you wish to comment on?

In their response, Arqiva wished to point out that:

- the consultation covers new contracts only
- there will be a cost implication for producing alternative designs
- in relation to the gain-share mechanism in Appendices 11 and 12, if costs are exceeded as a result of specification changes due to specific factors then the charge may be increased.
- Although electricity etc are pass-through there may be an administrative charge
- the option to customers to make a capital contribution is always available at the MTS layer

The BBC requests information on the Adjudicator's approach to transparency and that Arqiva demonstrate that pass-through costs have been efficiently incurred.

Another respondent notes that the Undertakings do not cover multiplexing for DAB. They also seek to minimise the barrier to entry for potential MTS. A further observation is that there is a degree of circularity between Reference Offer

Documents and the Undertakings and requests the Adjudicator to produce guidance that is stand alone and unequivocal.

Adjudicator's comment

The Adjudicator notes the points made by Arqiva and would refer to the Undertakings for the definitive wording on each point.

The BBC requests information on the Adjudicator's approach to transparency. The approach that the Adjudicator is adopting is to encourage transparency such that a customer can engage in discussions with Arqiva from a position of knowledge and understanding such that a mutually agreeable conclusion can be reached. The Adjudicator prefers this approach to attempting to issue extensive "one size fits all" guidance and would prefer to lay down general guidance leaving latitude for recognising the different needs of individual customers.

Ensuring Arqiva is an efficient supplier is not an easy task. Policing each supply contract would be expensive and time consuming (the costs of which ultimately increase the customer costs) and the result is somewhat subjective. For instance Arqiva may have negotiated a significant discount on some equipment from a particular supplier. The supplier is unlikely to reveal what discounts he has given to other parties and therefore the view on whether or not Arqiva has achieved the best deal is subjective. In other cases such as energy supply some benchmarking is possible. The Adjudicator intends to test from time to time aspects of the purchasing process to ensure that effort is being made to achieve efficient supply, particularly in pass through aspects.

The Adjudicator can confirm that DAB multiplexing is not covered by the Undertakings nor is DTT multiplexing.

A respondent sought that barriers to entry should be minimised. In finding that the merger has lessened competition in the Transmission Services area the Competition Commission acknowledged that barriers to entry for a new player are high and hence the Undertakings are intended to simulate the effect of competition. Arqiva are obliged to apply the same NA charge to themselves for new contracts as they give to a potential new entrant. It is then up to the new entrant to provide a competitive bundled offer.

4.0 Guidance

4.1 This guidance is issued under Section 8 (i) of Appendix 1 of the Undertakings and deals with New Transmission Agreements as set out in Para 9 of the Undertakings.

4.2 At present the Adjudicator does not see a need to issue guidance on the terms and conditions of New Transmission Agreements as referred to in Para 10 of the Undertakings. The Adjudicator would prefer to issue guidance on broad principles and encourage transparency such that an informed discussion between Arqiva and the Customer will lead to a conclusion, noting that the adjudication process exists as a backstop.

4.3 In principle the period for capital recovery should be aligned to the useful life of the equipment. In determining the case by case recovery period Arqiva may take note of the risk of stranded assets and other identifiable risks. In its offer to the

Customer Arqiva must set out its proposal and reasoning behind capital recovery and be prepared to discuss options with the customer. The Adjudication rules provide a route for settlement of a dispute should agreement not be possible.

4.4 In maintenance only contracts, Arqiva must make clear what mark up it is applying. Again transparency and a willingness to discuss options and the effect of those options on pricing is required. The Adjudication rules provide a route for settlement of a dispute should agreement not be possible

4.5 The ratecard approach is accepted as the approach for radio NA that meets the FRND requirement. The Adjudicator accepts that further work is needed to refine the ratecard and requires that Arqiva publish the ratecard together with an explanation of how it is derived and applied within 6 calendar months of the publication of this document.

4.6 In the short term WACC at 10.4% is to be applied to NA together with an annual markup of RPI

4.7 The requirement of Appendices 11 and 12 of the Undertakings continue to apply including the requirement to apply RPI-1% to Transmission Services Agreements.

4.8 MTS is a defined term in the Undertakings and covers the design, installation, monitoring, operation and maintenance of Transmitter Equipment (also defined in the Undertakings). In system terms, MTS starts at the output of the distribution system at the transmitter site and includes the Programme Input Equipment (PIE), the transmitter and any filter specific to that transmitter and ends at the input to the combiner or antenna feeder system (where there is no combiner), which are part of Network Access. Also included are any systems for monitoring and controlling the Transmitter Equipment and for SI management at the transmitter site. Contribution, Multiplexing and distribution are excluded from MTS.

4.9 The Adjudicator would wish to see the level of transparency below as a minimum.

Pricing should show the following elements:

- The split between NA, MTS and pass through costs such as electricity.
- The calculation of NA from the ratecard.
- The split between capital and operational cost in MTS and the recovery period of the capital.

This information is to be provided for each station in any quotation.

4.10 As set out in Para 9.5 of the Undertakings, Arqiva will offer alternative designs and costings in outline to allow the customer to select a system that matches their needs. It is recognised that more detailed designs will have cost implications. This requirement extends to outline design only and it is acceptable for Arqiva to charge for detailed design work of alternative options.

Appendix 1

Non-confidential Responses to Consultation 3

Response from Arqiva

Arqiva's responses to the questions raised in the above consultation are noted below.

Question 1: Do you agree with the principle that capital recovery should be aligned to the useful life of the equipment?

Response: Arqiva believes the principle of 'Service Provision' is central to this question; specifically, Arqiva is providing a service to the Customer, involving a range of assets, resource and assumption of risk, over a defined period.

Arqiva would refer to the economic life of an asset in pricing. As such, customer licence periods or significant market conditions (e.g. Analogue Switch Off) would be taken into account in establishing the life of the equipment and the resultant pricing. Where equipment lives do not reflect these conditions, appropriate compensation for stranded assets would be sought, either through contract pricing or an expiry fee (cost to recover stranded assets), as noted in the response to question two.

Question 2: Do you agree with the concept of allowing faster recovery where there is an identified risk of there being stranded assets?

Response: as noted in the response to the first question, there is a risk to Arqiva that an asset may become stranded if the pricing for the Service provided reflects a longer asset life than the contract term and there is a high likelihood of significant market change (e.g. Analogue Switch Off).

In such circumstances, Arqiva would support either a shorter asset life for pricing purposes or the introduction of an expiry fee (or annual premium) to cover the risk of an asset becoming stranded.

Question 3: Would you propose a different mark-up for maintenance only contracts?

Response: Arqiva would seek to earn a competitive return for maintenance only contracts which reflects the nature of the service provided; it does not necessarily follow that all services are the same and, as such, Arqiva would look to the margin of 15% as being a reference point, with variation for risk and complexity being allowable increments.

Question 4: Do you agree with the ratecard approach to Network Access Charges for Radio?

Response: as noted in the Consultation, Arqiva operates on the basis of Network Access recoveries for Radio being apportioned across all sites, to avoid large variations at specific locations. Arqiva believes this is equitable to Customers and the Company and, per the objectives noted in the Second Consultation (Principles for the sale of Transmitter Equipment, answer to question two), does not cause distortion. Arqiva will work with the Adjudicator to establish a new Ratecard in a reasonable timeframe.

Question 5: Do you consider maintaining both WACC at 10.4% real [nominal] and RPI-1 to be appropriate in the short term?

Response: as noted in the table on page five of the Consultation, the Ofcom Guidance in 2006 set a WACC of 7.71% real, 10.4% nominal for Arqiva's Network Access facilities (question 5 in the Consultation incorrectly referred to 10.4% real, rather than 10.4% nominal).

The economic challenges currently being experienced in the wider economy bring new challenges, including increased counterparty risk. Additionally, whilst it is noted that Bank of England ('BoE') interest rates are low, the traditional alignment between BoE interest rates and cost of capital has been broken and, as such, the use of BoE interest rates as a proxy for the cost of capital is not valid under current market conditions; additionally, access to capital is possibly at the most challenging level encountered.

As such, Arqiva believes the stated WACC remains at the low end of what is appropriate for Network Access; further, given the current unprecedented profile of RPI, Arqiva believes the focal point to be the 7.71% real rate.

Given the current cost of capital in the market and the low returns highlighted above, Arqiva remains concerned that such figures may not be viable in the long term if existing conditions persist. As such, we accept that the WACC should remain at 10.4% nominal in the short term for Network Access services we would propose that the WACC is reviewed again if the current finance conditions persist; in certain circumstances it may be necessary for Arqiva to decline to invest in the capital but nevertheless would be willing to provide the service if the customer funded the capital investment instead.

Arqiva notes that in the recent guidance given by Ofcom to the Adjudicator (16 January 2009, Section 4.4) the WACC as highlighted above was only applicable to the Network Access regime and Ofcom suggested that the MTS element of service should continue to be priced based upon a market rate principle. We seek confirmation from the Adjudicator that the guidance relating to the WACC above only applies to Network Access and that in accordance with Ofcom guidance MTS services should be priced at market rate.

Question 6: Are there any other aspects of pricing that you feel require guidance?

Response: Arqiva would welcome thoughts on the concept of 'Service Provision' that is referred to in the Company's answers to this and the second Consultation (Principles for the sale of Transmitter Equipment), specifically the aspect of pricing for the risk involved in guaranteeing service levels at, say, contract renewal stage where the same equipment may be used or may need to be replaced.

Additionally, further discussion around the concept of gainsharing mechanisms would be welcomed, particularly as set against the context of the efficiency measures already being set in the RPI-1 factor.

Question 7: Are there any other related issues you wish to comment on?

Response: There are some points raised in the Consultation Arqiva would like to expand on:

This Consultation covers pricing arrangements for new contracts only;

The cost implications of the effort required to consider various design and power efficiencies noted in Sections 3.3 (i) and (ii) could be significant and must not be overlooked, as they will need to be factored into any fees charged to Customers;

Arqiva notes that the reference in Section 3.3. (i) to a gainshare mechanism, as taken from Appendices 11 and 12 of the Undertakings, has a wider context, in that should actual costs exceed forecast costs, then Arqiva is entitled to adjust the resultant charges to reflect any change in specification, any change in the number or

mix of sharers, any force majeure event or other matters outside the Company's reasonable control through the Change Control procedure;

Arqiva agrees that pass through costs are not subject to a mark up, but would note that there are administrative costs involved (e.g. separate metering and analysis) which the Company would seek to recover;

The Consultation makes reference to the customer having the option to make an up front capital contribution in Section 3.3; it should be noted that this option is always available to the customer.

Response from BBC

Q1. Do you agree with the principle that capital recovery should be aligned to the useful life of the equipment?

As noted in our response to consultation 2/2009, we support the view that capital recovery should be aligned to the useful life of the equipment.

Q2. Do you agree with the concept of allowing faster recovery where there is an identified risk of there being stranded assets?

The BBC accepts in principle that to avoid inefficient entry and disincentives to invest, it is appropriate for a customer to bear the cost of their requirements and that Arqiva should expect to be able to recover its investment. Clearly, there is a possibility that an asset could become stranded if capital recovery is over the useful life of a piece of equipment but contracts to use that equipment are of shorter duration. A risk analysis will need to be undertaken to assess the likelihood of either the initial contract being renewed/extended or an alternative use being found for the asset.

The BBC believes it would be inappropriate for Arqiva alone to be in a position to determine the likelihood of an asset becoming stranded. Where there are clear and objective reasons to suggest that the asset will become stranded (e.g. no future use due to regulatory changes) and there is no secondary use (or second hand value, e.g. potential for sale overseas) then we would accept that faster recovery should be permitted. In all other circumstances, we believe that the customer should be offered the choice of faster recovery or agreeing a terminal value with Arqiva should the asset be proven to be stranded.

Q3. Would you propose a different mark-up for maintenance only contracts?

We do not feel sufficiently informed to be able to answer this question. Before we can comment on the appropriate EBIT, we look to the Adjudicator to provide additional detail about how he reached his view that an EBIT of 15% would be reasonable. Only then will we be in a position to provide comments.

The critical issue is to understand what EBIT comprises and to ensure that the allowed rate of return is appropriate. For example if EBIT is specified before overhead recovery (which would be unusual), then 15% may be an appropriate rate of return. However if the EBIT to be used is a true accounting definition, albeit on a service line-specific basis, then 15% would seem very high given that allocated overheads would already have been deducted. Marking up to give an EBIT margin of 15% in this case means a return of more than the cost of capital when the risks are considerably lower than whole of business risks because there is no capital investment in a maintenance-only contract.

We therefore believe that any determination should take account of any profit or overhead recovery already built into Arqiva's daily rate calculation. We would want the Adjudicator to confirm that the daily rate used for the calculation of maintenance charges to reflect only the cost of providing service (and essential overheads).

We also note that there is considerable opportunity for Arqiva to overestimate the manpower requirements associated with maintaining transmission systems (whether in maintenance-only contracts or in fully managed service contracts). To the extent that Arqiva is able to use less effort in maintaining these systems Arqiva is effectively able to increase its overall profitability. We are of the view that the Adjudicator's

guidance should emphasise the expectation that Arqiva's manpower estimates should demonstrate efficiency (see also response to Q6).

Q4. Do you agree with the ratecard approach to Network Access Charges for radio?

At present we are unable to comment on this question due to the lack of detail provided in the Adjudicator's consultation document. We believe that this issue warrants a separate consultation on its own, setting out Arqiva's proposed methodology for developing a single rate card and the likely prices that would result.

The BBC suggests that Network Access Charges for radio should be considered within the next 12-18 months in the context of the greater clarity which is expected to be confirmed by consultations and legislation arising out of the Digital Britain report.

Q5. Do you consider maintaining both WACC at 10.4% real and RPI-1 to be appropriate in the short term?

The BBC accepts that maintaining both WACC at 10.4% real and RPI-1 is appropriate in the short term. We would however welcome additional guidance from the Adjudicator about when this is likely to be reviewed. It is our view, as set out in our response to Ofcom's consultation, that the WACC should be reviewed in the near future in the light of changed market circumstances (both in the general capital and equity markets and in the transmission market following the merger of NGW and Arqiva). The current WACC would seem to offer Arqiva a disproportionately high return on equity given the lower risks they now incur as a monopoly provider.

We would note, however, that WACC is intended to be a company average rate of return and should not be assumed to apply to each and every contract. In a competitive world, contracts would reflect the risk profile of the activity and of the customer. The BBC, for instance, is a low risk customer. We would expect individual contracts to be adjusted according to the appropriate risk profile.

Q6. Are there any other aspects of pricing that you feel require guidance?

Efficiently incurred costs

As we set out in our response to Ofcom's draft guidance, we believe that the Adjudicator should ensure that charges are cost orientated and that the costs themselves have been efficiently incurred.

The BBC considers that this will be a crucial area for the Adjudicator to issue guidance. The BBC suggests that the Adjudicator should consider every form of efficiency – not just procurement efficiency (that is, whether Arqiva has purchased plant in the most efficient way) but also technical efficiency, or whether Arqiva has proposed the lowest-cost, simplest way of achieving the customer's requirements. Indeed, the Adjudicator should be able to have in mind whether a slight change to the customer's requirements would have resulted in a more efficient solution. This is especially true as broadcasters most often know only their final output requirement and are not always aware that slight modifications may lead to a cheaper outcome.

The BBC notes that there is – even in its own case and more so in the case of other broadcasters – a great information asymmetry between the customer and supplier and expects that the Adjudicator will be called upon frequently to make decisions in this area. The key concern for customers is the distinct asymmetry of information between Arqiva and its customers, which means that customers cannot act as a discipline to the monopolist. It is therefore vitally important that the Adjudicator is sufficiently informed to allow him to identify and eradicate inefficiency.

The BBC suggests that the Adjudicator should regulate on the basis of most-efficient pricing. Thus, if a dispute is brought to him and he decides that Arqiva has not been efficient in its design or execution, he should be able to decide that the customer will pay charges set as equivalent to those which would have been payable for the most efficient solution that would have been practical.

More generally, the Adjudicator may wish to consider, and consult on, his methodology for reviewing prices to incentivise Arqiva to undertake efficiency improvements to minimise their ability to bank inefficiently incurred costs (e.g. comparative efficiency analysis) and to account for improvements in technology or best practice.

Providing an incentive for Arqiva to provide alternative designs in a timely manner

In a related point, we observe that Arqiva currently has no incentive to provide alternative designs in a timely manner (i.e. before a final investment decision is required). We would welcome guidance from the Adjudicator on a method for incentivising Arqiva to produce alternative designs in a timely manner to close the information asymmetry gap and to ensure costs are efficiently incurred. He might, for instance, consider whether Arqiva should be required to produce an alternative design within a specified period of time. If Arqiva is not required to produce alternative designs in a timely manner, customers must rely on an appeal to the adjudicator based on inefficiencies.

Common costs

We accepted in our response to Ofcom's draft guidance on common cost recovery that it may be costly to re-allocate common costs every time a new service is offered. We noted, with some concern, however, Ofcom's suggestion that Arqiva should be allowed to offer prices to some new customers that do not include an appropriate share of common costs. We recognised that this might be profitable for both Arqiva and the entrant but noted that such entry comes at a cost to incumbent customers such as the BBC who are bearing the brunt of common cost recovery. The BBC believes such a system would be inappropriate for four reasons:

1. It is inappropriate for entrants not to bear the appropriate costs of entry. By artificially sheltering entrants from common costs, this guidance would encourage inefficient entry.
2. Such a system could distort competition between alternative platforms by artificially distorting pricing signals.
3. Such a system could distort competition downstream by artificially reducing the cost base of entrants relative to their competitors.
4. It is demonstrably unfair and discriminatory to require incumbents to pay more than their fair share of common costs and ultimately subsidise entrants.

The BBC therefore looks to the Adjudicator to provide additional clarity on how he will treat common costs. In addition, we would expect him to consult on a process by which he may review prices (or require Arqiva to do so) on a fairly regular basis (say, every 5 years) to draw a balance between price stability and the risk that Arqiva over-recovers common costs.

Ofcom's current regulation of MTS/NA

We believe that, following the merger of NGW and Arqiva, Ofcom now has a duty to reassess its current regulation of the provision of certain network access services put

in place in 2005 via a notification under the Communications Act. We would encourage the Adjudicator to make this point to Ofcom.

Q7. Are there any other related issues you wish to comment on?

We would welcome information on the Adjudicator's approach to transparency and note Ofcom's comments in paragraph 2.16 of its Guidance for the Adjudicator (published 16 January 2009). Given the Adjudicator's duties under the scheme, we believe it is vital that both Arqiva and its current and future customers have certainty about how the Adjudicator will deal with price transparency.

We note that in section 3.3(ii) of his consultation, the Adjudicator suggests that power, rent and rates should be "passed-through on an annual basis without mark-up". We believe that only those costs which are not open to amendment through the efforts of Arqiva (and its customers) should be passed-through. In particular, we do not believe that rent should be passed-through without Arqiva first having to demonstrate that it has achieved the most efficient position in its property portfolio. We note that Arqiva has the ability to influence rent levels, for instance through the efforts it puts into renegotiation of rents with landlords or decisions about whether to convert parts of its estate from leasehold to freehold. It should therefore have an incentive to maximise the efficiency of its estate management activities.

Response from Channel 4

Introduction

1. Channel 4 jointly hold the Ofcom Multiplex 2 licence with ITV through D34, and the current Ofcom licence for the Channel 4 analogue service, which will terminate at the completion of the DSO programme.
2. In August 2007 Digital 3and4 concluded an MTS contract (incorporating Network Access) with Arqiva expiring in 2034 subject to a number of early termination provisions. Channel 4 is interested in any future pricing principles for any new transmission business which may arise, either through D34 or with Channel 4 directly.

Consultation Questions

1. Do you agree with the principle that capital recovery should be aligned to the useful life of equipment?

Channel 4 agrees with this principle.

2. Do you agree with the concept of allowing faster recovery where there is an identified risk of there being stranded assets?

Channel 4 agrees with this concept, on the basis that there is agreed guidance to cover the circumstance where capital recovery has been completed, but the equipment continues to be used to service the contract.

3. Would you propose a different mark-up for maintenance only contracts?

Channel 4 believes that there should be a different mark up for maintenance only contracts, and agrees with the proposal of 15%, as applied to directly attributable costs.

4. Do you agree with the ratecard approach to Network Access Charges for radio?

Channel 4 agrees to a ratecard approach for radio as well television services. However we are concerned that there needs to be an agreed mechanism in place to ensure that all the costs attributed to radio, when combined with all the costs attributed to television, do not exceed Arqiva's total actual costs.

5. Do you consider maintaining both WACC at 10.4% real and RPI-1 to be appropriate in the short term?

The question should refer to "WACC at 10.4% nominal" not "10.4% real".

Channel 4 believes that there is a need to re-evaluate whether or not a WACC at 10.4% nominal is still appropriate. This should include the assessment of the individual parameters of the Arqiva WACC calculation.

Our current thinking suggests that for an infrastructure company such as Arqiva, the figure of 10.4% is high and there is a case for reducing this.

6. Are there any other aspects of pricing that you feel require guidance?

No

7. Are there any other related issues you wish to comment on?

No.

Response from Digital 3and4 Ltd

Introduction

1. Digital 3and4 Ltd is the company jointly owned by ITV and Channel 4 which holds the Ofcom Multiplex 2 licence. Multiplex 2 broadcasts the Qualifying services of ITV, Channel 4 and Teletext together with other Digital Services provided by the shareholders. As part of the forthcoming multiplex re-organisation to clear Multiplex B for HD, Multiplex 2 will also provide carriage for S4C in Wales and Channel Five.

2. In August 2007 Digital 3and4 concluded an MTS contract (incorporating Network Access) with Arqiva expiring in 2034 subject to a number of early termination provisions; nevertheless it has a strong interest in the pricing principles being applied to new transmitter contracts given the opportunities likely to emerge from the DDR.

Consultation Questions

1. Do you agree with the principle that capital recovery should be aligned to the useful life of equipment?

Digital 3and4 agrees with this principle.

2. Do you agree with the concept of allowing faster recovery where there is an identified risk of there being stranded assets?

Digital 3and4 agrees with this concept but clearly there needs to be Guidance to cover the circumstance where capital recovery has been completed but the equipment continues to be used to service the contract.

3. Would you propose a different mark-up for maintenance only contracts?

Digital 3and4 believes that the appropriate return should be defined as "a margin of 15% applied to directly attributable costs".

4. Do you agree with the ratecard approach to Network Access Charges for radio?

Digital 3and4 understands the reasons why the proposed approach may make sense for both Arqiva and the radio companies. However, we would ask the Adjudicator to consider how he will ensure that all the costs attributed to radio when combined with all the costs attributed to television do not exceed Arqiva's total actual costs.

5. Do you consider maintaining both WACC at 10.4% real and RPI-1 to be appropriate in the short term?

The question should refer to "WACC at 10.4% nominal" not "10.4% real".

Digital 3and4 believes that there is a need to exercise more rigour in the assessment of whether or not a WACC at 10.4% nominal is still appropriate. We do not believe that is sufficient to simply base an assessment on the Openreach and Stansted Airport calculations. Rather, we believe that it is necessary to examine each of the individual parameters of the Arqiva WACC calculation in order to confirm whether the 10.4% figure is still appropriate.

Our instinct is that such an examination will show that maintenance of the 10.4% nominal figure is generous to Arqiva and that there will be a case for reduction of the figure.

6. Are there any other aspects of pricing that you feel require guidance?

No

7. Are there any other related issues you wish to comment on?

No.

Response from Ericsson

Ericsson welcomes the opportunity to respond to this consultation.

In general Ericsson agrees with the analysis and conclusions put forward in the consultation paper, and has no further specific comments to make.

Response from The Local Radio Company

TLRC currently operates 19 local radio services throughout England and our replies therefore relate specifically to the analogue radio transmission market.

Consultation Questions

1. Do you agree with the principle that capital recovery should be aligned to the useful life of the equipment?

See our response to the separate consultation on the sale of transmitter equipment with regard to the difficulty of defining the “useful life of the equipment” in relation to analogue transmission. We have proposed a more rapid depreciation in the first 12 years (to 25% of the original value) followed by a more moderate write-off of the remaining residual value – down to zero – over the next 12 years. We would agree that the capital recovery element of any agreement would reflect this, effectively reducing the annual cost if still using the equipment after 12 years.

2. Do you agree with the concept of allowing faster recovery where there is an identified risk of there being stranded assets?

Yes, but subject to the assets being available for purchase by the user at the reduced value, or zero cost where applicable, at the end of any such contract.

3. Would you propose a different mark-up for maintenance only contracts?

Yes, this area is less demanding of regulation. We would be happy to compare Arqiva’s proposed charges for a maintenance-only contract with those available from other suppliers. More competition could be encouraged in this sector. This is of course subject to Arqiva and other site owners not placing unreasonable barriers to access by suitably qualified third-party engineers, something the Adjudicator should perhaps consider.

4. Do you agree with the ratecard approach to Network Access Charges for radio?

We would like to see the proposed ratecard before answering that question. Many small radio services use third party – often telecommunications – towers and facilities and the impact on the cost of these would need to be reviewed.

However, in principle, a clear transparent ratecard would be welcome. We are currently frustrated that the merger and subsequent Competition Commission decisions have removed any desire by Arqiva to deal with groups of radio stations as a single client, instead choosing to look at each individual transmitter contract as it falls due for renewal. This often amounts to dozens of separate contracts over a period of several years, usually each with slightly different terms and assumptions. Anything that normalises and simplifies our trading relationship is to be welcomed in principle.

5. Do you consider maintaining both WACC at 10.4% real and RPI-1 to be appropriate in the short term?

We have no opinion on this.

6. Are there other aspects of pricing that you feel require guidance?

Not at this time.

7. Are there any other related issues you wish to comment on?

Not at this time.