

Consultation 2/2015: The Cost of Capital in Relation to Broadcast Transmission

Introduction

The Weighted Average Cost of Capital (WACC) for Network Access (“NA”) was set by Ofcom in 2006 at 10.4% pre-tax nominal, 7.7% pre-tax real. In 2008 the Office of the Adjudicator was set up and in its Guidance to the Adjudicator (Para 5.36) Ofcom said “we suggest that Arqiva should continue using this rate until such time as the Adjudicator thinks it appropriate to revise the rate”.

In 2010 the Adjudicator commissioned Plum Consulting to review the market conditions and advise if the present rate was still applicable or if a full review was recommended. Their recommendation was that the present rate was still applicable and this was adopted by the Adjudicator.

Arqiva intended to refinance in 2014. Since the new financing arrangements could have a bearing on the applicable rate, the Adjudicator set 2014 as the next review. Plum was commissioned to carry out this review, and their report dated January 2015 is attached.

The duties of the Adjudicator are set out in the Undertakings; for these purposes, the relevant sections are:

Para 11.3, which obliges Arqiva to set charges, to the satisfaction of the Adjudicator, which are derived from costs and include an appropriate return on capital employed.

Appendix 1, Para 8 which permits the Adjudicator to issue guidance on matters covered by Paragraphs 9-12 of the Undertakings, specifically on the appropriate return on capital employed.

In their Guidance to the Adjudicator (5.16-5.19) Ofcom suggest that the Adjudicator might need to consider further mark-ups on cost to permit a return consistent with a competitive market and to encourage innovation.

The Adjudicator therefore has the power to set a new rate and in doing so take into account any relevant factors. The balance to be struck is ensuring that Arqiva make an adequate return in order to ensure continued investment and innovation but to limit it, such that the cost of NA is commercially viable.

The review is forward looking and the new rate would come into effect by the issue of a Statement following this consultation. The review period has been proposed as 10 years from that point. This period has been chosen as most contracts are long term and stability is advantageous. The risk profile, which is discussed later in this document, may change in that period and a significant change may trigger a review before the ten years elapses. It is not intended that the new rate would apply to existing contracts.

Assessing the return on capital for a listed company is fairly straightforward, however Arqiva is not listed, furthermore the provision of Network Access is only one part of their business. The work done by Plum looks at NA as if it was a standalone business requiring separate funding and derives the several variables that make up WACC.

Changes since the last review and changes forward looking

WACC pre tax, both real and nominal is affected by the corporation tax rate. This will have reduced from 30% to 20% (by April 2015), which reduces the WACC. Conversely the attitude to risk has hardened and the risk premiums have increased. These two virtually cancel each other out.

The report projects these factors into the future and recommends that WACC be set in the range 6.6% to 7.5% pre-tax real.

However, the report acknowledges that the capital asset pricing model (CAPM) formula for computing the WACC may not capture all of the risks faced by a broadcast transmission business. While company-specific risk is reflected on the debt side of the formula (via the company debt premium and the level of gearing), it may not be adequately captured on the equity side.

An element of company-specific risk is captured by the equity beta (the covariance between returns on the asset and returns to the market portfolio). Yet this measure may not fully reflect the risk that the business is displaced by technological change and competition (which, in any case, might not be correlated to market returns). To compensate for this, the report suggests ‘aiming up’ within the recommended WACC range.

Specific risk is relevant here as Arqiva’s ability to provide NA is directly related to future spectrum availability, which is uncertain. In the Ofcom work of 2006 there was no consideration that the life of Digital Terrestrial Television (“DTT”) might be finite. Since then Channels 61 and 62 have been cleared of DTT, and it now looks very likely that the 700 MHz spectrum will also be lost to DTT. The remaining spectrum for DTT looks to be available until 2030 but with a review in 2025. Furthermore, if DTT ceases the NA assets will become redundant. This “cliff edge” would make investors increasingly wary and would lead to the introduction of a premium to cover this risk.

Similar (but not so harsh) considerations exist in the radio market, which is slowly transitioning from analogue to digital.

The Adjudicator sees two options to deal with this specific risk

- a) Ignore it, which would make investment in new works increasingly hard to fund and risk shortening the life of DTT
- b) Accept that it is a factor over and above the computed WACC and make allowance for it.

The first option does not meet the Adjudicator’s duty to ensure adequate return and innovation. The second option of preserving the academic rigour of the report and making an allowance for the technological risk has been selected by the Adjudicator.

At the present time the risk is small but it will increase over time and the end of this proposed review period coincides with the review of the spectrum in 2025 at which point decisions on the lifetime of DTT may be made.

Setting the new WACC

The Adjudicator has to decide where in the range of 6.6% to 7.5%, pre-tax real, to set the WACC. Without the specific risk factors discussed above then a median value would have been adopted, but taking the specific risk into account the Adjudicator is minded to set the WACC at 7.5% pre-tax real.

The intention is that the new value would remain valid until 2025. The Adjudicator would conduct an intermediate review if there is a significant change in the market or Arqiva's finances such that the Adjudicator believes a review is required.

Consultation

Please respond either by email or post to the Office of the Adjudicator (BTS) to the following questions;

- a) Do you agree with the conclusions of the Plum report?
- b) Do you agree with the Adjudicator's approach to specific risk?
- c) Do you agree with the proposal to set WACC at 7.5%?

If you do not agree and wish to present alternative conclusions, please ensure that supporting evidence is included.

In line with the Adjudicator's duty to promote transparency, confidential responses will not be accepted and the Adjudicator will publish all responses received.

The deadline for receipt of responses is 17 March 2015

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