Office of the Director of
Telecommunications
Regulation

Rate Regulation Mechanisms for Cable and MMDS Television Operators

Report on consultation process

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This document sets out the Director's current position on the rate regulation framework to be adopted with regard to licensees under the Wireless Telegraphy (Programme Services Distribution) Regulations, 1999 and the Wireless Telegraphy (Wired Broadcast Relay Licences) Regulations, 1974. This document is without prejudice to the rights and duties of the Director to regulate the market generally or to the exercise of the Director's discretion.

1. Introduction

The Office of the Director of Telecommunications Regulation (ODTR) published a Consultation Document "Rate Regulation Mechanisms for Cable and MMDS Television Operators", ODTR 99/37, on 16th June, 1999, inviting submissions from interested parties on a proposed framework for price regulation. Responses were received[1] from cable and MMDS operators, broadcasting consultants and public representatives. The replies received from the respondents were wide ranging. This paper reports on the consultation process, the responses received, incorporates the Director's views on those responses and other relevant information and sets out the Director's intended approach to the issue of price regulation.

The main objectives of the Director in proposing a price regulation mechanism are to

(a) provide greater certainty for operators and the public as to how future price adjustment applications will be treated,
(b) provide consumer protection for the period in which there is not effective competition in the market, and
(c) facilitate the operators in planning the development of their networks and their services, while also ensuring viewers can be confident that the prices charged are reasonable.

While the Director envisages applying the methodology set out in this report during the period of in-platform exclusivity, she reserves the right to review the mechanism during this period, if, in her absolute discretion, she considers it appropriate to do so.

The framework provides clear guidance to the licensees on how individual applications will be evaluated, but does not in any way remove the direct obligation on operators to fully justify these proposals to the Director when seeking approval for price changes.

[1] A list of respondents is given in Appendix 1.

2. Basis of Regulatory Involvement

Under the terms of the licences issued in 1999, cable and MMDS operators enjoy a period of in-platform exclusivity until April 2004. This means that within each licence area, competition is not yet fully developed. Until such time as competition is fully developed, the control of rates that operators may charge for a basic (i.e. minimum) level of service is considered to be essential in ensuring that the interests of consumers are protected.

Under the provisions of Regulation 15 of the Wireless Telegraphy (Programme Services Distribution) Regulations 1999, the prior written consent of the Director of Telecommunications Regulation ("The Director") is required for proposed charges for basic televisions services distributed by cable or MMDS and for any subsequent changes to those prices. This power shall only subsist during the period of in-platform exclusivity associated with licences issued under those Regulations i.e. until April 2004. Similar powers exist in relation to cable licences issued under the Wireless Telegraphy (Wired Broadcast Relay Licences) Regulations, 1974.

3 Rate Regulation Mechanisms

3.1 Introduction

Ideally, any rate regulation arrangement should mimic the effects of competition in a competitive market by stimulating new services and greater efficiency, whilst at the same time protecting the consumer by limiting price increases and ensuring an appropriate level and quality of service.

Various methods of rate regulation can be used including the "rate of return" or "price control" mechanism. The Director believes that the price control mechanism is preferable to rate of return regulation because it not only provides controls on the level of prices charged to consumers, but it can also provide incentives to the operator to minimise costs.

3.2 Issues to consider in establishing a Price Control Mechanism

Under the price control mechanism approach, the ceiling or maximum price operators can charge for services is adjusted by a measure of inflation, minus an X factor, reflecting some measure of industry productivity improvement.

Appropriateness of Consumer Price Index (CPI) as a measure of inflation

The Director proposed, in her consultation, that CPI be used as a measure of inflation. Some alternatives to the CPI were suggested by respondents. The Director is not convinced that the proposed sector-specific measures are suitable because of the absence of reliable data to construct such measures. The main advantage of using the movement in the CPI as the measure of inflation is that it is widely known and used and, unlike company or sector specific measures, can be applied in a transparent manner. The Director's view, having considered the alternatives suggested, is that the CPI is the most appropriate index for this purpose.

However, the Director accepts the comments of some operators that using CPI as the measure of inflation may not accurately reflect all changes in costs and that allowing a pass-through of certain costs may more accurately reflect changes in the operators' costs. Accordingly, the Director has decided that CPI will be utilised but with pass-through of some specified costs (see Section 4.4 Satellite & UK Terrestrial Programming Costs).

The X-factor

The Director wishes to ensure that customers obtain best value for money in terms of the quality of service delivered. Accordingly, the Director intends to incorporate an X factor into the price control mechanism. The consultation paper proposed that the X factor would comprise two key components: a productivity factor and an efficiency factor.

Productivity

The consultation paper proposed to use the average annual percentage growth in the productivity index for the Distribution, Transport and Communication sector between 1992 and 1997. The proposed rate was 2 percent per annum.

In response to this proposal, cable and MMDS operators argued that this index was unsuitable for the proposed purpose because of the differing structures and stages of maturity of the industries comprised in the index.

The Director accepts that the application of a measure of productivity derived from a broad sectoral analysis to a specific industry within that sector may not be as satisfactory as an industry specific measure. However, the Director is not aware of any such suitable industry specific measure and did not find a workable alternative approach in the responses to the consultation paper.

In the absence of any realistic alternative proposals from respondents, the Director is satisfied that general economic productivity should be included within the price control framework. Such an economy wide measure of productivity also seems appropriate in view of the decision to use an economy wide measure of cost escalation through movements in the CPI. The 1995-1999 productivity index results in an average annual productivity rate of 3 percent. Accordingly, the X-factor will initially be set at 3 percent per annum and will be updated annually. Details of the general economic productivity index from 1995-1999 is provided in the table below.

General Economic Productivity Growth, 1995-1999

Year	GDP Index	Employment Index	Productivity Index	Percentage Change
1999	142.2	126.1	112.8	3.4%
1998	129.5	118.6	109.1	1.8%
1997	119.3	111.2	107.2	3.2%
1996	107.7	103.7	103.9	3.9%
1995	100.0	100.0	100.0	n/a

Source: Central Statistics Office

Efficiency

The Director had considered the inclusion of an appropriate efficiency factor in the price control mechanism. This would necessitate a major review of all licensees and include a number of benchmarking exercises using data on operators in other countries.

A pilot benchmarking exercise was carried out and highlighted variations in the level of relative efficiency both between operators themselves and between domestic and overseas operators. The Director recognises that a more thorough exercise would need to be conducted before any firm conclusions regarding the relative efficiency of individual operators could be reached.

These limited analyses also highlighted the complexity of the exercise involving the consideration of factors which include the perceived differing values of programme services offered, the differing scales of operation and the provision of additional services such as telephony and internet access. In view of the relatively short timescale within which detailed price control will be exercised, the Director feels that the inclusion of an efficiency factor may be at the expense of a timely introduction of the rate regulation mechanism. Accordingly, while the Director reserves the right to take account of operators' relative efficiency as a factor to be considered in the future, she does not intend to include efficiency as a factor to be included in the calculation of X for the present.

The price control mechanism, applied to operators net prices (i.e. prices, discounted for VAT, licence fees and programme costs) will therefore be based on movements in the Consumer Price Index adjusted for growth in national productivity.

Provisions in respect of smaller operators

Respondents were asked to comment on the possibility of giving operators with fewer than 1,000 subscribers the option to choose the basis on which their application will be assessed. Responses to this question were limited. The Director will apply the principles set out in this paper to all operators unless an applicant who is licensed under the 1974 Regulations demonstrates that such an approach would be inappropriate in specific circumstances.

3.3. Recovery of Capital Expenditure

As indicated in the consultation paper, the Director wishes, in the interests of making new innovative services available to subscribers, to encourage operators to invest in digital networks on an entrepreneurial basis. The Director is of the view that the bulk of current and future capital expenditure by cable and MMDS operators will relate to the provision of new services. She is, however, where a licensee is able to identify specific expenditure on the provision of basic service, prepared to consider allowing recovery of such expenditure in reviewing any price adjustment application. This will require operators to apportion their net capital expenditure, firstly between the investment required to provide television services and other services, and subsequently between the investment required for the provision of the basic television programme service and other television related services. The net capital investment may then be recovered by the operator over the period of the licence.

The Director is mindful that the prices which subscribers already pay contain an element attributable to the capital expenditure and is concerned that the rate regulation mechanism should not compensate operators twice for the same expenditure.

As regards the methods of apportionment, one respondent argued that capital expenditure should be apportioned based on the direct margin (revenues less direct cost of sales) for each specific service rather than turnover, as the direct margins vary greatly between different services. Although this approach has merit, the Director considers it to be impractical because of the time and resources required to implement it. The Director will, when considering a price increase application, discuss with operators appropriate means to apportion investment as indicated in the consultation paper.

Capping the increase allowable for capital investment is important in order to limit the possibility of over-engineering of the network, where an amount of capital expenditure is undertaken which results in substantially higher rates for subscribers without a matching improvement in service. Having considered operators' views, economic indicators and factors such as the average life of fixed assets, the Director considers it reasonable to limit the extent to which capital expenditure is passed through.

It was claimed by one respondent that limiting the ability to recover capital expenditure through price changes for basic television services would discourage investment. The Director does not accept this view and would point out that operators provide, or will shortly provide, other services which are not subject to price control. It is not apparent why such services should not bear most of the costs of network investment.

The views of respondents offered on this topic have not convinced the Director that her proposals should be modified except in relation to one aspect. The Director accepts the validity of the point made by one of the respondents that applying a fixed percentage capital expenditure element would result in a greater monetary increase for those operators, who for historical reasons charge a higher basic subscription rate. In cases where the Director is prepared to allow an adjustment to the annual charge in respect of capital expenditure, she will limit that adjustment to a maximum of £3 per application instead of the 2.5 percent of net prices which had been proposed.

3.4 Customer Service

The Director wishes to ensure that operators develop and maintain a high level of customer service and proposed in the consultation paper that operators should directly compensate customers for failure to deliver services to a high standard. While customer service is a priority of the respondents, various aspects of the proposals were considered to be problematic. In particular, it was felt by some respondents that adequate notice should be given to the operator to provide a fair opportunity for a satisfactory remedy to be put in place before any penalty should apply. It was also felt that any disputes as to fault, and the extent of any consequent loss, would have to be subject to a fair and equitable procedure.

The Director will take these comments into account when implementing future policy.

However, the Director does not accept that the inclusion of customer service measures in the price control mechanism is an unnecessary constraint on the freedom of operators. The Director is anxious not to unduly constrain operators in the course of their business but believes that the provision of consumer protection measures is an important element of the licensing regime introduced in 1999 and must be properly addressed by operators. Accordingly, the Director will not approve any application for a price increase unless satisfied of the operator's compliance with their licence requirements in the areas of service quality and delivery, including complaint management.

4 Administrative Provisions Relating to Price Control Mechanism

4.1 Price Control period

In the consultation paper, it was proposed that the period of the price control mechanism would be three years. However, given that the period of in-platform exclusivity will end in April 2004, the Director has decided to apply this mechanism until that date. The Director reserves the right to review the mechanism at any time if, in her absolute discretion, she considers it appropriate to do so.

4.2 Annual Submission

The chosen review mechanism will come into operation with immediate effect. Operators may apply for a price adjustment provided they have not had a price adjustment approved in the previous 12 months. In the case of cable operators, measurement of changes in CPI since their last review, adjusted for national productivity gains over an equivalent period will be taken as the allowable rate increase factor to be included in the formula. MMDS rates however have not been submitted to the Director for approval in the past as there was no requirement to do so under the 1989 Regulations. MMDS operators have been asked to submit justification for their existing rates. It will be necessary for MMDS licensees to have their existing charges considered before any adjustment proposals may be accepted.

Most respondents agreed with the annual submission proposals, provided that some allowance is made for unusual circumstances which may arise. On balance, the Director believes that a period of not less than one year is adequate but, in exceptional circumstances, may consider applications for a shorter period.

The Director will endeavour to give her decision on an application within a period of 8 weeks from the date that all information the ODTR considers necessary for its consideration has been received.

All operators will be required to give adequate notice to subscribers through direct notification or by placing a notice in the appropriate media before an approved increase may be implemented.

4.3. Billing Arrangements

Operators, and other interested parties, were asked whether they agreed with the approach outlined in the consultation paper in respect of multi-period billing. Two elements were proposed by the Director. With regard to the proposal to set an interest rate to reflect the cost of borrowing by the companies, the Director intends to apply the three-month EURIBOR rate plus a margin of 50 basis points, which today is 5 percent. Accordingly, the allowable rate will initially be set at 5 percent and will be updated annually.

The second element proposed was to allow operators to apply an additional charge of £1 per bill issued for multi-period payments. The Director has not been convinced of the appropriateness of any additional administrative charge and does not therefore consider that such an additional charge should be implemented. The Director may reconsider this issue, to a maximum of £1 per billing period, if individual operators demonstrate that such charges are warranted. The application of such a charge, if approved, would be subject to all subscribers of the relevant operator having the option to make payments annually rather than over shorter periods and of avoiding the additional charge by paying by direct debit or standing order. Subscribers would have to be made aware of such alternative payment options.

4.4 Satellite and UK Terrestrial Programming Costs

One of the operator costs associated with the cable/MMDS business which must be given specific consideration is the cost of satellite and UK terrestrial programming. The Director is concerned that every effort be made to minimise any proposed increases in such costs during negotiations with programming suppliers and proposed in the consultation paper that the allowed increase would be restricted to the increase allowed to the increase in the relevant inflation index in the country where the programming originates.

The Director feels it important to offer an incentive to purchase supplies more efficiently by restricting pass-through costs. However, in acknowledgement of the fact that costs are not fully within the control of the operator, the Director is prepared to incorporate the pass-through of programming costs into the price increase mechanism, subject to being satisfied that the operator has made reasonable efforts to minimise such costs.

4.5 Connection Charges

The Director will review the issue of connection charges. In the interim, operators will be allowed to continue to apply the previously approved charges in respect of cable and, in the case of MMDS, the charges which licensees applied prior to the surrender of licences under the 1989 Regulations. The Director's consent to the continuation of existing charges is a temporary measure and will expire on 31 December 2000. In the meantime, licensees will be required to submit proposals, including full justification, regarding future charges for the Director's consideration and approval.

4.6 Commercial Charges

Licensees are currently required to obtain the Director's consent for charges to categories of subscribers other than residential customers. The Director will permit a temporary continuation of existing approvals in relation to charges for non-residential subscribers, pending an examination of the issues involved.

4.7 Prices for the Provision of Authorised MMDS Service Within Cabled Areas

Within areas licensed for the provision of cable services, MMDS may not be installed without the consent of the Director. In cases where the Director may give consent to the provision of an MMDS service within a cabled area, she proposes to restrict the price which is charged for such service to a maximum of the price which applies for the cable service. As MMDS generally does not provide the same range of programme services, and does not have the same degree of functionality, the Director also considers that a discount from the cable price should also apply. Such a discount would be calculated by reference to the differential in the number of programme services between the MMDS service and the cable service.

There was some support for these proposals in the submissions received in response to the consultation paper, and some concerns were also expressed. Having considered these views, the Director is now proceeding with the proposals as set out above.

4.8 Accounting Separation

The Director wishes to ensure that full accounting separation is maintained between the various business streams and that there is visibility of costs between the regulated and any unregulated businesses. Most of the respondents were satisfied with this proposal. Accounting separation can be a complex process and the Director is prepared to work with operators to ensure that an appropriate methodology is devised.

4.9 Conclusion

The Director is satisfied that the proposals outlined will meet the objectives set out in Section 1 and provide an appropriate balance between operators' needs for stability and flexibility. The Director looks forward to working closely with those concerned and wishes to thank the individuals and companies who responded to the consultation paper for their contributions.

Appendix 1: List of consultation paper respondents

AIB Corporate Finance
Cable Management Ireland
Councillor Kieran O'Hanlon
Irish Multichannel
ntl/Cablelink
Orlynn Park Amenities