



Response to the CMA's Provisional Decision Report

Submission addendum: Profitability

Note: Confidential redacted information is shown [§<].

Assessing Airwave's profitability (quantification)

- 1.1. This note should be considered in combination with the Home Office's response to the CMA's provisional decision report (the **Report**).¹ It quantifies the impact of some of the Home Office's comments on the CMA's preliminary assessment of the profitability of the Airwave network.² In line with the CMA's approach, the focus of this note is on the estimated profitability of the extension period.³
- 1.2. The Home Office does not have access to sufficient information to quantify all of its proposed changes to the CMA's profitability assessment. In particular, the following proposed changes cannot be quantified with the information available to the Home Office:
 - a. excluding radio terminals from the profitability assessment that may be required on the basis that the CMA excluded radio terminals from the charge control that the extent of competition exists in relation to those services and that they are sufficiently separable from the provision of the Airwave network;⁴
 - b. delaying the drop in revenue from menu charges that Motorola assumes will happen in 2023 on the basis that the transition to ESN will not start until after 2023;⁵ and
 - c. adjusting the cost of internally sourced equipment to reflect that these costs may be overstated.⁶
- 1.3. The Home Office does have sufficient information to quantify the impact of the following proposed changes on Airwave's profitability:
 - a. increasing revenue and costs from Ambulance Bundle 2 in 2023 and 2024 to reflect that [§<] [§<];
 - i. as set out in its response to the Report, the Home Office recommended assuming no reduction in revenues in 2023 (instead of a 50% reduction

¹ Home Office (2022), 'Home Office's Response to the CMA's Provisional Decision Report', 22 November.

² For the complete set of the Home Office's comments on the CMA's profitability assessment, see Home Office (2022), 'Home Office's Response to the CMA's Provisional Decision Report', 22 November, sections 3.4, 5 and 6.

³ One of the Home Office's suggested changes is a reduction in the estimated redundancy costs. However, given that any changes in the estimated redundancy costs would affect only the profitability of the original period, the impact of this change is not discussed in this note. See Home Office (2022), 'Home Office's Response to the CMA's Provisional Decision Report', 22 November, para 3.10.

⁴ Home Office (2022), 'Home Office's Response to the CMA's Provisional Decision Report', 22 November, para 3.5.

⁵ Home Office (2022), 'Home Office's Response to the CMA's Provisional Decision Report', 22 November, para 3.8.

⁶ Home Office (2022), 'Home Office's Response to the CMA's Provisional Decision Report', 22 November, para 4.4.

in revenues assumed by Motorola and the CMA), and a 50% reduction in revenues in 2024 (instead of no revenues in 2024 assumed by Motorola and the CMA) to reflect that the contract is in the process of being extended until the end of 2023 [X];⁷

- ii. based on the CMA's profitability model, the revenues of Ambulance Bundle 2 in 2023 amounted to £[X]m and the associated costs amounted to £[X]m – leading to a profit for the year of £[X]m from the provision of these services.⁸ This estimated profit reflects the CMA's assumption that Ambulance Bundle 2 revenues (and costs) are reduced by 50% in 2023;
 - iii. thus, the Home Office has adjusted for the potential extension of the contract by doubling Ambulance Bundle 2 profit in 2023 (i.e. increasing the profit from Ambulance Bundle 2 from £[X]m to £[X]m for 2023 to change Motorola's and CMA's assumption from 50% revenues (and costs) in 2023 to the full revenues (and costs)) and assuming that the profit for the 2024 is equal to £[X]m;⁹ and
 - iv. with the CMA's assumed WACC of 5.5%, adjusting the revenues and costs from Ambulance Bundle 2 as described above would increase the excess profits by £[X]m;
- b. [X] management charges from the profitability assessment on the basis of the CMA's view that management fees are not justified, despite including some of these charges in the profitability analysis:¹⁰
- i. the CMA have adjusted Motorola's assumed management fees down by £[X]m a year, but included a charge of £[X]m in 2020, and £[X]m from 2021 onwards;¹¹
 - ii. the Home Office considers that this should be adjusted for further, in order to [X] management charges from the profitability assessment; and
 - iii. with the CMA's assumed WACC of 5.5%, removal of the management charges for the years 2021–26 leads to an increase in the estimate of excess profits by £[X]m;
- c. correcting for a potential error in the calculation of the depreciated replacement cost:
- i. the Home Office pointed out a potential error in the calculation of the depreciated replacement cost using Deloitte's estimate for the sensitivity analysis. Correcting for this decreases the 2020 opening asset value from £[X]m to £[X]m;¹² and
 - ii. this affects the excess profit estimate only under the sensitivity scenario, increasing it by £[X]m under any WACC assumption (given it is an

⁷ Home Office (2022), 'Home Office's Response to the CMA's Provisional Decision Report', 22 November, para 3.7.

⁸ CMA, Final profitability model October 2022, [X].

⁹ For simplicity, there is no adjustment in relation to inflation between 2023 and 2024.

¹⁰ Home Office (2022), 'Home Office's Response to the CMA's Provisional Decision Report', 22 November, para 4.3.

¹¹ CMA, Final profitability model October 2022, [X].

¹² Home Office (2022), 'Home Office's Response to the CMA's Provisional Decision Report', 22 November, para 5.4.

opening balance);

the Home Office noted that a zero gearing assumption would be appropriate for the Airwave network for both the 'high' and 'low' WACC estimates.¹³ The Home Office also commented that the high estimate of asset beta should be reduced from 0.55 to 0.49, to avoid giving disproportionate weight to non-utilities comparators:¹⁴

- i. the combined impact of a zero gearing assumption and lower 'high' estimate of the asset beta is a reduction in the nominal pre-tax WACC from 5.5% to 4.6%; and
- ii. changing the WACC from 5.5% to 4.6% increases the estimate of excess profits by £[<]m, when the other changes quantified above are adjusted for.

1.4. The impact of the above four changes leads to nearly an additional £[<]m of excess profits in the extension period as shown in the table below. This amount is material and should be considered by the CMA prior to its final decision. Moreover, as discussed above, the quantified amount does not include the impact of a number of additional proposed changes, which could lead to further increases in the excess profits estimate.

(£m, net present value terms)	Base	Sensitivity
CMA excess profits estimate	1,135	969
<i>Ambulance Bundle 2 correct</i>	[<]	[<]
<i>Management fees change</i>	[<]	[<]
<i>Depreciated replacement cost change</i>	[<]	[<]
<i>WACC change</i>	[<]	[<]
<i>Total quantifiable change</i>	[<]	[<]
Home Office excess profits estimate*	[<]	[<]

Note: Values are rounded. * Represents an underestimate of excess profits as a few comments have not been quantified.

8 December 2022

¹³ Home Office (2022), 'Home Office's Response to the CMA's Provisional Decision Report', 22 November, para 6.2.

¹⁴ Home Office (2022), 'Home Office's Response to the CMA's Provisional Decision Report', 22 November, para 6.5.