

CANADIAN COMPETITION RECORD

COMMENT & ANALYSIS

The following is the text of an address given by John F. Blakney on February 2, 1995 at an Infonex Conference on Canadian Telecommunications Regulation: Understanding, Integrating and Implementing the Regulatory Restructuring of C.R.T.C. Decision 94-19. Mr. Blakney was asked by the conference organizers to chair a panel reviewing the implementation of the CRTC's proposed new telecommunications regulatory framework.¹

**SPLIT RATE BASE AND PRICE CAP REGULATION:
UTILITY REGULATION AND FOSTERING COMPETITION - OVERVIEW**

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I. INTRODUCTION AND RECENT DEVELOPMENT

This paper examines in detail the regulatory measures adopted in Decision 94-19 of the Canadian Radio-television and Telecommunications Commission (the "CRTC" or the "Commission") to provide for continued regulatory control of the prices and earnings of the monopoly or Utility Segment of the Stentor companies, and to facilitate the continuing development of telecommunications services competition, through various price control measures affecting the Competitive Segment services.

The implementation of these measures has not gone as smoothly as the CRTC may have hoped.

The Commission has been persuaded by long distance competitors to delay its implementation of a shift from a per circuit to a per minute contribution recovery mechanism, effectively putting into abeyance for the time being the implementation of the Carrier Access Tariff ("CAT"). Instead, the Commission has decided to reconsider the merits of a shift to a per minute contribution mechanism through a paper proceeding established on December 29, 1994, in which the Commission wishes to focus debate around its own proposal to de-average a per minute contribution charge along conventional peak and off-peak periods.

The Commission was also persuaded by inter-exchange competitors and the cable industry to conduct an oral hearing this Spring into (a) the merits of Stentor's broadband facilities investment program (the Beacon Initiative) and the regulatory accounting of these costs for the purpose of ongoing rate of return regulation of the Utility Segment, and (b) the relevance and usefulness of data on the costs of providing long distance service in the United States in weighing and applying the results of the Commission's Phase III costing

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methodology that will be used both to notionally separate an integrated carrier's Utility and Competitive Segments for utility rate-setting purposes and to establish Competitive Segment and inter-exchange competitor contribution charges.

The effect of this hearing decision, in my view, has been to open up the Phase III methodology for a fundamental examination of its reasonableness and regulatory utility on a broader basis than the Commission's 1994 Phase III Review which was confined to a narrow list of purely methodological issues. As well, the hearings will provide a more meaningful opportunity to debate policy questions such as the appropriate going forward definition of "basic" telecommunications, and the related questions of whether, or to what extent, consumers should through "basic" service rates assist in funding the deployment of Stentor members' broadband fibre distribution plant. I do not believe that the merits and costs of the Stentor broadband investment plan could be meaningfully addressed, or assessed in a sufficiently timely manner through a special paper proceeding or at the Commission's informal and non-probative Construction Program Reviews for individual carriers.

Finally, the Cabinet was persuaded by an alliance of consumer groups and inter-exchange competitors that the Commission's rate rebalancing program (\$2.00 per month per year increases across the board in primary exchange services for the next three years) should be stayed pending a review at the previously announced Spring 1995 hearings of both the appropriate timing and extent of any rate rebalancing, and, just so there was no doubt, the merits of the Phase III methodology, the results of which were relied on by the Commission in formulating its rate rebalancing plan.

In announcing its compliance with Cabinet's decision, the Commission has, for good measure, also rolled an examination of the Stentor members' split rate basic proposals into the Spring oral hearing process.

How much of the transitional regulatory framework of Decision 94-19 remains intact at the end of this year after the Commission issues its decision from the Spring "implementation" hearing (probably in September), and the various competing interests have had a chance to react to it, remains to be seen, and it is obviously too early to speculate. What we do know is that whatever will remain of the Commission's September 1994 grand plan will have been delayed by a year, and will probably be substantially modified. This in turn calls into question at least the timing of the Commission's plan to move to price cap regulation in 1998, a move which, in any event, as Decision 94-19 informs, would not be advisable as long as there remain large "cross-subsidies" flowing from long distance to local service, and, presumably, as long as contribution charges remain a substantial part of an inter-exchange competitor's cost of doing business.

If the Commission's Decision 94-19 regulatory reform model continues to waver, if not crumble, there may well be opportunities, and good reasons, to reconsider more seriously, and in a public hearing context, the structural option - divestiture of Stentor members' long distance business from their local businesses - the option the Commission sought to bury forever in Decision 94-19 through flowery references to "globalization"

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and "economies of integration" in favour of the myriad of interwoven conventional regulatory behavioral constraints that is the cornerstone of Decision 94-19.

This paper will look both back to Decision 94-19 and the 1992-94 Regulatory Framework Proceeding to provide an overview of the various regulatory measures and policies orbiting the core concept of transitional Split Rate Base regulation. I will discuss some of the problems and issues arising from this approach with particular reference to the Commission's reliance upon the Phase III service category costing system.

II. SPLITTING THE RATE BASE

In announcing its regulatory framework proceeding in December 1992, the Commission put all players on notice that it would be moving away somehow from the corporate-wide rate base rate of return ("RB/ROR") method of regulation that it had applied to control the earnings and revenues of Stentor-members since it began to assume regulatory jurisdiction over them in 1976. Given that total deregulation of all Stentor member services was out of the question (and not even legally possible prior to the proclamation of the *Telecommunications Act* in September 1993 just before oral hearings in the proceeding began), the Commission's basic options for "improved" regulation were few:

- (a) require divestiture of utility (monopoly) and competitive business segments;
- (b) live with vertical integration but apply conventional RB/ROR only to the utility segments, with the competitive segment to be subject to less strict (and in some instances, possibly no) regulation (i.e. simulated divestiture); or
- (c) impose price caps, possibly in conjunction with price baskets and floors, to prevent predatory pricing and socially unacceptable price discrimination, and cease regulation of earnings and individual prices.

Competitors favoured divestiture and strict price caps on monopoly/utility services. Stentor favoured option (b). The Commission rejected option (a) on the grounds that it would not be in the national interest and that the bundle of measures adopted would be more "flexible" in preventing anti-competitive behaviour":

The Commission considers that there was no compelling evidence to support the dismantling, through divestiture, of the telecommunications system in Canada. There are better methods for dealing with problems stemming from the vertically integrated structure of the Stentor companies. Divestiture could be damaging to the competitiveness of Canada in global markets and could dampen the emergence of integrated services evolving from the convergence of the communications, information, computing and entertainment industries. Similarly, the Commission is not convinced that structurally separate affiliates are necessary, given the approaches adopted in this Decision. While such a solution does have merit in a new and distinct market such as wireless, it is generally a static solution that reduces economies of scope and still requires regulation to oversee intercorporate transactions.

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Rather, in establishing the new framework, the Commission has incorporated other, more flexible, regulatory alternatives that should be as effective as structural separation in safeguarding against anti-competitive abuses associated with the vertically integrated structure of the Stentor companies, but without many of the associated problems (at p. 30).

In any event, in my view, the record on the impact of divestiture was not well developed and there was probably some doubt within the Commission that it had the power to order divestiture even under the *Telecommunications Act* (which was not in force when the proceeding began in any event). As the regulatory framework proceeding developed, long distance competitors increasingly focused their attention and resources upon price caps, baskets, and floors to address the immediate problem in 1993: dramatic Stentor targeted discounts largely under the "Advantage" banner progressively introduced throughout 1993 and made possible under very loose selective price reduction controls established in Decision 92-12 (that had authorized facilities-based long distance competition).

The Commission rejected option (c), for at least three years for monopoly/utility services although it was found to be "more appropriate for regulatory utility services in an increasingly competitive environment" (p. 15). The Commission did, however, adopt a price cap for basic long distance services.

The Commission gave the following reasons for not moving more quickly to implement price regulation:

- (1) It will not produce anticipated benefits such as reduced regulation and increased incentives to reduce costs until rates are closer to costs:

Currently contribution rates are at levels such that the process of setting these rates requires reviewing earnings and forecasting demand, cost and revenues on an annual basis to ensure that the local/access shortfall is covered and that competitors are not contributing excess amounts (p. 56).

- (2) While price regulation was found to continue to be necessary in some competitive markets, the Commission concluded that detailed price baskets, caps, bands, and floors are neither necessary nor appropriate in the competitive segment, given the other safeguards in the Decision, and, in particular the "price floor" resulting from the Commission's interexchange service imputation test (see part V of this paper).

The Commission was therefore left with option (b), some form of Split Rate Base regulation because it was "least worst" and most easy to implement through modifications to the tool kit the Commission felt that it had been perfecting for several years (in particular the lynchpin Phase III broad service category costing methodology, see part III of this paper).

The principal positive reason advanced for the Split Rate Base approach was that, assuming Utility Segment costs were accurately estimated, confining RB/ROR regulation to utility services and imputing CAT revenues to it from the carrier's long distance services would "uncouple" monopoly and competitive service rates by

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reducing the incentive and opportunity (made evident to competitors and the Commission by numerous Stentor member revenue requirements proceedings in 1993) for a telco to try to recoup long distance losses from monopoly rate increases.

The Commission's plan was to examine the methodology used to split the rate base with the 1995 annual contribution charge proceeding. Little guidance on methodology is provided in Decision 94-19 other than to use the approach described by Stentor in its brief response to one Commission interrogatory in the Regulatory Framework proceeding as the basis for their proposals. Stentor interrogatory response depends upon Phase III results and proposes the following adjustments:

- (1) Common costs (see Part III discussion of Phase III) to be assigned to the Utility and Competitive Segments on the proportion of total operating expenses otherwise assigned to these segments.
- (2) The Other Services category revenues to be split between the segments based on their "nature" with expenses prorated by this revenue split.
- (3) Plant Under Construction ("PUC") to be assigned in the same manner as materials and supplies; Allowance for Funds Used During Construction ("AFC") to follow PUC assignment.
- (4) CAT contribution and switching and aggregation to be a Utility segment revenue and a Competitive segment cost.

Since the Stentor proposal and the Commission's decision rests upon the use of the Phase III costing methodology, the legitimacy and policy effectiveness of the Commission's decision, therefore, depends upon its assumption that Phase III was a credible and accurate costing methodology, and, in particular, that any prospect of ongoing attacks and regulatory litigation on Phase III would have largely been eliminated by 1995 by adjustments arising from the 1994 Phase III Review proceeding (discussed further below in Part III). As the Commission boldly asserts at p. 59 of Decision 94-19:

The Commission notes the concern of some parties that the split rate base process would be contentious because of disputes over the allocation of revenues and costs. However, Phase III costing will be required to establish the local/access shortfall and contribution rates, irrespective of the form of regulation adopted, and provides the logical costing framework to be used in splitting the rate base. The Commission's Phase III Review, initiated in Public Notice 94-16, is expected to reduce the contention over revenue and cost allocation.

Finally, as part of its Split Rate Base approach the Commission adopted the following regulatory accounting measures designed to avoid having to hear utility segment rate increase applications during the planned 3 year transition to price caps:

- (1) increasing the allowed rate of return from 100 to 200 basis points;

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- (2) establishing an earnings surplus/shortfall account to be carried into subsequent years and ultimately dealt with somehow during the price cap implementation proceeding; and
- (3) setting the Utility rate of return mid-point 50 basis points below the currently allowed mid-point.

Again 94-19's model may not hold. MT&T has now filed for a local rate increase based in part on long distance contribution decreases - the very relationship Decision 94-19 was supposed to break up. It remains to be seen whether the Commission will assess this application using corporate forecasts or a model of MT&T's Utility Segment despite the Commission's Regulatory Framework Implementation proceeding having just begun.

III. ROLE OF PHASE III COSTING

The most arcane, complex, and judgmental component of the CRTC's regulatory tool kit, the Phase III broad service category costing methodology, has now become its most important component.

Phase III is a set of algorithms that estimates from the telco's detailed accounts (assets, expenses, revenues at fine levels of disaggregation) the revenues of certain broad service categories (BSC) and the resources consumed (expenses, assets) by each in a given accounting period (one year).

The objective is to provide an estimate of the average "incremental" (there is a common or non-causal cost category for overheads that do not demonstrably vary with large changes in firm output) costs per dollar of revenue for each BSC using embedded or booked resource values (which are therefore "auditable") which as a group can be reconciled against corporate-level accounts for RB/ROR evidentiary purposes.

From this revenue/cost relationship, the CRTC considers that it is possible to quantify cross-subsidization between broadly defined lines of business within the integrated telephone company, particularly between monopoly and competitive business lines.

Prior to the development stage of its Phase III methodology (initiated in 1982), the Commission had in 1979 developed principles for conducting economic evaluation studies (essentially net present value studies) to be used in estimating streams of future revenues and costs associated with particular courses of action. This is known as the Phase II methodology, and we will return to it in the discussion on Competitive Services Regulation under the Split Rate Base approach. The current role for Phase II studies is to provide the Commission with evidentiary support for targeted long distance and other competitive service rate reductions (the original role for Phase II was to test whether, on a long run incremental basis, a new service would be compensatory and hence would, over a test period of 5-10 years, not require revenue support from monopoly services, i.e. cause primary exchange service rates to be higher than had the new service not been introduced).

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The premise behind Phase III is that, by using one-year snapshots of a telco's booked costs and revenue, and applying a variety of cost and revenue assignment techniques and other special adjustments, for example, for as yet unassignable Plan Under Construction costs and the internal consumption of telecommunication services (termed "Official Telephone Service" or "OTS"), one can replicate the average long run embedded costs of the carrier had it in fact been organized as several firms with separate books of account.

This premise might have been sustainable in the environment of the early 1980s when Phase III was developed through what can be fairly described as an arduous and highly contested process. In that period there was very limited competition in Network Services (CNCN offered data and enhanced services but the data services were protected until the end of the 1980s by CRTC price umbrella policy that required Telecom Canada to maintain data service prices set to "maximize contribution" and at a specified minimum percentage above CNCN's prices), and in Terminal Equipment. Both service categories presented a fairly small share of telco revenues. Switched long distance and local service competition were still hypothetical.

In 1985, the year of the CRTC's decision on Phase III principles (implementation took four more years), the Commission also denied CNCN's initial bid to enter the long distance market by way of mandatory line and trunk side interconnection with Bell and BCTel. Line side interconnection coupled with private line service resale rights to provide long distance service was not permitted until 1990, and of course "equal access", interconnection did not appear until mid-1994. In 1985, AT&T had only been split for one year and the terms of long distance competition RBOC access were still being worked out.

Thus, at the time Phase III was developed, there was no compelling reason, and probably not even the ability, to consider carefully whether the results of the methodology accurately estimated the long run embedded costs of the Competitive Segment as though that Segment was really being run as a separate business, had been exposed to the cost-minimizing pressures of competition, and had in fact bargained at arms' length with the Utility Segment for "common resources" (both overheads such as accounting support as well as common network capacity such as local switching and local loops).

Moreover, even before these important matters are addressed (which necessarily lead into the judgmental and adversarial areas of possible "non-linear" common cost assignment protocols, additional complex special work effort studies, and the reliability of "benchmark" cost/unit of output information from other jurisdictions), it is first necessary to make the assumption that RB/ROR regulation as practiced by the CRTC has in fact resulted in the highest possible level of overall carrier efficiency. Given that almost all expert witnesses appearing before the Commission in the Regulatory Framework proceeding said on this point, and what the Commission itself said about RB/ROR, this is a very heroic assumption indeed.

Phase III builds upon the Stentor Revenue Settlement Plan ("SSP") with modifications to SSP algorithms and additional assignment rules for accounts not caught by the SSP to estimate costs and revenues for the following Broad Service Categories ("BSCs"):

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Monopoly Local (ML: local service switching and aggregation, optional, local services, related support activities);

Competitive Toll (CT: switched long distance services);

Competitive Network (CN: unswitched private line and data services);

Competitive Terminal (CT: subscriber premises equipment); and

Other.

There are two non-service "common cost" categories:

Access (non traffic sensitive local network costs incurred for both local and inter-exchange services, primarily local loop asset and maintenance costs); and

Common (fixed non-network administrative overhead costs, the level of which cannot be statistically related to long term changes in BSC output).

The preferred approach is direct account assignment. But certain accounts contain resources used commonly by two or more BSC's. These account assignments are generally made by a study that attempts to model resource consumption through work or throughput measurement, or by a palpable proportioning factor (such as net plant value per BSC for certain maintenance resources or labour costs per BSC for labour force support activities including most general administration functions).

Thus, Phase III results over time incorporate a high degree of "cost linearity" and stability: e.g. the proportion of maintenance costs "caused" by CT is assumed to be consistently in direct proportion to the net value of assets assigned to CT as are the General Administration resources "caused" by that maintenance activity. This simplifying assumption helps to permit the "auditability" of Phase III in that the results can be traced back through transformation algorithms to the original books of account and, hence, corporate financial statements used for RB/ROR purposes.

No one should be surprised that the Phase III methodology and its results have been highly contested by competitors over the years as overestimating the revenue surpluses generated by the competitive categories, and even masking substantial monopoly to competitive service category cross-subsidization. Over the initial years of Phase III results, the Commission had sought in some cases to require corrective action by particular carriers or to shift some of the risk of projected competitive BSC shortfalls onto the carrier's shareholders. With Decision 92-12, Phase III forward year forecasts come of age as the mechanism for calculating a precise amount of long distance service "contribution" to the combined local/access BSC shortfall to be generated in that forecast year by internal carrier revenue surpluses and by explicit competitor contribution charges.

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The scrutiny of Phase III, as a result, became even more intense after Decision 92-12. Assisted in part by the 1993 "reclassification" by the CRTC of a large part of digital switching investment to Access without much due process, the presence of substantial differences between Bell and BCTel in the studies used to assign certain operating expenses between ML and CT, and very real conceptual difficulties in adapting original Phase III local switching investment assignment protocols to a digital switching environment, competitor concerns over Phase III occupied a very substantial part of their cases in the Regulatory Framework proceeding. The focal point was Unitel evidence that Phase III was inadequately documented (and hence unauditably by the Commission or anyone else) and that a large number of cost misallocations had arisen (or had never been corrected) which caused the Phase III estimated CT surplus to be 25% to 35% over what it really should be. Unitel also sought to corroborate its Phase III analysis with exhibits put to Stentor witnesses purporting to show that the unit costs of U.S. stand-alone long distance companies were significantly higher than Stentor member unit costs (to the point that Unitel suggested that Phase III made out AGT to be North America's most inefficient local telephone business and its most efficient long distance business).

The Commission in essence refused to consider such U.S. cost information. Arguably it could not because Unitel did not introduce it as evidence but in cross-examination in a fashion that Stentor, with some justification, compared to the classic cross-examiner's question: "When did you stop beating your wife?" And the Commission also refused to consider U.S. cost comparison evidence in its 1994 Inquiry Officer review of Unitel's list of specific methodology faults in Phase III. It has now elected to do so in the context of its May 8 omnibus Regulatory Framework Implementation hearings. Actual U.S. cost comparison evidence has for the first time been filed as of January 31.

The Phase III assignment errors considered in the Commission's 1994 Phase III review can be grouped as follows:

(1) Digital Switching:

- (a) Too much local digital switching investment is considered to be "non-traffic sensitive" ("NTS"), thus overestimating Access investment and expenses (note, a large share of Phase III Access labour expenses are loadings on net plant investment or loadings on these loadings).
- (b) The assignment technique for "traffic sensitive" ("TS") components of local digital switching investment between ML and CT which uses the ratio of peak period minutes is unauditably, improperly formulated, and inconsistent with actual cost causation principles (which favour other measures such as call attempts, processor holding time, or assignment according to the types of BSCs using the switch), with the result in any event being inadequate and arbitrary local digital switch assignments of total traffic sensitive component costs to CT.
- (c) Software cost assignments to Access were excessive and insupportable.

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- (d) The revised assignment of remote switching facilities to Access was dead wrong.
- (2) **Operating Expenses:** The rules for assigning a variety of common support activities (business sales, advertising, Stentor, record bureau clerical, order preparation for service, business office) do not reflect actual cost causation and individually assign insufficient expenses to CT.
- (3) **Official Telephone Service Adjustment:** conceptually invalid and in practice overestimates Access/ML costs due to the arbitrariness of estimating OTS concluded by BSC.
- (4) Competitive service category costs of capital should be higher than for ML/Access.
- (5) More due process should be introduced in the Phase III manual update process.
- (6) Cost assignments based upon "organizational analysis" are vague and unauditible.

The Inquiry Officer's report and the Commission's subsequent decision seek to put a number of these issues to rest in part by taking into account the Split Rate Base/CAT approach to be adopted post Decision 94-19.

As noted, Decision 94-19 is premised in part on Phase III having become less contentious as a result of the airing of issues provided by the 1994 Phase III Review. We are at the early stages of this year's implementation proceeding but there are several reasons to suggest that Phase III disputes will be with us for some time:

- (1) there still needs to be an estimation of local switching costs caused by long distance services for CAT calculation. The CAT is really just the sum of contribution and switching and aggregation charges (as set out in Decision 92-12);
- (2) Phase III is the only standardized domestic measure of Stentor member toll costs, and predatory pricing concerns whether targeted or system-wide, appear to be with us for some time to come;
- (3) Phase III also provides the only domestic measure of Access costs and hence the starting point for calculating the potential limits of "rate rebalancing" and for calculating the cost of "dial tone" as a distinct service (for example, as one possible new definition of "basic" telephone service); and
- (4) increased cable TV/telephone company competition will, at least in the near term, create interest in establishing a "level playing field" in terms of respective "cross-subsidy" obligations, and an interest in separate estimation of telephone company embedded narrowband and broadband network access costs.

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The record of the Phase III review demonstrates, in my view, that any effort to define the concept of Access costs for Phase III purposes in functional, market-reflective, or traditional traffic sensitive/non traffic sensitive terms ("TS/NTS") is bound to be contentious and to a substantial degree built upon images of current technology. The Commission has elected to continue to place primary reliance on the TS/NTS distinction and to use a component-by-component analysis, but then moves to divide digital switching plants between the two camps at "demarcation points" where investments driven by subscriber numbers (NTS investment) ends presently the DMS 100 Line card. Changing technology and the emergence of various local loop/access submarkets could well cause this house of cards to collapse requiring us again to address the conceptual validity of this access cost definition at least no later than the initializing of a generalized price cap model or a CT regulatory forbearance proceeding (whichever comes first).

The record on the appropriate assignment of non-Access local digital switching costs as between ML and CT to date is poorly developed and confused. One line of analysis supported by plant engineering protocols, suggests that different quantitative measures be used when considering the variability of individual switch components (with different results flowing from a short or a long run approach). This leads down a road to even more complexity, confusion, and disputes. Another line of analysis favours rejection of any attempts to force a square plant engineering protocol peg into the round economics hole. This takes us down a different road leading to acceptance that any effort to split TS plant costs between ML and CT categories is arbitrary, not science and probably only accurate by coincidence.

The inherent difficulties in selecting a logical and persuasive Access costs estimation technique were effectively seized upon by the CTA's recent Cabinet petition which has contributed to the CRTC's revisiting of Phase III this spring:

The nature of a telephone company is such that long distance services use local lines, local switching offices, long distance lines and long distance switching offices. Allocating these shared costs to the telephone companies' local and long distance operations requires judgment as to why the costs were incurred. Since local switching office costs are incurred to provide both local and long distance services, the costs could be allocated on the basis of the proportion of local and long distance calls. However, an equally defensible mechanism would be to allocate the costs on the proportion of local and long distance minutes. Each of these mechanisms would produce different costing results. There are as many mechanisms as accountants, engineers, economists or regulators care to develop. All of them may be justified but none of them can be said to produce the "correct" set of results.

(CTA Petition of November 23, 1994, at p. 8)

IV. UTILITY SEGMENT ISSUES

The method of regulation of services comprising the Utility Segment will continue to be RB/ROR at the Macro-level.

But as noted, at this level the Commission initially hoped (now apparently in vain) to be spared profit deficiency-based "revenue requirement" proceedings in the transition to initializing a price caps system for this segment.

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(a) Optional Local Services

The Utility Segment also includes optional local services many of which fall into the category of "enhanced" services and are subject to increasing competition. Over the last several years, the telephone companies have concluded that it has largely been revenue growth in these services (combined with initial contribution maximizing pricing) that has maintained or increased the Phase III ML revenue surplus.

During the Regulatory Framework proceeding, Stentor and AGT sought, essentially, deregulation of optional service pricing. This was rejected by the Commission. The Commission decided, as well, that optional local services should be compensatory and in general should continue to be priced so as to maximize long-run contribution to Utility Segment fixed common costs.

It is unclear how sustainable this policy will be given the Commission's wholesale endorsement of local network unbundling and local network facilities-based competition. Apparently, the Commission is betting that it will not be so great over the next few years as to undermine current telco optional service pricing plans.

(b) Local Network Competition

Nevertheless, perhaps the most far-reaching aspect of Decision 94-19 was the Commission's unqualified endorsement of local network unbundling and competition coupled with the Commission's decision to act proactively to remove regulatory entry barriers to local network competition including:

- (1) unbundling telco local service tariffs and to be jump-started by the submission by competitors of their requirements (by mid-December) followed by draft telco tariff filings (mid-March to be based upon principles published by Ameritech in early 1993); and
- (2) providing co-location rights (whereby customers can terminate their own transmission facilities in the telephone company central office - physical co-location, and virtual co-location involving termination at no greater cost outside the central office).

Reading between the lines of Decision 94-19 one can see the Commission:

- (a) pinning its hopes on local competition mitigating telco market power in other areas such as certain long distance segments;
- (b) providing a back-stop in the event that any future price cap system proves to be too generous; and
- (c) defining more precisely the services to be deregulated and those to be subject to price caps in the future.

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But there are questions:

- (1) What degree of local network competition can we expect in the next several years? Cable company network architecture is not readily adaptable to providing switched local services and the *Telecommunications Act* may impose foreign investment constraints on certain new local facilities-based competitors.
- (2) Can the rate rebalancing plan, if it occurs, go too far to create "uneconomic" margins in local services analogous to the margins available for arbitrage-based long distance competition in the 1980s?
- (3) Will new local competitors have to pay their own universal service tax (or contribution charge), and if so how will it be set, since Phase III generates only corporate-wide results, while what may be needed is the telephone industry equivalent to the thin route subsidy first developed for railways and airlines?
- (4) Does the Commission as a whole (including its broadcasting side) really have its heart in a messy, uncontrollable network-of-networks, or will it lapse into a managed cable/telco duopoly in order to ensure that both the cultural policy tools of the *Broadcasting Act* and the social equity tools of telephone utility regulation can demonstrably be seen to be respected?

We are at the very early stages of the process. But when compared to the long distance competition debate, the issues seem to be much more far ranging and perhaps more intractable.

V. COMPETITIVE NETWORK SERVICES REGULATION UNDER THE SPLIT RATE BASE

A cynic would say that, under the guise of reducing or streamlining regulation, Decision 94-19 does little more than to bow dutifully to the inevitability of competition without any meaningful change to the intensity of the behavioural controls practiced since Decision 92-12, which controls have only been modestly repackaged or renamed. That cynic would develop his case starting with the announced framework for regulating Stentor interexchange services.

In my view, it is still too early to determine whether that cynic is right or wrong. But on first glance, Decision 94-19 would seem to bind up Stentor long distance rates in quite a regulatory web. Here are the main elements:

- (1) Definition of four fairly broad competitive segment network services markets: basic toll, 800, discount toll, and CN.
- (2) No regulatory forbearance of any toll component until certain prerequisites are met:

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- (a) full technical and operational implementation of equal access;
- (b) resolution of issues concerning 800 access;
- (c) comparable access for competitors, including resolution of unbundling and co-location issues;
- (d) implementation of an imputation test (discussed further below) to deal with anti-competitive pricing concerns;
- (e) splitting of the rate base and the implementation of the CAT; and
- (f) evidence of "rivalry" in the relevant market.

(Some have queried whether the Commission may impose local network competition as a condition for toll service deregulation).

- (3) No general CN forbearance until there are more interexchange facilities-based competitors with the possibility held out for enhanced and packet switched service forbearance on a case-by-case basis.
- (4) Contribution reductions from rate rebalancing to be passed onto basic toll services, which are now subject to a price cap.
- (5) Confirmation and expansion of the imputation test announced in Decision 94-13. Both Unitel and Sprint Canada had complained bitterly that the targeted pricing controls adopted in Decision 92-12 permitted predatory pricing by Stentor based upon "contribution discrimination", in effect eliminating contribution generation by discounts targeted on the competitor's core markets while protecting overall toll contribution by maintaining higher contribution rates in basic and 800 toll services that were largely free from competition until mid-1994. Decision 94-13 (July 13, 1994) provided a strong, if perhaps belated, response to these concerns. By that point, it would appear that the Advantage program provided many businesses with rates very comparable to U.S. rates. With Decision 94-13, the Commission required Stentor members to include, as an imputed cost in Phase II studies used to support new discounts, the undiscounted average per minute contribution amount employed in the Decision 92-12 scheme for calculating competitor contribution charged (excluding telco DAL traffic). Significantly, the Commission also decided in favour of a service-specific imputation test as opposed to a market segment test, thus, further constraining potential discounts based upon telco contribution management.

Decision 94-19 amends this imputation test in three ways:

- (1) the imputed contribution becomes the CAT contribution charge applicable to the telephone companies;

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- (2) generalizing the imputation test to all instances where competitive and monopoly elements are bundled for purposes of pricing whereby the "bottleneck rate" becomes an imputed cost;
- (3) extension of the test to cover CN in addition to toll services (on the expectation that this differs little from the previous test for compensatory rates excluding cross-effects).
- (6) Confirming that customer-specific tariffs will not be approved unless the well-established conditions for special facilities tariffs are met or if customer specific elements or rate structures are supported by a Phase II study and resale of each element is permitted.

Measures benefiting the telephone companies would appear to be:

- (1) a speedier, more certain, and more confidential process for obtaining interim approval of relative toll decreases (which of course puts more responsibility on the Commission to identify potential predatory pricing), and
- (2) passing rebalancing reductions through on a "raw reprice" basis (which excludes market stimulation effects) that could leave some additional profits from productivity gains with the telcos to finance further targeted discounts.

Yet again, it is too early to tell what effects these measures, taken as a separate group, will have. Price innovation directed at business customers appears to have slowed down as of last summer as price competition and intense marketing aimed at the residential market picked up with the implementation of equal access. The extent of residential long distance market share loss by Stentor, churn among competitors and Stentor recapture depends still on who you listen to. The respective relevance of price and service competition in the residential market cannot yet be reasonably identified. There may at present be a period of passive win-back by the telcos based upon consumer confusion and some adverse publicity of competitors, but in my view this will be very short-lived.

Further interexchange pricing innovation by both Stentor and its competitors appears to be on hold pending the CRTC's current re-examination of the main elements of Decision 94-19.

VI. COMPETITOR CONTRIBUTION CHARGES

The Commission's decision to move from a per access circuit to a per minute mechanism for assessing competitor contribution in payments (made inevitable by the adoption of Stentor's CAT model), and to do so virtually immediately was the first element of Decision 94-19 to be challenged, and to date challenged successfully.

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There are three aspects that merit separate consideration:

- (1) the decision in principle;
- (2) timing; and
- (3) the initial failure to link the shift with de-averaging the contribution mechanism (and, conversely, whether the Commission's current proposal to move to a de-averaged per-minute mechanism some time later this year, whereby the per minute payment in conventional off-peak hours would be one-half the payment in peak hours, will prove to be an acceptable means of introducing a per minute mechanism).

The Commission's decision to review this aspect of Decision 94-19 (Telecom Decision CRTC 94-27, December 29, 1994) provides a fair and thorough review of recent events. Little more will be known until the first set of submissions on the CRTC's de-averaging proposal due February 20.

In fairness to the Commission, it moved quickly to review an element of Decision 94-19 that may well have been misconceived, particularly given the high degree to which the relative merits of a per circuit and a per minute contribution mechanism had been canvassed by the parties in the proceeding that led to Decision 92-12, and the fact that equal access interconnection mandated by Decision 92-12 (and generally viewed as a prerequisite to meaningful competition in residential long distance services) had only begun to be implemented two months prior to the publication of Decision 94-19.

It appears that de-averaging, while maintaining the overall CAT generated contribution level, may not benefit money-losing IXCs which have proportionately higher business subscriber revenues than do Stentor members. A revenue neutral de-averaging implies that the peak period per minute contribution charge needs to be higher than the average per minute charge.

As a result, there is a stronger incentive to get further into the lower contribution residential market which tends to call off-peak. But this course in turn may only further magnify the need for additional regulatory assistance to deal with customer inertia or the fact that Stentor members can help cover the high administrative and marketing costs associated with this segment by virtue of their integration of local and long distance services.

Thus, as often happens, finding a stop-gap regulatory solution for one issue may produce offsetting regulatory issues elsewhere.

Moreover, the Commission's about face on per minute contribution de-averaging could put it on a slippery slope towards even more complicated contribution differentiation based upon value-of-service or highly normative "who should pay the most tax" judgments. Much can occur during the "transition period" on

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this front that could create a sense of "contribution-discount entitlement" on the part of suppliers and consumers - quite the opposite of the contribution free world just prior to the initializing of price-caps envisioned by Decision 94-19.

Notes

¹ For a discussion of the CRTC Framework Decision see John F. Blakney, "The Changing Canadian Communications Law Environment" (1994) 15:3 Can. Comp. Rec. 50.

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