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1 August 1990

*Peter*

IBA TRANSMISSION PRIVATISATION: ECONOMIC REGULATION

In June last year, MISC 128 discussed the privatisation of the IBA's transmission system, and we agreed that the new company would initially need to be regulated by OFTEL, because of its dominant market position. We also agreed that there should be a uniform tariff for Channel 3 companies, based on their share of the total Channel 3 income, and that this arrangement should be reviewed following decisions to be taken on the future of the BBC transmission system after 1996. This we announced on 4 July last year, as part of our statement on the privatisation of transmission.

Early this year, we appointed National Economic Research Associates (NERA) to undertake a study of the economic regulation of the new company. The study, which was carried out with guidance from your officials, OFTEL, and the Treasury, has now been completed. Officials have discussed the report of the study, and agreed the attached paper.

The paper suggests the broad regulatory framework which OFTEL should operate through the new company's Telecommunications Act licence. Its main features will be:

- i) price regulation of site and mast rental, and operation and maintenance charges, for Channel 3 and 4 and S4C;

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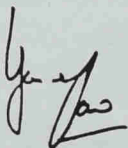
- ii) the use of a price formula, with no provision for passing through to the customer unanticipated changes in supply costs;
- iii) no price regulation of other Transcom services (eg radio, distribution, local services);
- iv) powers for OFTEL to prevent unfair discrimination between customers if market forces are not operating effectively;
- v) a review of the regulatory regime in 1996, to coincide with consideration of the privatisation of the BBC's transmission operation.

I believe that this framework strikes the right balance between excessive regulation on the one hand, and on the other the danger of allowing the new company to exploit its monopoly position before other transmission operators have a chance to establish themselves. Staff of the nascent company have some reservations about a number of detailed aspects which we shall be discussing further with them. There is, however, broad agreement to the main principles.

A great deal more work needs to be done to establish the correct initial prices for the new company; to set an X factor sufficient to give the company efficiency incentives without unduly threatening its profitability; to consider how far the BBC will require similar regulation. I propose that officials from our two Departments, OFTEL, Treasury and the Cabinet Office should supervise further work in order that the full regulatory regime may be ready for the New Year.

I should be grateful for your agreement to the proposals in the attached paper, and the proposed course of action.

I am copying this letter to the Prime Minister, other members of MISC 128, and to Sir Robin Butler.

A handwritten signature in dark ink, appearing to be 'G. J. ...' with a stylized flourish at the end.

**ECONOMIC REGULATION OF TERRESTRIAL BROADCASTING**

1. In June last year, Ministers agreed to the need for economic regulation of the private transmission company which is to inherit the IBA's transmission functions. Home Office and DTI engaged National Economic Research Associates (NERA) to undertake this task, which was completed in May.

2. This paper summarises and comments upon the main conclusions of the study.

Mechanisms for economic regulation

3. The economic regulation of the transmission company (National Transcom) will be effected through a Telecommunications Act (T Act) licence policed by Oftel. The principal aims of the licensing regime will be to prevent Transcom from abusing its monopoly position by obliging it:

- i) to grant transmission facilities to Channels 3, 4 and 5 so that they can fulfil their broadcasting obligations;
- ii) to do the same for the BBC;
- iii) to grant access to its masts to other transmission operators;
- iv) not to discriminate unfairly between customers (ie. arbitrarily subsidising one at the expense of another (but see paragraph 4 below));
- v) to charge certain captive customers prices regulated by a price formula (see paragraph 5 below).

4. Transcom will also be obliged to charge Channel 3 customers according to a special tariff which will charge each Channel 3 company on the basis of its revenues rather than

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actual transmission costs. This will protect the fringe companies (like Channel TV, Grampian and Ulster) whose transmission costs would otherwise be prohibitively high.

### Main conclusions of the NERA Report: scope of price regulation

5. On the scope of regulation, NERA have proceeded on the principle that price regulation (throughout this paper, "price regulation" means the regulation of prices by a formula) should be used only where there are neither real competitors nor comparative prices to enable Oftel to check whether Transcom is abusing a quasi-monopoly position.

\* Ministers are invited to endorse this principle

6. Using this principle, and dividing the transmission services offered by Transcom into the three categories of mast and site rental, operation and maintenance, and distribution, NERA conclude that price regulation will be required for the following services for the foreseeable future:

- Channel 3 mast and site rental
- Channel 4<sup>1</sup> mast and site rental
- Channel 3 operation and maintenance
- Channel 4 operation and maintenance

\* Ministers are invited to endorse this conclusion.

7. NERA also conclude that Channels 3 and 4 distribution (ie. the delivery of programmes between studios and transmitters by fixed or microwave links) will require price regulation until the end of 1994 (the expiry of Transcom's contract with

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<sup>1</sup>Throughout this paper, "Channel 4" includes S4C

British Telecom for distribution links); and that Channel 3 distribution will need price regulation beyond that date if the Channel 3 companies continue to be required (in order to preserve the cross-subsidy arrangements for Channel 3 transmission charges) to use Transcom for distribution (a question being considered by the Home and DTI at the moment).

8. In the period up to 1993, the ITV companies and Channel 4 will have contracts with Transcom for transmission services including distribution, and these can be used to regulate the price for that period. From 1993, Channel 4 will be able to make alternative distribution arrangements. It may also be possible to allow the Channel 3 companies to make alternative arrangements for distribution. While it is true that Transcom's very favourable contract with BT makes it unlikely that the Channel 3 and 4 companies will seek to make their own distribution arrangements, that is not an argument for regulation. Officials have therefore concluded that no price regulation for Channel 4 distribution will be necessary, and that price regulation of Channel 3 distribution will be required only if the Channel 3 companies are locked into Transcom as a result of the cross subsidy arrangements.

\* Ministers are invited to endorse this conclusion

9. On Channel 5, NERA conclude that it will be realistic for other transmission operators (using Transcom and BBC sites) to undertake the operation and maintenance of Channel 5; and that Channel 5 will have a choice of distribution suppliers. NERA also provisionally concluded against regulation for Channel 5 site and most rentals. With sufficient data, Oftel believe that the non-discrimination clause in Transcom's T Act licence will be sufficient protection for Channel 5. Subject to sufficient information being available, we think avoiding formal price regulation is the most attractive option.

\* Ministers are invited to endorse this conclusion

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10. NERA conclude that independent local radio transmission and all independent radio distribution will be subject to real competition, and price regulation will therefore be unnecessary.

\* Ministers are invited to endorse this conclusion

11. The extent to which independent radio companies will have a genuine choice over sites and masts is debatable. The national AM companies will have no effective choice of sites, and price regulation of the BBC for this function seems unavoidable. In the case of the national VHF and all local radio, there is in theory more choice of sites, though planning permission and coverage problems mean that in practice changing sites may be restricted. However, there are analogous site and mast services offered to cellular and other operators: NERA conclude that the existence of these analogous service, coupled with a prohibition on price discrimination, and the fact that for about two to three of the five years of the first regulatory period the independent radio companies will have fixed price contracts with Transcom, means that formal price regulation of site and mast rentals is unnecessary.

\* Ministers are invited to endorse this conclusion

A table showing the proposed scope of price regulation is  
... attached at Annex A.

### Main conclusions: mechanics of regulation

12. There are two main types of price regulation. Tariff basket regulation controls the total price of a specified list of services; revenue yield regulation controls the price per unit of output. The former is easier to apply, but in some circumstances can lead suppliers to tamper with prices for individual services. NERA conclude that in this case tariff

basket regulation is preferable to revenue yield, because:

- revenue yield requires the selection of a suitable supply unit, which in this case is not available;
- tariff basket is easier to apply, and appears to offer no significant disadvantages in this case.
- \* Ministers are invited to endorse this conclusion

13. For administrative simplicity, and because there appear to be no significant disadvantages, the Report suggests that the price formula should be based upon historic (rather than forecast) RPI; and that, given the likely regulatory and contractual arrangements governing distribution and power costs during the period up to 1996, it seems unlikely, at present, that a separate allowance for cost pass-through is necessary or desirable.

- \* Ministers are invited to endorse this conclusion

14. In order to balance the need for some medium-term certainty for the regulated company with the need to reconsider the price formula after the system has had time to settle down, NERA recommend a six year initial period for price regulation at the end of which Oftel would review the formula. This would allow the first review to coincide with the review of the BBC's Charter, at which time the BBC's transmission system may be privatised, so reducing the need for price regulation.

- \* Ministers are invited to endorse this conclusion

15. The Report considers the extent to which the price formula for Channels 3 and 4 should be applied separately to the three main service components - site and mast rental, operation and maintenance, and distribution. If distribution is not to be included in the price formula, the price formula will cover

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two service elements for each of the three channels (3, 4, S4C), making six potential tariffs in all.

16. The question is, to what extent do these six tariffs need to be individually specified and controlled?

17. It is clear that the price formula should be applied separately to the three Channels: if it were not, Transcom might start to increase charges to Channel 3 companies (which will be captive customers) in order to cut charges to Channel 4 and 5 companies (who will have the option to go elsewhere). Less clear is the extent to which the charges for the two regulated service components should be separately identified and controlled.

18. Channel 3 will effectively be obliged to procure both site and mast rental, and operation and maintenance, from Transcom for some time (so the separation of its charges into component services would, from the Channel 3 companies' point of view, be academic). However, Channel 4 may wish to consider using alternative operators for operations and maintenance from 1993; and Channel 5 may choose to use Transcom sites and masts but not Transcom operation and maintenance.

19. This suggests that it will be necessary for the Regulator to be able to check the true costs of each service category, rather than simply control the increase in total prices. However, this does not necessarily mean that each category of service has to be separately capped. It may be enough for the Regulator to be able to require Transcom to specify the prices of each category of service within the overall price caps of Channels 3 and 4.

20. Another way of regulating site and mast rental would be to use the site sharing agreement being developed by the BBC and IBA as a means of setting the rates they charge each other. We understand that this agreement will break down costs for individual classes of site, and thus could prove a



useful yardstick for Oftel to monitor whether new transmission operators (eg. the Channel 5 operators) were being charged a fair rental for site and mast use. We shall need to look closely at this.

21. NERA set considerable store by this agreement as a means of avoiding formal price regulation.

- \* Ministers are invited to agree that Channels 3 and 4 transmission should each be subject to price regulation by a price cap, with each service category price unbundled but not separately capped; and that officials should explore the use of the BBC/IBA site sharing agreement to facilitate this.

Outstanding questions: Mechanics of regulation

22. The main outstanding question on the mechanics of regulation is the way in which costs should be allocated between customers and reflected in regulated prices. The NERA report recommends that, in some circumstances, the price cap could be of the form RPI-X.. The difficulty arises when additional customers necessitate new sunk costs, or reduce unit costs. For example, if the advent of a Channel 5 transmitter on a mast means additional strengthening of the mast, how should these costs be apportioned? Similarly, if no new capital costs are incurred, the addition of a Channel 5 transmitter is likely to reduce the unit costs of maintenance and operation. Should Channels 3 and 4 share in this reduction? The NERA Report does not answer this question, except to say that the additional costs should be allocated equally when contracts come up for renewal.

23. Channel 5 is the only new entrant to the market which is likely to throw up the problem of cost allocation in a significant way. Whether Transcom secures Channel 5 business will have a major effect upon its cost profiles. It seems likely to be necessary to include in the licensing regime an

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assumption about Channel 5 business, and an ability to alter the price regulation formula if the assumption proves wrong.

- \* Ministers are invited to agree that the price formula should be capable of adjustment to allow for changes caused by the advent of Channel 5 business.

PROPOSED SCOPE OF PRICE REGULATION

<u>Programme co.</u>	<u>Site and mast</u>	<u>Op. &amp; Maint.</u>	<u>Distrib.</u>
Channel 3	Yes	Yes	No
Channel 4	Yes	Yes	No
Channel 5	No *	No *	No
All other cos.	No	No	No

\* Subject to OfTel having sufficient data to enforce the non-discrimination clause in Transom's licence.

