OTA-BTS
Office of the Adjudicator –
Broadcast Transmission Services

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

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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].

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 (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 sets out the principles for valuing Transmission equipment under such circumstances.

2.2 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.

Appendix 9 of the Undertakings contains a confidential list of contracts which are excluded from the right to purchase.

"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".

2.3 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)

3 Consultation responses and the Adjudicator's comments

3.1 Overview

Eight responses to the consultation were received. One respondent wished to remain confidential and a further two, Global and The Radio Centre, were willing to be identified but wished the content of their response to be confidential. The responses from Arqiva, D3&4, Ericsson, the BBC and TLRC are in Appendix 1 of this document.

The Adjudicator is grateful to the respondents for their valuable contribution. In the main there was support for the Adjudicator's proposals as well as some very pertinent additional points.

3.2 Consultation responses

Question 1: do you agree with the criteria used to assess the methodologies under consideration?

Respondents largely agreed that the criteria used are appropriate. Some supplementary points were made.

Arqiva wished for recognition that the company earns a fair return on its investment, including risk as well as a balance between risk and reward for providing a service. Another respondent sought to clarify that the calculated sale value would not include any labour costs and also sought clarification that any costs associated with multiplexing or distribution would not be included.

The BBC wanted the chosen methodology to recognise the risk profile of the Customer and identified the BBC as a low risk customer. The BBC wanted to ensure that Arqiva were not rewarded if the Transmitter Equipment sale came about through breach of contract (Undertakings Para 6.2).

Another respondent wished to ensure that the sale price only reflected the initial price of the equipment and not the cost of installation. They also wished to ensure that multiplexing equipment is excluded from the calculation.

<u>Adjudicator's comment</u>
Para 4.4 of Ofcom's Objectives for the Adjudicator, states that "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". Paragraph 4.5 goes on to say that Arqiva should also have the incentive to innovate.

The Adjudicator supports both of these objectives whilst balancing them with his other objectives to protect the customer and provide incentives for efficiency.
If the customer exercises his right to purchase, he is purchasing a piece of installed and working equipment rather than just an item of equipment. In some cases the contract with the original supplier will have included installation; in others Arqiva will have done the installation with in-house effort. In both cases the costs will have been capitalised and are recovered over a period of time.

The Adjudicator believes that it is appropriate for the cost of an installed and working system to be recovered. It is normal for a company to capitalise project costs and depreciate these along with the equipment. This issue also touches upon the possibility of capital over-recovery which is discussed further under Question 4 below.

The right of the customer extends to the purchase of the Transmitter Equipment which is defined in the Undertakings as "the transmitter and other equipment for MTS 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 and any other equipment provided for the purpose of Network Access or for the purpose of distribution services".

It is the view of the Adjudicator that distribution and multiplexing equipment are excluded and, in consequence, no costs associated with multiplexing and distribution are to be included.

Question 2: do you agree with the conclusion that the transmitter equipment has a sale value to Arqiva?
Most respondents agreed that the equipment has a value although some said that it would depend on circumstances.

Arqiva argued that the equipment is a means to provide a service and it is the service that has a value. Selling the equipment deprives Arqiva of a revenue stream and the loss of that revenue stream should be taken into account.

The BBC agreed that the asset has a value but disagreed that the future value should be guaranteed to Arqiva or that over recovery of capital should be permitted. The BBC also questioned the concept that a zero cost transfer "would always" lead to a market distortion.

Another respondent argued that Arqiva has achieved capital recovery in a single contract period and that the option to buy should be at zero cost after that.

TLRC agreed that there is residual value but that it should be small after 12 years on the basis of the equipment sale value.

Another respondent wanted to ensure that any costing mechanism did not permit Arqiva to over-recover their capital investment.

<u>Adjudicator's comment</u>.
The Adjudicator accepts that the equipment does have value; the real issue is how to calculate it. The Adjudicator agrees that the mechanism should not recognise lost future profit or permit over recovery of capital. The BBC response asked for further clarification on the notion that "a zero cost transfer would always lead to a market distortion". In the consultation the Adjudicator noted that a zero cost transfer *could* lead to a market distortion. The basis for this was that, if zero cost transfer were to be the norm then there could be circumstances where the customer acquired an asset with value, prior to Arqiva having recovered their investment. This would swing the choice unduly in favour of purchase.

The method of calculation of value is dealt with below in Question 3 and takes the above into consideration.

Question 3: do you agree with the conclusion that DRC (Depreciated Replacement Cost) represents the optimum valuation method?
Two respondents agreed without qualification whilst others agreed with qualification, and two disagreed.

TLRC recommended a non straight-line depreciation such that the equipment is at 25% value after 12 years. The basis (DRC or DHC) was not specified. They also noted that an operator would not replace like-for-like but use modern more efficient equipment.

Arqiva gave qualified support to DRC but wanted factors such as investment risk, installation cost and the condition of the equipment to be taken into account.

The BBC requested more detail on the reasons for the rejection of the first four criteria and more detail on the weightings against each criterion that lead to the conclusion. They do, however, agree that DRC represents the most appropriate valuation methodology. In conclusion the BBC wanted the Adjudicator to always err on the side of the customer and not guarantee that Arqiva always achieves the maximum return.

Digital 3&4 proposed DHC on the basis that it can be more objectively qualified but noted that this could have an upside or a downside when compared to DRC.

A respondent supported DRC with the reservation that the replacement cost value would very much depend on Arqiva efficiency with suppliers and projects.
Another respondent supported DRC as long as it was based on the capex incurred on the Transmitter equipment.

Adjudicator's comment
There was general support for DRC as the valuation method. For clarity this method takes the capital cost to purchase and install a system that provides similar performance (as opposed to replicating what is there) and then reduces that cost by the fraction of the useful life of the existing equipment that has been expended. The variables are the replacement cost, the age of the existing plant and the period over which the equipment is depreciated (see Question 4).

The Adjudicator supports the notion that any mechanism should not allow Arqiva to over-recover capital.

The reasoning behind the rejection of the first four methods identified was as follows:

a) Second hand value. This was rejected as no second hand market could be identified. In the UK, equipment that is removed from service, whether or not at the end of useful life, is usually scrapped, normally with a cost for removal.

b) Value implied by market transaction. This is the value that would have been placed on the plant at the time of the merger between Arqiva and NGW. It was unlikely that individual equipment could be identified and could also embody any past excess returns.

c) Un-depreciated current replacement cost. This would not take into account the age of the equipment being transferred and would lead to over-recovery.

d) Un-depreciated historic cost. This again would not take into account the age of the equipment and would lead to over-recovery.

D3&4 supported the use of DHC or "book-value". This would have been attractive to Arqiva in that it assures full cost recovery, however equipment design has moved on and the Adjudicator felt it was more appropriate to align the value with the cost of a present day system fit for the Customer's purpose.

Q4: 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 transmitter?
Arqiva support 24 years for DRC calculation as being consistent with their financial policy.
Another respondent supports matching with equipment lives.
Other respondents argued for depreciation periods ranging from 3 years upwards.
One respondent argued for the depreciation period matching the capital recovery period from the customer which they believed to be 12 years.

Adjudicator's comment
There are two separate issues which have become intertwined. The first is the internal accounting policy at Arqiva which sets the depreciation rate i.e. the period over which the value of the equipment is charged from the balance sheet to the profit and loss account. The second is the rate at which Arqiva recovers the capital from the customer which is a function of the contract with the customer. The two are not necessarily related.

In considering a value for the equipment both are relevant; the internal accounting policy of Arqiva gives the “book value”. Accounting rules dictate that it is linked to the useful life of the equipment.

The period over which the capital is recovered is a function of the contract between Arqiva and the Customer and will have taken into account such things as risk and the probability of contract renewals.

Arqiva state that their internal accounting policy is to depreciate over 24 years; this is outside the remit of the Adjudicator and, as such, has no direct impact on the customer.

In various responses the capital recovery period and the depreciation period have both been challenged, however the Adjudicator feels that the underlying concern is one of potential capital over-recovery. Once this is addressed the period becomes less of an issue.

Another consideration is that the period decided on for this consultation should be consistent with that used for pricing new contracts as well as the Ofcom Guidance to the Adjudicator which states that the depreciation should be calculated over the useful lifetime of the assets and not the contract.

The prospect of matching the period to specific types of asset is attractive; however there is little available evidence on which to base this.

Overall, the Adjudicator believes that the optimum solution is to use 24 years for the DRC calculation. This normally equates to two contract periods and will be consistent with new contract pricing. To avoid the possibility of capital over-recovery the Adjudicator will apply a cap such that the price that can be charged cannot result in more than 100% capital recovery.

The Adjudicator believes this is a balanced approach that will protect the customer from any disparity between capital recovery rate and depreciation whilst allowing Arqiva to recover its initial investment.

Q5: Is there any other issue you wish the Adjudicator to take into account in forming the guidance?

Arqiva noted that the right to purchase is limited and excludes contracts listed in Appendix 9 of the Undertakings.

A respondent noted the future uncertainty over analogue radio and considered that this would have the effect of reducing the value of such equipment.

Two respondents requested clarity on what is included in the sale and requested that it should include PIE and spare parts.

<u>Adjudicator’s comment</u>

The obligation on Arqiva is to offer an amendment to their transmission agreement (Para 6) setting out the principles and timescales for an offer to purchase the Transmission Equipment. Appendix 9, which is confidential, lists contracts where this provision does not apply; in these cases no amendment will have been offered.

The uncertainty over the future of analogue radio is noted but the Adjudicator believes that this is more a risk for the potential purchaser to consider than one to be taken into account in the prospective sale price.

In terms of what is included, the definition in 2.2 above of “Transmitter Equipment” applies. The Adjudicator regards the Programme Input Equipment (PIE) to be included but it is clear that distribution and anything before that, such as multiplexing, are not.

4.0 Guidance

4.1 This guidance is issued under Section 8 (iii) of Appendix 1 of the Undertakings.

4.2 The right of the Customer to purchase the Transmitter Equipment is set out in Paragraph 6 of the Undertakings and applies when an existing transmission agreement expires (Para 6.1) or when a transmission contract is terminated as a result of Arqiva’s default (Para 6.2).

The right under Para 6.1 does not apply to contracts listed in Part A of Appendix 9 and the right in Para 6.2 does not apply to contracts listed in Part B of Appendix 9. This Appendix is confidential but those customers who have acquired this right will have had an amendment to their contracts issued to reflect Para 6.

4.3 Transmitter Equipment means the transmitter and other equipment for MTS 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 and any other equipment provided for the purpose of Network Access or for the purpose of distribution services (page 30 of the Undertakings).

Under this definition, the transmitter and Programme Input Equipment (PIE) are included but equipment relating to distribution and multiplexing are excluded.

Any on-site spares specific to the Equipment are to be included. Centrally held spares which are shared across a number of sites are excluded.

4.4 Customer means a customer of Arqiva pursuant to an Existing Transmission Agreement (page 25 of the Undertakings).

4.5 The mechanism for valuing the Transmitter Equipment is Depreciated Replacement Cost (DRC).

The replacement cost is for the provision of an installed and working system of a type that would be fitted today to achieve comparable performance (not a like-for-like replacement of what is there) and taking into account Arqiva’s purchasing power.

The discounting period is 24 years.

The maximum value of the Transmitter Equipment is the remaining capital that Arqiva has yet to recover from the Transmission Contract for the existing installed and working system, taking into account both the initial capital spend and any subsequent capital spent on the system.

4.6 As well as the cost to the Customer of the Transmission Equipment calculated by the method in 4.5 above, Arqiva will detail the costs to the customer of continuing to operate the Transmission Equipment on the Arqiva site. These would include but not be limited to, Network Access charges and any charges to provide access to the equipment.

Appendix 1

Non-confidential Responses to Consultation 2

Response from Arqiva

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

Question 1: do you agree with the criteria used to assess the methodologies under consideration?
Response: Arqiva agrees with the criteria used to assess the methodologies and also considers the following to be equally important in considering values for the sale of transmitter equipment:

Recognition that the Company earns a fair return on its investment and recovers the costs (including risk) involved in providing a service;

Concept of risk and reward is properly balanced: risk the Company takes in providing a service and the reward it obtains for the sale of such a service.

Arqiva believes the above complement the criteria set out in the Consultation.

Question 2: do you agree with the conclusion that the transmitter equipment has a sale value to Arqiva?
Response: the Consultation considers the perception of capital recovery for equipment from customers in arriving at a conclusion on the sale value of equipment. Arqiva considers the concept of the 'Service Provision' is key in this regard; as noted in the response to the first question, the Company bears all of the risks in providing a service to meet contracted service levels of availability, which is balanced with the reward of revenue for such service provision As such, Arqiva contends that the fees it receives should not be considered repayments to cover equipment values but rather they are fees for the provision of a complete service.

Furthermore, Arqiva believes equipment can be used effectively in the provision of a service throughout its useful life – whether for the same customer in a period of contract extension or for another customer requiring a similar service – and, as such, is a source of revenue to the Company. Moreover, sale of equipment part way through its useful life needs to be considered not only in terms of the depreciated replacement cost, but also the future earning stream that would be lost.

Arqiva therefore supports the conclusion that the transmitter equipment has a sale value.

Question 3: do you agree with the conclusion that DRC represents the optimum valuation method?
Response: Arqiva notes that the Consultation considered a range of valuation methods and supports the principle of the correlation between asset values and their earning potential, set against the test of avoiding distortion of buyer choices.

Arqiva believes that Depreciated Replacement Cost ('DRC') is appropriate for establishing the 'base cost' of the equipment in question. However that methodology alone does not recognise that Arqiva has made an upfront investment in the equipment and taken the risk that it will be utilised for a fee paying service throughout its economic life.

It is important to note that in arriving at the ‘cost’ in the DRC calculation, a number of expense items need to be included where they are incurred in connection with the creation of the asset (examples being installation, design and project management costs). Additionally, the ‘cost’ calculation should reflect the condition of the equipment, which is a function of the efforts the Company goes to in ensuring it is carefully sited (e.g. controlled environment, free from damp).

In summary, Arqiva proposes DRC (to establish a base cost), plus a value in recognition of the investment risk taken by Arqiva.

Question 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?
Response: given the degree of uncertainty in the Radio Sector at present – economic conditions and date of analogue switch off – Arqiva believes the concept of a blended or average 20 year term for calculating the DRC would be inconsistent with the criteria set and commented on in the response to question 1.

Arqiva proposes that the term for the calculation of the DRC is retained at 24 years, matching the current practice of two 12 year licence terms.

It is important to note that any change to the useful life of transmitter equipment is likely to trigger accounting issues for Arqiva, particularly the risk of impairment and write offs, if the period is reduced.

Response from BBC

As the country's largest purchaser of broadcast transmission services and previously National Grid Wireless's biggest customer, the BBC was involved throughout the investigation and subsequent approval of the merger between Arqiva and National Grid Wireless. It also commented extensively on the proposed undertakings and on Ofcom's guidance to the Adjudicator.

We were strong supporters of the role that the Adjudicator can play in protecting customers from market abuse by Arqiva and remain so. We believe it is vitally important that the Adjudicator consults on and issues a range of guidance to provide comfort and certainty to all involved in the industry.

We therefore welcome the opportunity to comment on the above two consultations.

The BBC believes that the opportunity to take over transmission equipment in the event of a breach by Arqiva of its contract terms is an important discipline given the minimal opportunities to seek an alternative provider post merger.

Q1. Do you agree with the criteria used to assess the methodologies under consideration?
The BBC believes that the criteria proposed by the Adjudicator are broadly appropriate for assessing methodologies for the pricing of transmitter equipment. Indeed, we would suggest that the same criteria should be applied to the consideration of all pricing methodologies, not just the pricing of transmitter equipment. We believe, however, that the Adjudicator's guidance needs to go further.

These criteria are not mutually exclusive and there clearly exists situations where the individual criteria may be in conflict with each other. In such situations, it is important for the Adjudicator to be clear in advance on the weighting he will place on the various criteria and we would suggest that given the lack of competition on the supply side, the Adjudicator should err on the side of the customer. After all, the original merger process is designed to remedy any significant lessening of competition with the purpose of protecting customers ultimately.

The Adjudicator should also acknowledge that pricing should recognise and respond to risk, and that the risk profile of different projects and different customers may vary; clearly the BBC is a less risky client than a small local DAB multiplex operator. Any pricing determination taken by the Adjudicator should take account of the relevant risk profile.

Finally, and specifically to the case of the sale of transmitter equipment, it is important that Arqiva is not rewarded for breach of contract. In a competitive market, breach of contract would lead to contract termination and the customer would have a choice of alternative providers. This would leave Arqiva to bear the cost of any stranded assets caused by its contract breach. The Adjudicator's guidance should not remove this discipline on Arqiva by unduly protecting it to the detriment of customers.

Q2. Do you agree with the conclusion that the transmitter equipment has a sale value to Arqiva?

Clearly, it is a truism than an asset has a value to Arqiva when Arqiva can generate revenue from it. We do not, however, accept that this means that that projected future value should be guaranteed to Arqiva. Indeed, we were surprised that the Adjudicator has concluded that a zero cost transfer price would always lead to a market distortion and we would welcome further clarification as to why this conclusion has been reached.

Given we are no longer in a competitive marketplace, there are a number of reasons why the transfer price could be less than the possible value of that asset to Arqiva.

First, as the Adjudicator acknowledges, basing asset values on the incumbent's future revenue opportunities risks embedding future excess profits into current prices.

Second, if the capital cost of an asset has been fully recovered from the customer by Arqiva, then any future contract is largely risk free to Arqiva. It is not appropriate for Arqiva to continue to extract revenue from that customer to fund an existing, fully paid for asset.

Third, if the primary principle driving any price determination is that customers should not be disadvantaged by the lessening of competition, then we would expect the Adjudicator to favour the customer over the supplier.

Q3. Do you agree with the conclusion that DRC represents the optimum valuation method?
The BBC would like to understand the Adjudicator's reasoning for the rejection of the first four valuation methodologies listed on page 5.

As set out above, we also believe that the Adjudicator should weight his assessment criteria and, after making clear how each of the criteria match against each of the methodologies discussed, weight the results accordingly.

Given those comments, we can accept that DRC seems the most appropriate valuation methodology – although we believe this is the maximum that Arqiva could achieve in a competitive market and we have some concerns that this choice could be seen to protect Arqiva at the expense of customers.

In a competitive market a customer would have the choice to move to an alternative provider (or at least use that threat as a negotiating tool against Arqiva). Arqiva would be forced to better any competitive offer (which would likely as not be based on replacement cost, depreciated over the life of the contract or – assuming the competing entity is willing to take the full risk around licence renewal and its ability to re-sell that asset – the life of the asset). Replacement cost depreciated over the life of the asset is therefore the maximum that Arqiva could charge a customer at renewal and avoid that customer moving. If the asset value has already been recovered, Arqiva requires only ongoing operating costs of the asset (independent of any value of the asset itself) and any margin above that is better than having a stranded asset.

Therefore, the range of negotiable outcomes in a competitive market rests between:

- A ceiling of replacement cost depreciated over the lifetime of the asset plus operating costs (an element of risk premium might also be included); and
- A floor of operating costs only.

Any outcome in between would be justifiable economically and the choice between those intermediary outcomes merely reflects the distribution of profit between Arqiva and customers, all other things being equal. As set out previously, we believe that the Adjudicator should err on the side of the customer and should not guarantee that Arqiva always receives the maximum return it could have expected in a competitive environment.

Q4. 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?
In terms of depreciation periods, we believe that the period used should be determined by the appropriate economic life of the category of transmitter under consideration and should not be a single average figure.

Q5. Are there any other issues you wish the Adjudicator to take into account in forming the guidance?
No.

Response from D3&4

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.

3. Digital 3and4 recognises that due to the length of its current contract with Arqiva the Principles for the sale of transmitter equipment are unlikely to have early application to itself or its shareholders and we recognise that the consultation has focussed on radio broadcasting rather than television. Nevertheless the Guidance emerging from this Consultation will apply equally to television broadcast equipment and we believe it is important to register our comments.

1. Do you agree with the criteria used to assess the methodologies under consideration?
Digital 3and4 is comfortable with the criteria used.

2. Do you agree with the conclusion that the transmitter equipment has a sale value to Arqiva?
Digital 3and4 agrees that this is a logical conclusion in the context of the Consultation

3. Do you agree with the conclusion that DRC represents the optimum valuation method?
Digital 3and4 believes that cost-based values can be more objectively justified that those based on unrecovered value or future earnings potential. Therefore, we agree that the choice to be made lies between depreciated historic cost (DHC) and depreciated replacement cost (DRC).

Our comparison of these two methods leads us to express a preference for DHC rather than DRC:

- DHC would provide Arqiva's customers with more certainty than DRC.

- DRC would have both upside potential and downside risk for Arqiva's customers. The Consultation notes the possibility that a price based on DRC would be lower than book value if the market price of replacement equipment had fallen. However, it is equally possible that the price of replacement equipment had risen - in which case the customer would pay a price for the asset that was higher than its book value. Digital 3and4 would prefer the certainty that DHC would provide.

- The Consultation suggests in the chart on Page 6 that DHC fails to meet the objective of "Efficient Customer Choice". We do not support that contention. Given that the Consultation only applies to the principles for purchasing transmitter equipment at the end of (or following termination of) a contract, and given that the equipment would be old (and possibly close to obsolescence) the customer would face a rational choice between buying the old equipment at book value or securing new equipment at market price. We are unclear as to why this is an inefficient choice.

- Therefore, looking at the chart on Page 6, if a positive score is given to DHC against the objective of "Efficient Customer Choice" even if this is only 50% DHC scores better that DRC.

Digital 3and4 believes, therefore, that Depreciated Historical Cost should be adopted rather than Depreciated Replacement Cost.

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?
As stated above, Digital 3and4 prefers a valuation based on DHC rather than DRC. In terms of the period over which the investment should be depreciated we agree that if a single period is chosen 20 years looks to be as good as any other. The difficulty being that there is no experience yet of the useful life of the new transmitters currently being installed as part of the DSO process.

However, we believe that it is likely that there will be a differential in the useful life of different categories of transmitters and that the Guidance should reflect this. As a first step in confirming whether or not this is the likely outcome it would be interesting to understand from Arqiva what its planned replacement cycle is for the different categories of transmitter distinguishing between size of transmitter (e.g. relays v. main stations) and types of transmitter (e.g. solid state v. IOT).

5. Are there any other issues you would wish the Adjudicator to take into account in forming the guidance?
No.

Response from Ericsson

Ericsson welcomes the opportunity to respond to this consultation. In general Ericsson agrees with the analysis and conclusions laid out in the consultation paper, with the exception of the proposed 20 year depreciation period as explained below.

Question 1. Do you agree with the criteria used to assess the methodologies under consideration?
Yes, in general Ericsson agrees with the criteria used to assess the methodologies.

Question 2. Do you agree with the conclusion that the transmitter equipment has a sale value to Arqiva?
Yes, Ericsson agrees that usually the transmitter equipment will have some value.

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

Question 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?
Ericsson appreciates the arguments put forward in the consultation along with e Ofcom guidance that depreciation should be based on the lifetime of the asset and not the lifetime of the contract. However in the wider telecoms market, long depreciation periods of the order of 20 years, are generally reserved for long lived passive assets such as ducts and some forms of fibre optic cables. More typical depreciation periods for active electronics are in the 3 – 15 year range. This does not generally reflect the expected life of the equipment but is more a reflection of uncertainty in either market demand or (probably more importantly in this case) technology evolution.

Ericsson believes that, in free market conditions, a business case would prudently depreciate equipment over the life of a contract and that to mandate longer depreciation periods would result in distorted business models. This view is further reinforced in the case of FM radio by the recent Digital Britain Report with its stated aim of a radio digital switchover by 2017.

Question 5. Are there any other issues you would wish the adjudicator to take into account in forming the guidance?
No.

Response from The Local Radio Company (TLRC)

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

We believe you accurately sum up the position in your consultation document:

> "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)."

We also note the following proposal, but feel it creates some difficulties:

"For calculation purposes, the Adjudicator would propose therefore using a lifetime of 20 years."

After eliminating the first four possibilities you propose, you suggest four options for putting a valuation on existing transmission assets:

5. Unrecovered value – the price represents historic value of the asset that is yet to be recovered.

We agree that this might be difficult for the Adjudicator to assess but in most cases the station operator and/or Arqiva would know the level of TBC fees charged annually over the relevant contract period(s). However in many cases the annual fee was not itemised between site costs, network charges, maintenance costs and equipment depreciation – making it hard to establish exactly how much value has already been recovered. In addition many TBC agreements have been modified by additions and changes during their term, making such calculations even more complex.

6. Future earning potential – the price represents the future value that could be attributed to the asset

In the case of FM and AM radio we feel this would be impossible to assess given the uncertainties surrounding the future of analogue transmission.

7. Depreciated historic cost – book value

We have a difficulty with this option as, even if depreciated over 20 years, much of the equipment purchased by Arqiva/NTL in the past was over-specified in relation to today's market. Unfortunately we may not have the alternative of simple replacement with new, cheaper, equipment from another supplier where a site is controlled by a third party and installation costs may be considerable. The original equipment is usually solidly installed in racks at the site and we believe Arqiva's inflated valuation reflects the fact that it may not be financially or technically viable for the station to move to a new transmission location.

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.

This is superficially attractive, but fails to recognise that it might be wholly inappropriate, or even impossible, in today's market to specify the cost of an exact current replacement.

Not only has equipment generally fallen in price over the period since many of these sites were established, but the availability of cheaper alternatives for new manufacturers has challenged many of the traditional engineering assumptions. In particular, smaller radio stations now tend to spend very little on redundancy and back-up facilities at their studios (for example only a minority go to the expense of providing standby mains generators at the studio). In this situation the belt-and-braces provision at many traditional transmission sites can be inappropriate and the costs disproportional.

By way of example, in many cases we would not now provide a standby signal chain at the transmitter, instead choosing to specify a single modular transmitter that fails to a lower-power mode.

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

2. Do you agree with the conclusion that the transmitter equipment has a sale value to Arqiva?
Not always. We would agree that in many cases it has a small residual value, but where it has been in use, and depreciated under a TBC, for more than 12 years this must be regarded as very small. In a genuinely free market, were we to walk away from a transmission site, it would be unlikely that Arqiva could sell the elderly FM or AM equipment to any other purchaser for a substantial figure. As you yourself note: "The obvious method to value the equipment is its second hand value, however no such market exists for second hand transmitter equipment….."

3. Do you agree with the conclusion that DRC represents the optimum valuation method?
No. For the reasons given above, particularly in the case of smaller analogue radio stations, it is very unlikely that the service operator would choose to replace like-for-like. Looking at the transmission choices of the new wave of community broadcasters it is clear that there are now many cheaper configurations. In addition a small radio service, with limited future guarantee of an FM or AM licence, would be unlikely to specify the most sturdy and reliable equivalents to the existing gear.

We would propose, for analogue radio transmission equipment, a simple formula that more accurately reflects the typical value of the assets both to Arqiva and the radio station. The two-stage depreciation reflects the substantial recovery of the cost during the initial contract period and the fact that the asset then has a much reduced value: We suggest that the original cost of the equipment be depreciated linearly over the first 12 years of its life down to a value 25% of the original value. Thereafter this residual 25% value would be depreciated linearly down to zero over a further 12 years.

Effectively combining the merits of policies 5 and 7, this is a simple formula, easily applied, which fairly distributes the value of the assets over a realistic lifespan. While going some way to meet our feeling that we have “paid for the equipment already” it does not require costly and difficult analysis of previous rental charges nor of the prices of equivalent plant today. It far more closely reflects the real value of the ageing assets both to Arqiva and the operators.

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?
See above in relation to analogue (AM and FM) transmission. 20 years is too long a period in relation to a technology likely to be largely replaced by various forms of digital transmission. We accept that different arguments apply to DAB, DTT and other new digital technologies, where investment for the future is key.

5. Are there any other issues you would wish the Adjudicator to take into account in forming the guidance?
As mentioned above, you must bear in mind that not only is the future of FM and AM transmission in doubt but the Ofcom requirements for local radio coverage areas are under review, with the possibility of merging some smaller areas. In these circumstances no local operator would consider capital expenditure of the scale or high specification that was appropriate in the 1990s. Uncertainty as to its future utility reduces the perceived value of an asset.