



Guidance for the Adjudicator: The Arqiva undertakings

Ofcom's guidance to the Adjudicator for Broadcast
Transmission Services

Statement

Publication date: 16 January 2009

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Section 1

Summary

- 1.1 On 1 September 2008, the Competition Commission accepted undertakings from Arqiva as a remedy to the substantial lessening of competition created by the merger of Arqiva and National Grid Wireless¹. As part of those undertakings, an independent Adjudicator is required to be appointed by Ofcom to address disputes regarding the effective operation of the undertakings (the “Adjudicator”).
- 1.2 As required by the undertakings, Ofcom must issue guidance to the Adjudicator in order to enable him to produce his own guidance on the approach he will take in settling disputes between Arqiva and its customers pursuant to the undertakings. On 21 October, we therefore published a document containing Ofcom’s draft guidance and invited comments on this text before preparing the final form of our guidance to the Adjudicator.
- 1.3 There were 6 responses to our guidance document and we have considered these before preparing our statement. Section 2 of this document discusses the key points raised in our consultation and Ofcom’s comments on them.
- 1.4 Sections 3-5 provide Ofcom’s guidance to the Adjudicator. Section 3 provides some background to the guidance and section 4 discusses the objectives Ofcom considers the Adjudicator should work from. Section 5 discusses the various cost concepts that can be used to arrive at prices and provides general guidance on these.
- 1.5 We note that our guidance is not intended to be a prescriptive methodology applicable to all transmission services² as it is not possible to have a single methodology that might be equally appropriate in all circumstances. Rather, it provides general guidance on the analysis of costs and prices. In discharging his functions under the undertakings the Adjudicator must use his judgement of what can be considered reasonable in any particular circumstance. We would also stress that the Adjudicator will create his own guidance (which may differ from Ofcom’s) and will also consult on that guidance in due course.

¹ The undertakings given by Arqiva and the Macquarie Funds in respect of the acquisition of National Grid Wireless to the Competition Commission, which were accepted on 1 September 2008 – for the remainder of this document, they will simply be referred to as ‘the undertakings’. A non-confidential version of them is at http://www.competition-commission.org.uk/inquiries/ref2007/macquarie/pdf/notice_undertakings.pdf.

² As defined in the undertakings.

Section 2

Consultation Responses and Ofcom's comments

Overview of responses

2.1 We received 6 responses to the consultation:

- 5 from business and related organisations
- 1 from an individual

Three of the respondents (the BBC, RadioCentre and Arqiva) gave permission for their responses to be published and these are available on our website at:

<http://www.ofcom.org.uk/consult/condocs/arqiva/responses>

2.2 In our consultation, we asked stakeholders if they agreed with Ofcom's draft guidance to the Adjudicator and whether they had any further comments on the scope of the guidance.

2.3 Most respondents welcomed our draft guidance, although some issues were raised about its content and scope. The main comments were around the Adjudicator's objectives, the ability to comment on the Adjudicator's own guidance, transparency and concerns around the cost and pricing principles (such as the consideration of innovation, efficiency and cost allocation). Below, we discuss each of the main points that were made and Ofcom's comments on them.

Consultation on the Adjudicator's guidance

2.4 The BBC, RadioCentre and a confidential respondent commented that it will be important for the Adjudicator to consult with stakeholders prior to finalising his own guidance.

Ofcom response

2.5 We note that under paragraph 8 of the Adjudication Scheme³ the Adjudicator is required in issuing guidance to "consult with Arqiva, Ofcom, the Office of Fair Trading, purchasers of Transmission Services and Network Access and such other persons as the Adjudicator considers appropriate, and shall provide such persons with a reasonable opportunity to make representations". We therefore anticipate that the Adjudicator's guidance will be subject to prior consultation.

Objectives for the Adjudicator

2.6 A confidential respondent considered that it was not appropriate for Ofcom to define objectives for the Adjudicator because:

³ The Adjudication Scheme is Appendix 1 in the undertakings and available at http://www.competition-commission.org.uk/inquiries/ref2007/macquarie/pdf/notice_undertakings.pdf.

- it is unnecessary as the Adjudicator’s objectives are outlined in the undertakings, where the Adjudicator is already bound to have regard to Ofcom’s statutory duties and guidance issued by Ofcom; and
- the provision of objectives could undermine the independence of the Adjudicator from Ofcom.

2.7 The RadioCentre thought that the objectives should specifically recognise the particular position of commercial radio customers. It also considered that the objective for “protection of customers” should stress that customer protection measures “need to be comprehensive – that is accounting for all eventualities and covering all components of transmission services provided by Arqiva”.

Ofcom response

2.8 Under paragraph 13.3 of the undertakings Ofcom must “following consultation, issue guidance to the Adjudicator (with a copy to Arqiva) in relation to the matters set out in paragraph 8 of the Adjudication Scheme”. Paragraph 12 of the Adjudication Scheme sets out the matters to which the Adjudicator is required to have regard in carrying out its functions, including the functions under paragraph 8 of the Adjudication Scheme. Under paragraph 12(ii) the Adjudicator must “where relevant, take account of (but shall not be bound by) (a) Ofcom’s statutory duties and (b) any relevant guidance or specific advice issued by Ofcom either prior to, on or after the Commencement Date”. Under paragraph 12(iii) the Adjudicator must also act with a view to securing that there is no inconsistency between his decision and decisions made by Ofcom which are binding on Arqiva.

2.9 In relation to the arguments made by the confidential respondent, we agree that the Adjudicator must in any event have regard to Ofcom’s duties and decisions. The purpose of the objectives in the guidance is to assist the Adjudicator’s decision making process by suggesting a set of particular considerations which Ofcom considers should be taken into account in the analysis of disputes arising under the undertakings. We consider that, given the content of paragraph 12 of the Adjudication Scheme, it would be incorrect for Ofcom to separate these considerations from the background of the regulatory regime. It is also clear that the Adjudicator must have regard to the guidance rather than being bound to follow it (as with duties and decisions), and there is therefore no question of objectives being imposed.

2.10 In response to the points made by the RadioCentre, we think the objectives should be general in nature and therefore it would be inappropriate to refer to one particular customer group. We also note that the scope of the services covered by the undertakings is determined by the undertakings themselves.

Applying guidance developed for SMP regulation of Network Access

2.11 Arqiva makes several comments in its response to the effect that the Adjudicator should seek to use the cost and pricing principles developed by Ofcom for (the preparation of reference offers for network access services under the existing SMP regulation of) network access.

Ofcom response

2.12 Ofcom agrees the Adjudicator should consider Ofcom’s SMP guidance as the undertakings make it clear that the Adjudicator has a general obligation to achieve

consistency with sectoral regulation. This point is conveyed in our guidance to the Adjudicator.⁴

- 2.13 However, we must point out that the Adjudicator has to take into account a number of different objectives in reaching his decisions and that his analysis will reflect the particular circumstances of each case. This means that it is possible that the Adjudicator may choose to take an approach which could potentially depart from our SMP guidance.

Transparency

- 2.14 A confidential respondent considered that the guidance should specify how the Adjudicator's publications could help promote transparency. In particular there was a belief that the Adjudicator's published decisions and reports should contain pricing information as a matter of course. The RadioCentre was also surprised at the omission from the guidance of any outline of the approach which Arqiva should take to delivering pricing transparency.

Ofcom response

- 2.15 On transparency we note firstly that the guidance Ofcom has to provide under paragraph 13.3 of the undertakings relates to the Adjudicator's functions under paragraph 8 of the Adjudication Scheme. The Adjudicator's function of promoting transparency is however contained within paragraph 9 of the Adjudication Scheme.
- 2.16 We nonetheless agree that the Adjudicator's transparency objective forms a central part of his functions. Paragraphs 26 to 34 of the Adjudication Scheme contain the rules which apply to the disclosure of information by the Adjudicator. Paragraph 30(b) provides that the Adjudicator may disclose information for the purpose of fulfilling his transparency function. It is also however clear under paragraph 33 that disclosure decisions must take into account the particular circumstances of each case. Similarly, Arqiva's obligation under paragraph 9.5 of the undertakings to provide "sufficient" transparency regarding the transparency of pricing is likely to vary depending on the requirements of the relevant customer. We therefore consider at this stage that it would not be appropriate for our guidance to recommend the disclosure of particular classes of information.

Digital Switchover (DSO) costs

- 2.17 A confidential respondent considered that the Adjudicator should have a specific obligation to oversee the DSO build programme and ensure that costs are optimised.

Ofcom response

- 2.18 The guidance Ofcom is to provide under paragraph 13.3 of the undertakings relates to the Adjudicator's functions under paragraph 8 of the Adjudication Scheme. The Adjudicator does have certain functions regarding the auditing of DSO expenditure but these are defined in paragraph 14 of the undertakings. We have therefore decided not to include any specific comment on scrutiny of DSO expenditure in the guidance.

⁴ See paragraphs 3.16, 5.44 and 5.45 of this Statement.

Pass through of efficiency gains

- 2.19 A confidential respondent considered that the role of the Adjudicator should be extended to ensure that existing contractual mechanisms providing for pass through of efficiency gains operate effectively.

Ofcom response

- 2.20 The scope of Adjudicator's role is defined by the undertakings. In relation to existing contracts the scope is limited to disputes arising under paragraphs 3 (Contract variations), 6 (Sale of transmitter equipment) and 8 (Right to renew existing radio agreements).

Bidding costs

- 2.21 A confidential respondent was concerned that Arqiva will now require customers to underwrite all bidding costs and that this could be addressed through ex-ante measures.

Ofcom response

- 2.22 The undertakings do not contain any specific treatment of bidding costs. Arqiva is required to make an offer to provide particular services under the undertakings. In relation to those services it would therefore not be open for Arqiva to require bidding costs to be paid as a condition of providing an offer to a potential customer.

Price terms

- 2.23 The RadioCentre commented that the guidance lacks specificity and that it should state that transparency, FRND terms and cost-orientated pricing principles must be applied to each component of a service provided by Arqiva.

Ofcom response

- 2.24 Our approach to drafting the guidance has been to avoid a prescriptive methodology and instead to provide general guidance which will be of value in addressing the different circumstances that the Adjudicator is likely to face in addressing particular disputes. We continue to believe that is right approach. We also note that the scope of the services covered by the undertakings is determined by the undertakings themselves.

Rewarding and encouraging innovation

- 2.25 The BBC commented that that allowing "super normal profits" (its terminology) is necessary to reward and encourage innovation. However, it expresses doubt that the guidance accurately reflects the fact that most innovation is led by broadcasters and the regulators, not by the transmission companies. In particular, the BBC is concerned that customers may have to pay twice for innovation.

Ofcom response

- 2.26 Paragraph 4.17 of the guidance states that "**where** investments and innovations **are relevant** for the continuity of the service and for providing new services that customers value, it may be efficient for Arqiva to recover more than just its common costs" (emphasis made for the purpose of this response). We would therefore expect

that the Adjudicator would look at how and where innovation has occurred in determining the relevant impact of that innovation on prices.

Calculating prices based on forecast provided by Arqiva

2.27 The BBC commented that Arqiva should submit forecasts on which prices should be based.

Ofcom response

2.28 In our guidance, we do suggest this approach at paragraph 5.23⁵ but we also note that the approach gives rise to some potential problems. Firstly, it may provide incentives for Arqiva to understate its network utilisation since it would result in a higher mark-up on common costs. Secondly, because of demand uncertainty, providing forecasts does not eliminate the problem that Arqiva may still over-recover or under-recover its common costs. We therefore do not feel we need to amend the guidance in this respect.

Balancing the interests of Consumers and Producers

2.29 Some respondents have expressed concern that, through our discussion of common cost recovery in the guidance, there is a bias towards the interests of Arqiva and new customers and to the detriment of existing customers.

Ofcom response

2.30 We consider that in determining what is “efficient” cost recovery, the focus should be on achieving the best outcome for consumers. Therefore the desirability of a transaction taking place between Arqiva and any customer⁶ should be looked at in that sense. Transactions that generate net positive surplus should be encouraged to take place as long as competition is not distorted. The Adjudicator should ensure that the benefits of these transactions are well balanced among existing customers, new customers and producers. In looking at what is the most efficient outcome the Adjudicator should therefore take into account the impact on all parties in the market, but particularly on consumers.

2.31 This approach to the meaning of “efficient” cost recovery is explained in paragraph 5.30⁵ of the guidance, but we accept that it was less clear in other parts of the draft guidance. We have therefore made several amendments to the sub section ‘Services across which common costs are recovered’ (paragraphs 5.21 to 5.26 in our Statement)⁵ to give more clarity on what we mean by efficiency cost recovery.

Contribution to common costs

2.32 A number of respondents (BBC and two confidential respondents) have expressed concerns with the suggestion that some customers, in some circumstances, might make a smaller or no contribution to common costs.

⁵ Note that the paragraph numbers mentioned are those in this Statement – the numbers differ from those in the consultation document which contained our draft guidance.

⁶ We focused on new customers because these are the transactions that are still to occur.

Ofcom response

- 2.33 Ofcom’s pricing approach in the guidance is, as follows.⁷ We suggest that, in general, Arqiva charges non discriminatory cost-orientated prices that reflect equal contributions to common costs. However, where it appears that some customers that can offer services (that would benefit consumers) are not able to enter or stay in the market at these prices, then the Adjudicator may want to consider alternative prices for these customers. Hence the use of the words “in some cases” (paragraph 5.21), “in some situations” (paragraph 5.24) or “in some circumstances” (paragraph 5.26).
- 2.34 For these exceptions, the alternative suggested by Ofcom in the guidance is a contribution based on the customer’s willingness to pay. The Adjudicator may want to consider other alternatives if they appear more appropriate.
- 2.35 However, we also suggested the Adjudicator should have regard to two important issues. Firstly, while exceptions to the “equal contribution to common costs” rule may be beneficial for consumers, it does not imply that some customers are automatically entitled to it (paragraph 5.26). Secondly, in considering these exceptions, the Adjudicator will have to ensure that any alternative considered does not distort competition between customers (paragraphs 5.30 and 5.31).
- 2.36 In this respect, Ofcom notes a confidential respondent’s comment that “market exit is not required to demonstrate an anti-competitive impact”. Market exit was only cited as an example but we accept that it may be misleading in this context and therefore we have removed it from the guidance.⁸

Willingness to pay and price discrimination

- 2.37 A confidential respondent commented that Ofcom’s scheme amounts to first degree price discrimination where the monopolist appropriates all of the entire customers’ surplus. This respondent and the BBC also commented that it is not possible to know some customers’ willingness to pay.

Ofcom response

- 2.38 Ofcom does not suggest that in circumstances where an exception to the “equal contribution to common costs” rule is appropriate, a customer should pay a price *equal* to its willingness to pay. Instead, we suggest that it pays a price “*based on*” (in proportion to) its willingness to pay. Ofcom also does not suggest that it is easy to observe all customers’ willingness to pay.
- 2.39 Nevertheless, it is reasonable to assume that customers might be categorised in (possibly wide) groups whose willingness to pay can be ranked. For example, a new broadcaster addressing a very limited audience is likely to have a lower willingness to pay (at least in the short-term) than an established national broadcaster. Ofcom therefore does not feel the guidance needs to be modified in this respect (except by removing of the “market exit” example noted above).

⁷ Note that the paragraph numbers which are mentioned are those from this Statement – the numbers differ from those in the consultation document which contained our draft guidance.

⁸ The wording “say, by the potential exit of some existing customers” has been removed from paragraph 5.31 of this Statement.

Efficiency

- 2.40 The BBC welcomes Ofcom's guidance that Arqiva's costs have to be efficiently incurred and considers this aspect to be a crucial area for the Adjudicator to issue his own guidance. A confidential respondent commented that because Arqiva's prices are on a cost-plus basis, Arqiva has incentives to maximize costs and the Adjudicator should ensure that it does not behave in an anti-competitive manner. Another confidential respondent wishes to direct the Adjudicator towards taking into account the efficiency of equipment purchased and not just capital expenditure.

Ofcom response

- 2.41 We make clear at paragraph 4.6 that one of the Adjudicator's objectives should be to analyse whether Arqiva has incurred costs efficiently. We consider that the detail of how this will be achieved is for the Adjudicator to address.

Valuation of existing assets

- 2.42 A confidential respondent expressed a concern with the subsection which discussed the 'Treatment of existing and new capital expenditure/assets'. According to the respondent, it suggests that in some circumstances, it might be reasonable for Arqiva's assets to be paid for more than once.

Ofcom response

- 2.43 We recognise the legitimate concern that Arqiva should not be allowed to over-recover against its costs. There can however be a tension between the principle of cost recovery and addressing the true economic value of assets. The purpose of paragraph 5.39 of the guidance is therefore simply to point out the existence of this tension. It will be for the Adjudicator to take decisions on the appropriate treatment of assets in any instance.

Cost of Capital

- 2.44 A confidential respondent commented that the Weighted Average Cost of Capital (WACC) determined in 2005 by Ofcom in its sectoral regulation of Arqiva is 10.4% instead of the 10.7% reported in the guidance. The BBC commented that Ofcom should provide guidance to the Adjudicator towards a review of the WACC in light of the new market situation.

Ofcom response

- 2.45 Ofcom acknowledges the correct figure is 10.4% and this has been reflected in the final guidance. In terms of the BBC's comment, on whether or not this figure should continue to apply, we consider that is a matter for the Adjudicator to judge. Ofcom does not however intend to modify the sectoral position at this stage.

Conclusion

- 2.46 We are grateful to respondents for providing their comments. In summary, following consideration of consultation responses, we have amended the guidance by:
- modifying wording to provide more clarity on what we mean by efficient cost recovery – in the sub-section 'Services across which common costs are recovered'; and

- removing the market exit example in the sub-section “Effect on competition and consumers in downstream markets” as recognition that market exit is not required to demonstrate an anti-competitive impact; and
- correcting the figure on the Weighted Average Cost of Capital, to 10.4%.

2.47 The final form of guidance, incorporating these amendments, now follows in sections 3-5.

Section 3

Background

- 3.1 In this document, we set out:
- the background to Ofcom's guidance;
 - objectives for the Adjudicator; and
 - guidance on price terms.

The merger

- 3.2 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.
- 3.3 Arqiva and NGW overlap in the provision of Managed Transmission Services (MTS)⁹ and Network Access¹⁰ (NA) to sites and associated facilities to 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 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.
- 3.4 The CC concluded the merger of the two companies would lead to a “substantial lessening” of competition in relation to the markets for the provision of MTS and NA to television broadcasters and certain radio broadcasters within the UK. 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.
- 3.5 After consultation by the CC with Arqiva, its customers and other stakeholders, the Commission accepted undertakings from Arqiva on 1 September.¹¹

The undertakings

- 3.6 In summary, the undertakings will deliver:
- a 17 per cent price discount on existing radio transmission agreements¹²;
 - a 3.25 per cent price discount on existing analogue television and low-power DTT MTS/NA contracts;
 - a £50 million reduction to Network Access capital expenditure for DSO (Digital Switchover);

⁹ As defined in the undertakings

¹⁰ As defined in the undertakings

¹¹ http://www.competition-commission.org.uk/inquiries/ref2007/macquarie/pdf/notice_undertakings.pdf.

¹² As further described in the undertakings

- the option for certain contract renewals to be based on the same prices and terms as the existing contract, or to be determined on cost-oriented and fair, reasonable and non-discriminatory (FRND) terms;
- variations to certain contracts and new contracts to be determined with cost-oriented pricing and on FRND terms (or for similar services to an existing contract, the option for terms to be based on the existing contract);
- **an independent Adjudicator** to resolve disputes between Arqiva and its customers;
- enhanced service level and service credit provisions;
- a 'super credit' regime to compensate for customers' inability to move to an alternative provider in the event of persistent poor performance;
- the option, at the end of an MTS/NA contract, for the customer to acquire the relevant transmitter equipment¹³;
- the preparation and audit of separate regulatory accounts for Arqiva's MTS and NA operations; and
- an annual audit of the DSO programme to provide increased transparency to customers.

The Adjudicator

3.7 When carrying out his functions (including the resolution of disputes) the Adjudicator:

- must have regard to the undertakings;
- shall, where relevant, take account of (but shall not be bound by) (a) Ofcom's statutory duties and (b) any relevant guidance or specific advice issued by Ofcom;
- shall act with a view to securing that there is no inconsistency between his decision and any direction, notification, determination made by the Director General of Telecommunications or Ofcom or any decision of the Competition Appeal Tribunal or CC pursuant to their respective powers under the Communications Act 2003 which, in each case, is legally binding upon Arqiva at the time the Adjudicator takes his decision; and
- may take into account such other information as he considers relevant.

Ofcom's guidance

3.8 Paragraph 13.3 of the undertakings states that:

"Arqiva shall have regard to such guidance as is provided by Ofcom to the Adjudicator for the preparation of guidance under paragraph 8 of the Adjudication Scheme until such guidance is specifically superseded by guidance issued by the Adjudicator under paragraph 8 of the Adjudication Scheme. As soon as reasonably practicable

¹³ As defined in the undertakings

after the Commencement Date Ofcom will, following consultation, issue guidance to the Adjudicator (with a copy to Arqiva) in relation to the matters set out in paragraph 8 of the Adjudication Scheme.”

- 3.9 Paragraph 8 of the Adjudication Scheme relates to the issuing of guidance by the Adjudicator that will outline his principles for resolving disputes between Arqiva and its customers regarding certain of Arqiva’s obligations under the undertakings, in particular its obligation to provide MTS and NA on cost-oriented and FRND terms. Disputes may therefore arise with respect to both price and non-price terms.
- 3.10 There are therefore two sets of guidance: the Ofcom guidance (this document) and the guidance which will subsequently be produced by the Adjudicator pursuant to paragraph 8 of the Adjudication Scheme.
- 3.11 Until the Adjudicator produces his own guidance Arqiva must have regard to Ofcom’s guidance in setting the prices and terms for the supply of MTS and NA.

Purpose of Ofcom providing guidance to the Adjudicator

- 3.12 The main purpose of Ofcom’s guidance is to outline the various factors that should be taken into account by the Adjudicator in the resolution of a dispute. It is however not intended to be a prescriptive set of principles to be applied for all kinds of disputes. When having regard to this guidance, the Adjudicator will need to apply his judgement to assess which, if any, of the principles would be appropriate in any dispute.

The Adjudicator’s Scope – MTS and NA

- 3.13 The Adjudicator will cover potential disputes around both Managed Transmission Services (MTS) and Network Access (NA). In practice, all television broadcasters and most radio broadcasters presently purchase NA bundled together with MTS, through an MTS provider. Therefore, the Adjudicator is most likely to be examining issues around MTS and NA together.

Ofcom’s existing regulation

- 3.14 Pursuant to the EU framework, Ofcom has a responsibility to impose regulation in certain markets where it is established that there is evidence of Significant Market Power (SMP). We have to make sure that the regulation is appropriate and proportionate to the finding of SMP.
- 3.15 In relation to broadcasting transmission services¹⁴, Ofcom found SMP existed in the following markets¹⁵:
- the provision of access to the mast and site network and shared or shareable antenna systems acquired, constructed or installed by ntl:broadcast [Arqiva] for the purpose of providing analogue and/or digital terrestrial broadcasting transmission services within the United Kingdom, to deliver broadcast content to end users on a National, Regional or Metropolitan basis;

¹⁴ Broadcast transmission services was previously on the list of markets Ofcom was required to review, however this is no longer the case. So while Ofcom does continue to have sectoral powers in the area, we also have discretion in terms of how we exercise them.

¹⁵ http://www.ofcom.org.uk/consult/condocs/bcast_trans_serv/final/

- the provision of access to the mast and site network and shared or shareable antenna systems acquired, constructed or installed by Crown Castle [NGW] for the purpose of providing analogue and/or digital terrestrial broadcasting transmission services within the United Kingdom, to deliver broadcast content to end users on a National, Regional or Metropolitan basis;

3.16 We therefore already regulate the provision of certain network access services. These regulations were put in place on 28 April 2005 - via a notification under section 48(1) and 79(4) of the Communications Act 2003 - which placed obligations on NGW (then Crown castle) and Arqiva (then ntl:broadcast). The Adjudicator must act view a view to securing consistency with this existing regulation.

Section 4

Objectives for the Adjudicator

- 4.1 In order to promote consistency with Ofcom's own duties and regulation in terrestrial broadcasting transmission, we consider that the Adjudicator should undertake his functions with objectives which are similar to those pursued by Ofcom. We therefore discuss below a number of objectives which we think the Adjudicator should have regard to when carrying out his functions.

Protection of customers

- 4.2 In resolving a dispute under the undertakings the main aim of the Adjudicator is to ensure that Arqiva does not unfairly exploit the monopoly position conferred on it through the merger. The exploitation of a monopoly position can take various forms. It may be in the form of excessive pricing for certain contracts or the provision of services on uncompetitive terms, or even a refusal to supply services to meet certain types of demand (when it may be reasonable and economic to do so), or not provide sufficient information on the terms of the contract to allow customers to be able to negotiate competitive terms.
- 4.3 The undertakings require Arqiva to provide transmission services (i.e. a service consisting of MTS and Network Access provided to a radio or television multiplex operator or broadcaster) on reasonable request. The Adjudicator should seek to ensure that the prices charged by Arqiva for such transmission services are no higher than the prices which would be charged in a competitive market.

Ensuring incentives for investment and innovation

- 4.4 The charges that Arqiva makes for transmission services should provide a reasonable opportunity for the firm to earn a competitive return on its investment and to be able to recover all efficiently incurred costs, in line with what would be expected in a competitive market.
- 4.5 It is important that Arqiva continues to innovate in the provision of those services particularly given the changing nature of technology in broadcasting transmission. The prices that Arqiva charges should provide enough incentives to innovate both in the technology and provision of transmission services.

Providing incentives for efficiency

- 4.6 Arqiva should operate its existing transmission business in an efficient manner. In a competitive scenario, the market would provide incentives for efficiency through the necessity to reduce costs low enough to make an adequate return at competitive prices. However this discipline is not present in a monopoly situation and Arqiva should not pass on to its captive customers any inefficiencies arising as a result of that monopoly. In order to avoid such an outcome the Adjudicator should have regard to whether costs are incurred efficiently in determining the allowable costs to be passed on to customers in price disputes.

Section 5

Guidance on Price Terms

- 5.1 The guidance in this section is intended to enable an assessment of the prices of bundled NA and MTS services. However, we also refer at the end of this section to the position on Network Access.

Fair and reasonable

- 5.2 In assessing whether a commercially negotiated price is fair and reasonable, the Adjudicator should have regard to those prices that would be expected in a competitive market. The Adjudicator should also ensure that services are unbundled as much as possible such that the customer pays only for what it requires.
- 5.3 A fair and reasonable price implies a price that is not excessive in the circumstances in which the service is provided, but which allows Arqiva to recover its relevant costs including a reasonable rate of return. In assessing whether a price is excessive, the Adjudicator should have regard to a range of factors, including the costs of provision, the importance of investment, the potential for innovation and the overall policy framework.
- 5.4 In seeking to resolve a dispute on any aspect of “fair and reasonable” the Adjudicator will need to take the specific case into account and consider what might be considered fair in particular circumstances.

Cost orientation: cost concepts

- 5.5 In discussing cost orientation, it is first useful to set out certain cost concepts that are likely to be relevant in setting charges for transmission services.

Incremental costs

- 5.6 Incremental costs are those costs that arise only as a result of the provision of the service and would not arise if the particular service in question were not provided. Incremental costs can be short run or long run.

Common costs

- 5.7 Common costs are those which arise as a result of a group of services being provided, but which are not incremental to a single service. Costs can be common to a limited set of services or to the whole set of services provided by the firm.

Short-run costs

- 5.8 Costs that are relevant to price setting can be short run or long run. Short run costs are those which arise immediately from the provision of output. They commonly comprise only direct operating costs, as they are the costs which vary directly with the level of output. Short run costs typically exclude the costs of using existing assets as those assets exist anyway. The costs do not vary with the decision of whether to produce additional output during the period.

Long-run costs

- 5.9 Long run costs would include, in addition to the direct operating costs of providing a service, a share of the costs of the fixed assets used in providing the service. The shared costs of the assets to be included in a calculation of costs will depend on the methodology for recovering those costs overall: of particular importance is the volume of services being provided at different points in time and the overall expected life of the assets.

Cost orientation: principles of pricing

- 5.10 Cost orientation implies that prices must reflect the relevant costs with appropriate mark-ups where this is justified. Given the above description of different types of costs, the question is what costs are relevant for pricing purposes.

Prices should always recover short run incremental cost (SRIC)

- 5.11 At the very least, prices should reflect the short run incremental cost because this is required for the firm not to be worse off as a result of providing the service. A price below SRIC would encourage consumption which was valued less than the direct costs of providing the service.

Long run incremental cost will usually be relevant

- 5.12 In some cases, a price based on just the short run incremental cost may be appropriate. This might be the case if, for example, there is spare capacity and the service in question will use that spare capacity while it exists but the service will disappear before it is necessary to replace the capacity. In most cases, however, provision of the service in the long run will require investment to update, replace or add to assets and the price for a service should recover the capital costs of such investment incurred to support a particular service. Where such investment is likely to take place, it may be more appropriate to reflect the long run incremental cost (LRIC).
- 5.13 However, any capital expenditure considered needs to be efficiently incurred and included at its efficient cost. For example, where LRIC is the right cost concept for pricing purposes, the physical assets to be considered (e.g. transmitter equipment, masts) should be those that, for a given technical and quality requirement, would have been expected under competitive conditions. Furthermore, the Adjudicator should have regard to how reasonable in size any incremental investment is in order to avoid situations where a customer would pay for services that are more than what is necessary for its needs.

Value of current assets

- 5.14 A tension might exist between using forward looking LRIC to provide the right price signal and at the same time not allow (too much) over-recovery of costs. If the costs of Arqiva's assets have largely been recovered (i.e. its assets are operating beyond their expected or accounting life¹⁶) or if Arqiva has acquired NGW's assets at a substantial discount, then its Regulatory Asset Base (RAB) may be below the market value of new assets.

¹⁶ See the section on the treatment of existing and new capital expenditures/assets.

- 5.15 In this case, a LRIC methodology would likely yield a 'high' cost value and the Adjudicator may have to consider carefully whether this would lead to an undesirable over-recovery of costs.

Additional mark-ups for the recovery of common costs

- 5.16 The above discussion highlights the circumstances under which prices may be able to recover the long run incremental cost in order to enable investment in the network to be maintained.
- 5.17 However, this level of cost recovery may not be sufficient or appropriate and further mark-ups may be necessary for Arqiva to recover all its efficiently incurred costs and earn a fair return on its investment consistent with a competitive market. Indeed, since the market for network access is likely to involve high fixed costs for deploying infrastructure (masts mainly, which imply that it is inefficient to replicate the network), pricing at incremental cost is unlikely to allow recovery of all costs. This is because average costs are likely to be falling and above incremental cost. In these circumstances, pricing at incremental cost would likely fail to recover all costs, as there would be no provision for the recovery of common costs. Furthermore, where investments and innovations are relevant for the continuity of the service and for providing new services that customers value, it may be efficient for Arqiva to recover more than just its common costs.
- 5.18 As discussed earlier, common costs are those which are shared among a number of services. In the case of Arqiva such costs might be those shared among transmission services (e.g. broadcasting), or parts of Arqiva (e.g. broadcasting and mobile telephony)¹⁷. The ability to recover common costs is important for overall continued viability, and mark-ups above incremental costs are necessary to achieve this when common costs are present. Some methodologies for applying mark-up to recover common costs are briefly presented in Annex 1.
- 5.19 The extent to which mark-ups to cover common costs should be considered appropriate is an issue that the Adjudicator should consider on a case by case basis. In assessing how mark-ups should be determined (including their magnitude), the Adjudicator will need to apply his judgement of what might be constituted as a reasonable mark-up in the circumstances of the case. Some of the factors that the Adjudicator should take into account are discussed below.

Services across which common costs are recovered

- 5.20 Several services will be offered over the transmission network of Arqiva and it is likely that the fixed cost of the transmission network and some variable costs will be common to these other services. The multiplicity of services raises a number of important issues. Should common costs be recovered across all services or only a subset of services? How should they be shared among those services once they have been identified?
- 5.21 It seems reasonable that, if all services were offered at the same time their common costs should be spread across all of them. However, other considerations may imply that in some cases the recovery of common costs from only a subset of services or, at least, not equally from all services will deliver better outcomes to consumers.

¹⁷ In what follows, by common cost we shall mean those costs that are common to transmission services, which may include (allocated) common costs from other business parts of Arqiva.

- 5.22 Firstly, new services can be offered over time and it may be costly to re-allocate common costs to all services every time a new service is offered. Therefore, in situations where consumers' interest may justify that a customer contributes less to common costs than other customers (see below), it may be more efficient to only recover the incremental costs associated with some contract and not apply any common cost mark-up if the contract is using existing assets whose costs are recovered elsewhere. As mentioned earlier (and discussed more below), for contracts using shared infrastructure where the costs of the infrastructure are already recovered from other services, prices may in some circumstances be set on the basis of incremental cost alone (with only a mark-up to earn a fair return).
- 5.23 Alternatively, to avoid these issues, Arqiva could be required to provide a forecast of its network's total utilisation on which common cost recovery would be based. A potential downside of such a requirement is that it may provide incentives for Arqiva to understate its network utilisation so that it can be allowed to impose higher mark-ups.
- 5.24 Secondly, even if all Arqiva's services were offered at the same time and/or it was costless to re-allocate common costs, it may still be efficient not to recover a predetermined proportion of common costs from all services. In some situations, a "full" price that includes a mark-up predetermined for common cost may exceed the willingness to pay of a particular class of customers while the incremental cost of providing a service to them may be lower than their willingness to pay making it profitable for both parties to contract. Such customers may include local radio and TV broadcasters with a limited audience and generating limited advertising revenues, customers with temporary needs (i.e. contracting for only a part of the year), or where there is general uncertainty regarding the customers' business. Where such a transaction is also beneficial for consumers then it should probably be allowed to take place. If Arqiva insisted on charging these customers a price based on a predetermined equal contribution to common costs no contract would be signed whereas charging a lower price based on a smaller contribution to common costs could ultimately benefit consumers.
- 5.25 Therefore, for the purpose of recovering Arqiva's costs efficiently, it may be appropriate not to require new customers to fully contribute to common costs. If these customers are dependent on using the platform to grow the size of their retail market and achieve the scale required, consumers may benefit from Arqiva charging them a price based on their ability to pay that would make a reasonable contribution towards common costs.
- 5.26 However, although the form of price discrimination described above may, in some circumstances, ultimately benefit consumers, it does not follow that some classes of customers are automatically entitled to "lower" prices. It is necessary to consider the requirement for Arqiva to be compensated for providing access to its assets and services such that it is able to finance its regulatory activities. It is also necessary to consider the effects of allowing a particular customer to contribute less to common costs on competition between customers (see below).
- 5.27 Furthermore, while the Adjudicator will need to make an assessment of what is reasonable by reference to the particular circumstances of each case, it will be important to take into account the total margins (over all contracts) that Arqiva is making. This should keep in view the objective of providing Arqiva with incentives to expand the market, innovate and provide services to new customers. If any contribution to common costs from new customers were immediately removed by an adjustment to other prices, the incentives would be undermined.

- 5.28 On the other hand, where there would appear to be over-recovery by Arqiva in relation to its common costs (if, for example, existing contracts ensure the recovery of common costs and charges for new contracts include substantial mark-ups for common costs), the Adjudicator might want to re-evaluate the contribution of each contract to Arqiva's common costs.
- 5.29 The above discussion highlights potential points to consider on common cost recovery i.e. over-recovery and also the need to provide Arqiva with incentives to expand the market. Ultimately, the Adjudicator should strike an appropriate balance between them in devising his approach to overall cost recovery.

Effect on competition and consumers in downstream markets

- 5.30 In general, a transaction between Arqiva and a customer will not just affect these two parties - often, it will also affect the customer's competitors and/or consumers in the downstream markets. For example, by charging TV or radio broadcasters prices based on their willingness to pay, Arqiva can better ensure cost recovery, while consumers in downstream markets can benefit from greater choice and/or potentially greater competition. However, it is important to ensure that price discrimination in general¹⁸ does not have any adverse effect on competition that outweighs the benefits to consumers from a transaction taking place between Arqiva and a potential customer.
- 5.31 An adverse effect on competition may arise when new customers that compete in the same markets as existing customers are offered more favourable conditions putting the latter at competitive disadvantage. Where such discrimination is not justified (e.g. by differences in willingness to pay) or would result in competition being potentially weakened, then it may not be acceptable.
- 5.32 In some situations, however, an existing customer with a larger customer base would not be at competitive disadvantage in the final (retail) market over a new entrant even if the latter is charged a lower wholesale price. This may be either as the result of economies of scale or, in the case of radio or TV broadcasters, because of the minimum audience size required to attract advertisers. Because new radio or TV broadcasters would be able to generate revenues only when they develop a relatively large audience, the hurdles they need to clear appear, at least initially, higher than for existing competitors.
- 5.33 The above discussion suggests that disputes relating to price discrimination should be considered on a case by case basis. Where price discrimination by Arqiva implies that it more efficiently recovers its common costs while consumers in downstream (retail) markets are likely to benefit from it, it should not be considered undue.
- 5.34 In some cases, customers that are offered different terms by Arqiva will not compete in the same markets and price discrimination between these customers would be less likely to raise competitive concerns.

Additional mark-ups to allow a fair return

- 5.35 Arqiva should be allowed a normal rate of return that is consistent with a competitive situation. In the case of a regulated firm such as Arqiva, this return is normally expressed as the Weighted Average Cost of Capital and is applied to the asset base

¹⁸ So far, the discussion has been about charging (or not) common costs to some services, which is one particular case of price discrimination.

used in the particular analysis. In its sectoral regulation of Arqiva, Ofcom determined in 2005 that the weighted average cost of capital for network access should be 10.4% in pre-tax nominal terms.

- 5.36 We suggest that Arqiva should continue using this rate until such time as the Adjudicator thinks it appropriate to revise the rate.
- 5.37 Where Arqiva is providing only a maintenance service for MTS and does not own any transmission assets, a return on capital employed might not be appropriate. In such a case, in keeping with the principle of earning normal profits as it would in a competitive market, Arqiva should be allowed a margin on its revenues that would be consistent with margins for similar services in a competitive market.
- 5.38 Some important issues relating to Arqiva's cost of capital are discussed below.

Treatment of existing and new capital expenditure/assets

- 5.39 In assessing the appropriate measure of Arqiva's asset base, an issue which may arise is that a service might be provided with the use of existing assets that are operating beyond their expected or accounting life but which continue to have a useful economic life. We highlighted the fact that, in these circumstances, using LRIC based prices could allow an over-recovery of costs. To relax these tensions, it may be appropriate to value assets by reference to their useful economic life i.e. by revaluing them upwards (by a factor to account for the remaining useful life) to reflect the fact that the economic value remaining exceeds their net replacement cost. In other cases, existing assets may be valued at their net book replacement cost. The choice between the two methods (adjusted or unadjusted depreciated replacement cost) depends on whether it is more important to reflect the resource cost of the assets or to avoid them being paid for more than once.

Treatment of depreciation

- 5.40 Arqiva's annual depreciation charges should be based on the estimated value of the assets (including transmitter equipments) according to the methodology that is appropriate for those assets. Depreciation should however always be calculated over the (useful) lifetime of the asset and not over the lifetime of the contract.

Valuation of transmitter equipment

- 5.41 The undertakings contain provisions for broadcasters to purchase transmitter equipment at the end of a contract. A question for the Adjudicator is likely to concern the price at which such is made available. If a market exists for used transmitters and is competitive, then the price that prevails in that market should be the relevant benchmark price. An acceptable price for Arqiva and its customer would then be the market price plus any extra cost incurred by Arqiva (e.g. to install the equipment on the masts).
- 5.42 However, a market for used transmitters may not exist. One possibility is then to value these transmitters at their book value. If, as discussed earlier, transmitter equipment continue to operate beyond their expected or accounting life, valuing them at book value may imply that customers should get them for free, which would not reflect their true value in a competitive market. One solution identified above was to revalue them upwards. This can be done, for example, by recalculating the depreciation charge over the total expected life of the transmitter (as estimated at the time of the negotiations) and setting its price at the new book value. A further

possibility would be for the Adjudicator to assess value by reference to comparable transactions which have taken place pursuant to the undertakings.

Presentation of estimated charges for contracts

- 5.43 In considering how these overall costs should be presented in the pricing for any bundled transmission services contract, the Adjudicator should have regard to the particular circumstances of each case. Pricing for any contract should reflect the relevant costs to be recovered. The Adjudicator should apply his assessment of which methodology of common cost allocation (see Annex 1 for a few) is reasonable under particular circumstances. If the Adjudicator is of the view that a particular methodology is more suitable for particular types of transmission services, he can, not only require that cost information is collected by Arqiva that can facilitate the use of methodology, but could also issue any guidance or direction to that effect.

Prices for network access

- 5.44 The above guidance is intended to facilitate an assessment of bundled MTS and NA services. Arqiva is required under paragraph 9.4 of the undertakings to price the network access element of the bundled charge in accordance with the specific rules on network access pricing in paragraph 11 of the undertakings as well as the Ofcom SMP notification (see section 2 above), with no additional mark-up.
- 5.45 Paragraph 11 of the undertakings requires prices for network access to be on FRND and cost-oriented terms (in common with the SMP notification). In forming his view on whether prices are compliant, the Adjudicator may wish to take account of some or all of the guidance provided by Ofcom to the network access providers in connection with the preparation of their SMP reference offers for the provision of site access.

Annex 1

Some Methodologies for Recovering Common Costs

A1.1 Given the significant size of common costs in broadcasting, especially the use of common platforms, sites, overheads etc, the recovery of common costs is an important feature of the pricing of transmission services. There are many ways in which the shared costs can be recovered from customers. While there is no single methodology for allocation that may be appropriate across all types of contracts, some of the common ones are discussed below.

Fully allocated cost (FAC)

A1.2 One simple method for recovering common costs is to set prices according to a method by which all costs are allocated among services. Under such a fully allocated cost pricing methodology (FAC) all prices include an element reflecting common cost recovery, and if all prices are set on this basis, all costs are recovered. There are drawbacks with such a methodology however. First, this approach to cost recovery is not uniquely defined and is to a large extent arbitrary. The drivers chosen to allocate the costs by definition do not reflect cost (if they did and the costs were caused by those drivers, the costs would not be common at all; they would be incremental). The second drawback of an FAC approach is that it does not reflect the demand side conditions and can as a result lead to some inefficient pricing structures in which customers are deterred from using the service even though the value to them exceeds the costs of providing the service.

Equi-proportional mark-up (EPMU)

A1.3 This is a method which is quite similar to FAC, in which the allocation is made in the same proportion as the proportion of the incremental costs of each service to total incremental costs.

Willingness to pay

A1.4 Another approach would be to recover the common costs from each contract by pricing the service according to the willingness to pay of the customer. In other words, customers with a lower willingness to pay would bear a lower proportion of common cost compared to those with a higher one. This method of allocating common costs, while being a very efficient method (first-degree price discrimination), has the limitation of requiring knowledge of customers' willingness to pay. However, while the willingness to pay of a consumer is generally difficult to know, that of a business is arguably easier to estimate as it is determined to a large extent by the net revenues that the business can generate. In some cases, these revenues (or at least a narrow range) can be estimated.