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## **Arqiva Group Limited**

# **Regulatory Accounting Principles and Methodologies 2017/18**

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# 1 Regulatory Accounting Principles

## 1.1 Background

Arqiva Group Limited (“AGL”) and its subsidiaries (the Group) together is required, (under the terms of the Undertakings agreed with the Competition Commission in respect of the acquisition of the National Grid Wireless (“NGW”) Group by Arqiva Financing No1, the “Undertaking”) to prepare annual Regulatory Accounts (“RA”).

These RA report the Network Access (“NA”) and Managed Transmission Services (“MTS”) activities, as defined by the Undertakings, of the combined Arqiva and NGW businesses.

This document sets out the Regulatory Accounting Principles and Methodologies (“RAPM”) on which the RA are based; it sets out detailed methods applied in attributing revenues, costs, assets and liabilities to the NA and MTS activities of the Group.

The RAPM are maintained in accordance with Section 15.5 of the Undertakings given to the Competition Commission. The Competition Commission closed on 1 April 2014; its functions have transferred to the Competition and Markets Authority.

It is intended that this document is read in conjunction with the RA and the AGL Annual Report and Consolidated Financial Statements. This document will be updated annually in the event of any changes to either the RAPM or detailed attribution methods. Key changes are summarised in section 1.4.

## 1.2 Basis of preparation and form of Audit Opinion

The Undertakings require that the RA be prepared and externally audited on a Fairly Presents (“FP”) basis. This takes account of key regulatory reporting principles such as Cost Causality (see section 1.3 below).

The RA for the year ended 30 June 2018 (FY18) have been prepared and audited on a FP basis in accordance with the terms of the Undertakings.

## 1.3 Regulatory Accounting Principles

The RA are based on the following Regulatory Accounting Principles; this document is prepared to provide a suitably informed reader with a description of the accounting and attribution methods used in the production of the RA.

- **Accounting Principle:** the RA will be derived from the Consolidated Financial Statements of AGL prepared in accordance with International Financial Reporting Standards (“IFRS”) as defined by the Group accounting policies set out in the consolidated financial statements, unless any specific deviation is required as a result of conforming to this document.
- **Cost Causality:** Revenues (including transfer charges), cost components, assets and liabilities are attributed to NA, MTS and Non-Regulated Business on a basis which reflects the activities causing the revenues to be earned, costs to be incurred, assets acquired or liabilities incurred. Where such a direct relationship does not exist, revenues, costs, assets and liabilities are attributed on a fair, reasonable and non-discriminatory basis.
- **Data Source Accuracy & Completeness,** empirical data, both financial and non-financial, used as part of the accounting and attribution methodology is subject to financial controls and governance. The objective of the finance teams involved in the regulatory financial reporting of the AGL group, is to maintain financial information to an adequate degree of accuracy, such that the information included in the RA is free from material errors, misstatements or double-counting.
- **Consistency:** the RA are prepared on a consistent basis from one year to the next to allow for meaningful year on year comparisons. Should changes be made to the Regulatory Accounting Principles or the Attribution Methods that lead to a material effect on the information reported in the RA, the corresponding prior year figures will be restated if possible.

- **Objectivity**, each element of Regulatory Financial Reporting, so far as is possible, must take account of all the available financial and operational data that is relevant to that element. Where an element of Regulatory Financial Reporting is based on assumptions, those assumptions are justified and supported by available relevant empirical data. Cost allocations are intended to be impartial, and not intended to benefit any particular product/service or business unit or to benefit either Arqiva or any other operator.

## 1.4 Key Changes in the Year

The key change in the year has been the development of a new financial model for calculation of the RA. This has resulted in refined allocation methodologies as follows:

**Revenue** – continued refinement to increase direct allocation of revenue (NA and MTS) for unbundled contracts.

**Cost allocations** – refined allocations driven by cost type to improve cost causality allocation and streamline the calculation process.

**Debtors / creditors** – allocated on a standardised basis driven by revenue / third party costs respectively.

**700 MHz Clearance** – This has been a material programme in the current year, and it is envisaged to operate through until FY21. Certain allocation methods have been refined to ensure direct allocation of the 700 MHz Clearance programme is completed before allocation is made across the rest of Terrestrial Broadcast. This is in order to better reflect a different nature or volume of cost causality. The revenue from the programme is unregulated as pricing was based on commercial negotiations. Equipment which will remain part of the regulated business is classified based on its regulatory status of NA/MTS/Other. Equipment which is only used during the period of clearance activities to 2021, and will not form part of the regulatory business going forward, is classed as Other.

## 2 Attribution and Allocation Methodologies

### 2.1 Introduction

The reporting requirements set out in the Undertakings differ from the way in which AGL is organised for management and statutory reporting purposes. As such, the RA are derived from the general ledger used to prepare the consolidated financial statements of AGL with the reporting requirements of the Undertakings overlaid.

The consolidated financial statements are prepared on a historical cost basis, except for financial instruments which are measured at fair value at the end of each financial period. Fixed assets are held at cost, modified for the fair value of those assets acquired through business combination.

### 2.2 Organisation Structure

The Group owns and operates a portfolio of communications infrastructure and provides television and radio transmission services, tower site rental to mobile network operators, media services and radio communications in the United Kingdom (“UK”) and overseas.

There are three customer business units within the group: Terrestrial Broadcast, Telecoms M2M and Satellite and Media.

The regulated part of the business is Terrestrial Broadcast, with an element of the Corporate function requiring apportionment. Our Digital Platforms (“DP”), non-regulated, business is managed and reported within Terrestrial Broadcast. To ensure allocations based on Terrestrial Broadcast revenue measures are not distorted, we have removed the DP results at the outset of these calculations, and where appropriate, non-regulated 700 MHz Clearance revenues are also removed from revenue allocation methodologies.

NA and MTS services represent sub categories of the Regulated Business within Terrestrial Broadcast. "Other" represents the remaining Non-Regulated business included in the RA for the purposes of reconciliation to the consolidated financial statements. The table below shows the divisions, their key cost centres and how these are represented within the Regulated Business:

## Arqiva - Divisional Structure

|                      |  | Terrestrial Broadcast<br>(including Digital Platforms)   | Telecoms M2M   | Satellite & Media  |
|----------------------|--|--|--|--|
|                      |  | Split NA/MTS/Other   |  |  |
|                      |  | Regulated  | Non Regulated  | Non Regulated  |
| Overview of business |  | Provides TV and Radio transmission, distribution and media management.<br><br>Digital Platforms is non regulated - Delivers non-regulated TV and Radio services across The Digital Terrestrial Television (DTT) platform.            | Provides cellular, wireless broadband, voice and data solutions for the mobile communications, public safety, local government, and commercial markets | Provides customers with near global satellite coverage.  |
| Key departments      |  | Management, Client Management, Product & TDG, Field Operations, Service Management, Commercial, Engineering & Implementation<br><br>DP Directorate, Muxco and HD Muxes, Hybrids & IPTV, Technology & Operations & Market Development | Telecoms MD, Partnerships, Secure Solutions, Product & Technology, WIFI & Small Cells, Mobile & Fixed Networks   | Satellite MD, Client Management, Product & Technology Design, Eng Implementation, Operations and Capable |

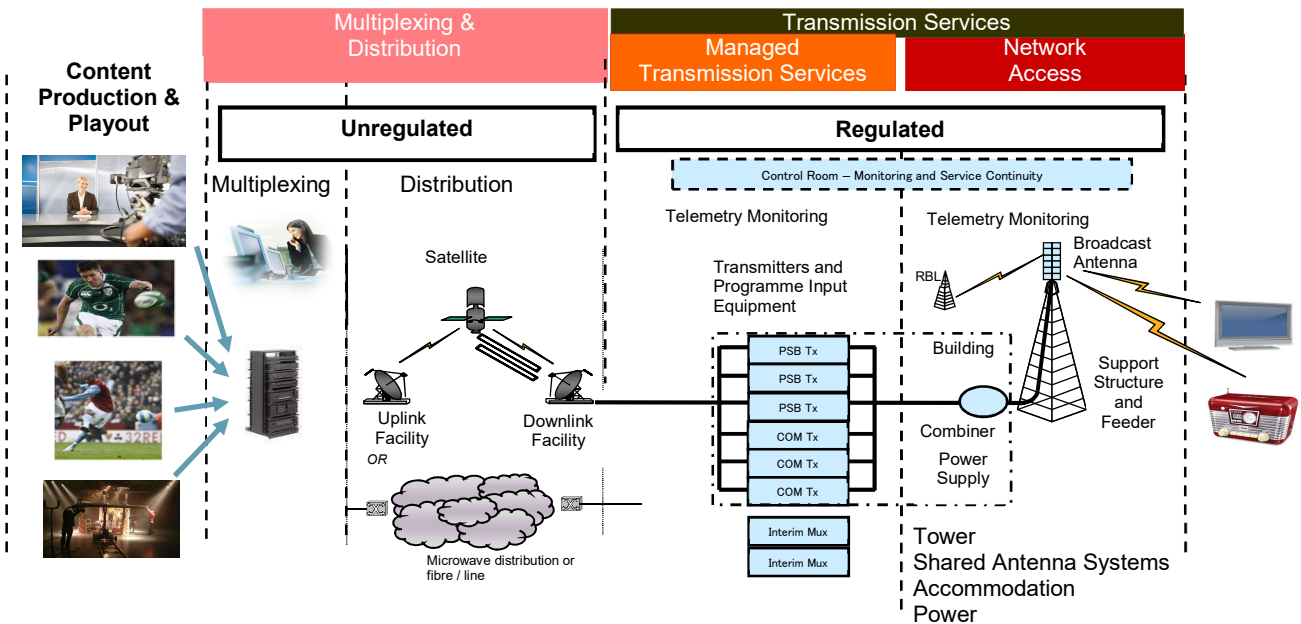
## Corporate Function

Support Functions i.e. Finance, Legal & Regulatory, IT & Connectivity, Procurement and Human Resources.

**Key**

- Contains regulated business
- Non Regulated
- Corporate

Terrestrial Broadcast contains the regulated NA and MTS business and Other non-regulated activities. Satellite & Media, Telecoms M2M and Digital Platforms (within Terrestrial Broadcast) are classified as Non-regulated. The Corporate Function provides support services across all divisions and as such requires attribution to the Regulated Business activities (NA and MTS) and Non-Regulated activities.



The RA analyse the activities within the Terrestrial Broadcast (including cost allocations from other Divisions for resources expended on Terrestrial Broadcast projects / business) and Corporate Function into two core categories: Network Access ('NA') and Managed Transmission Services ('MTS') with all remaining activities 'Other' being included in the RA only in order to support reconciliation to the consolidated financial statements.

NA and MTS can be defined as:

- Network Access - a package of services including combining output from transmitters and broadcasting the combined signal from antennas located on suitable masts or other structures. The provision of NA will include access to the following:
  1. Masts
  2. Antenna Systems including feeders and combining units
  3. Buildings and/or cabins
  4. Power systems including back-up power in a form of fixed generators
  5. Existing Re-Broadcast Links (receive antennas) at Relay Stations
  6. Remote monitoring of all the Stations
  
- Managed Transmission Service - a package of services including some or all of network design, procurement and installation of transmitters, network monitoring, quality assurance of the signal and maintenance of the transmission equipment, but excluding: the provision of programmes and other content for each channel, the transfer of the channels content to a multiplexing centre and blending them into a single digital signal. As such, MTS includes a mixture of service provision and return on assets.

## 2.3 Allocation Bases

### 2.3.1 Overview

The Group maintains its core accounting records in a manner which allows for revenues, costs, assets and liabilities to be separated into the various divisions and support functions noted above. As noted, the divisions which are relevant for analysis for the RA are Terrestrial Broadcast and Corporate.

Once costs have been analysed by division, these can then be attributed either directly or indirectly to NA, MTS or Other.

Where costs, assets and liabilities are captured at a total company level and fall into the Corporate division, these require further analysis and management judgement to apportion into the regulated activities presented in the RA.

Where data is recorded in the general ledger by site location code (for example fixed assets and rent costs) the windloading methodology (see section 2.3.9.1) is used to allocate these site specific shared costs/assets between Regulated and Non-Regulated activities.

### 2.3.2 Revenue

Revenue is shown net of VAT and discounts and is extracted directly from the accounting records and customer billing system. Revenue is coded at source to the divisions the income is attributable to.

Terrestrial Broadcast revenue is further analysed and allocated to NA, MTS or Other using its product classification based on contract values, unless the contracts are bundled – these methodologies are described below in further detail.

For bundled contracts which do not have a specific price for each service provided, allocation is required as follows:

- BBC bundled television contract revenues are split in accordance with the reporting contract cost model agreed with the BBC. The remaining bundled television contracts are split using the respective proportions of NA, MTS and Other charges identified for High Power Digital Terrestrial Television (HPD TT) contracts.
- BBC bundled radio contract revenues are split in accordance with the Schedule 13 radio allocations, part of the NRA (National Radio Agreement) with the BBC.
- Commercial radio unbundled revenues are allocated directly to MTS, NA or Other. Bundled revenues are split based upon an analysis of radio contracts renewed or amended on new terms (derived from cumulative radio reference offers across an indicative period), to estimate the portion of regulated revenue and how this is split between NA and MTS. Pass Through elements such as Rent & Rates and Electricity are allocated between NA and Other.

### 2.3.3 Costs – Cost of Sales and Operating Costs

All costs are recorded in cost centres which are unique to the three customer facing business units and a cross-business unit corporate function. Costs allocated to the corporate function are then allocated to Terrestrial Broadcast by:

- Certain costs are incurred directly by Terrestrial Broadcast and are captured in Terrestrial Broadcast cost centres.
- Other costs are allocated to Terrestrial Broadcast using methodologies identified in 2.3.3.1 and 2.3.3.2 below.

### Shared Regulated Business Costs

Where shared Regulated Business costs are not directly attributable to NA or MTS activities these have been allocated based on a number of methodologies, based on the cost driver:

- The EY RAB (Ernst and Young Regulated Asset Base) valuation - The % split is 84% NA and 16% MTS for TV and 93% NA and 7% MTS for Radio based upon a management estimate informed by data available from the EY independent valuation of the RAB carried out in 2012. The valuation has been updated annually by management reflecting additions and RPI to support Reference Offer Pricing for TV and Radio.
- Revenue percentages calculated as part of the revenue workings outlined above, attributable to TV NA, TV MTS, Radio NA and Radio MTS.
- OTL percentages calculated as part of the labour workings outlined in 2.3.9.2, again, attributable to TV NA, TV MTS, Radio NA and Radio MTS.

### 2.3.3.1 Cost of Sales (“COS”)

The allocation methodology used for each of the classification categories are as follows:

- **Rent and rates** are charged on a site by site basis and are therefore allocated directly to sites on an as incurred basis. Where Broadcast sites share common infrastructure with other services, such as Mobile Telecommunication (as part of our Telecoms M2M business unit), the Windloading methodology (described in the Non-Financial Data section below) is used to allocate the Regulated/Non-Regulated elements across both divisions. Satellite & Media only sites are allocated directly to Other, as no regulated infrastructure is present on these sites.
- **Power** is allocated directly from supplier invoices to sites as incurred. The majority of Terrestrial Broadcast electricity is consumed by MTS equipment. These costs are a pass-through to the customer (no margin being earned by AGL) and categorised as Other.
- **Circuits** - the majority of circuits and telephony costs within Terrestrial Broadcast are procured directly for a specific Customer contract. It is possible for Broadcasters to procure their requirements directly from a supplier, therefore the costs associated with this service are Non-Regulated and classified as ‘Other’.
- **Intercompany charges** – these costs are Non-Regulated and therefore classified as ‘Other’.
- **Labour COS and Maintenance** - Labour COS represent an allocation of time booked against Terrestrial Broadcast “billable projects” using OTL (described in the Non-Financial data section 2.3.9.2).
- **Maintenance costs** – these are allocated by Terrestrial revenue. Maintenance costs relate to third party invoices for Regulated Business infrastructure and equipment.
- **Other COS** - the majority of Other COS within Terrestrial Broadcast relate to Satellite and Microwave Links which are Non-Regulated therefore the costs are classified as ‘Other’.

### 2.3.3.2 Terrestrial Broadcast Division Operating Costs

During the year a refined RA model was developed which has resulted in changes to allocation methodologies (see 1.4 for details). Consequently, Terrestrial costs are allocated at type of cost and directorate level rather than cost centres as a method to best reflect cost causality and streamline allocation without losing data integrity. Terrestrial Opex costs now include separate allocation for Billable labour recharge, Capitalised Overheads, Expense Labour Recharge and Recharges as an improvement to using the available standing data. Determination of the OTL allocation percentages now includes capital charged labour (along with billable and expenses) in the over / under recovery stage of the calculation.

Employee and Agency related costs such as salaries are allocated using OTL derived percentages. These percentages are driven by the value of labour time recorded against projects which have been classified into NA, MTS and Other (see section 2.3.9.2 on Non-Financial Data for further information).



Terrestrial Broadcast operating costs are allocated into the 6 Business Areas (BAs), which are: DTT, Management, Client Management, Technical Solutions, Operations and Implementation.

- DTT is non-regulated and all costs are allocated to Other.
- Technical Solutions, Operations and Implementation

Operating costs within these areas are incurred and driven from the activity and the projects that staff are working on which is recorded within OTL.

- Management and Client Management

Operating costs (excluding labour) within these areas are considered to relate to the support of sales and revenue streams within Terrestrial Broadcast, therefore using Terrestrial Broadcast Revenue allocation is reflective of the total cost within these cost centres. Labour related costs are allocated on the basis of Terrestrial salary costs (weighted average).

Exceptions

- Bank charges and foreign exchange transactions predominantly relate to non-regulated foreign transactions and are classed as Other.

### **2.3.3.3 Corporate Division Operating Costs**

The Corporate division undertakes a number of activities which support the whole business, namely Finance, Legal & Regulatory, IT & Connectivity, Procurement and Human Resources. Accordingly, these corporate costs are allocated across the three business units (Terrestrial Broadcast, Satellite & Media, and Telecoms M2M). These are known as Corporate Cost allocations.

The RA model allocates total corporate costs (all business units) using a two step process. Firstly costs are allocated to Terrestrial on a headcount and revenue basis, and then secondly cost categories (e.g. Gross salaries, maintenance etc) are allocated to NA, MTS and Other based on Terrestrial Revenue (excluding DP).

Specific allocation methods are used for the following corporate cost categories:

- Corporate Adjustments

The nature of costs captured within Corporate Adjustments are usually specific to the three divisions to which they relate. Any such items are analysed on a line by line basis.

- Bank charges and foreign exchange transactions predominantly relate to non-regulated foreign transactions and are classed as Other.

### **2.3.3.4 Depreciation**

NA, MTS and Non-Regulated depreciation is identified based upon the Regulatory assets classification determined as part of the fixed assets methodology – see 2.3.5.

Accrued depreciation on regulated broadcast assets that have been completed but not yet added to the RFAR are allocated using the Regulatory Asset Base (“RAB”) (see section 2.3.5).

### **2.3.3.5 Exceptional Costs**

The exceptional costs for the Group are extracted from the accounting system on a business stream and cost centre basis. Any exceptional costs which are directly attributed to a business unit other than terrestrial or corporate are excluded from this analysis. Costs directly attributed to Terrestrial Broadcast, or attributed to Corporate, are further analysed. They will be allocated based on the nature of the cost incurred.

Categories of exceptional cost include but are not limited to:

- Restructuring, redundancy and organisational transformation - these costs are allocated using the Corporate Cost allocation based on revenue.

### **2.3.4 Capital Employed**

Capital employed comprises:

- Total assets, excluding goodwill, intangibles arising from acquisitions and retirement benefits; less
- Total liabilities, excluding dividends payable, borrowings and retirement obligations.

Deferred tax is included within Debtors and has been treated as Out of Scope, whilst current tax liability is within Other Creditors and has also been classified as Other.

### **2.3.5 Regulated Fixed Asset Register (“RFAR”)**

The RFAR is produced using the Fixed Asset Register (“FAR”) within AGL.

Assets are attributed to NA and MTS by firstly considering the site location to identify whether assets are located on broadcast sites. Assets which do not have any broadcast use or are at sites which do not broadcast regulated services are classified as Non-Regulated. Each asset type is subsequently sub-divided into a specific asset category (e.g. Masts, Buildings, Power, Antennas, Land and Transmitters) and finally these asset categories are then apportioned using the following steps:

1. Direct Allocation – where possible, assets are allocated directly to NA, MTS or Other based upon asset category as described above.
2. Network Access asset categories not allocated directly during step 1 are shared NA assets with other business divisions, such as Telecoms. These assets (e.g. Buildings, Masts, Land) are further categorised into Regulated/Non-Regulated using Windloading allocations, described in more detail in the Non-Financial Data Section below.
3. An element of the Head Office assets are allocated to NA, MTS or Other based upon the total Corporate Division allocation methodology into Terrestrial Broadcast NA, MTS and Other (see section 2.3.3.3).

Capitalised overhead costs are allocated between NA, MTS and Other based on the average split of total assets (excl. capitalised labour).

Telemetry systems relating specifically to the DSO project have been allocated 62%/38% (NA/MTS) based on expert operational assessments from the DSO Operations Team.

Telemetry systems relating specifically to Radio have been allocated 60%/40% (NA/MTS) based on expert operational assessments from the Engineering and Implementation team.

### **2.3.6 Work In Progress (“WIP”)**

In order to attribute Capital WIP balances to NA, MTS or Other, the Regulatory Project classification has been used. Projects are classified by Project Managers at the project initiation stage, as described in section 2.3.9.2. Where a Regulated project is identified as split between NA and MTS, this is allocated using the Regulated Asset Base (“EY RAB”) valuation as described above.

For large projects such as the Digital Switch Over (DSO) programme, the capital WIP balances supporting the new HPDTT NA assets have been identified and are allocated in full to NA. Windloading is not applied as these costs are incurred wholly and exclusively for the purpose of HPDTT. DSO Capitalised interest has been allocated using the appropriate EY RAB valuation.

Projects relating specifically to the 700 and 800 MHz Clearance project not directly attributable to NA or MTS are allocated using the proportion of actual spend of 700 and 800MHz Clearance of assets, as per the RFAR (see section 2.3.5).

For site NA infrastructure projects, the capital WIP balances have been allocated using windloading factors. This is in-line with the allocation of NA infrastructure assets within the RFAR (see section 2.3.5).

### **2.3.7 Other Assets**

These balances are allocated based upon their key driver in the profit and loss account.

Debtors and prepayments – The debtors balance is analysed by Business Unit, with accounts that are specifically non-regulated being excluded. Regulated related debtor balances are allocated by Terrestrial revenue, unless a superior method is applicable such as using third party costs (excluding labour) for prepayments.

Cash – The total cash balance, removing cash for other purposes such as refinancing and debt servicing, is attributed to NA, MTS and other using the proportion of EBITDA arising from each regulated activity.

### **2.3.8 Liabilities**

These balances are allocated based upon their key driver in the profit and loss account.

Creditors (including over and under 1 year) – The creditors balance is analysed by Business Unit, with accounts that are specifically non-regulated being excluded. Regulated related creditor balances are allocated by Third party costs which include agency costs but exclude payroll based labour, unless a superior method is applicable such as Terrestrial revenue for deferred income.

Provisions – Accounts are analysed and allocated into NA, MTS and other depending on the account drivers for each provision held. Accounts that are specifically non-regulated are excluded.

### **2.3.9 Non-Financial Data**

Certain attributions to NA, MTS and Other are made using Non-Financial Data. The use of such data and its application is consistent with methodologies applied in HPDTT and Radio Reference Offers previously audited for Ofcom.

The key methodologies used are as follows:

#### **2.3.9.1 Windloading**

Windloading is a technical assessment of the 'base moments' in relation to each antenna and associated feeder and apportioned bare structure on a Broadcast site. The base moment of each antenna on a mast is a function of the size and height of the antenna and related feeder (cable). The Windloading base moment for a site that relates to each category of antenna ("Broadcast" or "Other") is expressed as a percentage of the total base moment.

Windloading is a recognised methodology for attributing NA asset values and costs as it relates common services to the underlying cost drivers. It has been used extensively in various documents that have been reviewed and approved by Ofcom and their appointed advisors e.g. Windloading was used as a cost allocation base in the Reference Offers for DSO and Radio Reference Offers.

#### **2.3.9.2 Oracle Time & Labour (OTL)**

OTL is a time recording system which includes a dataset for cost allocation based upon time recorded data using employee skills based hourly rates.

Employees record time to projects which are subsequently allocated to Business divisions i.e. an employee in the Terrestrial Broadcast Division may record time against a project which belongs to the Telecoms Division, therefore the costs associated with this time would be Non-Regulated and excluded from the RA.

Projects are classified into three main categories; Billable (Cost of Sales), Expense (Operating Expenditure) and Capital (classed as Other – Balance Sheet).

The Labour cost allocated to NA, MTS and Other is derived using the following approach:

- **Project classifications**

All employees in Arqiva are allocated to a Business Area based upon their respective cost centre (e.g. Terrestrial Broadcast). Where Terrestrial Broadcast employees charge their time to a Regulated NA project, this is wholly attributable to NA. The hours recorded against specific Regulatory projects are multiplied by the equivalent skill based rate per hour, to give an overall labour cost for the time recorded against each project. Determination of the OTL allocation percentages now includes capital charged labour (along with billable and expenses) in the over / under recovery stage of the calculation, improving the use of the empirical data available.

For projects classified into Terrestrial Broadcast and Corporate the following allocations apply:

**Terrestrial Broadcast** - These projects have been categorised into NA, MTS and Other based upon their Regulatory Classification (TV/Radio/Other) assigned by Project Managers at project set up. Projects are reviewed by the finance team on a monthly basis to ensure accuracy. Projects which have no clear distinction between NA and MTS but are clearly Regulatory are divided using the RAB valuation (see section 2.3.3).

**Corporate** – The primary purpose of the Corporate Division is to support the AGL revenue generating business areas, an element of the hours charged to Corporate projects need to be recharged back into the Regulated Business. The process is as follows:

- All Corporate projects are classified as Regulated or Non-Regulated by establishing whether the project has an impact on the Regulated Business (e.g. a generic mast inspection project is classed as a regulatory project).
- Regulatory projects are given a secondary classification which identifies which allocation percentage to use to recharge the costs against this project back into the RA (e.g. estates and property projects which relate to owned sites are classified as 'Rates' and the weighted average percentages of Rates costs is used).

A reconciliation is performed from OTL to the General Ledger to ensure that any under/over-recovery and employees that do not time record within Terrestrial Broadcast are considered. A proportion of this cost is allocated to the Regulated Business based upon Terrestrial Broadcast revenue.