REGULATORY AND POLICY DEVELOPMENTS

CRTC GRANTS TELESAT INTERIM RATE INCREASES

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In a decision released in late December 1990 (*Telecom Decision CRTC 90-28*), the CRTC approved interim rate increases for Telesat's space segment services of 2.67 per cent in each of 1991 and 1992. The Commission also concluded that it would decide at a later date, possibly near the end of 1992, whether to approve an escalating rate structure to the end of 1999 (a period corresponding to the largest portion of the estimated use of life of the new Anik E Series satellites to be launched in the near future).

The Commission's decision is a striking rebuff of Telesat's application. First, it concluded that Telesat had not proven its case for rate approvals covering the entire ten-year life span. Second, the total increases sought by Telesat for 1991 and 1992 amounted to over 20 per cent compounded compared to the six per cent compounded total increase actually allowed. Finally, as discussed further below, the Commission went out of its way to criticize Telesat both for regulatory non-compliance with respect to its manner of introduction of specialized competitive services and for its poor case presentation.

Telesat is unique among federally regulated telecommunication carriers in having been successful in persuading the CRTC to approve a multi-year escalating rate structure corresponding to the expected useful life of new satellite series. The purpose of this escalating rate structure was to smooth out Telesat's corporate financial performance over the satellite series' lifetime, given the massive expenditures required in the construction and launch phase of new satellite series and the enormous drop in operating expenditures after launch. However, in this case Telesat was proposing not only to set rates applicable to the bulk of the estimated useful life of its yet-to-be-launched E Series, but also to cover the remaining useful life of certain D and C Series satellites, one of which will continue to earn revenue well into the mid-1990s. Arguably, the capital costs of these satellites should have been recovered through pre-1991 space segment rates. As well, at the time of the hearing, the precise launch dates and actual launch costs of the E Series satellites could not be determined. Hence, the actual capital cost and depreciation rates of the space segment activity of Telesat for the bulk of the 1990s remains uncertain. These factors worked against Telesat's request for final rates to recover E Series capital and operating costs.

The importance of the methods employed by Telesat to allocate corporate expenses to its space segment activity was much greater than in previous space segment rate cases. In the last multi-year case (dealing with the C Series 14/GHZ rates in 1984) Telesat's unregulated operations were not significant, since the company at that time was still subject to the marketing restraints of the Telesat/Telecom Interconnecting Agreement. Over the latter part of the 1980s, Telesat's unregulated businesses grew very rapidly. Hence, the manner in which corporate administration and operating expenses were allocated between regulated and unregulated activities was of considerable importance in this case. Unfortunately, Telesat elected to rely upon a proposed service category costing system which had not been approved by the Commission and which was harshly attacked by interveners as not providing adequate documentation on the manner in which cost causation was determined for major operating expense categories. The Commission decided

that Telesat's costing system must be settled and approved prior to pinning the possibility of establishing multi-year rates up to the end of 1999, and declined to employ it in this case.

The Commission specifically rejected Telesat's proposals for allocating engineering costs and marketing and selling expenses between regulated and unregulated activities, and concluded that the existing contributions to space segment cost bases were exaggerated. The resulting reduction in expense forecasts for regulatory purposes was a major reason behind approving rates lower than proposed. The Commission also noted that Teleglobe's corporate expense forecast over the proposed ten-year period had increased to between two and three per cent above inflation. The Commission concluded that the resulting overall expense increase had not been supported and, in calculating space segment expenses, reduced forecast corporate expenses by the estimated growth beyond the assumed inflation rate.

In addition to finding that Telesat had overestimated its space segment costs, the Commission also concluded that Telesat had significantly underestimated demand. The Commission focused on Telesat's forecast of customer losses of four full RF channels for each of its 14/12 and 6/4 GHZ space segment service categories. The principal reason advanced by Telesat for these forecast customer losses was uncertainty with respect to the Commission's policies on speciality and pay television services. The Commission concluded that it would be premature to speculate on the results of its reexamination of these policies anticipated for 1991 and 1992, and also found that it would be inappropriate to stipulate future customer losses based on the characteristics of customers who had dropped off Telesat over the last five years.

Telesat had proposed that its rate should increase by over 16 per cent in 1991. It argued that this would in fact bring it to the point where it should be following Commission-required 6/4 service reductions in 1989. Telesat also contended that without this increase, the corporation as a whole would be close to reaching its financial ratio limits under its existing debt financing. The Commission rejected both arguments as a basis for a high single-year increase, and emphasized that in setting space segment rates it would not be driven by Teleglobe's wide overall corporate performance.

The Commission also expressed "serious concerns" with respect to numerous past failures by Telesat to file for approval special assembly tariffs for particular customers, and to Telesat having, in a number of cases, provided its service to customers at no charge prior to actual CRTC approval of the service. The Commission was apparently persuaded that no disciplinary action was required since Telesat's President assured the Commission during the hearing that he had implemented measures to prevent future failure to comply with the tariff approval provisions of the *Railway Act*. The Commission also criticized Telesat for having on a number of instances provided information that was either ambiguous or incorrect and for failing to provide correct information in a timely manner. The Commission has signalled to other companies and parties which consume a considerable amount of Commission and intervener resources that inadequate case preparation in the future will certainly not help them. The Commission concluded that "Telesat often appeared unable, in this proceeding, to provide sufficient and accurate evidence on a timely basis. The Company is expected to take whatever steps are necessary to ensure that these problems do not occur in the future."

Telesat has petitioned the Federal Cabinet to have the decision varied. The precise remedy being sought by Telesat from Cabinet and the contents of the Telesat petition have not been made public. One major intervener in the 1990 hearings, Cancom, a broadcaster which also competes with Telesat in the provision of competitive private line telecommunication services through the resale of Telesat space segment services, has publicly criticized the secretiveness of this petition. It has noted that the government may well be in a serious conflict of interest position with respect to this petition, since it is a 50 per cent owner of Telesat and has announced its intention to sell these shares in the near future. At the time of writing, the government had not indicated how it intended to proceed with this petition.

CRTC PUTS TEETH IN CABLE RATE POLICY

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In related decisions issued at the end of December 1990, concerning major southern Ontario cable T.V. holdings of the Rogers Group of Companies the CRTC has gone further than ever before in applying line-by-line forecast cost analysis, as traditionally employed under its telecommunications jurisdiction, to the assessment of cable rate increase proposals based on economic need. This line-by-line approach involves an assessment of the reasonableness of proposed future year increases in expense categories based on past actual increases and on the nature of the services represented by the expense category.

Of particular concern to the Commission were intercorporate transactions involving the acquisition of services by the cable companies from Rogers' central organization.

Among the expense items examined in detail was the annual fee charged to licensees by the ultimate parent company, Rogers Communications Inc. (RCI), for various management and audit services furnished to the cable companies. This fee is calculated as a percentage of the cable companies' gross revenue and was increased from two per cent to five per cent in 1988. Rogers explained that the increase was justified in view of certain additional audit and management services provided by RCI to the licensee. The Commission found that Rogers' argument was not persuasive and as a result reduced this service fee component by approximately 60 per cent.

With respect to Rogers' Toronto system, the CRTC also questioned a 25 per cent increase in its general administration expenses in 1989. Rogers contended that this increase was a result of the startup costs of the regional business office in Toronto which, according to Rogers, assumed responsibility for business office calls throughout most of Ontario. However, the costs of these central service operations had not been allocated to each of the beneficiary Rogers cable systems. The Commission disagreed and found that the costs should have been allocated to each of the licensees' systems served by the business office and not merely to the Toronto system, since the costs associated with the duplication of staffing were not confined solely to Toronto.

The Commission also questioned the 48 per cent increase projected in 1990 for the other administration and general expense category. Rogers explained that this increase was the result of increases in both its Supersystem and corporate administration management charges. It noted that these charges related to the allocation to various licensee cable systems of head office costs and its computerized subscriber billing and accounting system (principally software improvements). These cost changes had been allocated to each system on a per-subscriber basis. In this case the Commission simply rejected the proposed increase as "not justified".

Finally, the Commission questioned Rogers' sales expense category, particularly its 1990 "other sales and promotion" expenses which represented a 95 per cent increase over similar 1989 expenses. Rogers indicated that part of this increase related to spending on "a new image and logo". The Commission found that these costs should be capitalized and amortized at a 10 per cent rate rather than expensed. Accordingly, this also resulted in a reduction in allowed 1990 expenses.

Regulatory expense adjustments such as these are not uncommon in the course of the Commission calculation of the forecasted profitability of telecommunications carriers for the test period for which a "revenue requirement" and major service rates are being established.

With these adjustments, the Commission found that the average return on net fixed assets of the systems' regulatory purposes was much higher than had been calculated by Rogers. The Commission then went on to examine the basis and amount of recent rate increases obtained by Rogers. It noted that Rogers had obtained three capital expenditure (capex) rate increases totalling $2.45 in the last three years. This represented a substantial increase of 24 per cent over the maximum monthly rate that had been authorized for the respective systems prior to the implementation of the capex rate increase concept

which had been harshly criticized by consumer representatives and recently cut back in 1990 revisions to the *Cable TV Regulations*.

The Commission also noted that the same capital expenditures already claimed by Rogers as the major underlying component of these increases also comprised significant factors in the economic need portion of its rate increase filing. Capital spending has the effect of increasing the asset base of the licensee, with a corresponding downward impact on return on fixed assets. The Commission noted that the levels of actual and projected spending by Rogers over the past three years were unusually high when compared with spending levels in previous years, and found that the recent capital expenditure rate increase adjustments had already been paid for by subscribers. The Commission concluded that these factors should be taken into account in assessing an economic need application.

As a result of these considerations, the Commission elected not to allow the economic need portion of the Rogers increase applications, even though the return on net assets calculated using regulatory adjustments fell below the 24 per cent per annum bench mark which is currently applied by the Commission as a profitability level for cable companies.

OTTAWA PURSUES OPEN SKIES AGREEMENT WITH U.S.

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On October 3, 1990, Doug Lewis, the Minister of Transport, announced that the Canadian and United States governments had agreed to initiate negotiations to establish a new bilateral air transport agreement. The announcement was made simultaneously in Washington, D.C., by the U.S. Secretary of Transportation.

Bilateral air agreements set out how scheduled air services may be operated between two countries. Typically, they specify:

- the cities that may be served and under what conditions,
- the frequency of flights,
- the routes (including how they may be combined with services to other countries),
- tariffs or pricing,
- provisions for safety and security,
- provisions for ground handling, and
- other details.

Canada's bilateral air agreement with the United States is the most complex of its 46 agreements with foreign countries. It consists of a number of separate documents dealing with:

- scheduled services (the main Air Transport Agreement),
- charters (the Nonscheduled Services Agreement),
- customs and immigration services in the other country (the Preclearance Agreement),
- cargo services (the All-Cargo Notes),
- commuter services (the Regional, Local and Commuter Services Notes), and
- aviation security.

Canada and the United States share the largest bilateral air relationship in the world. Under the current Canada-U.S. air transport agreement, over 13 million passengers moved between the two countries in 1990, generating some $2.3 billion (Canadian) in revenue.

At present, scheduled air services between Canada and the U.S., including local and regional services, are provided on 83 city pairs. Canadian carriers are the sole operators in 26 of these markets while U.S. carriers have exclusivity in 39 markets. Carriers from both sides share 18 city pairs. Canadian carriers are particularly strong in the smaller charter market with over 95 per cent of the traffic, while U.S. carriers dominate scheduled air service, taking almost two-thirds of the traffic. Important market pairs such as Montreal-Atlanta, Toronto-Washington or Vancouver-Denver have no direct service under the existing agreement.

According to the joint announcement, all aspects of the bilateral air relationship between Canada and the United States, including scheduled and charter services for the carriage of passengers and cargo, will be addressed at the negotiations. However, the Canadian regulatory régime, as it relates to safety and security, will continue to govern all aviation activity in Canada.

The Canadian government's position is that the current bilateral agreement, first negotiated

in 1966 and last revised in 1974, is out of date. It provides only limited opportunities for transborder air services and fails to meet today's growing demand for air transportation between centres in the U.S. and Canada. Canadian and U.S. scheduled air service patterns have been limited to what is permitted in the route schedules agreed on in 1974.

Under the current agreement, U.S. carriers have direct access to 90 per cent of Canada's market, while Canadian carriers have access to only 30 per cent of the U.S. market. The Canadian government is clearly trying to ensure that Canada's international carriers are better positioned to operate in a market which many analysts believe will soon be dominated by a few mega-carriers. The current régime and the strength of the U.S. hub-and-spoke system affords U.S. carriers significant competitive advantages, in the opinion of the the federal government.

Obviously, the North American air industry has changed significantly since 1974. The U.S. (in 1978) and Canada (in 1988) have deregulated their domestic air services, with the result that today's services are determined primarily by the commercial decisions of airlines and not by government regulators. The emergence of hub-and-spoke networks, especially in the U.S., has created new traffic patterns and new opportunities for carriers that were not envisaged at the time the main agreement was negotiated. Times are tough for airlines throughout the world. The industry has been buffeted by fluctuating fuel costs, a general drop in business due to the recession, security concerns, large-scale layoffs and labour unrest, mounting financial pressures, and corporate restructuring.

The federal government maintains that the existing bilateral agreement does not offer the travelling public enough service and fare options. A liberal agreement with cabotage is considered essential for Canadian carriers to access the U.S. market fully and to redress the structural imbalance.

Emphasizing the importance of public consultations in preparing for the negotiations, the Minister of Transport invited input from all concerned parties including communities, provincial governments, the Canadian airline industry, unions and the travelling public.

According to the government, the negotiations will be comprehensive, covering all aspects of the agreement including scheduled and charter passenger services, cargo, regional services, specialty operations, airport access, "doing-business" issues, and Customs and Immigration facilitation. As part of the consultative process, a special parliamentary committee was asked to conduct public hearings in centres across Canada to learn the views of Canadian stakeholders. The Committee held cross-country hearings in November, and travelled to Washington to speak to members of Congress, government officials and industry groups. The Committee reported in mid-February, supporting the view that the *status quo* is unacceptable and that the Canada-U.S. bilateral agreement should be renegotiated.

Formal negotiations were scheduled to begin in early 1991, following thorough assessment of the views expressed in submissions from interested parties. Government negotiators will explore the prospect of creating an "open skies" régime, which could allow carriers from each country to operate services between any point in one country and any point in the other as well as between points within the other country. Mr. Lewis stated that the negotiations will include the development of a phased approach to implementation of the new régime and of appropriate safeguards for air carriers. He has promised that the government will not agree to a deal that would put Canadian carriers at a competitive disadvantage.