Office of the Adjudicator – Broadcast Transmission Services

Consultation 3/2009: Principles for pricing new transmission contracts

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 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 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 9, "Charges for new transmission agreements". A new transmission agreement is a contract with a new customer or when an existing customer elects to adopt new terms, conditions and pricing rather than rolling over an existing contract.

Para 9 sets out the main principles for pricing new transmission agreements:

- That it is derived from cost and has been calculated in accordance with any guidance or direction issued by the Adjudicator (Para 9.3)
- That the Network Access element is calculated in accordance with the Ofcom Notification (published April 2005) and passed through without mark-up (Para 9.4)
- That it is sufficiently transparent to allow the Customer a reasonable understanding of the basis of calculation (Para 9.5)

This consultation is intended to assist the Adjudicator to prepare Guidance on some specific issues such as the period over which capital may be recovered and acceptable returns on investment. Should it prove to be necessary, a future consultation will be held to determine the level of transparency required to meet Para 9.5.

2.0 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 though 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 Issues for Consideration

3.1 Components of a Transmission Agreement

The new transmission agreement comprised two elements:

- Network Access (NA) which is the apportioned charge for the use of common facilities on a site (such as the tower)

- Managed Transmission Service (MTS) which relates to the provision of equipment that is solely for the use of the customer, such as transmitters

3.2 Network Access

The principles for setting Network Access Charges were set by Ofcom in its Notification of 2005. This process required Arqiva to determine the total NA costs per site and then apportion them between television, radio and third party users. The basis of the apportionment was wind loading i.e. the percentage of the structural capacity used by each category of service.

The NA Charges for television have already been determined and are being applied in the various television High Power contracts.

As part of this process, the cost per site attributable to radio was also identified. This mechanism has given rise to a large variation of NA charges site to site, therefore Arqiva have proposed taking the total sum to be recovered from radio across all sites and forming a single rate card.

Appendix 11 of the Undertakings sets out the principles for NA Charges for Television (Paras 21-25) and Appendix 12 (Paras 21-25) for Radio. Both appendices refer back to Para 11, Charges for Network Access.

Para 11.3 requires that NA Charges be "*reasonably derived from cost of provision allowing an appropriate mark-up for the recovery of common costs including and appropriate return on capital employed".*

The two key figures in determining the appropriate return are WACC (Weighted Average Cost of Capital) and the RPI-X efficiency factor to be employed. These are both considered below.

Para 9.4 of the Undertakings requires that the NA Charges are determined in accordance with the Ofcom Notification and passed through without mark-up.

If the ratecard approach is adopted for radio, the Adjudicator will require publication of the radio ratecard.

3.3 MTS

MTS usually involves Arqiva purchasing and installing capital plant which is then used to provide the Service. The ongoing costs include maintenance, spare parts and electricity. The initial capital spend and capitalised construction labour is recovered over a period of time.

The Adjudicator wishes to promote transparency of pricing and regards the requirements set out in Para 9.5 as establishing a minimum level. This aspect will be reviewed separately and specific guidance issued subsequently if necessary.

As a generality, all figures put forward by Arqiva should have supporting explanation including the basis of any apportionment. These costs are classified as “short run incremental costs” in Ofcom’s Guidance (Section 5). The Guidance acknowledges that these costs should be recovered as a minimum.

Appendices 11 (Television) and 12 (Radio) are specific on aspects of charging including electricity, annual adjustment at RPI-1 and the use of gainshare mechanisms. The Adjudicator intends that these Appendices will continue to apply in full and that its Guidance should amplify rather than replace them.

3.3 (i) Capital costs

The onus is on Arqiva to demonstrate to the Customer that the capital costs have been efficiently incurred. This will include the provision of alternative designs to demonstrate that the suggested design is the one that best meets the customer requirements.

Capital recovery is to be over the economic life of the equipment and not the contract period (see Para 5.4 of Ofcom’s Guidance).

There are occasions where the projected life of the equipment will fall short of its economic or useable life; for instance if MF transmitters are replaced in the near future, their life will be determined by the date of analogue closedown. In situations such as this, it is acceptable to recover the capital against a projected and stated end date for the use of those assets. It is also accepted that there is an element of uncertainty and therefore risk. The Adjudicator will expect this to be addressed by a risk sharing mechanism between Arqiva and the Customer.

Appendices 11 and 12 require a gainshare mechanism to be applied where the actual costs of provision are less than forecast but which does not allow for the charges to be raised when the cost exceeds forecast.

3.3 (ii) Power, rent and rates

The Adjudicator proposes that these should be passed through on an annual basis without mark-up. The onus is on Arqiva to demonstrate to the Customer that they have achieved efficient supply of energy and in doing so have considered additional levies such as a climate change. Similarly the onus is on Arqiva to demonstrate to the customer that they have taken energy efficiency into account in their system design.

3.3 (iii) Maintenance and operations

Normally this will form part of the MTS and the supporting information should show the basis of the calculation including any apportionment of costs such as control/monitoring facilities.

In exceptional cases the customer may make an up front capital contribution in which case a margin can be applied to the O&M costs see Para 5.37 of Ofcom's Guidance

The Adjudicator considers a mark-up producing an EBIT of 15% to be reasonable.

3.4 WACC

WACC (Weighted Average Cost of Capital) is the minimum return that a business will need to make in order to service its debt and satisfy its equity providers.

WACC takes into account the risk that an equity participant is exposed to and modifies the return expected accordingly. Similarly, for debt, a premium may be applied.

Ofcom published Guidance in 2006 which set a value for WACC of 10.4% pre-tax nominal. This was at the bottom end of the range that they determined.

Subsequently, interest rates have fallen but risk has increased. It has therefore been suggested that it might be appropriate to review WACC for Arqiva. Examination of the component parts of WACC, however, indicates that the situation for Arqiva has not changed materially. Furthermore a Competition Commission review of a similar infrastructure business, Stansted Airport, in 2008 concluded that a WACC of 7.1% real was appropriate (and then revised this upwards by 0.2% in March 2009).

	Arqiva Site access 2006	**Openreach December 2008**	**Stansted, December 2008 Competition Commission recommendation.**	
			Low	High
Risk free rate	4.60% nominal	4.10%-4.80% nominal	2.0% real	2.0% real
Equity risk premium	4.50%	4.50%-5.00%	3.0%	5.0%
Equity beta	1.00	0.75-0.85	1.00	1.24
Gearing	35%	35%	50% assumed	50% assumed
Debt premium	1%	2-3%	1.4%	1.7%
Pre-tax WACC	10.4% nominal 7.71% real	9.25%-10.75% nominal	5.20% real	7.54% real

The Adjudicator believes that 10.4% remains appropriate for Arqiva but will review this again in due course.

3.5 RPI

RPI is a consumer price index which includes both mortgage costs and indirect taxes. RPI as an indexation reflects what is happening to the economy generally and all companies are exposed to this. The RPI-X factor is intended to promote efficiency, i.e. if set at zero there would be no efficiency gains.

Appendices 11 and 12 set the annual adjustment at RPI-1%; the Adjudicator proposes to maintain this.

Consultation Questions

1. Do you agree with the principle that capital recovery should be aligned to the useful life of the equipment?
2. Do you agree with the concept of allowing faster recovery where there is an identified risk of there being stranded assets?
3. Would you propose a different mark-up for maintenance only contracts?
4. Do you agree with the ratecard approach to Network Access Charges for radio?
5. Do you consider maintaining both WACC at 10.4% real and RPI-1 to be appropriate in the short term?
6. Are there other aspects of pricing that you feel require guidance?
7. Are there any other related issues you wish to comment on?

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
Consultation 3/2009
Riverside House
2a Southwark Bridge Rd
London SE1 9HA

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

Responses are to be received by 5pm on 19th June 2009. Unless responses are marked confidential, the Adjudicator will publish the name of the respondent as well as some or all of the content.