

REGULATORY AND POLICY DEVELOPMENTS

IS THE CABLE INDUSTRY TOO PROFITABLE? CONTROVERSIAL PROPOSALS FOR THE AMENDMENT OF THE CABLE TELEVISION SUBSCRIBER FEE REGULATIONS

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In 1986, the Canadian Radio-television and Telecommunications Commission (CRTC) made substantial amendments to regulations governing the cable television industry. Perhaps the most significant change was a reduction in the regulatory oversight the Commission exercised over the adjustment of the monthly rates charged by cable television licensees for access to the package of television and radio services commonly referred to as basic cable service.

Section 18 of the *Cable Television Regulations, 1986* dealing with increases in basic cable rates was intended to alleviate regulatory lag, decrease the paper and regulatory burden for the Commission and cable licensees, and provide an incentive for cable companies to invest in the expansion, upgrading, improvement and rebuilding of cable facilities in a timely fashion, with a view to providing improved and expanded cable service to subscribers.

Before 1986, any change in basic cable rates required a formal application to the Commission and a written or oral public process, with the usual procedural requirements and attendant delays. Under the revised *Regulations*, cable rates can be increased, either automatically or with a minimum of Commission intervention, in the following three instances: increases in the Consumer Price Index, increased payments related to the transmission of cable services

remitted by a licensee to a regulated party, and capital expenditures by a licensee referable to the reception, processing or distribution of cable services. The Commission was to review the impact of the new regulatory regime in two years.

The CRTC has received well over a thousand letters of complaint from irate subscribers over the level of basic cable rates since 1986. The perception that basic cable service was fast becoming unaffordable was exacerbated by the Commission's decision in 1987 to allow cable companies to add to the basic cable service narrowcast services such as the Sports Network and MuchMusic, purchased from licensed network operators, and to pass through the wholesale fees paid to all cable subscribers in a franchise area, in the form of an increase in the basic cable monthly rate charged.

In February 1990, the Commission held a public hearing to review the effect of its 1986 amendments and to examine proposals for a readjustment of that part of the *Regulations* governing subscriber fees. The hearing found the cable industry, more particularly the Canadian Cable Television Association (CCTA), pitted against subscribers, subscriber representatives, the Consumers' Association of Canada and the Director of Investigation and Research. Subscribers and their representatives argued that, under the new rules, cable licensee profitability had become excessive. The cable industry and the CCTA, the latter armed with a study commissioned from Price Waterhouse, claimed that the cable industry's rate of return on basic cable service was reasonable. Moreover, the industry argued, the Commission's policies with regard to the structuring, packaging and pricing of cable services were in large part responsible for the recent increases in basic cable rates. The Commission's 1986 regulatory approach, the cable industry contended, should be maintained. In addition, the industry requested that the definition

CANADIAN COMPETITION POLICY RECORD

of the third party payments that could be passed through automatically to cable subscribers be expanded to include copyright payments set by the Copyright Board, soon to be levied on cable companies for the retransmission of distant television signals. The Director, for his part, argued for greater reliance on competition in the delivery of programming services to control profitability by increasing consumer price and programming options.

On May 15, 1990, the Commission issued Public Notice CRTC 1990-53 in which it announced proposals for amendments to the *Cable Television Regulations, 1986* aimed at tightening CRTC control of cable television price increases and cable industry profit margins.

Cable industry profitability has been measured by the Commission, historically, by reference to an annual return on net fixed assets before interest and income taxes. In Public Notice 1990-53, the Commission found that, on the basis of available data, the average annual return on net fixed assets earned by the cable industry for the eight-year period 1981 to 1988 was 24.2%. According to the evidence submitted, it had increased steadily since 1980, rising to a high of 28.1% in 1988. There were allegations by some parties that the return earned by some cable companies has reached 70%.

In Public Notice 1990-53, the Commission concluded that the currently used profitability benchmark of 24% is unacceptably high. It also expressed the view that industry profitability should be examined over an eight-year business cycle, rather than over just one year. The Commission also decided no longer to be governed by historical averages for the industry as a whole to establish a profitability benchmark for the cable industry. In its view, a benchmark should instead be struck on the basis of an appropriate rate of return for basic cable service determined by independent assessment. The Commission took issue, however, with the Price Waterhouse profitability study which it found "flawed in several ways" in estimating that the expected return for the cable industry should be between 22.8% and 25.6%. The Commission announced that it would retain an independent consultant to conduct an analysis of industry profitability and to recommend a benchmark rate of return.

All three circumstances in which a less restrictive approach to the implementation of rate increases was adopted by the Commission in 1986 were reviewed during the February hearing. The Commission's May 1990 proposals involve major changes that should provide mechanisms through which increases in basic cable rates can be restrained and the cable industry's profitability can be reduced.

Indexing

The Commission proposed changes in the formula used to calculate cable rate increases on the basis of increases in the Consumer Price Index. Instead of being able to recover 80% of the percentage increase in the Index in a given year, the new formula would permit a maximum increase of two percentage points less than the increase in the Index for the previous year. Moreover, when the rate of inflation exceeds 10%, indexing increases would be capped at 80% of the increase in the Index. At current inflation levels, the revised formula is expected to allow for an approximate 60%, rather than the current 80% recovery of inflationary cost increases.

Pass-through Increases

A major revision of the definition of "pass-through" charges is proposed by the Commission in Public Notice 1990-53. The net result would be to permit automatic pass-through treatment only for the wholesale fees for licensed programming services authorized by the CRTC pursuant to its broadcasting mandate. Payments such as telephone pole attachment and duct rental tariffs approved by the CRTC pursuant to its telecommunications mandate, or microwave charges, heretofore all eligible for pass-through, would be considered a normal cost of doing business.

Moreover, to the dismay of the industry, the Commission announced its intention not to consider as a pass-through charge, the copyright fees soon to be levied for each distant signal carried by a cable system. Such fees would also be considered a normal cost of providing cable service. Should some cable licensees wish to

CANADIAN COMPETITION POLICY RECORD

demonstrate that they will suffer economic hardship if no rate increase is available to them to recover copyright charges, they will have to do so on the basis of economic need through a 'special circumstance' application for an increase in basic cable rates.

Capital Expenditures

Before the February 1990 hearing, the Commission had announced its intention possibly to discontinue, for larger cable systems, the regulatory mechanism that has allowed cable licensees, since 1986, to recover automatically a portion of capital expenditures made or to be made in a given fiscal year. Such expenditures, to be eligible, had to constitute an investment related to the reception, processing or distribution of basic programming services. The level of the recovery permitted was up to 50% of eligible capital expenditures, that is, 10% per year for five years of any eligible capital investment made or to be made in the year of application.

Strong representations were made by the cable industry for the retention of the method put in place in 1986 for increases in fees on the basis of capital expenditures. The capital-intensive nature of the industry was emphasized. The need for the ongoing upgrades necessary to improve technical quality and reliability and to expand channel capacity was stressed. The incentive for such investment in a timely fashion would be impaired, the cable industry argued, if the capital expenditure fee increase method were eliminated.

The Commission announced in Public Notice 1990-53 that it will retain the capital expenditure fee increase method for larger cable systems but that it will introduce an upper limit to the total amount of each licensee's annual capital expenditures recovery equivalent to 3% of the base portion of the authorized basic monthly fee (the basic monthly fee exclusive of taxes, pass-through charges and previous capital expenditure increases) at the end of the previous fiscal year. New plant construction, since it generates an additional revenue stream, would no longer be considered a capital expenditure eligible for rate increase treatment. Moreover, future fee increases would be based on eligible capital expenditures already incurred in the previous fiscal year.

Perhaps the most controversial issue at the hearing was a Commission proposal to introduce a five-year 'sunset' provision with regard to both capital expenditures already claimed by cable licensees and to those to be claimed in the future. The Commission announced its decision in Public Notice 1990-53 to add to section 18 of the *Regulations* sunset provisions applicable both to future increases and to increases already implemented. Past increases would remain in effect until January 1995. All future increases would terminate five years after implementation. Fee decreases would therefore start by January 1995 to remove increases implemented prior to May 15, 1990. Any increase implemented after May 15, 1990 would be effective for a five-year period only.

Conclusion

The Commission has issued its proposals for the amendment of section 18 of the *Cable Television Regulations, 1986*. It will publish for comment at a later date the exact wording of the proposed amendments, as required by its governing legislation. Nevertheless, a war of words has since raged on between the Commission and the cable industry and the Commission and Price Waterhouse. Their respective views regarding the level of profitability of the cable industry, and the validity of the study filed on the matter by the CCTA at the hearing, have been aired in the press and became a focal point at the recent CCTA annual convention held in Edmonton.

The cable industry has been arguing that the imposition of restrictions with regard to automatic increases in cable fees and, more specifically, the ability of cable companies to pass through to subscribers copyright payments with respect to the retransmission of distant signals, will lead to a return to a regime of costly, time-consuming regulation. Cable licensees, it contends, will find that they have to resort once again to repeated and detailed formal applications in which they will have to argue economic need every time they wish to recover increases in their recurring costs.

The Commission has also announced in Public Notice 1990-53 that it will hold a public hearing in 1991 to review the structure and cost of cable

CANADIAN COMPETITION POLICY RECORD

service, including tiering and linkage policies. One major issue to be addressed is a possible restructuring of basic cable service which would allow subscribers an expanded ability to choose the services they want to receive and to pay only for such services.

UNITEL FILES LONG DISTANCE APPLICATION WITH THE CRTC

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On May 16, 1990, Unitel Communications Inc. (formerly CNCP Telecommunications) filed its long awaited application for interconnection with CRTC-regulated telephone companies to provide public switched long distance telephone services.

Unitel's application stresses that its entry into the conventional long distance market will result in improved service, choices, and product innovation, particularly through price differentiation over the prospects of improved network efficiency.

Two types of services would be provided as a result of the proposed interconnection with the telephone companies. First, and the principal object of the application, would be the provision by Unitel of conventional message toll and WATS services within Canada, to the United States, and overseas. To attract customers, Unitel proposes to emphasize product differentiation and innovative pricing options, volume discounts and subscription services targetted at specific market niches. These would include innovations such as unlimited flat-rated calling within a specified zone, reduced rates to frequently called area codes, and blocks of long distance calling time for one all-inclusive rate. Second, and riding on its new long distance services, Unitel proposes to offer advanced network services that will rely on the intelligence built into the network control points and data bases of its digital network. Such advanced services could involve provision of call-routing and store-and-forward or other enhanced services.

Unitel intends to provide its new long distance services with a fully digital network using Common Channel Signalling No. 7 technology (CCS7). At present, however, the construction plans of most Telecom Canada members also involve full digitalization and adoption of the CCS7 standard during the 1990s. Unitel does not contend at this time that the technological capabilities of its long distance network will be superior to the capabilities of the Telecom Canada companies at the time Unitel hopes to begin offering long distance services.

Unlike the firm's unsuccessful 1985 long distance competition application, the present application provides a service roll-out plan defining the year in which the company proposes to begin serving particular areas over a six year period commencing about one year after receipt of interconnection authorization from the CRTC (assuming the carriers provide all necessary facilities and interconnection arrangements by that time). Not surprisingly, dense and higher income population areas in Canada are targetted for the early years in the roll-out period, while the less dense or below average income areas of the country are targetted for the later years of the roll-out period.

The three Prairie telephone companies are not yet included in the application as they are not subject to CRTC jurisdiction. Once legislation is passed, making them subject to CRTC regulation, Unitel proposes to include those companies in its application and roll-out plan.

With regard to pricing, Unitel's application suggests that, on average, its long distance rates will be 15% below those of its competitors. However, this will not be an across-the board difference; rather, this difference will reflect a variety of selective differentials and innovative pricing approaches. Calculation of the actual Unitel price advantage at the time of the CRTC's hearing may prove difficult since a variety of discount structures each having different market stimulation and traffic-shifting characteristics may have to be examined. It is also conceivable that, to preserve an overall price level below Telecom Canada, Unitel may ultimately have to seek some comfort from the CRTC that Telecom Canada companies will be prevented from lowering

CANADIAN COMPETITION POLICY RECORD

their long distance price level or marketing Unitel's innovative services in order to reduce this effective price spread.

Access arrangements proposed by Unitel would take on two basic forms. The preferred arrangement would involve the connection at the carrier's lowest order toll switch (termed a Class 4 switch). The fall back interconnection point would be at the carrier's local (Class 5) central office. Class 5 switches route local flat rate calls and pass long distance traffic on to Class 4 switches which route calls over the carrier's long distance network.

Access at the Class 4 switches is proposed by Unitel because it involves fewer interconnection points, the interconnection points would be close to existing Unitel switching facilities, and, generally, the quality of technology at Class 4 switches would be higher than at Class 5 switches (thus permitting less complicated and more efficient network interconnection involving digital technology to a larger extent).

Unitel proposes to compensate the telephone companies for their local loop costs and switching and traffic aggregation costs through per minute charges. The level of these proposed charges is, however, not discussed in the application. In addition, Unitel proposes to pay a "contribution charge" to the telephone companies to help keep the costs of basic access services down. It is generally recognized that existing monopoly long distance service rates generate revenues far in excess of their causal costs. This excess revenue has traditionally been used by regulators to keep local access rates down partly to encourage maximum access to telephone service.

Unitel has not specified the level of access contribution which it is prepared to make. This will undoubtedly be a major issue of contention during the course of this proceeding. However, Unitel has suggested that this level of contribution should be similar to the level established in other proceedings providing for competitive interconnection. If so, Unitel may be implying that its business plans have anticipated a contribution premium of approximately 25% over the tariffed rates for interconnection channels from the telephone companies which rates would be based upon actual causal costs. This is the

premium the CRTC has required Unitel to pay for other types of interconnection. Unitel is also requesting that this contribution charge be lower in earlier years to recognize the lower quality of interconnection that it will obtain in these years from the telephone companies and the lower level of calling volumes it will generate from customers (i.e. lower level of market penetration) during the start-up period of its services.

Some time in this proceeding will undoubtedly be spent defining similarities, differences and improvements in Unitel's business plan relative to the failed 1985 application. Unitel's application document suggests a strategic decision on its part to defer debate on this issue until a full public process is established by the CRTC. The respondent telephone companies have successfully persuaded the CRTC that Unitel must provide further particulars on its application to permit them to prepare their answers. The CRTC has given the respondent telephone companies (Bell, BC Tel, Maritime Tel & Tel, Newfoundland Tel, Island Tel, and New Brunswick Tel) to July 20, 1990 to file answers. Unitel then has an additional ten days to reply to those answers.

There is little doubt that the CRTC will establish, through a Public Notice, a process involving all potentially interested parties and extensive written exchanges of information as well as a full public hearing into the application, possibly including regional hearings. It is presently anticipated that public hearings will not occur until the late Spring of 1991. If so, the CRTC's decision may not be issued until the Fall of 1991. Thus, if Unitel wins its case, the earliest expected date in which it might start offering long distance services could be the fall of 1992, with termination of its roll-out plan in the Fall of 1998.

Thorough written particulars and evidence will be exchanged among Unitel, the respondent telephone companies and the number of interested parties, including possibly several provincial governments and the Director of Investigation and Research. Issues to be explored will include the method of calculation and charging of the permanent access contribution payment by Unitel, the extent to which that payment should be discounted over the early years of Unitel's roll-out

CANADIAN COMPETITION POLICY RECORD

plan, the level of traffic diversion from the telephone companies caused by Unitel's entry, the level of market growth stimulated by Unitel's entry, the extent to which Unitel's services will actually be innovative (this will help determine the market stimulation, traffic diversion and market share issues), the structure of Unitel's long distance facilities compared to those currently being constructed by the established telephone companies to provide conventional message toll

and WATS facilities and their related operating costs (i.e. comparative firm efficiency and overall industry efficiency consequences of Unitel competition), the level of market penetration to be achieved by Unitel, the price differential assumptions made over the roll-out period to achieve that level of market penetration, and the extent of deregulation or re-regulation of limited and other telephone company rates necessary to permit Unitel to achieve its business plans.