

**Comments of the Commissioner of Competition to
the Canadian Radio-television and Telecommunications Commission
re: Telecom Public Notice CRTC 2001-37**

Price Cap Review and Related Issues

Executive Summary

A well designed price cap regime and regulatory framework should replicate, as nearly as possible, the economic incentives of a competitive market and protect customers and competitors from abuse of market power during the transition from regulated monopoly to an effectively competitive market. At the same time, it should provide incumbent telephone companies with sufficient pricing freedom to engage in economically efficient pricing, investment, and innovation. Choosing the appropriate number of sub-baskets will also ensure the distribution of efficiency gains to consumers and competitors.

In this proceeding all parties – incumbents, competitors and consumer groups – have expressed concerns that the existing price cap regime has not fulfilled this potential. Many believe that local telephone competition is not developing as quickly as anticipated. They point to the formula linking residential and business sub-baskets and the high prices for wholesale services used by competitors as major stumbling blocks to the growth of competition.

The proposals advanced by the incumbent telephone companies and the competitors in this proceeding do not adequately address these concerns and in fact, may exacerbate them. The Competition Bureau does not believe that these proposals will protect consumers from potential abuse of market power or lead to efficient entry by new competitors.

The Bureau submits that the incumbent telephone companies continue to possess market power over basic local services and that the current price cap is the appropriate one to constrain this market power. It does not require a major overhaul. Nor does the Commission need to depart significantly from its current pricing rules within the sub-baskets or from the price of wholesale services to spur competitive entry. Rather, by making some modifications to the number of baskets and re-examining the identification and pricing of essential facilities, the Commission can meet its objectives for the price cap regime.

To assist the Commission in its efforts to improve the current price cap for the next phase of regulation, the Bureau recommends the following:

1. The Commission should maintain the current price cap structure and regulatory framework in order to ensure continuity and reducing uncertainty for consumers, industry participants and investors. The next phase should be for four or five years with no earnings overlay. There should be a single basket of capped services subject, in aggregate, to the Price Cap Index (PCI). As is currently the case, the PCI should include an inflation measure, a productivity offset (X factor), and limited exogenous factors arising from events which are beyond the incumbents' control. The Bureau defers to the expertise of the Commission for the determination of the appropriate measure for inflation and X.
2. The single basket of capped services should be divided into five sub-baskets subject to additional pricing constraints. These baskets are: non-High Cost Residential Local Service, Single and Multi-

Line Business Local Services, Competitor Services (essential and near essential facilities), Other Capped Services, and High Cost Service Areas. The productivity offset (X factor) should apply to the single basket. This allows for the possibility of substitutability between wholesale and retail services, and the subsidy for high cost areas.

3. The Bureau recommends the creation of a sub-basket to control the subsidy for high cost areas entitled High Cost Service Areas. This basket is based not on the price of residential service in High Cost Service Areas, but instead on its Phase II cost component. By including this cost sub-basket, the ILECs could substitute reductions in the costs they are allowed to recover in high cost service areas for price reductions in other services in order to meet their PCI constraint. This allows for the possibility of substitutability between wholesale and retail services and the costs associated with providing service in High Cost Service Areas. The effect of this, if rates in High Cost Service Areas were frozen, is to reduce the incumbents' total subsidy requirement. Alternatively, if rates increase, the costs decline by the amount of the increase.
4. As an alternative, the Commission may wish to place High Cost Residential Local Services rates in a separate basket outside the price cap. As these rates are below cost, an X factor should not apply to this basket. The Commission has the option of freezing these rates for the term of the price cap or increasing them gradually over the price cap period. In this situation, the Bureau would favour a policy of moving these rates toward cost during the term of the price cap to encourage economically efficient pricing. If equity issues are a concern, the Commission may address these using other tools available to it as recommended in the *Local Service Pricing Options* proceeding.
5. The ILECs continue to possess market power over business local rates as well as residential rates in non-High Cost Service Areas. Absent evidence that competition will develop quickly in these areas, the Bureau recommends that the Commission maintain the constraints currently in place for the non-High Cost Residential Local Services and Single and Multi-Line Business Local Services sub-baskets until such time as the Commission forbears from rate regulation.

6. With respect to the test for business rate forbearance, the Bureau recommends that the Commission reject the *ad hoc* proposals by the incumbents. They are essentially requesting rate forbearance. Therefore, they should be required to meet the test set out in s. 34 of the *Telecommunications Act*. In examining forbearance proposals, the Commission should apply the forbearance criteria set out in its *Regulatory Framework* decision. This requires a comprehensive assessment of competitive conditions in each relevant geographic and product market to determine if sufficient competition exists to permit rate forbearance.
7. The new “Competitor Services” sub-basket would comprise the current group of essential and near essential network services as defined in the *Local Competition* decision. By placing this sub-basket within the price cap regime, competitor services become eligible for any X-factor efficiency gains that are to be passed on to the market. The going-in rates for individual items within the sub-basket would be priced at Phase II costs. In the absence of compelling evidence that the incumbents will not break even, essential services price should not include a markup to cover fixed and common costs. The incumbents should cover these costs from other services.
8. To address policy issues related to entry, the Bureau recommends that the Commission apply its essential facilities test to the entire group of wholesale services required by competitors. Such an assessment should focus on the competitors’ actual entry experience with obtaining access to wholesale and retail services. The test should incorporate a relevant market analysis when measuring monopoly power held by incumbents. This analysis is necessary to determine if additional facilities should be added to the Competitor Services basket prior to the new regime coming into force.
9. The Bureau recommends that the amount of the mark-up for essential facilities be calculated by determining at existing retail price levels the shortfall in revenues required to be recovered. The

mark-up on essential facilities should recover this amount. If there is no shortfall, then essential facilities should be priced to competitors at long run incremental cost i.e. with zero mark-up.

10. The Commission should not unbundle facilities that do not meet the essential facilities test. Nor should it mandate wholesale prices that are below long run incremental cost. To do so would result in inefficient competition and incentives for entry as well as remove incentives for ILECs to continue to invest in their networks.

11. To allow local competition to occur more quickly in non-High Cost Service Areas, the Bureau recommends that the Commission make ILEC basic residential and business local telephone services available to new entrants with an avoidable cost discount. The discount represents the marketing, administrative and other costs avoided in providing the service on a wholesale basis. This policy has been adopted in the United States as a means of permitting new entrants to meet the bundled offerings of the incumbents and allows new entrants to offer local services immediately in any region of the country. Adopting such a policy will encourage entry outside of Band A and provide some discipline on ILEC pricing in those areas.

The Bureau believes these recommendations will maintain the continuity of the current price cap regime and protect the interests of consumers and competitors from the exercise of market power by the ILECs. At the same time, they maintain the pricing flexibility of the incumbents and their ability to earn greater profits through cost reductions and service innovation.

Competition Bureau

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