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7 November 1990

*Peter*

IBA TRANSMISSION PRIVATISATION: ECONOMIC REGULATION

Colleagues agreed during August to the broad regulatory framework for the new private transmission company - National Transcommunications Limited (NTL) - proposed in the paper attached to my letter of 1 August. Since then officials from our two Departments and from OFTEL have, with the assistance of further economic and accountancy advice from NERA and Grant Thornton, been carrying out the detailed work necessary to establish the initial transmission tariff (Po) and the price increase formula (i.e. the value of X in the RPI-X formula). The purpose of this letter is to seek your agreement, and that of colleagues, to one development of the regulatory framework originally proposed; and to the proposals agreed between our officials for Po and X.

The development of the regulatory framework concerns the rental of site and mast space by NTL to Channel 5. The paper circulated on 1 August proposed that this should not be subject to price regulation; reliance on the general non-discrimination clause in NTL's licence would suffice provided that OFTEL had sufficient information to detect any abuse. Both you and Francis Maude expressed some reservation about this conclusion. Having reconsidered this, our officials now agree that price regulation would be a necessary protection for Channel 5, if the 25 site model is adopted, since this model would give the Channel 5 operator no option but to use certain NTL sites. If, however, the local opt-out model is adopted price regulation may not be necessary; depending on the precise configuration chosen, the operator might have a range of non-NTL sites to choose from. Officials have therefore proposed that NTL's Telecommunications Act licence should be drafted in such a way as to enable the Director General of Telecommunications to impose a price cap if thought appropriate. I endorse this proposal.

.... Turning to the details of the price regulation formula, officials have proposed that the overall Po (i.e. for ITV, Channel 4, and S4C combined) should be £61 million and that the value of X should be 1. I attach an annex which shows how Po breaks down as between different customers and services.

The two main determinants of this decision are the target rate of return over the regulatory period, and the scope for efficiency savings. Both these are matters of judgment; there is no objectively "correct" answer to either question. As to the rate of return, officials have concluded that a

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rate of return of 17% on an HCA basis would be acceptable. This judgment is based on the assessment that NTL's regulated business will have a very low degree of risk attached to it over the regulatory period. It is virtually immune from the normal business cycle, and it is hardly conceivable that NTL will lose any of its customers. Accordingly, the regulated business appears to be less risky than that of most other regulated utilities, and to be roughly on a par with the water industry.

As regards efficiency savings, the proposals give NTL an implicit target of making a 2% annual reduction in real unit labour costs. As the output of the regulated business cannot increase (this follows from the way in which the unit of supply has been defined), NTL will have to reduce labour costs in the regulated business by 2% in real terms each year to meet this target. Against the background of the 20% reduction in manpower being made in the preparations for privatisation, I believe that this target, though achievable, is very tough. The reason why such a tough target results in a fairly modest value of X is simply that, as the output of the regulated business will not increase, productivity gains cannot be achieved (as typically happens in other regulated utilities) by spreading greater output over the same fixed costs. The financial model developed for the regulatory exercise showed that the proposed values of Po and X would enable NTL to earn an average rate of return of 17%, rising over the period assuming that the efficiency savings were made evenly. But my officials will be looking to ensure that, in revising its business plan, NTL makes as many savings as possible early in the period, thus tending to even out the rate of return.

We also have to be aware of the relationship between the sum of Po and the regulatory charges to be imposed on the ITV companies by the ITC and the rental which the companies would have had to pay the IBA had privatisation not taken place. It would clearly be embarrassing if privatisation generated a real increase in costs for the ITV companies, particularly having regard to the recent drop in advertising revenue. Our assessment is that, provided the costs of regulating ITV do not increase in real terms, the overall cost for ITV companies in 1991, assuming a Po of £61, should be broadly equivalent in real terms to the present IBA rentals. However, a higher value of Po could cause serious political difficulties.

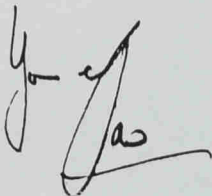
Colleagues may also wish to be aware of the implications of these proposals for Channel 4 and S4C. Their position will be fully protected in 1991 and 1992, as the IBA have undertaken that the Fourth Channel subscription will be increased to cover the full amount of their transmission charges. From 1993 onwards they will be protected by the safety net arrangements in the Broadcasting Act. In calculating the level of the safety net, assumptions were made about future transmission charges. In the case of Channel 4, these assumptions are broadly consistent with my proposals. However, in the case of S4C, the charges would be roughly £1.25 million higher than assumed. (The reason for this is that, when making the original assumption, the IBA underestimated the proportion of Fourth Channel transmission costs attributable to S4C). This amounts to about 2.5% of S4C's current budget. It is not clear

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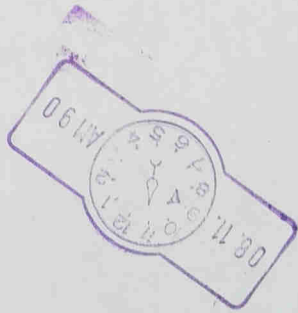
at this stage whether this will cause S4C any difficulties, largely because it is difficult to predict the exact level of terrestrial NAR (on which the safety net is based) in 1993. The Broadcasting Act does, however, enable the safety net to be revised to take account of transmission costs. If S4C express any concern about the proposals, we will therefore be able to indicate, without commitment, that we would look at this point in 1992, having regard to their overall financial position at that stage.

We need to agree our proposals on Po and X very soon, in order to allow sufficient time for the period of statutory consultation on NTL's Telecommunications Act licence. I should therefore be grateful for a response by 14 November.

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

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

BROADCASTING: POLY ON PT12.



## ANNEX

## BREAKDOWN OF REGULATED PRICES: Po

1. Operation and maintenance and site-rentals

Channel 3	£26.78m
Channel 4	£21.01m
S4C	£ 3.71m

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Total	£51.50m
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2. Distribution

Channel 3	£ 6.84m
Channel 4	£ 2.26m
S4C	£ 0.40m

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Total	£ 9.50m
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3. Totals by Channel

Channel 3	£33.62m
Channel 4	£23.27m
S4C	£ 4.11m

4. Overall total


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Po	£61.00
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All figures assume £9.5m for distribution with the remainder falling to operation and maintenance and site rental. NTL are currently receiving the distribution figure which may vary up or down by perhaps £100-200k, with a compensating variation in the non-distribution figure. These calculations do not affect the overall Po figure of £61m, and any adjustment will not substantially affect the Channel by Channel breakdown above.

(ANNEXB)