OTA-BTS
Office of the Adjudicator –
Broadcast Transmission Services

Consultation 2/2009: Principles for the sale of transmitter equipment

1.0 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 would 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 [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 consultation relates to Para 8 (iii) of Appendix 1 which refers to the right of customers of Arqiva to acquire transmitter equipment in certain circumstances at the end of their contracts introduced by paragraph 6 of the Undertakings and contains draft guidance on the principles for valuing transmitter equipment in such circumstances.

2.0 Customer options upon contract termination

When a transmission contract approaches expiry or termination due to Arqiva's breach, the customer may purchase the transmitter equipment which is specific to its service and make its own arrangements to operate and maintain it. The customer will still require a Network Access agreement with Arqiva to use the common site facilities.

"Transmitter Equipment" is defined in the Undertakings to mean "the transmitter and other equipment for Managed Transmission Service at a Station which is owned by Arqiva and is dedicated exclusively to service provision under an Existing Transmission Agreement, but excluding all masts, towers, antenna systems, feeders, combiners, filters or any other equipment provided for the purpose of Network Access or for the purpose of distribution services".

3.0 Objectives

Paragraph 12(ii) of the Adjudication Scheme set out in Appendix 1 of the Undertakings, states that the Adjudicator shall in carrying out his functions, *"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…"*

In January 2009 Ofcom issued guidance to the Adjudicator. 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
- providing incentives for efficiency.

To meet these objectives, the Adjudicator proposes to use the following criteria in assessing methodologies for the pricing of transmitter equipment:

- that customers should not be disadvantaged by the lessening of competition as a result of the merger
- that the asset transfer price should not distort buyer choice between buying a service and purchasing outright
- that the asset transfer price should not distort Arqiva's decisions on asset replacement and maintenance
- that the asset transfer price should not distort the price for purchasing a transmission service
- that the asset transfer price should not remove incentives for Arqiva to invest and pass on efficiencies to the customer (e.g. replacement of plant with more energy efficient equipment)

4.0 Issues for consideration

The right to purchase transmitter equipment is enjoyed equally by radio and television broadcaster customer. However, in practice the right is more likely to be exercised by radio customers because of the greater preponderance of transmission contracts, many of which are of relatively short duration. Thus there is greater emphasis in this Consultation to valuation of Transmitter Equipment for radio broadcasting than for television. However, the Guidance resulting from this Consultation will apply equally to both categories of equipment.

A key issue to consider is the potential disparity between the useful life of equipment, the way in which it is depreciated and the rate at which capital recovery is effected from the customer.

Arqiva's policy is that the book depreciation is over 25 years whilst customer contracts are typically 12 years. Customers believe that capital recovery is achieved in one contract period and that they have effectively paid for the equipment such that, if they exercise the option to buy, it should be at zero cost to them.

Arqiva, on the other hand, would contend that the equipment is a source of revenue to them and therefore the value of the equipment is represented by the lost revenue over its remaining useful life.

The Adjudicator accepts that usually the equipment has some value and that a zero cost transfer could lead to a market distortion. It is noted however, that if indeed the capital has been recovered in the first term and that the expected life of the equipment is 25 years then the price for the second 12 year contract term should reflect this. Depreciation should be calculated over the lifetime of the asset and not the contract (Ofcom Guidance para 5.40).

Looking at actual lifetimes for transmitter equipment, the Adjudicator notes that some equipment has a lifetime in excess of 25 years whilst other equipment has achieved only 15 years. There are also situations where equipment will be taken out of service before the end of its useful life as a result of technology/regulatory changes.

For calculation purposes, the Adjudicator would propose therefore using a lifetime of 20 years. An alternative approach would be to have lifetimes for particular classes of equipment that reflect their operational lives [for example different figures for Medium Wave, Band II FM, DAB and high/low power DTT].

Where the transmitter equipment has transfer value then the next issue is the basis of that valuation.

5.0 Valuation

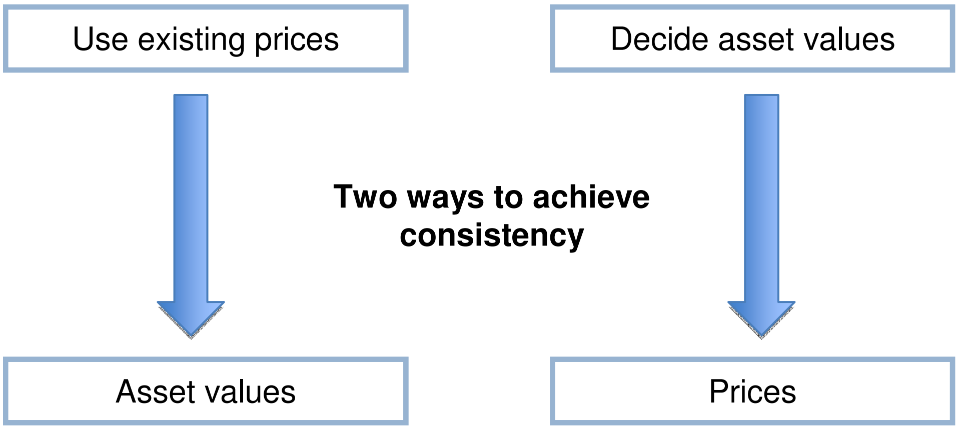
The obvious method to value the equipment is its second hand value, however no such market exists for second hand transmitter equipment so this is not feasible.

In a competitive market, competition determines prices and, and, in turn, determines the market value of assets. Where competition is limited, there is no reliable indication of the market value of assets.

However, if assets are valued according to their earning potential, then the value of transmitter equipment assets is determined by the revenues implied by transmission agreements (alongside operating costs and the cost of capital). This implies circularity – cost reflective prices would provide a return on capital equipment, yet prices (and revenues) determine the value of equipment.

There are two ways of resolving this circularity if consistency is sought:

- start with prices and revenues as a basis for valuing assets, or
- start with an asset value (however determined) as a basis for determining prices.



To avoid distorting the customer choice between purchasing transmission assets and entering into a new transmission agreement, consistency between pricing and asset values is desirable.

The following valuation methodologies were considered:

1. **Second hand equipment value** - the cost to purchase and install second hand equipment, purchased in an open market
2. **Value implied by market transactions (merger)** – value prescribed to the transmission assets in the merger between Arqiva and NGW
3. **Current replacement cost (un-depreciated)** – the cost to purchase and install a direct replacement to the current transmitter equipment
4. **Historic cost (un-depreciated)** – the price that was originally paid for the asset
5. **Unrecovered value** – the price represents historic value of the asset that is yet to be recovered
6. **Future earning potential** – the price represents the future value that could be attributed to the asset
7. **Depreciated historic cost** – book value
8. **Depreciated replacement cost** – similar to 'depreciated historic cost', with the cost to replace the asset depreciated over the full lifespan of the existing asset.

These were tested against the initial objectives and, as a result, the first four were rejected and the second four above were retained for further consideration in this Consultation. The following table indicates the extent to which these methodologies are consistent with the objectives:

	Valuation method	Consistent	Inconsistent
5	**Unrecovered value**	Addresses customer concern in relation to "paying twice" for an asset i.e. provides a measure of backward-looking customer protection which recognises that asset recovery is not simply a matter of accounting depreciation to date.	Would distort customer choice between purchase and contract unless contract price was also revised accordingly based on remaining unrecovered value.
6	**Future earning potential**	Recognises service value of assets and ensures that asset transfer only occurs if self-provide management option is seen as more efficient.	Requires estimate of remaining economic life of asset and future operating costs. Embeds any "excess returns" in asset value.
7	**Depreciated historic cost**	Provides greatest assurance of cost recovery and therefore promotes investment.	May get out of alignment with current market reality if replacement costs are falling/rising.
8	**Depreciated replacement cost**	Maintains alignment with current market reality.	Provides less assurance of cost recovery if replacement asset costs are falling.

The four methodologies were then tested against the initial objectives to gauge levels of attainment:

	Customer protection and perception of protection	**Investment incentives**	**Efficient customer choice**	**Simplicity and transparency**
Unrecovered value	●	◐	○	◐
Future earning potential	○	◐	●	○
Depreciated historic cost	◐	●	○	●
Depreciated replacement cost	◐	◐	◐	◐

○ Low
◐ Medium
● High

Unrecovered Value appears attractive from the customer perspective if Arqiva have effected capital recovery ahead of the useful life of the equipment. It does potentially distort the market and would involve looking back into contracts that were in place prior to the commencement of the Undertakings; this is felt to be outside the remit of the Adjudicator.

Future Earnings Potential involves valuing the equipment on the basis of the revenue it would make over its remaining life. This method could be as advantageous to Arqiva as the first could be to the customer and would be both circular and speculative.

Depreciated Historic Cost is the original purchase price depreciated by the amount of the life of the equipment that has been expended. For instance a piece of equipment originally purchased at £10,000 with a lifetime of 20 years would be valued at £5,000 when 10 years old. It would be attractive to Arqiva in that it guarantees that investment is recovered and thereby encourages investment; however it fails to take into account equipment pricing trends.

Depreciated Replacement Cost is similar to depreciated historic cost but uses the current equipment cost rather than the original. When the price of technology is dropping, this will benefit the customer.

6.0 Conclusion

The Adjudicator believes that the transmission equipment will usually have a transfer value.

From the above analysis, it is clear that there is no perfect method, however the Adjudicator believes that the one that best fits the objectives and can be effectively policed is the Depreciated Replacement Cost Method ("DRC"). The Adjudicator also believes that 20 years is a realistic lifespan for present day transmitter equipment.

Consultation Questions

1. Do you agree with the criteria used to assess the methodologies under consideration?

2. Do you agree with the conclusion that the transmitter equipment has a sale value to Arqiva?

3. Do you agree with the conclusion that DRC represents the optimum valuation method?

4. Do you agree with 20 years as the period to be used in the DRC calculation? Should there be a single figure or should there be different figures applied to different categories of transmitters?

5. Are there any other issues you would wish the Adjudicator to take into account in forming the guidance?

Replying to this consultation

Any person wishing to reply to this consultation should do so in writing to the address below:

The Office of the Adjudicator-Broadcast Transmission Services
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London SE1 9HA

Or by email to alan.watson@adjudicator-bts.org.uk

Responses should be received by 5pm on Friday 12th June. Unless responses are marked confidential, the Adjudicator will publish the name of the respondent as well as some or all of the content.