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GENERAL NOTICE

Independent Communications Authority of South Africa

General Notice

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GENERAL NOTICE

NOTICE 239 OF 2009



Independent Communications Authority of South Africa

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GENERAL NOTICE – POSITION PAPER ON GENERAL LICENCE FEES

- (1) On 24 October 2008 in Notice No. 1305 in Government Gazette Number 31542, the Authority published draft General licence fees regulations. The Authority also invited interested parties to submit written representations on the draft regulations.
- (2) The closing date for submissions was 5 December 2008 and hearings were held on 13-15 January 2009 whereat parties who have expressed an interest to participate in oral hearings were afforded such an opportunity.
- (3) The Authority hereby publishes the attached position paper to reflect some of its findings and to contextualize the revisions incorporated in the draft regulation as published in the Government Gazette.

Paris Mashile
Chairperson
ICASA

(1) This Position Paper is the culmination of a process that included:

- (i) an industry workshop held on 4 October 2007;
- (ii) comments submitted pursuant to the publication of Draft Regulations Notice No. 1305 published in Government Gazette Number 31542 of 24 October 2008; and
- (iii) Public hearings held between 13 and 15 January 2009.

(2) The Draft Regulations are prescribed in terms of section 4(1) (c) and 5(7) (a) (iii) of the Electronic Communications Act 36 of 2005, (The Act). In terms of above notice (Government Gazette No. 31542), the closing date for comments was set at 5 December 2008 and hearings were held on 13 - 15 January 2009. A total of 38 submissions were received from interested parties and 30 participated in the public hearings.

(3) The primary purpose of the Draft General Licence Fees Regulations is to:

- Prescribe a new regulatory framework on administrative and annual licence fees consistent with the Electronic Communications Act, 36 of 2005, as amended; and
- Provide certainty in relation to the conversion of Licences as regards various fees that were due prior the new dispensation as contained in the Act.

(4) The introduction of the Act brought with it a requirement for a reviewed approach to licence fees in general. This required a rethink of the principles that underpin a regulatory approach to licence fees. The principles are also considered against the background of the Act and the objective of ensuring that the impact of licence fees on the ICT sector does not contradict any of the Act's objectives. The relevant objectives of the Act that provide the backdrop are outlined in section 2 of the Act and include to:

- (i) encourage investment and innovation in the communications sector;
- (ii) promote competition within the ICT sector;
- (iii) ensure the provision of a variety of quality electronic communications services at reasonable prices; and
- (iv) develop and promote SMMEs and cooperatives.

- (5) The Telecommunications Act of 1996, IBA Act of 1993 and the Broadcasting Act of 1999, to the extent they were applicable prior to the introduction of the Act, allocated the right to provide specific services over specific technology platforms as evident in the types of licences that could be issued in terms of those statutes. Further, the statutes created restricted markets wherein players in specific markets were protected against competition through the creation of a restrictive licensing framework. Largely, new entrants to new various markets were guaranteed financial viability as they faced little or no competition and had access to pre-existing consumer pools that were not being serviced. Most markets ultimately became Monopolies or Oligopolies where consumers were denied the benefits of a competitive market.
- (6) This type of market structure ultimately provided justification for the levying of high annual licence fees as licensees were guaranteed excess profits and consumers were denied the benefits of competition. The fees collected could then be redirected to other initiatives by the Government to ensure that some compensation was afforded to consumers as they have been denied the benefits that may have accrued had the market been competitive. Further, the market structure also created value in the possession of a specific type of licence, thus justifying the imposition/collection of an entry fee in the form of Fixed/Once Off licence fees.
- (7) However, the unintended consequences of this approach have included the transfer of these licence fees to the consumer as a cost of providing the service. In the electronic communications sector, this translated itself into the creation of a market with some of the world's highest telecommunications costs.

1. THE MARKET

- (8) The Act ushered a new era in the approach to regulating the communications sector at large. This change represents an acknowledgement of the convergence of services and technologies within the communications sector as well as the goal of introducing competition as a mechanism to reduce prices¹. The Act actively promotes a competitive environment, specifically adopting a standard licensing framework as well as introducing the opportunity for ICASA to introduce pro-competitive remedies under Section 67.
- (9) Under the new open-market structure envisaged by the Act, all licensees have to compete against each other to satisfy total consumer demand. Thus the concept of a protected market no longer exists for any licensee. In this scenario licensees have to compete on both price and quality; these choices were not available to the end-users under the monopolistic market structure. Licensees are therefore not guaranteed monopoly profits. The redistributive function of licence fees under the now repealed Telecommunications Act has been replaced by a more direct approach to improving social welfare, which is the introduction of competition between licensees to ensure greater differentiation of services at reasonable prices. Socio-economic welfare at the end-user level is therefore maximised *a priori* and there is no need for government/regulatory intervention in the form of licence fees, as compared to the rationale under the Telecommunications Act.
- (10) In a totally open environment, licence fees for participation in the market may not be justified. However, there remains a case for licence fees to be levied on a market that requires government intervention or regulation, as it presently is. It is evident from the market structure of the ICT sector in South Africa that pro-active intervention by a regulatory body is required to create the framework for competition. This implies the need for funds to cover the cost of regulating the sector. Therefore, given the objectives of the Act and the current structure of the market, a rationale exists for the levying of licence fees in the ICT sector where the cost is related to the cost incurred in regulating the market.

¹ See objectives in sections 2(f) and (m) quoted on page 3 above.

(11) The questions that then remain are:

- the level of such fees;
- the activity on which fees are levied; and
- how the fees are calculated.

(12) There are two types of fees to be considered, each with their distinctive roles. The first type of fee is an administrative fee charged to cover costs such as applications, amendments, renewals of licences and so forth. The second type of fee is one designed to cover the cost of regulating the sector and may best be described as an annual licence fee.

2. ADMINISTRATIVE FEES

(13) Administrative fees may be set at a level that covers pure activity-based costing. However, this may not be feasible, as demonstrated in the following example:

“A licensee has changed the location of its headquarters and therefore needs to amend its licence. Such an amendment may mean the changing of two lines in a licence and requires minimal effort on the side of both the licensee and the regulatory body. However, if true activity-based costing were to be applied, a fee on such an action would have to include the portion of both fixed and variable costs incurred by the regulatory body. This is virtually an impossible task and is not practical”.

(14) In the above example, it is most likely best for the regulatory body not to impose any fee whatsoever. However, there may be other amendments/transfers that have a material impact on the licensed activity. In this case the regulatory body may wish to levy an administrative fee. However, the difficulty of activity-based costing again occurs. It may be more feasible for the regulatory body to apply a fee that acts as a deterrent to frivolous amendments rather than to base the fees on activity-based costing.

3. COVERING THE COST OF REGULATION: ANNUAL LICENCE FEES

(15) The first principle is that the annual licence fee may only be imposed on the economic activity linked to the licensed activity. Secondly, annual licence fees may be

levied on a number of different financial measures, such as on gross profit or gross revenue. The table below shows the strengths and weaknesses of either levying fees on Gross Revenue or Gross Profit.

Table 1: the impact of licence fees being levied on Gross Revenue

| Strengths | Weaknesses |
|--|---|
| Easy to administer for both licensee and regulator | Is susceptible to double-taxation |
| | Negatively affects new entrants compared to incumbents as these firms may not yet be breaking even but are still required to pay annual licence fees |
| | Accentuates the trends in the business cycle, i.e. a licensee faces a significant downturn in sales revenue, is required to pay CIT but also has to pay annual licence fees. This is of particular concern for firms with high fixed costs relative to their variable costs, typically being the smaller firms. |
| | Annual revenue received by regulator is dependent on business cycle |
| | Heavy administrative burden on both the Authority and the licensee if certain items have to be declared deductible to counter the double-taxation effect. |

- (16) Licence fees levied on gross revenue are counter the objectives of the Act as they reduce the incentive for firms to enter the ICT sector, harm smaller players in a disproportionate manner and may increase rather than decrease the administrative burden of regulation.

Table 2: The impact of licence fees levied on gross profit

| Strengths | Weaknesses |
|--|--|
| Easy to administer for both licensee and regulator. | Annual revenue received by regulator is dependent on business cycle. |
| Avoids double taxation. | |
| Is neutral in relation to new entrant versus incumbents as fee is only based on profits, i.e. competition neutral. | |
| Is business cycle neutral as fee is only based on profits. | |
| No requirement for justification of specific items that may be declared deductible, thereby removing administrative burdens. | |

(17) At first glance, it appears that whether the licence fee is levied on gross revenue or profit, administration of the fee remains the same. One could then conclude that there is no justification for either approach based on the burden of administration. However on further analysis (particularly when having to declare an Adjusted Gross Revenue approach³) levying fees on gross revenue generated from licensed activities actually increases the administrative burden as the Authority will have to more closely audit the fees payable⁴. Levying fees based on gross revenue is anti-competitive and harmful towards smaller players in relation to levying fees based on gross profit.

(18) Both approaches suffer from the fact that annual revenue will fluctuate according to the trends of the business cycle.

(19) Given that the objectives of the Act include promoting competition as well as supporting small businesses, the optimal financial measure on which to base licence fees appears to be gross profit (of licensed activities).

Telecom Regulatory Authority of India, September 13, 2006. **Recommendations on components of Adjusted Gross Revenue (AGR)**

Gross profit can be cross-referenced with information released to the public in annual reports or in annual tax submissions to the South African Revenue Service.

4. REVENUE COLLECTION

(20) The ICASA Act of 2000 states in Section 15(3) that “*all revenue received by the Authority [other than from a parliamentary appropriation] must be paid into the National Revenue Fund within 30 days after receipt of such revenue.*”

(21) The Act is silent on the principles for the charging of annual licence fees, whereas it is prescriptive in requiring the Authority to prescribe fees for the renewal of licences and other pure administrative functions⁴. Taking into account the discussion above about the impact of licence fees on the consumer, enhancing competition and small businesses, the only justification for licence fees under the Act is to cover the cost of regulation, as explained in Chapter 3 above. If a cost recovery approach is adopted it is important to compare the historic revenue collection to the cost of regulating the sector. The parliamentary appropriation to ICASA will be used to represent the cost of regulating the sector⁵

Table 3: Year-on-year revenue collection versus the regulatory budget (R millions)

| | Financial Year | | | | | | | |
|----------------------------------|----------------|--------|--------|--------|--------|---------|---------|---------|
| | 2003/4 | 2004/5 | 2005/6 | 2006/7 | 2007/8 | 2009/10 | 2010/11 | 2011/12 |
| Total revenue | 822.6 | 988.9 | 1066.2 | 1346.6 | 1656.9 | | | |
| Year on year growth | | 20% | 8% | 26% | 23% | | | |
| ICASA's budget | | 219.6 | 178.4 | 180.7 | 256.3 | 269.6 | 300.9 | 328.4 |
| year on year growth | | | -19% | 1% | 42% | 5% | 12% | 9% |
| Total revenue less budget | | 769.3 | 887.9 | 1165.9 | 1400.6 | | | |
| % over-collection | | 350% | 498% | 645% | 547% | | | |

(22) The table above reflects the licence fee revenue received from six licensed operators, namely Vodacom, MTN, Cell C, Telkom, WBS and Swiftnet. The table also

⁴ Section 4(1) (c) of the Act.

⁵ In future, it may be prudent to review the current funding model of the Authority, particularly given the current International Best Practice where regulators are funded by monies appropriated via licence fees directly.

indicates the forward-looking MTEF allocations to ICASA for the 2009/10 to 2011/12 period. On a cost-recovery basis the table indicates that ICASA has over-collected revenue by an average of 510% for the four years 2004/5 to 2007/8. Table 3 also indicates the future cost of regulating the ICT sector given the recent parliamentary appropriations, indicating that total revenue collected in 2009/10 should decline by R906 million if an average of the 2003/4 to 2007/8 revenue collection is used on a cost recovery model. However, it should be categorically stated that Parliamentary allocations do not properly reflect to true cost of regulating the sector as the Authority has not received the full allocation of the revenue that would be required to run a fully resourced and capacitated regulatory body.

5. DETERMINING THE LEVEL OF TAXATION OF ANNUAL LICENCE FEES

(23) This section focuses on applying licence fees to gross revenue and gross profit, based on information collected from the consultant acquired by the Authority to conduct research into Licence Fees and to undertake a benchmarking exercise to inform the setting of appropriate fees in line with international best practice.

(24) In terms of the information collected, the gross revenue within the regulated sector for the 2006/2007 and 2005/2006 financial years stood at R 102 349.86mil and R88,184.13 respectively with gross profit at R 25 113.29mil and R22 202.09mil for the respective years. Using these figures, the table below shows that an Annual Licence Fee set at 1.5% of Gross Profit may amount to a slight over-collection if measured against recent parliamentary allocations.

Table 4: Calculation of licence fees based on cost of regulation⁶

| | 2006 | 2007 | 2009/10 | 2010/11 | 2011/12 |
|-------------------------------|-----------|------------|---------|---------|---------|
| Gross Revenue | 88,184.13 | 102,349.86 | | | |
| Operating profit ⁴ | 22,202.09 | 25,113.29 | | | |
| ICASA budget ⁵ | 180.7 | 256.3 | 269.6 | 300.9 | 328.4 |

⁶ The figures used are as provided on page 36 of the report submitted in Phase 1

| | | | | | |
|-------------------------------------|-------|-------|--|--|--|
| ICASA budget as a % of profit | 0.81% | 1.02% | | | |
| Licence Fee = 1.5% of Gross Profit* | | | | | |
| Profit* | 333 | 376.7 | | | |

*Amounts indicated in ZAR million.

(25) Based on a cost-recovery approach, annual licence fees may have been set at around 1.1% of profit. However, taking into account the increasing budget of ICASA over the period 2009/10-2011/12 as well as the expected slow-down in economic activity over the ensuing few years it is proposed that the annual licence fee be set at 1.5% of profit from licensed activities. This should also cater for adjustments that have been effected to the information that was used by the Authority in calculating the appropriate percentage. It should be noted, however, that although parliamentary appropriations have been substituted for ICASA's budget, a more accurate proxy for the cost of regulating the industry would be ICASA's proposed budget that gets submitted to parliament every year or a zero-based budget. What ICASA receives as a parliamentary allocation is determined by the contestations among different government departments as opposed to an objective assessment of what it would cost ICASA to regulate the industry effectively and efficiently.

6. FIXED LICENCE FEES

(26) As mentioned earlier, there is no longer any need for fixed licence fees as the change in government policy under the Act advocates against such a measure. The fixed licence fees would only serve as a barrier to entry into the market and ultimately have an anti-competitive effect. The move away from Fixed Licence Fees is of little consequence for new entrants, but is of significant importance to those players who received licences under the now repealed Telecommunications Act and are still paying their fixed licence fee.

(27) As provided for in the draft regulations, it is proposed that the requirement to pay the fixed licence fee is dropped, subject to a final payment as agreed with ICASA under the current payment plans.

7. CONCLUSIONS

(28) Based on the foregoing discussion, the Authority has decided that:

- a. the levying of Administrative Fees should be based on a principle of deterring frivolous processes;
 - b. Levying of Annual Licence Fees should be based on a cost-recovery model, using ICASA's parliamentary allocation as a floor, and not activity based costing but subject to a review of the true cost of regulating the sector as would be displayed by a zero-based budget;
 - c. Licence Fees are to be levied on Gross Operating Profit generated from licensed activities;
 - d. a flat fee structure should be adopted with fees set at 1.5% of Gross Profit; and
 - e. Fixed/Once Off Fees will not be levied in future, and
 - f. Residual "Once-Off" Fees still due from the incumbents are to be written-off, subject to compliance with the applicable regulations.
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