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Conseil de la radiodiffusion et des télécommunications canadiennes

Telecom Decision CRTC 2002-43

Implementation of price regulation for Télébec and TELUS Québec

31 July 2002

Canada

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Telecom Decision CRTC 2002-43

Ottawa, 31 July 2002

Implementation of price regulation for Télébec and TELUS Québec

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Summary

This summary provides highlights of the price regulation regime that will be applicable during the next four years to Télébec and TELUS Québec (the "Companies"). With the introduction of this regime, the Commission has taken the steps necessary to bring the Companies under a regulatory framework directly comparable to that applied to the other large incumbent local exchange carriers (ILECs) in Canada.

The price regulation regime for the Companies has been designed to meet the following objectives:

- *to render reliable and affordable services of high quality, accessible to both urban and rural area customers;*
- *to balance the interests of the three main stakeholders in the telecommunications markets (i.e., customers, competitors and incumbent telephone companies);*
- *to foster facilities-based competition in Canadian telecommunications markets;*
- *to provide incumbents with incentives to increase efficiencies and to be more innovative; and*
- *to adopt regulatory approaches that impose the minimum regulatory burden compatible with the achievement of the previous four objectives.*

To further these objectives, the Commission is adopting a regime that is similar, in most respects, to the regime implemented for the other large ILECs in Regulatory framework for second price cap period, Telecom Decision CRTC 2002-34, 30 May 2002. The basket structure and pricing constraints ensure that the benefits of productivity gains are equitably distributed across the services offered by the Companies. They also indirectly help foster local competition by ensuring that the Companies cannot reduce prices in a competitive market and recoup the lost revenues by raising prices in a market where competition is weak or absent.

The Financial Review

Given that the Companies have not previously been subject to price regulation, the Commission conducted a financial review to determine their revenue requirements and to set just and reasonable rates prior to the implementation of price regulation.

The Commission has used a cost of equity of 11% and a maximum capital structure of 55% in determining the Companies' revenue requirements. The Commission has also made several adjustments to the Companies' proposed going-in expenses.

The Commission has approved Télébec's proposed business rate restructuring but has denied its request to raise its residential rates. The company has a going-in revenue shortfall which will be recovered by means of a transitional subsidy from the national contribution fund. This transitional subsidy will be phased out during the price regulation period. The Commission is suspending the application of certain pricing constraints during the transitional period.

TELUS Québec had applied for both residential and business rate increases over the course of the price regulation period. Upon review of the company's financial requirements, the Commission determined that the company does not have a going-in revenue shortfall. Consequently, the proposed rate increases are denied.

The Basket Structure and Pricing Constraints

The price regulation regime for the Companies includes eight baskets or groups of services: residential local services in high cost serving areas (HCSAs); residential local services in non-high cost serving areas (non-HCSAs); business services; other capped services; Competitor Services; services with frozen rates; public payphones; and uncapped services. Each of these baskets or service groups is subject to pricing constraints tailored to meet the circumstances of the relevant services.

The individual basket constraints rely on an inflation factor, a productivity factor and an exogenous factor, as appropriate. The Commission has selected the chain-weighted GDP-PI published by Statistics Canada as the inflation measure and it has set the productivity offset at 3.5%.

In addition to basket constraints, a variety of rate element constraints are imposed on specific services in light of expected competitive circumstances and related considerations. These rate element constraints provide customers with additional price protection.

The basket and service group structures and key pricing constraints are as follows:

- *A basket of residential local services has been created for non-HCSAs. This basket is divided into two sub-baskets: basic residential services and residential optional local services. The basket is subject to a constraint of inflation less a productivity offset given that little competition is anticipated in residential local services in most locations over the next four years. However, in order to avoid the possibility that the operation of the constraint might force price reductions which would have a negative impact on the development of local competition, this basket is subject to a deferral account mechanism. The disposition of the deferral account will be reviewed annually.*

- *In order to provide additional pricing protection to customers, the sub-basket of basic residential services in non-HCSAs is subject to a constraint of inflation less a productivity offset, provided that productivity does not exceed inflation. If productivity does exceed inflation, the constraint will be set at zero. Services in this sub-basket are also subject to a rate element constraint which limits increases in any service rate element to 5% per year. The second sub-basket, which contains residential optional local services in non-HCSAs, is not subject to a basket constraint. However, some services in this sub-basket are subject to a constraint which limits price increases to $1 per feature per year.*

- *A basket has been established for residential local services in HCSAs. This basket is subdivided into two sub-baskets: basic residential services and residential optional local services. No constraint is imposed on the basket. However, the sub-basket of basic residential services is subject to a constraint of inflation less a productivity offset, provided that productivity does not exceed inflation. If productivity exceeds inflation, the constraint will be set at zero. Services in this sub-basket are also subject to a rate element constraint which limits increases in any service rate element to 5% per year. Some residential optional local services in the second sub-basket are subject to a constraint which limits price increases to $1 per feature per year.*

- *Single-line and multi-line business local exchange services are grouped in a single basket and subject to a constraint set at inflation. No productivity offset is imposed. These services are also subject to a rate element constraint limiting individual rate increases to 10% per year.*

- *Services that are in the nature of an essential service or are primarily used by competitors are assigned to the Competitor Services basket. No constraint is imposed on this basket as a whole. However, the basket is divided into two service groups which are subject to pricing constraints: Category I Competitor Services (i.e., services in the nature of an essential service) and Category II Competitor Services (i.e., other competitor services).*

- *Services in the Category I Competitor Services group are subject to a rate element constraint equal to inflation less a productivity offset, except for a limited number of services that are already priced to reflect productivity gains. The rates for services in Category II Competitor Services are capped at existing levels.*

- *Services such as 9-1-1 service and Message Relay Service are subject to frozen rate treatment.*

- *Public and semi-public pay telephones are placed in a separate category and their rates are frozen until the Commission conducts a policy proceeding on this service.*

- *All tariffed services not in one of the previous baskets or service groups are classified as other capped services or uncapped services. The other capped services basket is subject to a constraint of inflation less a productivity offset. In addition, these services are subject to a rate element constraint limiting rate increases to 10% per year. Uncapped services are not subject to any upward pricing constraints.*

Other Issues

The Commission is introducing quality of service mechanisms which provide for rebates to customers and competitors if the Companies fail to meet the Commission mandated quality of service indicators. These mechanisms are being introduced on an interim basis and will be finalized in a follow-up proceeding. The Commission has also decided that the Companies will be parties to the proceeding it intends to initiate in the near future to examine the establishment of a "consumer bill of rights".

The Commission has approved the Service Improvement Plans of the Companies, subject to certain adjustments to be finalized in subsequent filings. These plans will extend service to unserved customers and upgrade service to underserved customers.

In keeping with the ongoing effort to streamline and improve the efficiency of regulation and in light of the structure of the price regulation regime, the reporting requirements of the Companies have been revised to eliminate the filing of Phase III/Split Rate Base reports, as well as intercorporate transaction reports.

Finally, with respect to contribution issues, the Commission has set the productivity offset for the Companies for the national subsidy fund calculation at 3.5%. The Commission has also clarified certain aspects of the subsidy calculation.

The Commission will conduct a review of the price regulation regime for the Companies commencing in the fourth year of its term.

I Background

Introduction

1. In *Review of regulatory framework*, Telecom Decision CRTC 94-19, 16 September 1994 (Decision 94-19), the Commission developed a regulatory framework for the telecommunications industry intended to allow all Canadians, over time, ubiquitous and affordable access to an increasing range of competitively provided telecommunications services. At the time of its release, the Decision 94-19 framework applied to certain large incumbent local exchange carriers (ILECs) including AGT Limited (AGT), BC TEL, Bell Canada, The Island Telephone Company Limited (Island Tel), Maritime Tel & Tel Limited (MTT), The New Brunswick Telephone Company Limited (NBTel) and Newfoundland Telephone Company Limited (NewTel).

2. Following the release of the Supreme Court of Canada's decision in *Attorney-General of Quebec et al. v. Téléphone Guèvremont Inc*, Québec-Téléphone (now TELUS Communications (Québec) Inc. (TELUS Québec)) and Télébec ltée (now Société en commandite Télébec (Télébec)) began to be regulated by the Commission under the *Telecommunications Act*. An initial question faced by the Commission was whether Télébec and TELUS Québec (collectively, "the Companies") should be subject to the regulatory regime outlined in Decision 94-19.

3. In *Regulatory Framework for Québec-Téléphone and Télébec ltée*, Telecom Decision CRTC 96-5, 7 August 1996 (Decision 96-5), the Commission decided that the regulatory framework set out in Decision 94-19 would apply to the Companies. Under that framework, the Companies would eventually be subject to a transitional period of earnings regulation, followed by price cap regulation.

4. In *Implementation of Regulatory Framework for Québec-Téléphone and Télébec ltée*, Telecom Decision CRTC 97-21, 18 December 1997 (Decision 97-21), the Commission approved a split rate base regime for the Companies which divided their operations into utility and competitive segments, effective 1 January 1998. The utility segment relates mainly to the local and access operations of the companies (the Utility Segment) and the competitive segment refers to services subject to varying degrees of competition (the Competitive Segment). Decision 97-21 also initiated a transitional period of earnings regulation, beginning 1 January 1998, for the Companies' Utility Segments. This transitional period was deemed necessary in order to create conditions conducive to price regulation; more specifically, to bring local service rates closer to costs and decrease the subsidy provided by long distance services.

5. Earlier in 1997, the Commission had issued *Price cap regulation and related issues*, Telecom Decision CRTC 97-9, 1 May 1997 (Decision 97-9). This decision established the price regulation framework applicable to AGT and BC TEL (now TELUS Communications Inc. (TELUS)), MTS Netcom Inc. (MTS), Bell Canada, and Island Tel,

MTT, NBTel and NewTel (now Aliant Telecom Inc. (Aliant Telecom)). Implementation details of the price cap framework were decided in *Implementation of price cap regulation and related issues*, Telecom Decision CRTC 98-2, 5 March 1998 (Decision 98-2).

6. The Commission initiated a proceeding to determine the appropriate form of price regulation for the Companies in *Implementation of price cap regulation for Québec-Téléphone and Télébec,* Public Notice CRTC 2001-36, 13 March 2001 (PN 2001-36). The Commission indicated that the price regulation regime would commence in 2002.

7. On the same date, the Commission also issued *Price cap review and related issues*, Public Notice CRTC 2001-37, 13 March 2001 (PN 2001-37), initiating a proceeding to review the Decision 97-9 price cap regime and to establish the terms of the next price regulation regime for Aliant Telecom, Bell Canada, MTS, Saskatchewan Telecommunications (SaskTel) and TELUS (collectively, "the other large ILECs").

8. In PN 2001-36, the Commission noted that it was also issuing PN 2001-37. In order to permit parties to the PN 2001-36 proceeding to have access to the evidence, interrogatories and argument of parties in the PN 2001-37 proceeding prior to making their filings in the PN 2001-36 proceeding, the Commission set the deadlines for the filing of materials in the present proceeding some two weeks later than the PN 2001-37 filing deadlines.

9. The Commission issued its determinations arising from the PN 2001-37 proceeding in *Regulatory framework for the second price cap period*, Telecom Decision CRTC 2002-34, 30 May 2002 (Decision 2002-34). That decision set out, among other things, the price regulation regime for the next four years for the other large ILECs.

Scope of the proceeding

10. In PN 2001-36, the Commission indicated that the scope of the proceeding would be twofold: first, to develop and implement an appropriate price cap methodology for the Companies by establishing the principles and components of price cap regulation; and second, to conduct a financial review for the Companies in order to set just and reasonable going-in rates coincident with the implementation of price cap regulation.

11. With respect to the price regulation regime, the Commission invited proposals on the principles and components of price regulation for the Companies, including:

    a) the components of a price cap formula, including the appropriate measure of inflation, the level and applicability of a productivity factor, and the treatment of any exogenous factors;

    b) the definition and treatment of capped and uncapped services;

c) the service basket structure;

d) the length of the price cap period;

e) the appropriate treatment of any Utility Segment competitive service rates that may be excluded from the capped services basket as well as the appropriate treatment of Competitive Segment service rates that are subject to tariff regulation;

f) the appropriate self-correcting mechanism, including an earnings-sharing overlay, as a measure of protection for consumers against possible errors in setting the price cap parameters;

g) the appropriate ancillary regulation and reporting requirements under the price cap proposals and how the effectiveness of price cap regulation should be monitored;

h) the appropriateness of including a quality of service component in the price cap regime, or other methods such as targeted refunds to customers, to address inadequate service quality; and

i) the extent to which the Companies' adherence to other benchmarks for consumer service, if any (e.g., billing policies, consumer bill of rights), should be linked to the price cap regime and what form any such benchmarks might take.

12. The Commission indicated that the Companies' proposals could also address whether there should be any departure from the use of uniform parameters for the Companies to recognize company-specific circumstances.

13. In *Telephone Service to High-Cost Serving Areas,* Telecom Decision CRTC 99-16, 19 October 1999 (Decision 99-16), the Commission set a basic service objective (BSO) for telephone service in Canada. To ensure that the telephone companies met that objective, the Commission ordered all ILECs to either submit a service improvement plan (SIP) for approval or show that they met and would continue to meet the BSO in their respective areas. The Commission directed Télébec and TELUS Québec to submit their SIPs in the present proceeding.

14. As far as the financial review was concerned, the Commission indicated that, in order to calculate the Companies' going-in rates, it would examine the sum of any incremental revenue requirement impacts arising from material changes that the Companies proposed to the financial assumptions used to finalize their 2001 contribution requirements. Those changes could include:

a) any SIP proposals;

b) any additional depreciation expense from proposed changes to asset service lives over those reflected in the determination of the 2001 contribution requirement;

c) any changes to the allowed Utility Segment rate of return on common equity (ROE). In this regard, the Commission sought comments as to why the Companies' going-in rates should not reflect the same ROE and capital structure that were used in setting the other large ILECs' initial going-in rates;

d) net annualized revenue impacts of pending and planned tariff items;

e) adjustments for the amortization of any deferral accounts; and

f) any proposed recovery of Phase III/Phase II contribution shortfalls that may be warranted.

15. The Commission also indicated that it would review the continued application to the Companies of the restrictions on basic toll prices established in *Forbearance – Regulation of toll services provided by incumbent telephone companies*, Telecom Decision CRTC 97-19, 18 December 1997 (Decision 97-19).

16. Finally, the Commission indicated that it would deal with a number of issues related to the total subsidy requirement (TSR) of the Companies. The Commission also invited proposals on the appropriate treatment of rates in high-cost serving areas (HCSAs).

The proceeding

17. Télébec and TELUS Québec were made parties to the present proceeding and were directed to file evidence.

18. The Commission also invited evidence and submissions from interested parties. A total of 20 interested parties registered to participate in the proceeding. However, Action Réseau Consommateur, the Consumers' Association of Canada, Fédération des associations coopératives d'économie familiale, and the National Anti-Poverty Organization (ARC et al.) was the only party, other than Télébec and TELUS Québec, to file evidence. ARC et al. also submitted comments on the Companies' proposals, as well as final argument and reply argument.

19. The Commission received 316 letters and several petitions containing a total of 563 signatures. Of those letters, 287 (91%) were from Télébec subscribers.

20. An oral hearing was held in Québec City from 13 November to 15 November 2001 before Commissioners Jean-Marc Demers (chairman of the hearing), David Colville and Andrée Noël.

21. The oral hearing began with comments from the general public, followed by opening remarks from each of the Companies and ARC et al., followed by cross-examination of the evidence by the parties. Final arguments were filed on 27 November 2001. Reply comments were filed on 11 December 2001.

II Design of the price regulation regime

The circumstances of Télébec and TELUS Québec

22. As noted above, the Commission concluded in Decision 96-5, and reiterated in subsequent decisions, that it is appropriate to apply the same regulatory framework to the Companies as it applies to the other large ILECs. Nonetheless, when establishing the price regulation regime for the Companies, including setting going-in rates, it is necessary to consider the Companies' specific circumstances in order to determine the appropriate regulatory mechanisms and parameters.

23. In the present proceeding, the Companies put forward proposals that were similar to those filed by their affiliated companies in the PN 2001-37 proceeding. However, the Companies' proposals included certain differences which, in their view, indicated that they operate under unique circumstances.

24. In contrast, ARC et al. submitted that Télébec and TELUS Québec did not provide conclusive evidence to warrant them being treated differently from the other large ILECs. On the contrary, ARC et al. argued that the Companies should be subject to the same price regulation regime as the Commission would develop for the other large ILECs pursuant to the PN 2001-37 proceeding.

25. In the Commission's view, while it is true that the Companies face their own unique operating circumstances, the price regulation regime set out in this Decision is sufficiently flexible to accommodate these differences.

Prospects for local competition

26. In designing the price regulation regime for the Companies, including the appropriate basket structure and pricing constraints, the Commission considers it essential to take into account the prospects for local competition in the territories of the Companies. The form of regulation depends, in part, on the extent to which market forces can be relied on to discipline the Companies' behaviour.

27. In *Commission approves terms and conditions for local exchange and local payphone competition in the territories of TELUS Communications (Québec) Inc. and Télébec ltée,* Order CRTC 2001-761, 3 October 2001 (Order 2001-761), the Commission determined that local exchange and local payphone competition would be permitted as of 1 September 2002 in the territories of the Companies. In Order 2001-761, the Commission set terms and conditions for local competition that are similar to those applicable in the territories of the other large ILECs.

28. In the present proceeding, both Télébec and TELUS Québec submitted that the cost of providing local service in their territories was higher than in the territories of the other large ILECs. Nonetheless, the Companies stated that they expected competition to develop in the local business market once it was permitted. They also noted that the tariffs of both Companies permit resale of local services.

29. Télébec submitted that in local markets it faced competition from Centrex resellers and from resellers of services such as digital network access and interexchange circuits. In support of its position, Télébec provided forecast market share information, on a confidential basis, for Centrex lines that would be used by resellers for competitive purposes. Télébec also provided similar confidential information for digital network access and interexchange private line markets.

30. TELUS Québec expected competition to develop for business exchange services, particularly from Bell Canada. TELUS Québec submitted that Bell Canada was providing service to the head offices of many companies in Québec and could easily serve these companies' branches in TELUS Québec's territory. In support of its position, TELUS Québec provided forecast market share information, on a confidential basis, regarding the business access market and Centrex lines.

31. TELUS Québec anticipated that Cogeco Cable Canada inc. (Cogeco), a cable distributor in TELUS Québec's territory, would enter the market for residential exchange services since, in TELUS Québec's view, it would not make business sense for Cogeco not to use its bi-directional network to provide telecommunications services.

32. ARC et al. noted that according to the *Report to the Governor in Council: Status of Competition in Canadian Telecommunications Markets and Deployment/Accessibility of Advanced Telecommunications Infrastructure and Services*, September 2001 (GIC Report), competitive entry into the business market had occurred only in large urban centres. ARC et al. also noted that there were no large urban centres in the territories of either Télébec or TELUS Québec. In light of these two facts, ARC et al. submitted that it was questionable whether effective competition would develop in the Companies' territories.

33. ARC et al. noted that TELUS Québec had not submitted a market analysis in support of its views. ARC et al. argued that geographic and economic realities would make it difficult for Bell Canada to compete in TELUS Québec's territory. ARC et al. submitted that strategic considerations might limit Bell Canada's competitive impact, since, if Bell Canada were to make inroads into TELUS Québec's territory, TELUS Québec could also expand into Bell Canada's territory, with financing from TELUS Québec's parent, TELUS.

34. RSL COM Canada Inc. indicated that it did not plan to enter the market for primary local exchange services in the territories of Télébec and TELUS Québec. In response to a Commission interrogatory, Rogers Communications Inc. stated that it was not providing wire-line services in the Companies' territories and that it did not expect any impact from

local competition in the Companies' territories on its revenues. Bell Canada indicated that it had not made any decision whether or not to enter TELUS Québec's local market. Bell Canada also indicated that it had recently begun providing other wire-line services in TELUS Québec's territory and that it did not provide wire-line services in Télébec's territory.

35. The Commission considers that local competition in the Companies' territories will likely begin in the business market and be concentrated in urban areas. Competitors without facilities could serve the business access market through resale of the Companies' services and facilities, especially Centrex service where Télébec and TELUS Québec offer this service. The Commission notes that, where available, Centrex service may generally be obtained at discounts that depend on national volumes, permitting profitable Centrex resale through volume aggregation. Thus, the Commission considers that some resale competition is likely.

36. Further, the Commission is of the view that once local competition becomes possible, national or regional organizations with offices or plants in the territories of Télébec and TELUS Québec could elect to receive local service, as well as other telecommunications services, from a single supplier.

37. Given that Bell Canada's serving territory is adjacent to that of TELUS Québec, the Commission is of the view that Bell Canada could enter either as a facilities-based carrier or as a reseller. If this were to occur, TELUS Québec would face competition in the business market, especially in parts of its territory close to Bell Canada's facilities.

38. The Commission does not anticipate significant facilities-based entry into the market for residential services. If competitors enter certain exchanges to serve large business customers, they could also serve residential customers. However, the Commission considers that such limited competition will not be sufficient to protect the interests of residential subscribers.

39. The Commission notes TELUS Québec's submission that Cogeco may enter the local residential services market. However, the Commission is of the view that possible entry by cable distributors during the upcoming price cap period is unlikely to limit the Companies' market power in the market for residential services in their serving territories.

40. The Commission notes that residential optional local services may also be resold. However, as these services are not available at volume discounts, the Commission does not consider that a resale market for these services is likely to develop. While competitors with their own facilities would be in a position to offer such services profitably, and since the Commission does not expect significant facilities-based residential competition in the foreseeable future in the territories of the Companies, it is of the view that the Companies will face little, if any, competition for residential optional local services.

41. Accordingly, the Commission does not anticipate that competition will be sufficient to discipline the Companies' residential local exchange and residential optional local service rates during the price cap period.

42. In light of the prospects for local competition over the next several years, the Commission has established a price regulation regime for the Companies that places regulatory constraints on particular services, while still providing the benefits and incentives of price cap regulation. Details of the regime are set out in Parts III, IV and V of this Decision.

Objectives of the price cap regime

43. In Decision 2002-34, the Commission identified a number of objectives for the price regulation regime applicable to the other large ILECs. Those objectives were as follows:

a) to render reliable and affordable services of high quality, accessible to both urban and rural area customers;

b) to balance the interests of the three main stakeholders in telecommunications markets, i.e., customers, competitors and incumbent telephone companies;

c) to foster facilities-based competition in Canadian telecommunications markets;

d) to provide incumbents with incentives to increase efficiencies and to be more innovative; and

e) to adopt regulatory approaches that impose the minimum regulatory burden compatible with the achievement of the previous four objectives.

44. In the present proceeding, Télébec, TELUS Québec and ARC et al. were all of the view that the regime for the Companies should resemble the regime developed for the other large ILECs.

45. In light of the Commission's view that the Companies should be subject to the same general regulatory regime as the other large ILECs, the Commission considers it appropriate to set the same objectives for the Companies' price regulation regime as for the regime applicable to the other large ILECs.

Earnings sharing

46. An earnings sharing mechanism involves setting an earnings threshold which, when reached, triggers the sharing of additional revenues with customers – typically either through rebates or via other rate adjustments.

47. In PN 2001-36, the Commission sought comments on whether an earnings sharing mechanism would be appropriate in the price cap regime for the Companies.

48. Neither Télébec nor TELUS Québec supported the inclusion of an earnings sharing overlay to the price cap regime. Both submitted that the length of the price cap period would be sufficient to ensure the protection of the various stakeholders. In addition, the Companies expressed the view that allowing an exogenous factor in the price cap formula (as discussed in Part IV of this Decision) would adequately address unexpected circumstances or events during the price cap period.

49. ARC et al. submitted that in establishing a price cap regime for the Companies, the Commission needed to seek a balance between the desire of consumers of telecommunications services to pay the lowest rates possible, and that of the telephone companies' shareholders to achieve the highest possible return on their investment. ARC et al. submitted that a price cap regime with an earnings sharing overlay would be one way of achieving this balance. In ARC et al.'s view, earnings sharing would ensure that customers would not pay higher rates for services than necessary, based on the cost of providing these services.

50. In the Commission's view, an earnings sharing mechanism would introduce elements of earnings regulation that would diminish the incentive for the Companies to reduce their costs and improve productivity. Further, in the Commission's view, any form of earnings regulation would negate the regulatory streamlining benefits inherent in price cap regulation, since most of the details relating to the current reporting requirements would have to be maintained. Overall, the Commission considers that the disadvantages of such an approach outweigh its benefits. Consequently, the Commission has decided not to include an earnings sharing overlay in the price regulation regime for Télébec and TELUS Québec.

Price cap period

51. In PN 2001-36, the Commission invited comments on the length of the price cap period to be applied to Télébec and TELUS Québec.

52. Télébec proposed a four-year price cap period. Télébec submitted that a longer period would expose the company to undue risks associated with the rapidly evolving telecommunications industry while a shorter period would not give the company the opportunity to benefit from the advantages of the price cap regime.

53. TELUS Québec proposed a price cap period of four years with an automatic renewal for an additional three years, unless the Commission felt it necessary to have a review in the last year of the initial four-year period. TELUS Québec also proposed that the Commission allow interested parties the opportunity to request a revision in the last year of the initial four-year price cap period.

54. No other party commented on the length of the price cap period.

55. The Commission agrees with the Companies that a four-year plan would allow the benefits of price cap regulation to be realized, while providing for the possibility of a timely adjustment to correct the regulatory framework for any errors in its structure or to reflect the evolution of competition over the price cap period. Accordingly, the Commission determines that the price cap period will be for a four-year term.

56. The Commission notes that automatic extensions to the four-year price cap period, as proposed by TELUS Québec, could result in staggered price cap periods among the Companies and the other large ILECs. This could favour some ILECs over others, depending on market conditions and other factors present at the time of a particular review. As well, plan assessments performed at different times would result in administrative inefficiency.

57. The Commission considers that a review toward the end of the price cap period offers the Commission the best opportunity to examine how well the plan is working and to modify the regulatory framework, as necessary. Accordingly, the Commission determines that a review of the price cap regime will be initiated in the final year of the plan.

III Services, baskets and pricing constraints

Background

58. As noted above, the Commission concluded in Decision 96-5 that the same basic regulatory framework as the Commission had developed for the other large ILECs in Decision 94-19 should apply to Télébec and TELUS Québec. The Commission noted that this framework would eventually include price regulation.

59. The Commission established the initial price cap regime for the other large ILECs in Decisions 97-9 and 98-2. In Decision 97-9, the Commission imposed an overall price cap constraint equal to inflation less a productivity offset on revenues from a single basket of ILEC services. This basket was divided into three sub-baskets that were also subject to additional sub-basket, service or rate element pricing constraints:

- Basic residential local services;
- Single and Multi-line Business local services; and
- Other capped services.

60. Services that were priced to maximize contribution before the implementation of price caps, such as optional local services, and services for which the Commission considered that a price cap would be redundant, such as Special Facilities Tariffs (SFTs), were generally not assigned to a capped services sub-basket. Competitor Services, as defined in Decision 98-2, were also not included in capped services. Rates for certain other services, such as 9-1-1 service and Message Relay Service, were subject to a price freeze over the four-year price cap period.

61. In PN 2001-36, the Commission directed Télébec and TELUS Québec to file proposals with regard to the principles and components of price cap regulation for themselves, including but not limited to:

a) the definition and treatment of capped and uncapped services;

b) the service basket structure;

c) the appropriate treatment of any Utility Segment competitive service rates that may be excluded from the capped services basket as well as the appropriate treatment of Competitive Segment service rates that would be subject to tariff regulation; and

d) whether or not any departure from the use of uniform parameters for either telephone company is appropriate.

Positions of parties

General

62. Télébec, TELUS Québec and ARC et al. were the only parties who provided specific comments on how the next price regulation regime should be designed.

63. The Companies' proposals were significantly different from one another, as well as from the initial price cap regime established in Decision 97-9 for the other large ILECs. However, aspects of the Companies' proposals were similar to those submitted in the proceeding leading to Decision 2002-34.

64. In particular, Télébec proposed a basket structure similar to that proposed by its affiliate, Bell Canada, but with different pricing constraints. TELUS Québec's proposal was similar to that of its affiliate, TELUS, in respect of the proposed basket structure and pricing constraints. Furthermore, TELUS Québec argued that it should be subject to the same regulatory framework that would be established for the other large ILECs provided that modifications were made to certain specific price cap parameters.

65. The proposal of ARC et al. was substantially the same as its proposal in the PN 2001-37 proceeding. In ARC et al.'s view, the Companies should be subject to the same form of price regulation as would be established for the other large ILECs. In general, ARC et al. was of the view that the initial price cap regime established in Decision 97-9 for the other large ILECs was flawed. ARC et al. submitted that the Commission should learn from past experience and take the opportunity to establish a regime that balanced the interests of the three main stakeholders (i.e., consumers, ILECs and competitors).

Télébec's proposal

66. Télébec's proposal assigned Utility Segment services to the following categories:

a) services subject to an upward pricing constraint; and

b) services not subject to an upward pricing constraint.

67. Télébec took the position that a productivity offset should not apply to any basket or sub-basket of services or to Utility Segment revenues as a whole. Télébec proposed that a productivity offset should apply only to the costs for residential local exchange service in HCSAs.

68. Télébec noted that its business primary exchange service (PES) revenues represented only 27% of its total PES revenues. Télébec submitted that, since residential rates were not compensatory, establishing a link between the residential and business sub-baskets under an overall price cap constraint would result in strong pressure to lower business rates. The company argued that this would result in lower local rates for business services which, in turn, could dampen the incentive for competitive entry.

Services subject to upward pricing constraints

69. Télébec assigned its services that would be subject to upward pricing constraints to the following service groupings: Basic Residential Local Services, Basic Business Local Services, Other Capped Services, services with frozen rate treatment. The company also proposed that it receive a special subsidy from the national contribution fund (NCF).

1) Basic Residential Local Services

70. As discussed in more detail in Part IX of this Decision, Télébec proposed residential individual line service rate increases to take effect during the price cap period. Télébec requested: (1) monthly rate increases of $4.17 and $3.52 for residential individual line service in rate bands N1 and N2, respectively, in 2002; (2) a $3.33 monthly rate increase in 2003 for residential individual line service in rate bands N1, N2 and N3; and (3) residential monthly rate increases to take effect in 2004 and 2005 that the company would propose, following the decision in the proceeding initiated by *Implementation of competition in the local exchange and local payphone markets in territories of Télébec and TELUS (Québec)*, Public Notice CRTC 2001-69, 14 June 2001 (PN 2001-69). Télébec proposed no other upward pricing constraints on these services.

71. Télébec submitted that its proposed pricing flexibility was essential for the harmonious introduction of a price cap regime. The company stated that the rate increases proposed for 2002 and 2003 were necessary to bring rates closer to costs. Télébec also indicated that its proposed banding structure in the PN 2001-69 proceeding would differ from the banding structure established in *Restructured bands, revised loop rates and related issues*, Decision CRTC 2001-238, 27 April 2001 (Decision 2001-238) for the other large ILECs. As such, Télébec anticipated a need for residential PES rates to increase in the years 2004 and 2005 to continue to bring rates closer to costs.

72. Télébec proposed rate increases that would result in additional revenues of $0.5 million and $5.1 million in 2002 and 2003, respectively. Télébec suggested that, notwithstanding the pricing flexibility requested, residential local rates would remain affordable. Télébec

noted that, if its proposal were approved, residential local rates in all its exchanges would rise to $34.43. Télébec submitted that this rate had already been deemed affordable when it was approved by the Commission for certain Télébec exchanges. Further, Télébec noted that the rates it would propose in 2004 and 2005 would be developed by the company following the outcome of the proceeding initiated by PN 2001-69 and would be subject to Commission approval during the price cap period.

2) Business and Other Capped Services

73. Télébec submitted that average price changes should be constrained by the rate of inflation each year for those services assigned to the business and other capped services group. Télébec also proposed an annual 10% limit on price increases for these services at the rate element level. The company argued that this pricing flexibility would encourage the growth of local competition in the business market. Télébec also submitted that such flexibility would provide the incumbents with incentives to increase efficiencies and to be more innovative, which would allow them an opportunity to earn a fair return on their investments.

3) Services with frozen rate treatment

74. Télébec was in agreement with the approach taken in Decisions 97-9 and 98-2 whereby the Commission froze the rates or terms of certain services (e.g., 9-1-1 service, Message Relay Service) given the nature of these services.

4) Special Subsidy

75. Télébec argued that it should receive an annual recurring special subsidy of $12.3 million from the NCF for the duration of the price cap period in order to recover its going-in revenue requirement shortfall. Télébec submitted that its rate proposal would permit a gradual reduction in its proposed special subsidy since additional revenues resulting from the rate increases would be directed towards reduction of the subsidy.

Services not subject to an upward pricing constraint

76. Télébec submitted that a service should not be subject to upward pricing constraints if any of the following conditions were met:

- the service was subject to sufficient competition to discipline pricing;
- the service was discretionary; or
- the service was a substitute for services whose rates were constrained by market forces or regulatory pricing constraints.

77. On this basis, Télébec proposed that there be no upward pricing constraint imposed on the following baskets of services:

a) a "value added" services basket that would include services such as Centrex, Megalink and Microlink;

b) an "other non-capped services" basket that would include services such as optional and special facilities and assemblies;

c) a competitor services basket that would include services such as equal access, and switching and aggregation; and

d) a payphone services basket.

78. Télébec argued in favour of the assignment of services to these four sub-baskets and the absence of upward pricing constraints primarily on the ground that competition would develop in its territory. Télébec noted that toll competition was well established and that local and payphone competition would be introduced in its serving territory on 1 September 2002.

79. Télébec submitted that the Commission should allow payphone rates to be adjusted in accordance with costs. The company recommended that no price cap be imposed on payphone services.

TELUS Québec's proposal

80. TELUS Québec proposed that all Utility Segment services except residential local service in HCSAs be uncapped and placed into one of three categories:

- a) non-forborne services subject to both an upper pricing constraint and a price floor;

- b) non-forborne services subject only to a price floor; or

- c) forborne services that are not subject to pricing constraints.

81. TELUS Québec noted that forborne services were constrained by the terms and conditions on which forbearance was granted. TELUS Québec's proposal with respect to local payphone services is discussed separately below.

Non-forborne services subject to an upper pricing constraint and a price floor

1) Residential local exchange service

82. TELUS Québec requested the flexibility to increase rates for residential local exchange service (including extended area service) by an annual maximum of $2.50, to a maximum monthly rate of $31.00, to be reached over the four-year price cap period. TELUS Québec noted that the rate increases in HCSAs would be offset by an equivalent reduction in its TSR.

83. TELUS Québec submitted that an imputation test would continue to apply to these services. It argued that a monthly rate of $31.00 was affordable, and had been deemed so by the Commission when it approved the current rate for Télébec ($34.43).

84. TELUS Québec argued that any proposal to limit price increases to residential services to a greater degree than it proposed could limit competitive entry in non-HCSAs and would delay these rates from reaching market levels. The company submitted that competitors would pick and choose only attractive markets where the rates were compensatory. TELUS Québec also argued that competitors had an advantage over the company, considering its obligation to serve.

2) Services with frozen rates

85. TELUS Québec proposed to freeze rates for services with social welfare considerations and public safety concerns at their current rates. These services include 9-1-1 service, Message Relay Service and Toll restriction service.

3) Competitor Services

86. TELUS Québec proposed that Competitor Services be priced at Phase II costs plus an approved mark-up.

4) Business local exchange service

87. TELUS Québec proposed that there not be any pricing constraint imposed on rates for business local exchange services. TELUS Québec noted that the imputation test would continue to apply to these services. The company was opposed to the application of an additional pricing constraint on these services on the basis that doing so would further limit its pricing flexibility.

5) Subsidy

88. TELUS Québec proposed that an upper pricing constraint equal to inflation minus productivity be applied to the TSR.

Non-forborne services subject only to a price floor

89. TELUS Québec proposed that rates for those non-forborne Utility Segment services that were not included in the baskets described above should be subject to a price floor to protect against anti-competitive below-cost pricing. The company noted that the Commission's current imputation test, established for the other large ILECs, would determine the price floor.

90. TELUS Québec did not support the application of a pricing constraint to optional local service rates on the basis that these services were discretionary in nature. It further submitted that the rate increases on these services would be subject to Commission approval to ensure that rates levels would continue to be appropriate.

91. TELUS Québec argued that its pricing flexibility proposal for optional services was warranted on the grounds that competition could be expected to develop for these services. TELUS Québec argued that it should be afforded the opportunity by the Commission to respond to market conditions.

Comments on the Companies' proposals

92. ARC et al. argued that the Companies' residential customers had seen their rates significantly increase over the last few years. ARC et al. noted that Télébec's subscribers currently pay the highest telephone rate in Canada for basic telephone service. ARC et al. also noted that TELUS Québec's residential monthly rates had risen from approximately $14.00 in 1995 to the current rate of $23.50.

93. ARC et al. submitted that the further rate increases proposed by the Companies over the price cap period would be significant to consumers.

94. ARC et al. also argued that the proposals submitted by Télébec and TELUS Québec as part of this proceeding would not properly balance the interests of the three main stakeholders and should be rejected.

ARC et al.'s proposal

95. ARC et al. submitted that the other large ILECs had been able to make significant productivity gains and had earned consistently higher than normal rates of return on equity over their initial price cap period. ARC et al. also noted that at the same time, residential customers had been subjected to ever increasing rates for local service, that few competitors had entered the residential markets and that a number of competitors had failed. ARC et al. submitted that the result was that not enough of the productivity gains generated by the industry under price cap regulation had accrued to residential subscribers.

96. ARC et al. argued that the Commission should learn from its experience with the initial price cap regime established for the other large ILECs, to ensure that imbalances in benefits that had occurred would be avoided in the price cap regime established for Télébec and TELUS Québec.

97. ARC et al. submitted that it would be appropriate to establish the same basket structure and pricing constraints for Télébec and TELUS Québec as those established for the other large ILECs pursuant to the PN 2001-37 proceeding.

98. ARC et al. argued that Télébec and TELUS Québec were similar enough in size, operating structure, and faced comparable geographical and territorial challenges to those faced by a number of the other large ILECs. ARC et al. further argued that the Companies could achieve significant productivity gains over their price cap period, particularly considering their affiliations with larger ILECs (i.e., Télébec with Bell Canada and TELUS Québec with TELUS).

99. ARC et al. proposed the following basket structure and price constraints which, in its view, would balance the interests of the three main stakeholder groups:

- For the Residential service basket, a price cap index (PCI) would be set to equal inflation less productivity. Further, the price of any individual rate element would not be allowed to increase by more than inflation on an annual basis.

- For the Business service basket, no price cap formula would apply. Instead, an individual rate element would not be allowed to increase by more than 10% per annum.

- For the Optional local services basket, the PCI would be set to equal inflation. Further, the price of an individual rate element would not be allowed to increase by more than 10% per annum.

Commission consideration of parties' proposals

100. While it considers that certain aspects of the proposals had merit, the Commission is of the view that no party submitted a proposal that would adequately balance the interests of customers, competitors and ILECs.

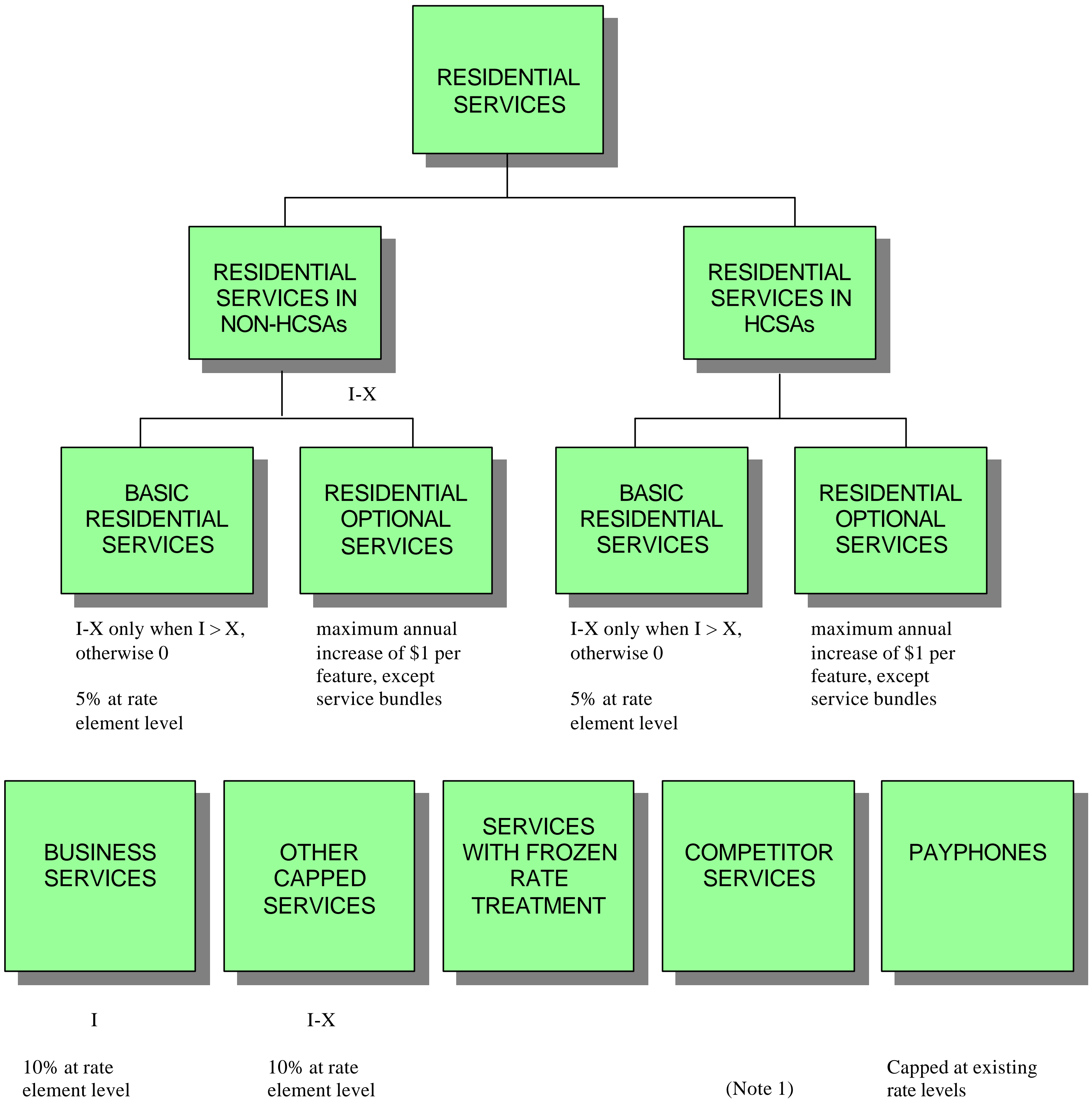
101. The Commission notes that Télébec and TELUS Québec did not propose that either customers or competitors would receive any of the benefits of the productivity gains that they can be expected to achieve under price regulation. At the same time, as discussed in Part II of this Decision, the Commission is not convinced that certain markets will be sufficiently competitive to discipline the Companies' prices. The Commission therefore considers the proposals made by the Companies to be unsuitable.

102. The Commission notes that the proposal of ARC et al. focused primarily on ensuring that residential customers would benefit from a proportionate share of the productivity gains to be achieved by the Companies under price regulation. In the Commission's view, ARC et al.'s proposal would result in residential rate decreases that would discourage competitive entry in the serving territories of Télébec and TELUS Québec. If implemented without modification, ARC et al.'s proposal would not adequately take into account the Commission's objective of fostering facilities-based competition. The Commission therefore declines to adopt the proposal made by ARC et al.

103. As discussed in Parts I and II of this Decision, the Commission has indicated in a number of decisions its intention to establish the same general regulatory regime for the Companies as it has developed for the other large ILECs. The Commission notes that all three parties to the present proceeding filed proposals which were similar to proposals submitted in the proceeding leading to Decision 2002-34. The Commission also notes ARC et al.'s suggestion that the Companies be subject to the same price regulation regime as is developed for the other large ILECs.

104. In light of the above, and in order to meet the objectives identified in Part II of this Decision, the Commission has decided to adopt a regulatory framework which, while drawing on certain elements of the proposals of the parties, closely resembles the regime established in Decision 2002-34 for the other large ILECs. Specifically, the Commission has decided to introduce a price cap regime that involves multiple baskets and service groups with individualized basket constraints, as well as specific rate element constraints in some cases. The overall scheme of the framework is illustrated in Figure 1.

Figure 1 – Capped Services



Note 1: Most Category I services are subject to I-X at the rate element level. Category II services are capped at existing rate levels.

105. In the Commission's view, this framework allows regulatory constraints to be focused on particular services, while still providing the benefits and incentives of price cap regulation. However, in order to avoid the possibility that the operation of the price cap constraints might force price reductions that could have a negative impact on the development of local competition, the Commission has included a deferral account mechanism. The full rationale for and operation of the deferral account is discussed in the context of the relevant service basket.

General conclusions regarding the basket structure and the application of a productivity offset

106. In a price cap regime, a productivity factor or offset is generally applied to a basket of services if competition in those services is insufficient to ensure that subscribers will benefit from productivity gains. Consequently, a decision to group services into a single basket and apply a productivity factor involves an assessment of whether competition sufficient to discipline prices exists for those services.

107. In Part II of this Decision, the Commission discussed the general environment under which Télébec and TELUS Québec operate, as well as the prospects for the development of local competition in their serving territories. Based on that analysis, the Commission has reached the following conclusions regarding the general grouping of services into baskets and the need for a productivity offset. The classification of specific services within these baskets is dealt with later in this Part.

Residential market

108. As discussed in Part II of this Decision, significant competition is not expected to develop over the next several years in the residential local exchange and optional local services markets of Télébec and TELUS Québec. Consequently, the Commission does not anticipate that competition will be sufficient to discipline the Companies' residential local exchange and residential optional local service rates during the price cap period.

109. In light of the above, the Commission considers it appropriate, with the exception of services provided in HCSAs, to subject residential services to a productivity offset. The treatment of residential services in non-HCSAs, as well as a full explanation of the basket structure for these services in HCSAs, is set out below.

Business market

110. The Commission notes that none of the parties proposed that a productivity offset be applied to business services. As discussed in Part II of this Decision, facilities-based competition in markets for business local exchange services in the Companies' serving territories will probably be concentrated in urban areas. Competitors are already established in some exchanges that are adjacent to the serving territories of Télébec and TELUS Québec. Finally, some competition already exists, notably through Centrex resale.

111. In order to ensure a proper balance among stakeholders, and given that competition is likely to develop first in the business market, the Commission considers that it would not be appropriate to subject these services to a productivity offset.

Market for Other capped services

112. In Decision 97-9, the Commission assigned a number of services offered by the other large ILECs to Other capped services (e.g., Digital Network Access). The Commission notes that Télébec and TELUS Québec offer these same services. Further, the Companies' rates for these services were often established based on the rates of large ILECs, typically those of Bell Canada and TELUS.

113. While competitors are likely to attempt to enter the markets for services identified as Other capped services, they are not likely to make significant inroads into these markets, since the pricing of these services is such that resale would not be a viable option. Accordingly, the Commission considers that there will not be sufficient competition to discipline the rates for Other capped services.

114. The Commission also notes that technological advances continue to reduce the cost of providing many of these services. The Commission considers it reasonable to expect that Télébec and TELUS Québec will achieve productivity and efficiency gains with respect to these services over the next few years. Accordingly, the Commission finds it appropriate to subject these services to a productivity offset.

Market for non-forborne Competitive Segment services

115. In Decision 97-21, the Commission assigned services to Télébec's and TELUS Québec's Competitive Segments based chiefly on the consideration that competition was permitted in these services at that time. Most of the services assigned to the Competitive Segment, however, are offered in markets that are not sufficiently competitive to support a decision to forbear from regulation of the services pursuant to section 34 of the *Telecommunications Act*.

116. The Commission notes that it has received no applications from Télébec or TELUS Québec to reduce rates for non-forborne Competitive Segment services. In fact, both Companies have filed applications to raise rates for some of these services over the last few years. In the Commission's view, non-forborne Competitive Segment services are offered in markets that have not been sufficiently competitive to discipline rates for these services. The Commission considers that it is necessary to apply a productivity offset to non-forborne Competitive Segment services to ensure that customers derive some benefit from productivity and efficiency gains that will be achieved by the Companies. The Commission accordingly concludes that it is appropriate to include non-forborne Competitive Segment services in the price cap framework and to subject them to a productivity offset.

117. As determined later in this Decision, the Commission has decided to include non-forborne Competitive Segment services in the Other capped services basket.

Market for Competitor Services

118. In Decision 2002-34, the Commission established two categories of Competitor Services. Category I Competitor Services were those services deemed to be in the nature of an essential service. Competitor Services not classified as Category I were assigned to Category II Competitor Services.

119. The Companies offer a number of services comparable to the services classified as Competitor Services in Decision 2002-34. In the Commission's view, there are few, if any, competitive alternatives for those of the Companies' services which are comparable to services classified as Category I Competitor Services under Decision 2002-34. The Commission is also of the view that the Companies, like the other large ILECs, are likely to experience productivity and efficiency gains in respect of these services. Consequently, the Commission concludes that rates for those of the Companies' services that will be classified as Category I Competitor Services should reflect productivity gains on an ongoing basis.

120. In Decision 2002-34, the Commission determined that it would not be appropriate to apply a productivity offset to the rates for Category II Competitor Services. The rates for these services were either mandated or market-based and were based on considerations in addition to or other than Phase II costs. The Commission also considers that the rates for services that will be classified as Category II Competitor Services for Télébec and TELUS Québec should not be subject to a productivity offset.

Basket structure and pricing constraints: specific conclusions

General

121. In this proceeding, Télébec, TELUS Québec and ARC et al. argued in favour of establishing specific price cap constraints for individual service baskets rather than an overall price cap constraint. The Commission agrees that it is preferable to design constraints that can be tailored to more closely match the circumstances of individual baskets or groups of services.

122. The Commission has determined that two different types of constraints will be in effect in the price cap regime established for the Companies. First, there will be "basket constraints" that will impose a constraint on the revenues derived from a basket or sub-basket of the Companies' services. Basket constraints will apply on an annual basis and operate through service basket limits. The second type of constraint is a "rate element constraint" that will impose a restriction on the price of a specific service. A service that is subject to a basket constraint will, in many cases, also be subject to a rate element constraint.

123. The Commission notes that the basket structure and pricing constraints adopted in this Decision reflect its view of the expected state of competition and the degree to which market forces will be sufficient to protect customers by disciplining the Companies' pricing during the price cap period. They are also designed with a view to fostering facilities-based competition and providing the Companies with incentives to increase efficiencies and to promote innovation.

Basket structure for residential local exchange services and residential optional local services

124. As discussed in Part II of this Decision, the Commission does not anticipate that competition will be sufficient to discipline the Companies' residential local exchange and residential optional local service rates during the price cap period. Accordingly, these services will be subject to the basket structure and pricing constraints discussed below.

125. TELUS Québec was of the view that there should be separate baskets for residential local exchange services in HCSAs and non-HCSAs, while Télébec's proposal did not differentiate between HCSAs and non-HCSAs.

126. Given that significantly different circumstances will apply in HCSAs and non-HCSAs, the Commission concludes that it is appropriate to establish two baskets for residential local services for these companies: a basket of residential local services in HCSAs and a basket of residential local services in non-HCSAs. Each of these baskets will include both residential local exchange services and residential optional local services.

127. The Commission notes that Télébec and TELUS Québec do not currently offer bundles that include a residential local exchange service or a residential optional local service with other telecommunications services. The Commission notes that, from the perspective of a residential customer, service bundles would be discretionary. In view of this, the Commission finds it appropriate to consider service bundles that would include a residential local exchange service or a residential optional local service as a residential optional local service. In the event that Télébec or TELUS Québec choose to offer such service bundles, the revenues derived from these service bundles will be included in the calculation of the revenues for the HCSA residential local services basket or the non-HCSA residential local services basket, as appropriate.

128. The Commission notes that different pricing policy considerations apply to residential local exchange and residential optional local services, including service bundles that include a residential local exchange service or a residential optional local service. As residential local optional services are discretionary, the Commission considers that less price protection is warranted than for residential local exchange service.

129. In light of these differences, the Commission concludes that each basket of residential services should be divided into two sub-baskets: a sub-basket of residential local exchange services and a sub-basket of residential optional local services which includes service bundles that include a residential local exchange service or a residential optional local service.

130. The constraints applicable to the two residential services baskets and their respective sub-baskets are discussed in the following sections.

Residential local exchange services and residential optional local services in non-HCSAs

131. As indicated above, the Commission has concluded that it does not anticipate that market forces will be sufficient to discipline the Companies' prices for residential local exchange and residential optional local services during the price cap period and that a productivity offset should be applied to these services in non-HCSAs. The Commission therefore considers it appropriate to apply a basket constraint equal to inflation less a productivity factor to the non-HCSA basket of residential local services.

132. As noted earlier, residential PES costs have yet to be determined for Télébec and TELUS Québec. Further, the Commission considers that it would be inappropriate to mandate reductions to residential local service rates as such reductions might force rates below compensatory levels. The Commission also considers that such reductions could have a negative impact on the development of competition. Consequently, the Commission has decided to use a deferral account mechanism to mitigate these potential effects.

133. With a deferral account mechanism, an amount equal to the revenue reduction required by a basket constraint is assigned to the deferral account and retained in that account, instead of reducing the revenues of the basket by means of rate reductions. The monies in the deferral account are then available for other purposes, including possible subscriber rebates.

134. The Commission considers that the use of a deferral account for residential local services will assist in achieving the objective of balancing the interests of the three main stakeholders in telecommunications markets: customers, competitors and ILECs.

135. The Commission notes that it has implemented rate rebalancing initiatives over the last several years for both Télébec and TELUS Québec. These initiatives and Commission determinations in other decisions have brought rates much closer to the costs of providing residential local service. This, in turn, has fostered competition in the residential long distance market. The Commission considers that residential local rate reductions that flow from market forces would be generally preferable to mandated rate reductions.

136. In light of the above and consistent with its approach in Decision 2002-34, the Commission concludes that, in non-HCSAs, it is appropriate to use a deferral account in conjunction with the application of a basket constraint equal to inflation less a productivity offset to all revenues from all residential local services. Further, the Commission anticipates that an adjustment to the deferral account would be made whenever the Commission approves rate reductions for residential local services that are proposed by Télébec or TELUS Québec as a result of competitive pressures. The Commission also anticipates that the deferral account would be drawn down to mitigate

rate increases for residential service that could result from the approval of exogenous factors or when inflation exceeds productivity as discussed below. Other draw downs could occur, for example, through subscriber rebates or the funding of initiatives that would benefit residential customers in other ways.

137. The Commission will review the amount in each company's deferral account on an annual basis, no later than the second year of the price cap period, at the time of the annual price cap filings. Beginning in the second year, it is the Commission's intention to dispose of amounts outstanding in the deferral account that accrued during the previous year. The Commission intends to clear these amounts in a manner that contributes to achieving the objectives for the price cap framework, including balancing the interests of the three main stakeholders in the telecommunications markets. Starting 1 August 2002, amounts in deferral accounts will bear interest at the company's short-term cost of debt, which is to be adjusted annually thereafter.

138. In addition to the basket constraint applied to the non-HCSA basket of local residential services as a whole, the Commission considers it necessary to impose an additional basket constraint on the sub-basket of basic local exchange services in non-HCSAs in order to provide additional pricing protection to subscribers to these services.

139. Accordingly, the Commission has decided that the following basket constraint should apply to this sub-basket of services: Télébec and TELUS Québec may, subject to the deferral account mechanism, increase residential local exchange service rates in non-HCSAs, on average, by inflation less the productivity offset in each year in which inflation exceeds the productivity offset. If the productivity offset exceeds inflation in a given year, then the average rates for residential local exchange services assigned to their respective residential local exchange service sub-baskets in non-HCSAs may not increase in that year. Should Télébec and TELUS Québec choose not to increase residential local exchange service rates in a given year to the extent permitted by this constraint, they may use any unused "room" to increase residential local exchange service rates in a subsequent year. Rate increases would still be subject to the rate element constraint described below.

140. However, the Commission is of the view that rate element constraints are also required for the services in each of the non-HCSA residential sub-baskets in order to provide additional protection to Télébec and TELUS Québec subscribers.

141. The Commission considers it appropriate to impose a rate element constraint that limits increases in Télébec's and TELUS Québec's rates for residential local exchange services in non-HCSAs to 5% per year on a non-cumulative basis. The Commission considers this 5% limit will provide the Companies with pricing flexibility while, at the same time, adequately protecting subscribers.

142. As far as residential optional local services in non-HCSAs are concerned, the Commission is of the view that the discretionary nature of these services justifies a more liberal rate element constraint. The Commission has therefore concluded that rate

increases for residential optional local service rates in non-HCSAs should not exceed $1.00 per feature per year for Télébec and TELUS Québec subscribers. This limit would not apply to the prices of service bundles that include a residential local exchange service or a residential optional local service.

143. In the PN 2001-69 proceeding, the Commission will be classifying and identifying HCSAs and establishing bands for Télébec and TELUS Québec. Once those determinations have been made, rates for residential local services in non-HCSAs, including bundles consisting of residential local exchange services and/or optional services, should generally not be de-averaged within a band.

Residential local exchange services and residential optional local services in HCSAs

144. The Commission notes that Télébec's and TELUS Québec's residential subscribers in HCSAs have experienced significant rate increases in the last few years. In the Commission's view, residential local subscribers in HCSAs should be protected from rate increases during the price cap period to the same extent as residential local subscribers in non-HCSAs.

145. That being said, the Commission does not consider it appropriate to impose a basket constraint on the HCSA basket of residential local services. Such a constraint could force down local exchange rates in HCSAs that are already set below cost. A basket constraint could significantly impair the ability of the Companies to achieve the annual implicit contribution target amount of $60.00 per residence Network Access Service (NAS) included in the subsidy calculation for HCSAs. Consequently, there will be no basket constraint on the HCSA basket of residential local services.

146. However, in order to protect subscribers in HCSAs, the Commission considers it appropriate to impose a basket constraint on the sub-basket of residential local exchange services in HCSAs as follows: Télébec and TELUS Québec may increase residential local exchange service rates, on average, by inflation less the productivity offset in each year in which inflation exceeds the productivity offset. If the productivity offset exceeds inflation in a given year, the Companies' average rates for residential local exchange services assigned to the residential local exchange service sub-basket in HCSAs may not increase in that year. Should Télébec and TELUS Québec choose not to increase residential local exchange service rates in a given year to the extent permitted by this constraint, they may use any unused "room" to increase residential local exchange service rates in a subsequent year. Rate increases would still be subject to the rate element constraint described below.

147. Consistent with its approach above for non-HCSAs, the Commission also considers it appropriate to impose a rate element constraint that limits increases in Télébec's and TELUS Québec's rates for residential local exchange services in HCSAs to 5% per year on a non-cumulative basis. As noted above, this 5% limit will provide the Companies with pricing flexibility while, at the same time, adequately protecting subscribers. Moreover, the Commission considers that residential local exchange services should not generally be de-averaged within a band.

148. Similarly, consistent with its approach in non-HCSAs, the Commission is imposing a rate element constraint on residential optional local services in HCSAs. Specifically, rate increases for residential optional local service rates in HCSAs should not exceed $1.00 per feature per year. This limit will not apply to the prices of service bundles that include a residential local exchange service or a residential optional local service as these services are generally available on a stand-alone basis and are subject to constraints at the rate element level when sold on that basis. Consistent with the policy regarding de-averaging of residential local exchange rates, rates for residential optional local services in HCSAs, including bundles consisting of residential local exchange services and/or residential optional local services, should generally not be de-averaged within a band.

Single and multi-line business local exchange services

149. As discussed above, the Commission has concluded that it is not appropriate to apply a productivity offset to business services. However, since the Companies are expected to retain some market power with respect to these services in their serving territories, the Commission concludes that it is appropriate to cap the index of prices for the basket of single and multi-line business local exchange services basket at the rate of inflation to provide broad protection for these customers.

150. The Commission therefore establishes a basket constraint equal to inflation applicable to the basket of single and multi-line business local exchange services.

151. To provide additional protection with respect to rate increases, especially to those customers in areas with limited access to competitive alternatives to Télébec's and TELUS Québec's services, the Commission adopts a rate element constraint to limit increases in the Companies' rates for single and multi-line business local exchange services to 10% per year. The Commission considers that rates for these services should not generally be de-averaged within a band.

Other capped services

152. Given that the Companies' rates for these services have often been established on the basis of other telephone companies' rates and given the limited competition that is expected to evolve in respect of Other capped services (including non-forborne Competitive Segment services), the Commission has concluded that it is appropriate to apply a constraint equal to inflation less productivity to this basket of services.

153. In order to provide customers of these services with additional protection from rate increases, the Commission considers it appropriate to also impose a rate element constraint which limits rate increases for a service in the Other capped services basket to 10% per year.

154. The Commission notes that in Decision 2002-34, it determined that it would not require an ILEC to file a rate reduction for a service in the Other capped services basket, below its Phase II costs plus a mark-up of 25% in order to meet the ILEC's price cap commitments. The Commission determines that the pricing policy established in Decision 2002-34 will also apply to the Other capped services of Télébec and TELUS Québec.

155. The Commission further considers that rates for Other capped services should not generally be de-averaged further within a band.

Competitor Services

156. As noted above, the Commission concluded that Télébec and TELUS Québec can be expected to experience productivity gains in respect of Category I Competitor Services. The Commission considers that the application of a basket constraint on a basket of Category I Competitor Services would allow the Companies freedom to assign the productivity gains for that basket to particular services, possibly advantaging one competitor over another. Consequently, the Commission has decided against imposing a basket constraint on Category I Competitor Services. Instead, the Commission considers it generally appropriate to adopt a rate element constraint equal to inflation less the productivity offset (I-X).

157. The Commission notes that the current rates for most of Télébec's and TELUS Québec's Competitor Services have been set based on approved rates for Bell Canada or TELUS. The Commission further notes that some Competitor Services rates approved for the other large ILECs already reflect productivity gains. In Decision 2002-34, the Commission found it inappropriate to subject these services to a further productivity offset. The Commission's determinations with respect to which of the other large ILECs' Competitor Services rates are subject to inflation less a productivity offset are set out in Appendix 1 to Decision 2002-34.

158. Therefore, with the exception of those Category I Competitor Services rates that explicitly reflect productivity gains, the Commission adopts a rate element constraint equal to inflation less the productivity offset established in Part IV of this Decision. This constraint would apply to all the Companies' services that will be assigned to Category I Competitor Services, with the exception of those services corresponding to the exempted services identified in Appendix 1 to Decision 2002-34. The Commission further considers that, due to these annual I-X adjustments, all usage rates of less than $1.00 are to be rounded to the fourth decimal place, with the exception of the Direct Connection and Access Tandem service rates which are to be rounded to the fifth decimal place.

159. The Commission notes that, later in this Part of the Decision, all tariffed rates are made interim, effective 1 August 2002. Further, subject to the considerations set out in Part X of this Decision concerning Télébec, the Commission directs Télébec and TELUS Québec to file by 1 October 2002 proposed tariff pages to be effective 1 August 2002 with their price cap filing to reflect the application of an I-X constraint at the rate element level of Category I Competitor Services. Further, the Commission directs the

Companies to issue tariff pages by 31 May of each year, beginning in 2003, reflecting the application, effective 1 August, of an I-X constraint at the rate element level to Category I Competitor Services.

160. In Decision 2002-34, the Commission found it appropriate to cap, at existing levels, the rates for Category II Competitor Services. The Commission's classification of Category II Competitor Services is set out in Appendix 1 to that Decision.

161. With respect to the services that will be classified as Category II Competitor Services, the Commission considers it appropriate to also cap the rates for these services at existing levels.

Services with frozen rate treatment

162. The Commission notes that Télébec and TELUS Québec proposed to freeze rates for 9-1-1 service, Message Relay Service and Toll restriction service for residential subscribers at current levels considering the importance and social nature of these services.

163. The Commission agrees with Télébec and TELUS Québec that rates for 9-1-1 service, Message Relay Service and Toll restriction should be frozen. Further, the Commission notes that the 9-1-1 service rates will be adjusted annually in accordance with *Rates modified for province wide 9-1-1*, Order CRTC 2000-630, 6 July 2000 (Order 2000-630). In Order 2000-630, the Commission outlined the formula to be used by the telephone companies for the annual recalculation of their province-wide 9-1-1 services rates.

164. In Telecom Order CRTC 98-109, 4 February 1998 (Order 98-109), the Commission concluded that increased availability of listing information, combined with other sources, posed a threat to personal privacy for residential subscribers and capped the rate for Unlisted Number Service for residential subscribers for the other large ILECs at $2.00 per month.

165. Currently, Télébec and TELUS Québec charge rates of $4.25 per month and $4.45 per month, respectively, for the service. The Commission considers that the personal privacy concerns identified in Order 98-109 are equally a concern for subscribers in the Companies' serving territories.

166. Télébec and TELUS Québec are accordingly directed to show cause by 30 August 2002 why they should not also be subject to the Commission's determination set out in Order 98-109.

Uncapped services

167. The Commission is assigning tariffed services that are not included in any basket or subject to a rate element constraint to a service group entitled Uncapped services. In particular, Centrex and business optional local services are classified as Uncapped

services. The Commission considers that service bundles that include a business local exchange service or a business optional service should also be classified as Uncapped services.

168. The Commission notes that Centrex service is a premium business service that is used as a substitute for single-line and multi-line business local exchange services. As this Decision makes these services subject to a basket constraint and a rate element constraint, the Commission does not consider it necessary to subject Centrex services to the same pricing constraints.

169. Similarly, in view of the substitutes available, the Commission does not consider it necessary to apply constraints to business optional local services. The Commission considers that rates for Uncapped services should generally not be further de-averaged within a band.

170. The Commission considers it appropriate to generally assign SFTs or Special Assemblies Tariffs (SATs) to Uncapped services. The Commission will determine when, if any, SFTs or SATs will be assigned to other baskets or service groups at the time it reviews the Companies' proposed assignment of services.

171. The Commission also assigns the Companies' Late Payment charge to Uncapped services. The Commission considers that it is not necessary to apply a constraint to these charges, given that they are calculated based on a Commission-approved formula.

Classification of services

General

172. The Commission directs the Companies to file, by 1 October 2002, a complete list of all tariffed services with a proposed classification of each service by basket, sub-baskets or service grouping. When developing their proposed classifications, the Companies should have regard to Figure 1 above and the short descriptions provided below, as well as Appendices 1 and 2 to Decision 2002-34.

173. As discussed earlier, in non-HCSAs, residential local services are assigned to a basket of services. This basket is composed of two sub-baskets: residential local exchange services and residential optional local services, including service bundles that include a residential local exchange service or a residential optional local service. In HCSAs, residential services are assigned to a sub-basket of residential local exchange services and to a sub-basket of residential optional local services, including service bundles that include a residential local exchange service or a residential optional local service.

174. The residential local exchange services sub-baskets contain residential local exchange services, installation charges and non-discretionary services associated with various grades of residential local exchange services but do not include 9-1-1 service and Message Relay Service.

175. The residential optional local services sub-baskets include services such as voice mail, call display and call waiting. As stated above, bundled services that include a residential local exchange service or a residential optional local service are to be included in residential optional local services sub-baskets.

176. The single and multi-line business services basket includes single-line and multi-line business local exchange services, including contract options, installation charges and non-discretionary services associated with various grades of business services, but excludes 9-1-1 service and Message Relay Service.

177. The group of services that will have their rates frozen over the price cap period includes 9-1-1 service, Message Relay Service, and Toll restriction. Further, the Commission considers that Call blocking and the Instalment payment plan for residential subscribers should be assigned to this sub-basket.

178. The Uncapped services group of services includes Centrex service, business optional local services, SFTs or SATs that are not assigned to other baskets or groups and the Late Payment Charge.

179. The Other capped services basket includes all services for which a tariff exists that are not assigned to another basket or service group.

Treatment of new services

180. Télébec submitted that new services should not be subject to upward pricing constraints unless they are competitor services that are essential or near-essential. TELUS Québec submitted that new services are non-essential by definition and proposed that they should not be subject to pricing constraints on the basis that doing so would dampen the companies' incentives to innovate.

181. The Commission notes that Télébec's and TELUS Québec's proposals regarding the treatment of new services would be inconsistent with the Commission's determinations in this Decision.

182. The Commission considers that new services should be assigned to a basket, sub-basket or service group on a case-by-case basis based on the criteria set out above.

183. Accordingly, Télébec and TELUS Québec will be required to submit a proposed price cap classification with tariff applications for new services or new service elements.

Other issues

184. A number of additional issues arose in the present proceeding regarding the pricing of services and related issues. These issues are addressed below.

Basic toll constraints

185. In Decision 97-19, the Commission forbore from regulating ILEC-provided toll and toll-free services, subject to certain conditions. The Commission required, among other things, that the ILECs provide to the Commission, and make publicly available, rate schedules setting out the rates for basic toll service. The ILECs were also required to update their respective schedules within 14 days of any change to the rates for basic toll service. The Commission also required that reasonable advance notice of rate changes be provided directly to subscribers; it prohibited route de-averaging; and it required that any increases to basic toll rates be offset by corresponding rate decreases that would ensure no change to the basic toll schedule's weighted average rate.

186. In PN 2001-36, the Commission stated that it would examine whether to continue to apply to the Companies the pricing constraints on North American basic toll schedules (BTS) established in Decision 97-19.

187. Télébec requested that the basic toll constraints be removed. The company argued that the interexchange market was competitive, that the basic toll constraints did not apply and that the basic toll constraints constituted a disadvantage to the incumbents, notably Télébec. TELUS Québec did not request any changes to the Decision 97-19 restrictions on the BTS.

188. No other party to the proceeding commented on this issue.

189. The Commission considers that toll market conditions have not changed significantly since 1997. The Commission is of the view that no party provided evidence in this proceeding to warrant elimination of the conditions regarding the BTS.

190. Accordingly, the Commission considers it appropriate to maintain the conditions on the BTS for Télébec and TELUS Québec established in Decision 97-19.

Pay telephone rates

191. As noted above, Télébec submitted that the Commission should allow payphone rates to be adjusted in accordance with costs, and recommended that no constraints be imposed on payphone service. TELUS Québec also proposed that no constraints be imposed on payphone service.

192. In Decision 2002-34, the Commission determined that the other large ILECs' public and semi-public pay telephone services should be assigned to a separate basket and that rates for these services should remain at current levels until the Commission considers policy issues related to payphone service in a forthcoming proceeding.

193. The Commission considers that the same approach should be adopted for Télébec and TELUS Québec. Accordingly, the Companies' public and semi-public pay telephone services are to be assigned to a separate basket and rates for these services are to remain at current levels until the Commission undertakes its policy proceeding regarding payphone service.

194. Accordingly, the Commission rejects the pricing flexibility proposals made by Télébec and TELUS Québec in respect of public and semi-public payphones.

Implementation issues

195. The Commission notes that Télébec proposed that the annual price cap filing be made at the end of March each year. TELUS Québec did not provide any specific comments with respect to the timing of annual price cap filings.

196. The Commission directs Télébec and TELUS Québec to file the first annual update to their respective price indices on 1 October 2002.

197. For service groups subject to upward pricing constraints, compliance with the applicable overall upward pricing constraint would be demonstrated by comparing a price index of actual price changes with a price index of allowable price changes. The allowable average price changes would be indicated by a service band limit (SBL) while the actual average price changes would be indicated by a service band index (SBI).

198. All Télébec's and TELUS Québec's tariffed rates are made interim, effective 1 August 2002. The Commission expects that any rate changes approved by the Commission to meet the 2002 price cap commitment would become effective 1 August 2002. The SBLs and SBIs should be set at 100 effective 1 August 2002.

199. The Commission therefore directs:

- Télébec and TELUS Québec to file the SBL and SBI with supporting calculations, formulae and spreadsheets, for each basket/sub-basket of capped services, as applicable, by 1 October 2002; and

- on an annual basis, by 31 May for the remainder of the price cap period, Télébec and TELUS Québec are to file updates to the SBL and SBI, with supporting calculations, formulae and spreadsheets, for each basket/sub-basket of capped services, as applicable.

IV Components of the price cap formula

Background

200. In Decision 97-9, the Commission established a price cap formula for the other large ILECs (except SaskTel) that consisted of three basic components: an inflation factor, a productivity offset (the X-factor) and an exogenous factor (the Z-factor).

201. These three components were used to determine the maximum allowable annual price changes for the basket of capped services. The inflation factor allowed for cost increases in keeping with changes in the national economy. The X-factor imposed a downward constraint to reflect productivity improvements. The Z-factor permitted adjustments required by certain unanticipated events beyond the control of the ILECs.

202. In *Changes to the contribution regime*, Decision CRTC 2000-745, 30 November 2000 (Decision 2000-745), the Commission determined that residence PES costs would be one of the components of the TSR. The Commission further determined that these PES costs would be adjusted annually using a pre-determined productivity offset. In Decision 2001-238, the Commission determined that the base PES costs in the TSR calculation would also be adjusted annually for an inflation factor. The TSR is discussed in more detail in Part XI of this Decision.

203. In PN 2001-36, the Commission sought comments on the use and value of these components in the price cap regime, as well as in the TSR calculation.

Inflation index

204. In Decision 97-9, the Commission used the Gross Domestic Product – Price Index (GDP-PI), published by Statistics Canada, as the measure of inflation. The GDP-PI is a measure of the national output price change.

205. Until recently, there were two forms of GDP-PI produced by Statistics Canada: a chain-weighted index and a fixed-weighted index. The chain-weighted index reflects changes in the price of a basket of goods and is updated to reflect actual expenditures on a quarterly basis. The fixed-weighted index also tracked price changes for a basket of goods but was updated less frequently.

206. TELUS Québec proposed that the GDP-PI be used as the measure of inflation. The company noted that, effective 31 May 2001, the fixed-weighted GDP-PI was no longer published by Statistics Canada and that Statistics Canada had adopted the chain-weighted GDP-PI as the official measure of the economy-wide inflation rate. Consequently, TELUS Québec suggested the Commission use the chain-weighted GDP-PI as the measure of inflation for the price regulation regime.

207. Télébec proposed that the Consumer Price Index (CPI) published by Statistics Canada be used in the price cap formula. In Télébec's view, CPI would be more readily understood by its subscribers when tariff changes were being proposed. Télébec also submitted that, over the past five years (1996 to 2000), the GDP-PI and CPI both averaged 1.7%.

208. No other party commented on the measure of inflation.

209. The Commission considers GDP-PI to be preferable to CPI for price regulation purposes since the latter measure is more limited in scope and is therefore vulnerable to greater fluctuations due to changes in one or two sectors in the economy (e.g., energy). In addition, as a broader measure of inflation, the GDP-PI more closely reflects the cost increases the Companies are likely to face.

210. Given the above and given that the fixed-weighted GDP-PI is no longer available, the Commission agrees with TELUS Québec that the chained-weighted GDP-PI is the appropriate inflation measure. The Commission notes that, in Decision 2002-34, it also decided to use the chain-weighted GDP-PI.

211. Accordingly, the Commission directs Télébec and TELUS Québec to use the preceding year's annual chain-weighted GDP-PI published by Statistics Canada as the measure of inflation for the price cap indices and pricing constraints, and in the calculation of the TSR.

Productivity offset (X-factor)

Background

212. In Decision 97-9, the Commission concluded that the productivity offset should be calculated using the following components:

a) the industry total factor productivity (TFP) defined as the measure of efficiency of the telephone companies taking into consideration all the inputs (labour, material, and capital) and outputs (revenues);

b) the economy-wide TFP defined as the productivity index for the business sector of the economy as a whole, produced by Statistics Canada;

c) the input price differential defined as the difference between the industry and economy-wide input price growth rates; and

d) the consumer productivity dividend (stretch factor).

213. The first three components comprised the basic offset. The stretch factor was included in order to ensure that consumers shared in the benefits resulting from the streamlining of regulation and the increased incentives for efficiency for the telephone companies under price cap regulation.

214. In determining the level of the basic offset, the Commission relied on time periods that were long enough to capture the sustained effects of productivity growth and to mitigate the effect of one-time events and short-term fluctuations. In Decision 97-9, the Commission approved a basic productivity offset of 3.5% along with a stretch factor of 1.0% for an annual X-factor of 4.5% for the other large ILECs' initial price cap period.

215. In PN 2001-36, the Commission invited parties to provide proposals and evidence on the appropriate level and applicability of a productivity offset, if any, for the price cap regime, as well as the offset to be used in the calculation of the TSR for the Companies.

216. The Commission has identified four issues which must be addressed:

a) whether company-specific productivity offsets should be used for the Companies;

b) what productivity offset should be used in the TSR calculation for the Companies;

c) what productivity offset should be used in the pricing constraints under the price regulation regime applied to the Companies; and

d) whether a stretch factor should be applied to either of these productivity offsets.

Positions of parties

Télébec

217. Télébec did not recommend the inclusion of a productivity offset in any pricing constraints applied to capped services. In the company's view, productivity gains would be difficult to achieve in light of the rural nature of its serving territory, the lack of large population centres and the limited economies of scale available to it. In Télébec's submission, the majority of its territory was high cost.

218. Télébec also submitted that it had already achieved significant productivity gains in the previous six years through workforce reductions, process/systems re-engineering, and other measures, and that it would be difficult to achieve comparable productivity gains over the price cap period. Finally, the company submitted that the introduction of price caps would not necessarily lighten its regulatory load and, hence, would provide minimal opportunity for productivity gains.

219. Télébec acknowledged that a productivity offset should be applied to the Phase II costs used in the calculation of the TSR, in accordance with Decision 2001-238.

220. As far as methodology was concerned, Télébec submitted that the productivity offset should be set on a company-specific basis. In its own case, Télébec argued in favour of the Total Implied Productivity (TIP) approach. Télébec indicated that TIP was a method of productivity measurement the company understood and found easy to produce.

221. Télébec acknowledged that there were problems with the use of TIP, such as the exclusion of increases in revenues, capital costs, taxes and other exogenous factors. However, Télébec submitted that it did not have the expertise or the resources to rely on the TFP and the marginal cost approaches.

222. Based on the company's TIP for the period 1996 to 2001, Télébec proposed that a 2.7% company-specific productivity offset be used in the calculation of the TSR. In accordance with Decision 2001-238, Télébec submitted that this productivity offset would be applied to the Phase II costs associated with the annual update to the TSR in HCSAs.

223. On the issue of a possible stretch factor, Télébec argued that its proposed 2.7% productivity offset incorporated a stretch factor in light of the rationalization in the telecommunications industry caused, primarily, by toll competition.

224. Finally, Télébec submitted that, in the event the Commission decided to use a common productivity offset for both Télébec and TELUS Québec, the Commission should use the average of the offsets being proposed by the two Companies.

TELUS Québec

225. TELUS Québec stated that it favoured a common price cap regime in Canada, subject to certain adjustments to reflect its unique circumstances. In keeping with the submissions of the other large ILECs in the PN 2001-37 proceeding, TELUS Québec did not recommend the inclusion of a productivity offset in a price cap formula applied to capped services.

226. For the purposes of the TSR calculation, TELUS Québec proposed a company-specific productivity offset calculated using a marginal cost approach. The company also submitted that if the Commission were to decide to include a productivity offset in its price cap constraints, the offset should be calculated using a marginal cost approach.

227. TELUS Québec argued that the productivity offset for the TSR should be set based on the expected reductions in marginal costs for services provided in HCSAs. TELUS Québec also argued that the marginal cost methodology would preserve the ideal incentive properties of price cap regulation by setting the average growth rate of prices for capped services equal to the average marginal cost growth rate for those services.

228. TELUS Québec submitted that its proposal relied, in part, on the evidence of TELUS in the PN 2001-37 proceeding. In its evidence, TELUS proposed a 3.0% productivity offset based on marginal cost data of TELUS and Bell Canada.

229. TELUS Québec submitted that the 3.0% offset developed by TELUS should be modified to reflect what TELUS Québec considered to be its unique circumstances (e.g., low line density in its rural territory, lack of dense urban centres, higher costs to introduce technological changes and slower pace to introduce these changes). TELUS Québec argued that companies with primarily high cost operating territories could not benefit from the allocation of fixed costs to a larger number of subscribers and, therefore, should be subject to a lower productivity offset than ILECs with more urban territories. On the basis of these considerations, TELUS Québec proposed an adjusted productivity offset of 1.65% for the TSR calculation.

230. Even though TELUS Québec's proposal would apply a productivity offset to the costs for residential service in HCSAs only, the company indicated that its proposed productivity offset could be applied to a basket of capped residential services.

231. Finally, TELUS Québec argued that if the Commission decided to have a common productivity offset for Télébec and TELUS Québec, the Commission should use TELUS Québec's proposed offset of 1.65%. TELUS Québec argued that the TIP methodology was not appropriate as it was too narrowly focused.

ARC et al.

232. ARC et al. argued that neither Télébec nor TELUS Québec provided conclusive evidence in the proceeding that would warrant a different treatment from the other incumbent telephone companies in Canada. In ARC et al.'s view, it would be appropriate to integrate Télébec and TELUS Québec into the overall price cap regime applicable to the other large ILECs.

233. ARC et al. argued that the Companies had an incentive to propose a lower productivity offset in order to retain the benefit of a greater portion of their efficiencies. Accordingly, ARC et al. submitted that the Commission should ensure that the price cap regime adopts an X-factor that would properly reflect the opportunities available to the Companies to achieve productivity gains.

234. ARC et al. noted that the Commission decided against developing a company-specific productivity offset for MTS in Decision 97-9. ARC et al. also submitted that, in order to conclude that a distinct productivity offset would be warranted for Télébec and TELUS Québec, the Commission would have to determine that the circumstances of these Companies were significantly different from the circumstances of the other large ILECs, such as Island Tel, MTS, TELUS and Bell Canada. ARC et al. argued that, if the Commission were to grant a lower productivity offset for Télébec and TELUS Québec than for the other large ILECs, then it could expect that some of the other large ILECs would ask for similar treatment.

235. ARC et al. submitted that the productivity measurement should be sufficiently broad-based that it would include the total company benefits associated with the provision of telephone services. ARC et al. argued that the TIP methodology proposed by Télébec was too narrow. In ARC et al.'s view, the TFP approach would provide a good indicator of company-wide productivity gains and, hence, a good indicator of Utility Segment productivity gains.

236. ARC et al. argued that the experience with the other large ILECs confirmed that the productivity offset of 4.5% set in Decision 97-9 was too low and had resulted in extraordinarily high profits for the other large ILECs.

237. According to ARC et al., the fact that Télébec and TELUS Québec considered themselves smaller ILECs or served HCSAs, did not justify a lower productivity target. ARC et al. submitted that Island Tel and NewTel had no difficulty in surpassing the 4.5% productivity target despite their smaller size and operating circumstances.

238. In ARC et al.'s view, an industry-wide productivity factor would be appropriate for the Companies and that offset should be significantly higher than 4.5%.

Conclusions

239. Having considered the positions of the parties, the Commission concludes as follows in respect of the four issues identified above.

Company-specific offsets

240. The Commission notes that, in Decision 97-9, it concluded that an industry-wide X-factor rewards those companies that have achieved higher than average productivity results and forces those companies with lower productivity results to become more efficient. The Commission reiterated this view in Decision 2002-34. Accordingly, the Commission used the same productivity offset for all of the other large ILECs subject to those Decisions.

241. Based on the evidence in the present proceeding, the Commission acknowledges that Télébec and TELUS Québec face their own specific challenges in their operating territories. However, some of the other large ILECs have larger and more diverse territories to serve than Télébec and TELUS Québec. Others have a greater mix of population centres and demographic groupings.

242. The Commission concludes that neither Télébec nor TELUS Québec have demonstrated that their operating circumstances are sufficiently different from the other large ILECs or from each other to warrant company-specific productivity offsets in their cases.

Productivity offset for the TSR

243. In the Commission's view, there are problems with the TIP approach advocated by Télébec to define a productivity offset for the TSR calculation. The TIP methodology is too narrow and fails to adequately take into account capital costs or new service revenue streams. Accordingly, consistent with Decision 97-9, the Commission rejects the use of the TIP approach to set the productivity offset.

244. As noted above, ARC et al. argued in favour of a TFP approach for setting the productivity offset. The Commission acknowledges the merits of a TFP approach when establishing a productivity offset which would be applied to the entire Utility Segment or to a regulated company as a whole. However, for the purposes of the TSR calculation, the Commission agrees with TELUS Québec that a marginal cost approach would more accurately reflect the actual productivity gains which a company could be expected to achieve in respect of residential local services in HCSAs.

245. The Commission notes that TELUS Québec relied on evidence submitted by TELUS in the PN 2001-37 proceeding when deriving its proposed productivity offset of 1.65%. In the Commission's view, the adjustments proposed by TELUS Québec to derive its productivity offset are not justified. As indicated above, the Commission has concluded that neither Télébec nor TELUS Québec have sufficiently different operating circumstances to warrant company-specific productivity offsets.

246. In the Commission's view, based on the evidence in this proceeding, the Companies have not demonstrated that the marginal cost trends for residence PES costs in high-cost bands in their territories are significantly different from those in the territories of the other large ILECs. In Decision 2002-34, the Commission set the basic productivity offset for the TSR calculation for the other large ILECs at 3.5%, based on a marginal cost approach. In the Commission's view, it is appropriate to set the basic productivity offset for the TSR calculations of Télébec and TELUS Québec at the same level.

Productivity offset for pricing constraints

247. In light of the basket and service group structure the Commission has adopted in Part III of this Decision, the Commission is of the view that the productivity offset used in the relevant pricing constraints should be based on a marginal cost approach. In this way, the offset will reflect the actual productivity gains that are likely to be achieved for individual capped baskets.

248. Since company-specific offsets have not been justified by Télébec and TELUS Québec, and since the Commission considers that an industry-wide productivity offset would be desirable, the Commission concludes that it is appropriate to adopt the same basic productivity offset for the Companies as approved for the other large ILECs in Decision 2002-34 (i.e., 3.5%).

Stretch factor

249. The Commission notes that in Decision 2002-34, it did not include an explicit stretch factor. This determination was based, in part, on the view that the basic productivity offset of 3.5%, based on the marginal cost approach, incorporates a limited stretch factor. The implicit stretch factor results from the fact that the marginal cost growth for the years 1998 to 2001 included the productivity gains achieved by the other large ILECs under price cap regulation.

250. The Commission is of the view that the same approach is appropriate for the Companies. Accordingly, the Commission concludes that no stretch factor should be applied to the productivity offset.

The value of the productivity offset

251. Based on the above, the Commission determines that an annual X-factor of 3.5% will be used in the TSR calculation and in the price cap indices and pricing constraints, as applicable, in the price cap regime for both Télébec and TELUS Québec.

Exogenous factor (Z-factor)

Background

252. In Decision 97-9, the Commission established an exogenous factor as a component of the price cap formula for the initial price cap regime of the other large ILECs (except SaskTel). This Z-factor flows through the impact associated with certain events not captured by the other elements of the price cap formula. Adjustments would be considered for events or initiatives which satisfy the following criteria:

a) they are legislative, judicial or administrative actions which are beyond the control of the company;

b) they are addressed specifically to the telecommunications industry; and

c) they have a material impact on the Utility Segment of the company.

253. The Commission also directed that the impact of an exogenous event be determined on a company-wide basis and be assigned between the Capped and Uncapped Services on a cost-causal basis. In addition, the Commission considered that, in general, actual data should be used to determine the impact.

254. In PN 2001-36, the Commission invited comments on whether a Z-factor should be included in the price cap formula for Télébec and TELUS Québec and, if so, how it should be treated.

The need for an exogenous factor

255. Both Télébec and TELUS Québec submitted that it would be appropriate to allow for exogenous adjustments in the price cap regime to account for variations in expenses and revenues associated with events that would be beyond their control.

256. Other parties did not comment on the need for an exogenous factor in the price cap formula.

257. In the Commission's view, if there were no mechanism in place to make adjustments for exogenous events, Télébec and TELUS Québec would unfairly be required to bear the risk associated with events beyond their control that increase their costs to a significant extent. At the same time, consumers and competitors using the Companies' services would not benefit from cost savings that could be passed on to them through these adjustments.

258. The Commission considers that the most appropriate way to capture an exogenous event is as a component of the price cap formula that is triggered when that event occurs. Accordingly, the Commission determines that the price cap regime for Télébec and TELUS Québec will include exogenous adjustments.

Criteria for exogenous treatment

259. Télébec and TELUS Québec agreed to use the criteria established in Decision 97-9 to determine an exogenous event subject to certain proposed adjustments to the criteria.

260. Télébec submitted that an exogenous adjustment should be considered in cases where events did not specifically address the telecommunications industry. As an example, Télébec referred the possible costs associated with access to public rights-of-way.

261. TELUS Québec proposed to add a fourth criterion that would summarize the reason for an exogenous adjustment: a firm would be entitled to an exogenous adjustment for an event where it would have otherwise been possible to recover the impact of such an event in the absence of price cap regulation. TELUS Québec further submitted that a firm should be entitled to an exogenous adjustment for a significant natural disaster, for changes to the rules for establishing larger local free calling areas and for the imposition of fees for access to public rights-of-way.

262. In addition, both Télébec and TELUS Québec submitted that an exogenous adjustment should be allowed for fluctuations in the percentage of contribution payments the Companies would make into the NCF.

263. Other parties did not comment on the criteria to be used to identify an exogenous event.

264. In the Commission's view, events which affect more than just the telecommunications sector would likely be reflected in changes to inflation and, hence, should not qualify as exogenous events, contrary to the proposals of Télébec and TELUS Québec.

265. The Commission considers that exogenous events should be events of a material impact beyond the control of the Companies that are not otherwise accounted for in the price cap parameters. The Commission notes that in Part XI of this Decision, it has determined that Télébec and TELUS Québec are no longer required to produce Phase III/Split Rate Base (SRB) results. Therefore, no separate financial reporting of the Utility Segment will be available in the price cap regime. The Commission notes that it made a comparable change in the regime applicable to the other large ILECs in Decision 2002-34. In that decision, the Commission modified the third criterion for an exogenous event by requiring that the effects of an event be material as measured against the company as a whole. The Commission has decided that the same approach is appropriate for the Companies. Accordingly, the Commission determines that an exogenous event will be defined to be material as measured against the total company.

266. In light of the above, the Commission concludes that the criteria for exogenous events should be as follows:

a) they are legislative, judicial or administrative actions which are beyond the control of the company;

b) they are addressed specifically to the telecommunications industry; and

c) they have a material impact as measured against the total company.

Assignment of the impact of an exogenous event

267. Both Télébec and TELUS Québec submitted that it would be difficult to establish an assignment methodology that could be generally applied to all exogenous events. They were of the view that there should be some flexibility for assigning the impact of an exogenous event to the various service baskets. Télébec proposed that where possible, the assignment should take into consideration the cost causal basis of the event. TELUS Québec proposed that the impact of an exogenous event should be assigned to the different service baskets based on the revenue weight of each service basket affected by the event.

268. Other parties did not comment on the assignment of the impact of an exogenous event to the various service baskets.

269. As each exogenous adjustment proposed in the price cap regime will be reviewed on an individual basis, taking into consideration the particular circumstances of each event, the Commission is of the view that the basis of assigning the exogenous adjustment should be determined on a case-by-case basis. This will provide the flexibility needed to ensure that the amounts are properly assigned to the appropriate baskets. Accordingly, Télébec and TELUS Québec will be expected to file a proposal, with supporting rationale, with each application for an exogenous adjustment stating the preferred basis of assignment.

270. The Commission is also of the view that exogenous factors should not be assigned to the Frozen Rates and the Competitor Services baskets. If it is determined that all or part of an exogenous adjustment should be assigned to the Competitor Services basket, the Commission considers that this event would likely affect the Phase II costs directly, which would require the revised rates to be filed using the Phase II costing methodology.

Identification of an exogenous event

271. Télébec and TELUS Québec proposed that they and other interested parties should be required to notify the Commission of any exogenous adjustments, either positive or negative. Télébec proposed that the adjustments should be identified within 30 days of the event's occurrence. However, TELUS Québec was of the view that the 30-day window would be unfair to interested parties as it would be unlikely that it would provide enough time to identify and analyze the impacts of any potential exogenous adjustments. TELUS Québec proposed no time limit for the identification of an exogenous event.

272. Other parties did not comment on the need to identify an exogenous event.

273. The Commission is of the view that in order to ensure fairness to all stakeholders, the Companies should be required to notify the Commission of all proposed exogenous adjustments as soon as possible after they have been identified. The Commission shares the concern voiced by TELUS Québec that 30 days may not allow enough time to identify and analyze the impacts of any potential exogenous adjustment. Therefore, Télébec and TELUS Québec are required to notify the Commission of any proposed exogenous adjustment within 60 days of the event's occurrence. Other parties who believe an exogenous adjustment is required should notify the Commission as soon as possible after they learn of the relevant facts.

274. The Commission also concludes that the impact of any proposed exogenous adjustments should be initially captured in a separate deferral account pending a ruling from the Commission as to its applicability. The impact of any proposed adjustment is to be measured from the time the event occurred. The disposition of the deferral account would follow the Commission's ruling on the proposed exogenous adjustment.

V Quality of service

The current regime

275. The Commission has had a quality of service monitoring regime in place since 1982. In Decision 94-19, the Commission decided it was necessary to review that regime in light of the introduction of facilities-based competition and the proposed shift to a price cap regulatory regime for the large ILECs.

276. In *Quality of service indicators for use in telephone company regulation,* Telecom Decision CRTC 97-16, 24 July 1997 (Decision 97-16), the Commission set out its revised regime for the monitoring and reporting of quality of service by the large ILECs (except SaskTel). Under this regime, ILECs must file quarterly reports on performance of approved quality of service indicators. An ILEC that does not meet the approved standard for a particular indicator for three consecutive months or seven out of twelve consecutive months is required to report that indicator's performance monthly, rather than quarterly until such time as performance has met or exceeded the approved standard for three consecutive months. In addition, the ILEC is required to explain the reasons for non-compliance and provide a detailed plan describing how it intends to rectify the situation and prevent it from recurring.

277. Since 1998, Télébec and TELUS Québec have filed quality of service reports as required by Decision 97-16. Those reports indicated that quality of service problems occurred during much of the period from 1998 to 2000 for each of the Companies.

278. In PN 2001-36, parties were invited to comment on the appropriateness of implementing a quality of service component or other regulatory mechanisms in the price cap regime (e.g., targeted refunds) in order to address quality of service issues.

Positions of parties on the need for changes to the regime

279. The Companies expressed the view that the current monitoring regime was sufficient to ensure quality of service.

280. Télébec submitted that its performance was and had been excellent, considering its low density of population, its weather and geographical conditions. Télébec stated that it did not adjust its reports to take into account weather conditions and noted that its service quality had been like that of other ILECs on some indicators.

281. Télébec submitted that the indicators established by the Commission were exhaustive in their coverage and were all that the Commission required to assure itself that service quality was being maintained. In the company's view, under the current regime, the Commission had all the powers necessary to inquire into service quality issues and, if necessary, impose sanctions.

282. Télébec submitted that the introduction of local competition would, in and of itself, act as an incentive to provide quality service, and that adding safeguards to the existing regime would result in an undue level of regulation and bureaucracy. The company also argued that it was not necessary to link quality of service with the price cap regime because the Terms of Service in its General Tariffs provide a mechanism for compensating customers.

283. TELUS Québec submitted that it was delivering very high quality customer service and that there was no need to establish a quality of service component in the price cap regime. In its view, the current regime effectively protected the interest of consumers and assured the maintenance of an appropriate level of service quality.

284. TELUS Québec argued that there was no relationship or link between quality of service and price caps. The company submitted that any reductions in service quality that may have been observed in other serving territories were likely due to the impacts of the introduction of competition, industry rationalization and restructuring, and that these adverse consequences were temporary. TELUS Québec argued that it would be premature to conclude that the introduction of local competition in its serving territory would have a negative effect on the quality of service.

285. TELUS Québec argued that market forces, combined with the established indicators, would ensure that service quality would be maintained. In the company's view, quality of service was at the heart of its business because, by building a good relationship with its customers, it improved its chances of retaining customer loyalty. The pressures of present and future competition, in TELUS Québec's view, would provide a sufficient incentive to maintain its high quality service.

286. TELUS Québec submitted that, if the Commission were to require a higher level of service, it would have to adjust its cost of doing business, which would impact part of its submissions in this proceeding.

287. ARC et al. submitted that there was a need to establish, for Télébec and TELUS Québec, the same quality of service component as the Commission established for the other large ILECs pursuant to the PN 2001-37 proceeding.

288. ARC et al. argued that competition in Télébec's territory would be limited to urban centres and that, under a price cap regime, the Companies would have an incentive to cut their cost of doing business which would have a negative impact on quality of service.

The Commission's conclusions regarding the need for change

289. The quality of service standards established by the Commission are intended to be the minimum level of performance for each associated indicator. The Commission notes that, during the period from 1998 to 2001, although the service levels delivered by Télébec were markedly better than those delivered by TELUS Québec, overall service quality performance of the Companies, like that of the other large ILECs, was significantly below standard and, in the Commission's view, not satisfactory.

290. The Commission is not persuaded that competitive pressures in either the retail or competitor services markets will be sufficient to ensure that the Companies meet approved service quality standards. The Commission notes that, even where limited local competition has taken hold in the operating territories of the other large ILECs, service quality has been below standard. In the Commission's view, under the price regulation regime for the Companies, the drive to improve earnings at the expense of quality of service would not be adequately offset by competitive pressures.

291. The Commission notes that TELUS Québec suggested it would have to adjust its cost of doing business if the Commission were to require a higher level of service. As set out below, the Commission is not changing the level of service expected of the Companies and is maintaining the quality of service indicators that have been applicable for the past several years.

292. The Commission disagrees with Télébec's submission that the Terms of Service are sufficient for the purposes of quality of service. The quality of service indicators focus on issues which are not addressed in the Terms of Service and hence, a quality of service component in price cap regulation would not duplicate the Terms of Service.

293. In light of the above, the Commission considers that the existing monitoring regime is not sufficient to ensure that the Companies' service quality performance meets the Commission's approved standards. In the Commission's view, it is necessary to establish incentives to ensure the Companies' compliance with quality of service performance standards for services provided to the Companies' own customers, as well as services that would be provided by the Companies to competitors.

Classification of services for a quality of service mechanism

294. TELUS Québec submitted that no change to the current regime was required. However, the company argued that if the Commission deemed a new quality of service mechanism to be necessary, it should be in the form of direct rebates to customers who actually suffered substandard quality of service. This would require the mechanism to distinguish between residential and business customers and competitors.

295. No other party commented specifically on the classification of services for the purposes of a quality of service mechanism.

296. The Commission notes that the current retail quality of service indicators are not reported by customer type. The Commission notes that establishing separate quality of service components for business and residential services would require separate monitoring and reporting of indicator results.

297. The Commission believes that the costs associated with establishing separate business and residential mechanisms outweigh the potential benefits. The Commission has therefore determined that a single quality of service mechanism should be established to cover both residential and business services.

298. As far as competitor services are concerned, the Commission notes that most of the competitor indicators, established in previous decisions including those to be effective for the Companies on 1 September 2002, will be reported by customer. The Commission is of the view that this monitoring and reporting regime for competitor services remains appropriate. Accordingly, the Commission has decided to establish a separate quality of service mechanism for competitors.

Form of quality of service mechanism

Q-factor

299. One of the issues in this proceeding was whether there should be a quality of service component (or Q-factor) incorporated in the price cap formula. A Q-factor is a numerical factor which reflects the compliance (or non-compliance) of the regulated company with quality of service standards. The inclusion of a Q-factor in a price cap formula permits quality of service performance to have a direct effect on the pricing constraints.

300. The Companies did not support the use of a Q-factor as the remedy for substandard quality of service. Télébec argued that a Q-factor would be complex and would add an additional layer of regulation. TELUS Québec submitted that a Q-factor would be inappropriate because, in its view, it would have no effect on customer satisfaction. TELUS Québec also argued that a Q-factor would be inappropriate because a single below-standard performance, which might only reflect a single occasion, could have a long term negative effect on the income of the company. In addition, TELUS Québec argued that a Q-factor would constitute a burden on the company without ensuring that the subscribers who suffered a temporary reduction in quality of service were actually

compensated. Finally, TELUS Québec submitted that there was no relationship between a Q-factor and quality of service because, regardless of the introduction of a Q-factor, the focus of the company was and would continue to be the delivery of quality service.

301. The Commission considers that, if a Q-factor were in place, substandard performance would result in rate reductions by the ILEC. In such a situation, the Commission considers that customers might delay or refrain from moving to competitors while awaiting, and obtaining, the benefit of the reduced rates.

302. In the Commission's view, a Q-factor could have a distorting effect on competition and, therefore, would be less suitable for use as a quality of service component than other possible mechanisms. The Commission also notes that a Q-factor would not provide a competitor-specific remedy for non-compliance with competitor indicators. In light of these considerations, the Commission has decided not to include a Q-factor in the price regulation regime for the Companies.

Approaches to rate adjustments for residential and business customers

303. Parties to the proceeding identified two forms of rate adjustments for residential and business customers as possible alternatives to a Q-factor. The first would involve customer-specific rate adjustments and would be structured to provide compensation only to each customer actually affected by a service quality failure. The second approach would not be customer-specific but instead would provide for rate adjustments either to the aggregated class of residential and business customers or separately to residential and business customers as distinct classes.

304. Télébec opposed customer-specific rate adjustments, such as the targeted rebates proposed by TELUS Québec. Télébec argued that a rate adjustment plan would not be appropriate because it would duplicate rebates that were already provided for in its General Tariff. Télébec submitted that its employees were already empowered to deal with problems on a case-by-case basis and that customer satisfaction surveys indicated no customer dissatisfaction. Télébec also argued that a rate adjustment plan would be expensive to establish and administer and, yet, there would be no assurance it would respond to the needs of customers.

305. TELUS Québec stated that, if the Commission mandated a rate adjustment mechanism, the company would prefer a customer-specific rate rebate approach for business and residential customers. Under TELUS Québec's approach, the company would provide rebates solely to those customers that suffered quality of service degradation as measured by certain specific indicators. Only indicators that could measure effects on individual customers would be included. TELUS Québec submitted that its approach would be appropriate because it would constitute, in effect, a market response rather than a regulatory penalty.

306. ARC et al. stated that it would not oppose the further study of targeted rebates in a consumer rights proceeding. However, it was of the view that, if the Commission were to adopt this approach, interim measures would be necessary. In ARC et al.'s submission, the Commission should establish the same mechanism for the Companies as would apply to the other large ILECs.

307. The Commission notes that a customer-specific rebate plan would not be compatible with several of the established indicators for business and residential customers, which do not measure customer-specific performance. The Commission also considers that it would be highly impractical, in light of the administrative burden, to track an indicator's results customer by customer. The current Commission-approved indicator results are reported in aggregate for non-competitor customers. As a result, adopting the TELUS Québec approach would require changes to the definition and application of most, if not all, of the non-competitor service quality indicators.

308. On the other hand, a customer non-specific rate adjustment scheme for residential and business customers, as a single group, would be administratively reasonable since the same quality of service indicators are used by the Companies for both types of customers.

309. In light of the above, the Commission considers that a customer non-specific rate adjustment approach is the most appropriate quality of service mechanism for ILEC business and residential customers.

Rate adjustment plan for residential and business customers

310. As indicated above, neither Télébec nor TELUS Québec specifically addressed issues regarding rate adjustment plan models for residential and business customers.

311. ARC et al. submitted that the Commission should impose on the Companies, the same rate adjustment plan as ARC et al. proposed for the other large ILECs in the PN 2001-37 proceeding.

312. In Decision 2002-34, the Commission adopted, on an interim basis, a rate adjustment plan based primarily on ARC et al.'s proposal for the other large ILECs. However, the Commission considered it necessary to explore certain aspects of the rate adjustment mechanism in greater detail before establishing a plan on a final basis.

313. The Commission notes that Télébec and TELUS Québec are currently subject to the same quality of service standards as the other large ILECs. In the Commission's view, it is also appropriate to adopt the same remedial approach to the Companies as was adopted for the other large ILECs in Decision 2002-34.

314. Accordingly, the Commission approves on an interim basis, effective 1 October 2002, the rate adjustment mechanism adopted in Decision 2002-34 for business and residential customers of Télébec and TELUS Québec. The mechanism is to be based on a maximum annual adjustment of 5% of total annual business and residential local revenues. This

revenue base is not to be restricted to local exchange services; it is to include revenues from all other local retail business and residential services that are not forborne. Worksheets for the calculation of rate adjustments are presented in Appendix 1 to this Decision. Sample calculations are also included. Any rate adjustments flowing from this interim regime will be addressed in the follow-up proceeding.

315. The Commission is of the view that periodic audits of quality of service results would enhance the effectiveness of the rate adjustment plan. The Commission will gather input from parties on the methodology of an audit process, in the proceeding to establish a final retail quality of service regime. The Commission will issue a public notice shortly, initiating this process.

Rate adjustment plan for competitors

316. None of the parties specifically addressed the issue of a rate adjustment plan for competitors.

317. Télébec opposed the general concept of a customer-specific rebate plan on the grounds that it would be expensive to establish and administer, and it would be duplicative of the refund provisions in its Terms of Service.

318. TELUS Québec argued that if the Commission were to conclude that a quality of service component were required, then the most appropriate mechanism would be a customer-specific rebate plan.

319. ARC et al. submitted that the quality of service regime for the Companies should be as similar as possible to the regime the Commission implements for the other large ILECs in the PN 2001-37 proceeding.

320. In Decision 2002-34, the Commission established, on an interim basis, a rate adjustment plan for competitors based primarily on the proposal submitted by GT Group Telecom Services Inc. The plan, as approved, provides for a rate adjustment mechanism which is triggered when there is substandard performance with respect to one or more competitor-specific indicators.

321. As stated in Decision 2002-34, it is the Commission's view that for competition to succeed, competitors must be able to provide service to their customers of a quality that is comparable to that which the ILECs provide to their own customers. If a competitive local exchange carrier (CLEC) cannot provide comparable quality of service, it will not be able to compete effectively. Further, CLECs must be able to quickly correct substandard service to their customers if they are to be able to retain customers and minimize any possible customer rebates.

322. Given the importance of ILEC quality of service to the introduction of local competition, the Commission considers it necessary to implement a rate adjustment mechanism for competitor services. However, the Commission also believes it is necessary to explore certain aspects of a rate adjustment mechanism in greater detail before establishing a

plan on a final basis. Consequently, the Commission will initiate a follow-up proceeding for this purpose in the near future. In the meantime, the Commission considers that an interim mechanism is required.

323. Accordingly, the Commission has decided to establish, effective 1 October 2002, an interim competitor-specific rate adjustment plan that is the same as the plan established in Decision 2002-34. A description of the interim rate adjustment plan, including worksheets, is set out in Appendix 2 to this Decision.

324. As provided for under the retail quality of service regime, the Commission is of the view that an audit process should be incorporated into the rate adjustment plan for competitors. The Commission will consider proposals for the methodology of an audit process, in the proceeding to establish a final competitor quality of service regime.

VI Consumer service issues

Background

325. In PN 2001-36, the Commission invited comments on the extent to which the Companies' adherence to benchmarks for consumer service, such as billing policies or a consumer bill of rights (CBOR), should be linked to the price regulation regime and what form any such benchmarks might take.

Consumer bill of rights

326. ARC et al. submitted that the presentation of consumer rights was scattered over several pages of the telephone directories, and that much of the information was written in legal style. According to ARC et al., this could be frustrating for a large number of consumers. To rectify this situation, ARC et al. suggested that the Commission require the publication of a CBOR, setting out the basic rights of consumers in plain language, without technical or legal expressions.

327. ARC et al. proposed that the CBOR be linked to the price regulation regime by a Q-factor, with the mechanism to be defined at a subsequent proceeding. ARC et al. requested the Commission to initiate a public process to consider the CBOR proposal, and also proposed that the proceeding be used to clarify the language of the Companies' Terms of Service.

328. ARC et al. submitted that the CBOR for Télébec and TELUS Québec should be identical to the CBOR for the other large ILECs.

329. Télébec argued that consumer rights were explained well in the introductory pages of its directories, and that the Terms of Service constituted an existing CBOR. Télébec submitted that there should be no link between the price regulation regime and the CBOR.

330. Télébec submitted that there was no need for a broad public hearing on the CBOR issue, and recommended that the CRTC Interconnection Steering Committee be used to clarify the introductory pages of the directory.

331. TELUS Québec submitted that many consumer rights were already set out in the Terms of Service published in telephone directories, and that a separate CBOR was unnecessary.

332. TELUS Québec argued that ARC et al.'s request for a proceeding on consumer rights and its comments regarding that proceeding constituted additional evidence, since ARC et al.'s full proposal had only been filed in the PN 2001-37 proceeding.

333. In the Commission's view, ARC et al. has raised an important issue for consumers. The white pages and the Terms of Service are not always easy to understand, nor do they contain all the rights of consumers. The Commission agrees with ARC et al. that consumers would benefit from a comprehensive and concise statement of consumer rights.

334. Given that the Terms of Service and the rights of consumers are essentially the same for all ILECs, the Commission concludes that the CBOR should also be essentially the same for all large ILECs.

335. The Commission does not agree with TELUS Québec's argument that ARC et al.'s proposal constitutes additional evidence. ARC et al.'s submission on this issue was included in its final argument, giving other parties a reasonable opportunity to respond in their final reply arguments.

336. In Decision 2002-34, the Commission announced that it would hold a proceeding on the development of a CBOR. That proceeding would also determine whether it was necessary to review the Terms of Service. The Commission intends to make Télébec and TELUS Québec parties to that proceeding.

Billing policy issues

337. ARC et al. submitted that billing policy should be one of the issues considered in its proposed consumer rights proceeding.

338. In Decision 2002-34, the Commission required Bell Canada and Aliant Telecom to show cause why they should not send monthly itemized billing statements to their customers. The Commission is of the preliminary view that the practice of sending monthly itemized billing statements to customers should be extended to the Companies. Accordingly, the Commission directs Télébec and TELUS Québec to show cause, by 30 August 2002, why they should not be directed to send their customers monthly itemized billing statements at the same level of detail as is currently provided on an annual basis, copying parties to the proceeding leading to *Commission modifies reporting requirements for affordability*, Order CRTC 2000-393, 10 May 2000

(Order 2000-393). Any interested parties may file comments on the Companies' responses to this direction to show cause by 10 September 2002, copying parties to the proceeding leading to Order 2000-393. Télébec and TELUS Québec may file reply comments by 20 September 2002, copying those interested parties who filed comments. All material must be received, not merely sent, by these dates.

339. In Decision 2002-34, the Commission also decided that issues relating to the content of billing statements should be addressed by the Committee on Bill Management Tools and Access to Telephone Service (the BMT Committee) established by Order CRTC 2000-393. The Commission directs Télébec and TELUS Québec to participate in the BMT Committee's work on billing issues.

VII Service improvement plans

Background

340. In Decision 99-16, the Commission examined the level of telecommunications service in Canada and concluded that it was, in general, very high. The noted exceptions were HCSAs which are generally found in remote, rural regions and in the far north. Telephone service to these areas generally costs more to provide and is often of lower quality than service in other regions.

341. In light of the lower service levels in some areas, the Commission decided it was appropriate to define a BSO which set a basic level of telephone service that the Commission would attempt to ensure is available to the public throughout Canada.

342. In Decision 99-16, the Commission defined the BSO as comprising:

a) individual line local service with Touch-Tone dialling, provided by a digital switch with capability to connect via low-speed data transmission to the Internet at local rates;

b) enhanced calling features, including access to emergency services, Voice Message Relay service, and privacy protection features (included in call management services);

c) access to operator and directory assistance services;

d) access to the long distance network; and

e) a copy of a current local telephone directory.

343. The Commission then set three goals for service improvement in HCSAs:

- to extend service to the few areas that are unserved;

- to upgrade service levels in those areas where customers do not have access to telecommunications services which meet the BSO (i.e., underserved areas); and

a) to maintain service levels, and ensure that existing levels do not erode under competition.

344. In order to implement these goals, the Commission directed all ILECs to file SIPs for approval, or to demonstrate that the BSO has been and will continue to be achieved in their territory. ILECs were required to consult stakeholders prior to preparing their SIPs.

345. The Commission also stated that it would require the ILECs to provide a tracking plan to monitor SIPs as they are implemented.

346. In connection with the design of a SIP, the Commission decided that where construction is taking place in a specific area pursuant to the SIP, the customer's contribution to the costs should not exceed $1,000 per customer premises. Furthermore, where payment instalment plans are not available in a company's tariffs, the Commission directed the ILECs to file with their SIPs, proposed tariffs giving customers the option to pay for extensions on a reasonable basis.

347. The Commission also required the SIPs to incorporate least-cost technology, target larger communities or areas first, serve unserved areas prior to providing upgrades, and serve permanent dwellings before seasonal ones.

348. In PN 2001-36, the Commission directed Télébec and TELUS Québec to file SIP proposals which would include the following: SIP roll-out plans; forecasts of capital expenditures for each year of the SIP; any related operating costs; and associated revenue requirement impacts and SIPs cost recovery proposals. The Commission indicated that it would review the Companies' SIPs to ensure that Télébec and TELUS Québec were meeting the BSO and other key elements of Decision 99-16.

Télébec's SIP proposal

349. On 6 July 2001, Télébec filed its SIP proposal. Télébec proposed to provide service to 194 unserved dwellings for total capital expenditures of $149,000. On 9 November 2001, Télébec revised its SIP proposal to extend service to 327 dwellings requiring capital expenditures of $344,000. The company included in its going-in revenue requirement an annual expense of $36,000 related to its SIP proposal.

350. In preparing its SIP, Télébec conducted a sample survey of premises whose prior requests for service were denied by the company. In addition, the company published information on its SIP in 22 local newspapers covering its territory. Based on the survey

results, Télébec proposed a construction cost limit of $5,000 per permanent and seasonal dwelling, including a maximum $1,000 customer contribution. The company stated that any higher construction cost limits would result in rate increases to current subscribers.

351. With respect to the $1,000 maximum customer contribution, Télébec proposed that premises receiving service under the SIP should pay a deposit of $100 before work commences, and the remainder in eleven equal monthly instalments.

352. Télébec indicated that respondents to its survey cited the cost of obtaining service and the possibility of obtaining wireless service as reasons for stating that they would not be participating in its SIP. Télébec also stated that several of its urban customers expressed concerns that additional rate increases could be triggered by extending service in remote areas.

353. Based on the results of its survey, Télébec expected that about 21% of unserved permanent dwellings and 11% of unserved seasonal dwellings would elect to receive wireline service if it became available. Télébec submitted that, in view of the widespread use of wireless communications, the participation rates used in its SIP were realistic.

354. In response to Commission interrogatories, Télébec provided data regarding the number of unserved premises which would be captured under its SIP if the capital cost criterion varied. The company indicated that there were 22 premises that exceeded a capital cost limit of $25,000. According to Télébec, the average capital cost to provide service to these premises would be $85,000.

355. The James Bay Cree Communications Society, the Grand Council of the Crees and the Cree Nation of Chisasibi indicated that the SIP proposed by Télébec did not address their concerns with respect to the lack of Internet access, the organization of the telephone book and the lack of 9-1-1 emergency service.

356. In reply, Télébec submitted that its network could support Internet access in all locations, but there were no Internet Service Providers (ISPs) offering Internet services in the localities identified by the interveners. Télébec also submitted that its network was capable of providing 9-1-1 service in all locations. The company indicated this service would be provided following receipt of a formal request. With respect to the organization of the telephone book, Télébec indicated that its telephone book was organized along the lines of its administrative regions while the interveners wanted it to be organized on the basis of the relevant Cree communities.

TELUS Québec's SIP proposal

357. TELUS Québec did not include any capital expenditures for unserved premises in its SIP proposal. The company submitted that its previous regulator, the Régie des télécommunications du Québec, had required it to make single-line service available throughout its territory and, as a result, the company had no unserved areas. TELUS

Québec submitted that service extensions in served areas should continue to be governed by the current provisions in the company's tariffs. Pursuant to its tariffs, TELUS Québec is required to pay up to $2,500 in construction costs, and the new subscriber is responsible for any costs in excess of this amount.

358. At the oral public hearing, TELUS Québec acknowledged that there might be unserved premises in its territory. The company also indicated that it had not reviewed past service requests to determine whether those persons who had requested service might wish to be included in the company's SIP proposal.

359. In regard to underserved premises, TELUS Québec proposed a plan to meet the BSO in l'Île-aux-Grues, Grosse-Île and Aylmer Sound. TELUS Québec also proposed to relieve network congestion caused by high Internet usage in the Basse-Côte-Nord and other HCSAs.

360. Other parties did not comment on TELUS Québec's SIP proposal.

361. In response to an application by TELUS Québec for an expedited decision on the company's SIP proposal, the Commission rendered *TELUS Communications (Québec) Inc.'s proposed service improvement plan*, Telecom Decision CRTC 2002-16, 19 March 2002 (Decision 2002-16). In that Decision, the Commission approved the company's capital expenditures required to meet the BSO in l'Île-aux-Grues, Grosse-Île and Aylmer Sound. The Commission also approved the capital expenditures required to relieve network congestion but held that these expenditures did not qualify as a SIP since they did not relate to the BSO.

362. In Decision 2002-16, the Commission indicated that both approved expenditures should be included as part of the company's going-in revenue requirement. The Commission also indicated that the recovery of the SIP and the network improvement capital expenditures would be addressed in this Decision. Finally, the Commission directed TELUS Québec to consult with stakeholders, to identify unserved dwellings, to propose a SIP addressing the requirements of unserved dwellings and to file a follow-up SIP by 20 December 2002.

Conclusions

363. Based on its examination of the Télébec and TELUS Québec SIPs, the Commission finds that, as required by Decision 99-16, they: (a) use least-cost technology; (b) provide a tracking plan; and (c) generally comply with the BSO, except as discussed below.

364. The Commission has identified a number of issues which are common to the SIPs under consideration as they relate to unserved premises:

- the capital cost criteria;
- the take rates used when estimating the cost of a SIP;
- the terms of an appropriate instalment payment plan for the $1,000 customer

contribution;

- the requirement for an instalment payment plan for large construction charges;
- roll-out plans;
- tracking plans; and
- tariff pages.

365. The Commission also addresses issues related to Internet access and the cost recovery of current and follow-up SIP proposals.

366. The Commission's determinations on each of these issues are set out in the following paragraphs.

Capital cost criteria

367. Télébec proposed a capital cost limit of $5,000 per permanent and seasonal dwelling. Télébec submitted that its subscribers already faced the highest local rates in Canada, even without factoring in the possible rate impact of the SIP. Télébec stated that its proposed capital cost limit was nearly twice the $2,600 that the company contributed to service extensions under its current tariff. Télébec also submitted that the capital cost limits proposed by Bell Canada and TELUS in the PN 2001-37 proceeding would likely result in rate increases for its subscribers if these limits were applied to its SIP.

368. TELUS Québec submitted that the capital cost limits of $25,000 per permanent dwelling and $5,000 per seasonal dwellings that were proposed by Bell Canada in the PN 2001-37 proceeding, would not be appropriate for TELUS Québec. The company stated that there were numerous unserved localities in Bell Canada's territory, and that many of Bell Canada's unserved localities would qualify for service at the capital cost limits proposed by Bell Canada. By contrast, TELUS Québec provided service to all localities in its territory, and only a few localities did not have acceptable access to the Internet. Furthermore, TELUS Québec's rates would likely increase if it were required to adopt the capital cost limits proposed by Bell Canada. TELUS Québec also expressed concerns that low income customers in its territory may have to subsidize the provision of telephone service to secondary residences like cottages if its SIP proposal were modified to incorporate higher capital cost limits.

369. The Commission notes that it is often difficult to differentiate between permanent and seasonal premises. In addition, the status of a particular dwelling could change. Accordingly, the Commission is of the view that the capital criteria should be the same for seasonal and permanent premises.

370. In *Long distance competition and improved service for Northwestel customers*, Decision CRTC 2000-746, 30 November 2000, the Commission approved a capital cost limit of $25,000 for unserved premises, with no distinction between permanent and seasonal premises. The Commission adopted the same approach for the other large ILECs in Decision 2002-34. In both cases, the customer was required to pay the first $1,000 of capital costs, as decided by the Commission in Decision 99-16.

371. In the Commission's view, it would be appropriate to approve capital cost criteria which would ensure that service is provided to as many unserved premises as is reasonably possible over the next four years. The Commission notes, as discussed later in this Decision, that monies will be available to offset the costs of the SIPs without rate increases to customers.

372. In light of the above, the Commission finds that the capital cost criterion of $25,000 for both permanent and seasonal premises is appropriate for both Télébec and TELUS Québec. In accordance with Decision 99-16, the customer would be required to contribute $1,000 toward the capital costs.

Take rates

373. As noted above, when estimating the cost of the SIP, Télébec used take rates of 21% for permanent dwellings and 11% for seasonal dwellings. TELUS Québec's proposal did not address this issue.

374. The Commission considers that it would be appropriate to assume a take rate which reflects the maximum extension of service, thereby ensuring that funding is available for the maximum number of unserved premises which meet the capital cost criteria.

375. Accordingly, the Commission concludes that the total cost of the SIPs for Télébec and TELUS Québec is to be calculated using a 100% take rate in each locality.

Instalment payment plan for $1,000 customer contribution

376. In Decision 99-16, the Commission decided that a new customer should pay up to a $1,000 contribution towards the capital costs. The Commission also directed the ILECs to file an instalment payment plan with their SIPs, unless such plans were already available in the company's tariffs.

377. Télébec proposed an instalment payment plan that would require a customer to pay a deposit of $100, with the balance payable in 11 equal monthly instalments.

378. In light of its objective to extend service to as many unserved premises as possible, the Commission considers Télébec's proposal to be appropriate.

379. TELUS Québec did not address this issue in its SIP proposal.

380. Accordingly, the Commission directs TELUS Québec to institute an instalment payment plan that is the same as Télébec's plan.

381. The Commission notes that the Companies would be allowed to charge their tariffed late payment interest rate for late payment of instalments that are due each month. Each of the Companies should file their instalment payment plan with the Commission for approval as part of their follow-up SIP proposal.

Instalment payment plan for large construction charges

382. The Commission notes that even with the approved capital cost limit, a number of unserved premises would still not qualify for service. The Commission is of the view that it would be appropriate for the Companies to offer a plan whereby the customer could pay an amount over and above the $1,000 maximum customer contribution whenever the cost of a service extension exceeds the $25,000 capital cost limit. For example, if the cost to serve a premises were $34,000, then the cost to the customer would be $10,000 (i.e., $1,000 + [$34,000-$25,000]).

383. Accordingly, the Commission directs Télébec and TELUS Québec to notify any premises that do not currently qualify for service under the SIP that the occupants of the premises can pay the additional costs to obtain service. These costs would be described as large construction charges.

384. In the Commission's view, it would also be appropriate to institute an additional instalment payment plan that would enable customers to pay for large construction charges over a reasonable period of time. This would mitigate the disincentive to take service because of a high up-front cost.

385. In Decision 2002-34, the Commission required the other large ILECs to adopt a large construction instalment plan with the following terms:

    a) instalments may be spread over a period of up to 36 months;

    b) interest is charged on the unpaid balance of construction charges at a rate of the company's cost of capital;

    c) a minimum deposit of 20% of the construction charge is to be paid prior to the start of the construction;

    d) maximum construction charges of $10,000 per customer premise (calculated as the difference between the actual construction charges and $24,000) are eligible for the instalment payment plan; and

    e) the instalment plan is available to residence customers only.

386. The Commission directs Télébec and TELUS Québec to adopt this instalment plan for the period of the SIP roll-out. Each of the Companies should file its large construction instalment plan with the Commission for approval as part of its follow-up SIP proposal.

387. The Commission also wishes to explore an instalment payment plan for large construction charges greater than $10,000 per customer premise. Accordingly, Télébec and TELUS Québec are directed to file such a plan, as part of their follow-up SIP proposals, for Commission consideration.

Roll-out of SIPs

388. In light of the above, the Commission directs Télébec and TELUS Québec to start a project in a locality if it meets the following criteria: (a) the maximum average cost per premises is $25,000 using a 100% take rate, and (b) at least one customer requests service and is willing to contribute $1,000. The Commission directs the Companies to start with those localities that have the highest demand.

389. Télébec proposed to roll out its SIP in 2002. However, in view of the expanded scope of the SIP as determined in this Decision, the Commission directs Télébec to file for approval a revised roll-out plan as part of its follow-up SIP proposal discussed later in this section.

390. In Decision 2002-16, the Commission directed TELUS Québec to file, by 20 December 2002, a further SIP to extend service to unserved dwellings. With its filing, the company should include a proposed roll-out plan for the expanded SIP.

Tracking plans

391. Télébec proposed to file tracking reports before 1 April of each year, which would provide the following information:

a) a list of exchanges where extension projects are forecast;

b) a list of exchanges where extension projects are completed, and exchanges where the work is forecast to complete in the current year; and

c) total capital expenditures for the year.

392. TELUS Québec proposed to file tracking reports on 1 June of each year, which would provide the following information:

a) work completed the previous year;

b) work which was deferred to the current year;

c) summary of the work remaining for the SIP;

d) total capital expenditures for the year; and

e) if the company deems it necessary, an additional proposal which would meet the criteria for a SIP.

393. In Decision 2002-34, the Commission established tracking plans for the other large ILECs which were similar to the tracking plans approved for the small ILECs modified to add a number of reporting requirements to track the efficiency and effectiveness of the roll-out, as well as track additional premises that will be added to the SIPs. This information would be used to support a request for additional capital funding.

394. The Commission finds it appropriate that tracking plans be consistent amongst ILECs. Therefore, the Commission directs Télébec and TELUS Québec to file, by 31 March of each year, the following tracking information:

a) a list of localities scheduled for completion in the previous year and those actually completed;

b) the forecast and actual number of premises to which service was upgraded or was made available in the previous year;

c) the total capital investment for the previous year;

d) the projected service upgrades and extensions for the upcoming year;

e) any changes to the yearly program with supporting reasons;

f) operating expenses for the previous year related to the SIP;

g) the number and location of new customers requesting service;

h) the number of customers whose past requests have been reassessed and now qualify for service;

i) the number of customers requesting service who do not qualify because of cost;

j) the number of customers who have been offered service but refused because of cost;

k) the status of new ISPs locating in upgraded exchanges; and

l) the status of a new plan to serve residents in those remaining exchanges that currently do not have access to the Internet via a local call, using new or alternative technologies.

Tariff pages

395. Neither Télébec nor TELUS Québec proposed to submit tariffs implementing its SIP for approval. Nonetheless, as part of the Companies' follow-up SIP proposals, the Commission directs Télébec and TELUS Québec to file tariff pages to implement the Commission's determinations related to its SIP. These tariff pages should include:

- the SIP period;

- conditions for a project start up ($25,000 capital criterion, 100% take rate and one customer service request);

- the instalment plan for the $1,000 customer contribution;

- the treatment of new premises built during the roll-out period;

- the reassessment of premises denied in the past;

- the opportunity for customers to pay additional charges in the case of large construction projects;

- the instalment plans for large construction charges; and

- the treatment of service requests in localities already established before the commencement of the SIP.

Internet access

396. As noted above, Télébec indicated that customers in some locations may not have toll-free Internet access available to them. In the Commission's view, the company should monitor this situation. If there is no ISP providing toll-free Internet access to these locations by the second quarter of 2003, the Commission will consider whether Télébec's obligation to serve includes an obligation to provide toll-free access to the Internet.

Follow-up SIP proposals

397. As indicated above, the Commission has altered the criteria applicable to Télébec's SIP. Under these revised criteria, more dwellings should qualify for service. The Commission directs Télébec to file, by 31 October 2002, a revised SIP proposal showing the dwellings included in the SIP and the capital expenditures by year over the price regulation period. In addition, the dwellings and capital expenditures should be segregated between HCSAs and non-HCSAs. The company should also provide all assumptions, including the percentage penetration forecast for subscribers who will take the service.

398. In Decision 2002-16, the Commission directed TELUS Québec to consult with stakeholders and to submit a further SIP by 20 December 2002. The company's follow-up SIP should comply with the criteria established above.

SIP cost recovery

399. In Decision 99-16, the Commission determined that SIPs should include proposals to fund service improvements. The Commission noted that ILECs could fund SIPs in a number of ways, including through rate increases. The Commission stated that when funding proposals included rate increases, a reasonable balance should be achieved between the speed and cost of implementation and the need to maintain affordable rates.

400. The Commission finds that the expenses to extend services to unserved dwellings, estimated by Télébec at $36,000, are reasonable. These expenses have been included in the company's going-in revenue requirement.

401. As noted above, in Decision 2002-16, the Commission approved TELUS Québec's proposed capital expenditures for underserved premises, together with certain capital expenditures for network improvements and determined that these expenditures should be included in the calculation of the company's going-in revenue requirement.

402. As far as the follow-up SIPs are concerned, the Commission notes that the price regulation regime approved in this Decision is similar to the regime for the other large ILECs in Decision 2002-34. In that Decision, the calculation of the TSR for the other larger ILECs includes SIP-related costs for HCSAs. Since the Commission determined in Decision 2002-34 that it was not appropriate to increase rates to recover the SIP-related costs in HCSAs, the Commission considers that the Companies' SIPs in HCSAs should be funded from the NCF. Accordingly, each company is directed to add its Phase II SIP costs for HCSAs to the costs that flow into its TSR calculation.

403. With respect to non-HCSAs, the Commission considers that funds accumulated in the deferral account established in Part III of this Decision can be used to compensate the Companies for expenditures associated with their SIPs in non-HCSAs.

404. The Commission directs each of the Companies to identify, at the time that it files its follow-up SIP proposal, pursuant to the determinations in this Decision, the related Phase II SIP costs. These Phase II costs should be separated by HCSAs and non-HCSAs.

VIII Going-in revenue requirement

Methodology

Background

405. A revenue requirement is the amount of revenue that a regulated company needs in a given year to recover its operating expenses and capital and financial costs, including a reasonable return on shareholders' equity. The revenue requirement is then used to set a company's rates.

406. The objective of the Commission's financial review in the present proceeding was to set just and reasonable rates for both Companies, coincident with the implementation of price regulation (going-in rates). As indicated in PN 2001-36, the Companies' proposed going-in rates were assessed by examining the sum of any incremental revenue requirement impacts arising from material changes to the financial assumptions used to finalize the Companies' 2001 contribution requirements.

407. PN 2001-36 further stated that these material changes could include, but were not limited to, the following: a) any SIP proposals; b) any additional depreciation expense associated with proposed changes to average service lives; c) any changes to the allowed rate of return on common equity (ROE); d) net annualized impacts of pending and planned tariff items; e) adjustments for the amortization of any deferral accounts; and f) any proposed recovery of Phase III/Phase II contribution shortfalls that may be warranted.

408. The going-in revenue requirement methodology described in PN 2001-36 was similar to that used in calculating the going-in revenue requirement for the other large ILECs in Decision 98-2.

409. In the present proceeding, Télébec and TELUS Québec filed, as part of their price cap proposals, their going-in revenue requirements and associated going-in rates based on their 2001 proposed contribution requirements. The Companies' contribution proposals were then being considered in separate proceedings.

410. In *Télébec final 2001 contribution requirement and rate*, Order CRTC 2001-598, 26 July 2001, the Commission approved Télébec's 2001 contribution requirement of $27.3 million. In *TELUS Québec final contribution requirement and rate*, Order CRTC 2001-641, 10 August 2001 (Order 2001-641), the Commission approved adjustments to TELUS Québec's 2001 contribution calculations that resulted in an approved contribution requirement of $32.6 million. As a result, on 31 August 2001, TELUS Québec filed revised evidence and responses to interrogatories reflecting the new contribution requirement figures approved by the Commission.

Positions of parties

411. Télébec submitted a proposal that included rate increases for the first two years of its proposed four-year price cap plan. More specifically, Télébec proposed to amortize in the first year of its proposed four-year price cap period the balance of $5.1 million accumulated in its deferral account and to increase most residential rates by $3.33 in 2003 to offset the full depletion of its deferral account. Télébec also stated that it might propose further rate adjustments after it finalized its banding classification and applicable costs, and the Commission rendered its decision in the proceeding initiated by PN 2001-69.

412. TELUS Québec proposed that its revenue requirement be re-calculated each year based on proposed rate increases and certain revenue and expense adjustments. As a result of these proposed rate increases and other adjustments, the amount of subsidy payments from the NCF would gradually decrease to $5.9 million in 2005, the last year of the company's proposed price cap plan.

413. Other parties did not provide comments on the Companies' proposed going-in revenue requirement methodologies.

Conclusions

414. In the Commission's view, once price regulation is implemented, rates should be adjusted only in accordance with the regulatory framework. If rates were modified during the price regulation period based on other considerations, such as revenue and expense adjustments as suggested by the Companies, the regulatory framework would become a mix of price and earnings regulation, thereby undermining the benefits of price regulation.

415. The Commission considers that the methodology used to determine the going-in revenue requirement for Télébec and TELUS Québec should be similar to the methodology used to set the going-in revenue requirement for the other large ILECs (except SaskTel) in Decision 98-2. In that Decision, the going-in revenue requirement was calculated by taking the sum of the incremental changes to an ILEC's approved Utility Segment forecast (for example, additional depreciation expense from proposed changes to asset service lives). This calculation yielded the revenues that would be required from rate adjustments at the start of the price cap period.

416. The following sections discuss the application of this methodology to the Companies' price cap proposals.

Depreciation and related issues

Introduction

417. The Commission has developed its depreciation policy and practice within the Phase I Directives established in *Inquiry into Telecommunications Carriers' Costing and Accounting Procedures Phase I: Accounting and Financial Matters*, Telecom Decision CRTC 78-1, 13 January 1978 and subsequent decisions and orders. The Phase I Directives were designed to promote intergenerational equity between customers, and their main objective has been to recover the investment in plant and equipment equally over its useful service life.

418. Over the years, the Commission has issued specific directives on the procedures to be used by regulated carriers to determine how depreciation rates are calculated and how to account for over/under accruals. To date, the Commission has encouraged carriers to

develop depreciation life characteristics based on their own particular circumstances. The Commission has emphasized two main factors when determining depreciation life characteristics: historical retirement patterns and future expectations.

419. In PN 2001-36, the Commission directed the Companies to include in their price cap filings any proposed modifications to their depreciation expense and associated changes to asset service lives.

420. During this proceeding, Télébec maintained that, due to competitive and technological factors, there was a need to substantially reduce the service lives of some of its existing plant prior to the implementation of price caps. If these adjustments were accepted by the Commission, they would give rise to a Depreciation Reserve Deficiency (DRD), as the recovery of the value of the assets to date would be less than what would have been recovered had the proposed service lives been implemented when the assets came into service. The method for recovering the DRD would then have to be addressed when setting going-in rates for Télébec.

421. TELUS Québec did not propose any changes to the service lives of its plant. However, as discussed below, the company did propose an adjustment to the level of its depreciation expense for 2002.

Télébec's proposed changes to its depreciation life characteristics

Positions of parties

422. Télébec identified a number of asset accounts which, in its view, required adjustments to their depreciation life characteristics in light of technological changes and the advent of local competition. The company filed a depreciation study in support of its proposed changes. In total, the company's proposed changes would result in an increase in the going-in revenue requirement of $3.8 million.

423. Other parties did not provide comments on Télébec's proposed changes to the depreciation life characteristics of its accounts.

Account 225 – Circuit & TV

424. This account includes various transmission equipment in central offices, test panels, other centres and repeater stations together with fibre optic transmission equipment.

425. Télébec requested a service life reduction of four years to an Average Service Life (ASL) of 10 years for this account using an Iowa R-1 dispersion curve. To support its proposal, the company indicated that 25% of the assets consisted of obsolete analog equipment which was vulnerable to effects of new technology and competition. The company further noted that retirements of about $5 million made in 2001 were not included in its depreciation study.

426. The Commission notes that Télébec's historical analysis resulted in an ASL of 15 years for the 1998 to 2000 experience band. Although the impact of the retirements in 2001 was not evaluated by the company, the Commission did take this information into account in its analysis. The Commission considers that an ASL of 12 years would be more appropriate than either the 10 years proposed by Télébec or the current approved figure of 14 years, since 12 years would be more in line with historical data. Accordingly, the Commission approves an ASL of 12 years with an Iowa R-1 dispersion curve.

Account 226 – Radio

427. This account includes radio transmission equipment located in central offices, test centres and repeater stations. Télébec requested a service life reduction of four years to an ASL of 13 years for this account. The company noted that assets in this account, including analog equipment, were subject to increasing obsolescence as the present equipment line had been discontinued and was not expected to be supported starting in 2006. In Télébec's view, fibre-based facilities would replace parts of the old radio investment, and significant retirements should be expected in the near term. The company submitted that these retirements would affect a large portion of the investment added before the 1990s.

428. The Commission notes that historical analysis for this account resulted in an ASL of 11 to 12 years for the 1998 to 2000 experience band. The Commission considers that the proposed ASL of 13 years with an Iowa R-1 dispersion curve is a very close match to historical analysis. Therefore, the Commission finds the company's proposal to be reasonable and approves the proposed change.

Account 227 – Digital switching

429. This account comprises electronic digital multiplex switching (DMS) systems for local and toll services. Télébec requested a reduction of one year in the approved service life for this account to an ASL of 12 years.

430. Télébec submitted that its historical life analysis supported its proposed change. The company also argued that the life of DMS central processing units was similar to that of computers which was significantly shorter than the current approved life of 13 years. According to Télébec, the same was true of the lives of line and trunk peripherals.

431. Télébec argued that the present DMS technology and installed equipment had an increased exposure to obsolescence which was expected to continue for a variety of reasons, including: proliferation of the Internet protocol, the convergence of communications, computing, information and entertainment, the continued proliferation of fibre into the network, the explosive increase of the use of the Internet and the continuing local and global competitive pressures.

432. The Commission notes that Télébec's historical analysis resulted in an ASL of 11 to 12 years for the 1998 to 2000 experience band. Although the company's analysis did not reflect the retirement of 8% of these assets in 2001, the Commission took this information into account in its analysis. The Commission is of the view that the proposed ASL of 12 years with an Iowa R-1 dispersion curve is a good match to the historical analysis. Therefore, the Commission finds the proposed ASL of 12 years to be reasonable and approves the proposed change.

Accounts 232 – Outside wiring, 242 – Aerial cable – Metallic, 243 – Underground cable – Metallic, 244 – Buried cable – Metallic

433. These accounts comprise aerial, underground and buried metallic cables and metallic outside wiring. Télébec requested a reduction of four years in the service life to an ASL of 16 years for account 232, of two years in the service life to an ASL of 18 years for account 242, of four years in the service life to an ASL of 16 years for account 243 and of two years in the service life to an ASL of 19 years for account 244.

434. To support its proposed changes, Télébec submitted that copper-based networks were facing increasing obsolescence due to the demand for greater bandwidth. In the company's view, the need to offer simultaneous voice and data, and possibly video communication, required more robust networks with increased accuracy and capacity. Consequently, the company anticipated ongoing migration to more efficient technologies such as fibre and wireless. The company noted, however, that the effect of technological change had not yet materialized in a significant way.

435. Télébec also submitted that an estimated 40% of its aerial, buried and underground copper pairs were not utilized and could be classified as being "retired in place". The company noted, however, that it did not have an accounting system in place to keep track of copper pairs retired in place. Hence, in the company's submission, recorded retirements that were used in the historical life analysis were deficient and did not reflect pairs retired in place.

436. With respect to accounts 242, 243 and 244, the Commission notes that the historical analysis diverges significantly from the proposed ASLs. The Commission also notes that the approved ASLs for copper cables already diverge substantially from the ASLs that resulted from historical analyses. In the past, the Commission has accepted this divergence as reasonable, given the anticipated impact of new technologies, new services and competition on the ASLs of copper cables. The Commission further notes that the company recognized that this impact had not yet materialized in the case of copper cables.

437. The Commission also notes that while the company stated that more than 40% of the copper pairs were "retired in place", it also indicated that there was no accounting system in place to quantify the impact on the ASLs for metallic cables.

438. The Commission is of the view that the ASLs already approved by the Commission sufficiently reflect the future impact that new technologies, the introduction of new services and competition would have on the ASLs of metallic cables. In addition, the Commission is of the view that cable pairs that are "retired in place" should not be considered in establishing ASLs since, according to the company, there is no accounting system in place to quantify their impact on ASLs.

439. With respect to account 232 – Outside wiring, the Commission notes that Télébec did not carry out an historical analysis since the retirements in this account are computed with those of accounts 242 – Aerial cable – Metallic and 244 – Buried cable – Metallic. The Commission further notes that the currently approved depreciation life characteristics for account 232 are identical to those of account 242. Given that no analysis or rationale has been provided to justify a change, the Commission is of the view that the depreciation life characteristics for account 232 should remain identical to account 242 – Aerial cable – Metallic.

440. In sum, the Commission considers that the company has not justified the proposed changes to the ASLs of the four metallic cable/wiring accounts and denies the company's application with respect to these accounts.

Account 246 – Underground conduit

441. Télébec proposed to reduce the current ASL for this account from 55 years to 40 years. To support its proposal, the company argued that the retirement of conduit would be caused by three factors: physical limitations and events; public utility requirements; and, the replacement of underground copper cables with fibre optic cable. This latter factor would also lead to under-utilization of existing conduit given the smaller size and much greater transmission capacity of fibre optic cable as compared to copper cable.

442. Télébec also submitted that the currently-approved life parameters produce an average remaining life of 42 years, which the company considered inordinately long and unrealistic. The company was of the view that the historical analysis for this account was inconclusive because of the scarcity of past retirements.

443. In the Commission's view, Télébec has not provided any compelling evidence or analysis which would justify reducing the ASL for this account from 55 years to 40 years. In particular, the fact that copper cable is often replaced by fibre optic cable has no apparent effect on the service life of underground conduit. Consequently, the Commission has decided that the currently-approved ASL of 55 years should be retained.

Method of recovery of the Depreciation Reserve Deficiency

444. The Commission has accepted, in whole or in part, a number of Télébec's proposed adjustments to the depreciation life characteristics of its asset accounts. These changes give rise to a DRD since the relevant assets have not been depreciated to the extent they would otherwise have been if the revised ASLs had been in effect. It is, therefore, necessary to consider the appropriate method for recovering the DRD.

445. Under the current Phase I DRD recovery method, Télébec would be entitled to recover a greater portion of the DRD in the initial years than in subsequent years. If this method were applied in the present circumstances, it would result in going-in rates higher than needed to ensure full recovery of the DRD.

446. In Decision 97-9, the Commission decided it was not appropriate to use the Phase I DRD recovery method when setting the going-in rates of the other large ILECs. Instead, the Commission chose to use an alternative linear method to recover the DRD in equal amounts based on the core composite average remaining service life of each company's assets. This approach involved amortizing the DRD on a straight-line basis over the average remaining service life of the plant and equipment for regulatory purposes. This ensured that the amount included in the going-in rates would not change relative to the amounts reflected in the rates for subsequent years of the price cap plan.

447. The Commission notes that Télébec is currently using the Phase I method of DRD recovery (i.e., non-linear amortization). The company stated that it would find the linear method appropriate provided the same method were applied to TELUS Québec.

448. The Commission further notes that TELUS Québec indicated that, prior to being regulated by the Commission, it was already using the linear method of DRD recovery. Following the release of Decision 97-9, the company decided to continue with the linear method.

449. In light of the above, the Commission considers it appropriate to use the same approach in the present context as was adopted in Decision 97-9. Consequently, the Commission directs each of the Companies to amortize any DRD, as of the implementation date of the price regulation plan, for regulatory purposes, using the core composite average remaining service life of each company's assets as of that date. Using this approach, the amortization of the DRD would be on a straight-line basis for regulatory purposes. As noted above, this would ensure that the amount included in the going-in rates would not change relative to the amounts reflected in the rates for subsequent years.

Depreciation expense adjustments to the going-in revenue requirement

450. Based on its proposal, Télébec's depreciation expense would have increased by $3.8 million. However, based on the approved adjustments to Télébec's various depreciation life characteristics and the approved DRD recovery method discussed above, Télébec's depreciation expense is reduced by $2.2 million, resulting in a $6 million reduction to the going-in revenue requirement proposed by the company.

451. The Commission notes that, relative to 2001, TELUS Québec proposed to reduce its 2002 depreciation expense by approximately $12.3 million without any changes to depreciation life characteristics. The Commission further notes that the company confirmed this reduction in depreciation expense several times during the proceeding.

452. Accordingly, Commission has accepted TELUS Québec's proposed going-in depreciation expense reduction of $12.3 million.

Capital Structure and Return on Equity

Introduction

453. In order to determine the going-in revenue requirement of Télébec and TELUS Québec, it is necessary to establish the appropriate capital structure for the Companies (i.e., proportion of common equity and debt capital), as well as the appropriate ROE for the Utility Segments of the Companies.

454. In Decision 98-2, the Commission decided that the going-in revenue requirement for the other large ILECs should generally be determined using a capital structure with a maximum common equity of 55% and a Utility Segment ROE of 11%.

455. In PN 2001-36, the Commission sought comments as to why the going-in revenue requirement for Télébec and TELUS Québec should not reflect the same capital structure and Utility Segment ROE as were used in Decision 98-2.

Capital Structure

456. In Decision 97-21, the Commission determined that for regulatory purposes the Companies' capital structure would be deemed not to exceed 55%.

457. Télébec submitted that the capital structure used by the Commission in Decision 98-2 would be appropriate for determining its going-in revenue requirement in the present proceeding. Télébec's capital structure in 2001 was approximately 54% common equity.

458. In the present proceeding, TELUS Québec forecast that its actual consolidated common equity ratio would be 55.8%, approximately the same capital structure as was used by the Commission in Decision 98-2. TELUS Québec submitted that there was no reason to conclude that it faced a materially different level of business risk than the other large ILECs so as to justify a different capital structure. Consequently, the company supported the use of the Decision 98-2 capital structure for the purpose of setting its going-in revenue requirement.

459. No party who filed comments objected to the capital structure proposed by the Commission in PN 2001-36.

460. In light of the above, the Commission has used a capital structure with a maximum common equity of 55% for the purposes of determining the going-in revenue requirements of Télébec and TELUS Québec.

Return on Equity

Background

461. For the past several years, Télébec and TELUS Québec have been subject to rate base/rate of return regulation with ROEs approved by the Commission in Decision 97-21. In that Decision, Télébec was granted a Utility Segment ROE range of 10.4% to 12.4% while TELUS Québec was granted a Utility Segment ROE range of 10.3% to 12.3%. For the purposes of calculating the contribution requirement, the Commission used the midpoints of the Utility Segment ROE ranges (i.e., 11.4% and 11.3% for Télébec and TELUS Québec, respectively).

Positions of parties

462. Télébec agreed with the Commission's proposal that its going-in revenue requirement be set using a Utility Segment ROE of 11.0%. Télébec submitted that this rate reflected the company's historical average over the last four years and indicated that the company was seeking an ROE that would be competitive in the market and in line with what the other large ILECs earned during their initial price cap period. It further submitted that its proposal was fair and would lead to the proper balance amongst all stakeholders.

463. TELUS Québec did not agree with the Commission's proposal to use 11%, but instead proposed to use an ROE of 12% for setting its going-in revenue requirement. The company filed expert evidence, prepared by Ms. McShane, proposing that the company's going-in Utility Segment ROE be set to reflect the operating environment and regulatory framework that would be implemented in 2002. It submitted that the use of the equity risk premium method combined with the analysis of business and financial risk indicated a cost of equity range of 12.0% to 12.5%. This range was derived using a forecast of long-term Canada bonds at 6.0%, "bare-bones" equity risk premium of 5.5% to 6.0% (made up of a Market Risk Premium (MRP) of 6.5% to 7.5% and a beta of 0.8 to 0.85) and an adjustment for financing flexibility of 50 basis points.

464. ARC et al. submitted that the target ROE should be set so that Télébec and TELUS Québec could expect to earn a normal return on equity taking into account all of the benefits of the pricing flexibility that would be permitted under a price cap plan. ARC et al. also submitted that the use of an alternate methodology, such as the formula employed by the National Energy Board (NEB), would result in lower cost of equity than proposed by the Commission or the Companies (i.e., 10.25%).

465. In its final argument, ARC et al. stated that it had re-calculated TELUS Québec's proposed Utility Segment ROE using a 6.0% long-term Canada bond rate, a beta of 0.60 and an MRP of 3.5% on a forward looking basis and 5.0% on a historical Canadian estimate basis. ARC et al. submitted that the resulting cost of equity was less than 10% and, therefore, a rate lower than the 12% proposed by TELUS Québec or the 11% proposed by the Commission was appropriate.

Analysis of the technical evidence

466. The Commission has traditionally employed three tests to estimate the cost of equity: equity risk premium, discounted cash flow (DCF) and comparable earnings. Increasingly, however, the Commission has relied upon equity risk premium evidence. The NEB formula has not previously been used by the Commission.

1) National Energy Board formula

467. Under the NEB formula, the risk premium increases 0.25% for every 1.0% decline in the long-term Canada bond yield forecast. For example, if the long-term Canada bond yield were 7.0%, then the associated cost of equity would be 11.0% (assuming a risk premium of 4%, as was the case in Decision 98-2). Using the NEB formula, if the bond yield were reduced to 6.0%, the decrease of 1.0% would result in an increase of 0.25% in the risk premium, resulting in a cost of equity of 10.25% (i.e., 6% plus 4.25%).

468. ARC et al. submitted that the Ontario Energy Board, the British Columbia Utilities Commission and the Public Utilities Board of Manitoba all use a formula similar to that of the NEB. In response, TELUS Québec submitted that a number of the companies subject to this approach were dissatisfied with the results and had requested that the approach be reviewed.

469. Although the Commission considers that the NEB formula has merit, it is concerned that this approach assumes that business and financial risk is relatively constant across an industry. The Commission concludes that it should continue to rely on the equity risk premium supplemented by an analysis of the business and financial risks faced by the regulated company. In the Commission's view, this approach is more comprehensive in nature as it takes into account both general industry factors, as well as each company's individual circumstances. The Commission also notes that retaining this approach has the benefit of promoting regulatory consistency, as it has been used by the Commission in several previous decisions.

2) Equity risk premium methodology

470. TELUS Québec proposed to calculate the cost of equity using the equity risk premium method, noting that this approach was consistent with previous Commission determinations. TELUS Québec also submitted that this approach should be supplemented by an analysis of the company-specific business and financial risks.

471. The equity risk premium method is based on the concept that there is a direct relationship between the level of risk assumed and the return required. Since an investor in common equity takes greater risk than an investor in bonds, the former requires a premium above bond yields in compensation for that greater risk.

472. The equity risk premium method consists of two basic components: the risk-free rate and the equity risk premium. This latter component has two elements – the MRP and the beta. The sections that follow examine these basic components. Together, these

components provide a "bare-bones" cost of equity which may then be adjusted by a flotation charge to ensure that the regulated company can raise additional equity without diluting the book value of existing equity.

473. The equity risk premium method to calculate the cost of equity is:

R = Rf + B x (Rm – Rf) + Fltn Cost

Where R is the cost of equity
Rf is the risk free rate
Rm is the market return
B is the beta
Rm-Rf is the market risk premium
Fltn Cost is the flotation cost

474. The "bare-bones" equity risk premium proposed by TELUS Québec was calculated based on Canadian and international market data, using historical and forward-looking estimates, over a post-World War II timeframe using an average of compound and arithmetic holding periods. TELUS Québec then adjusted this figure, referred to as the MRP, by the beta, which measures risk as the volatility of an individual stock or portfolio of stocks relative to the volatility of the market. Finally, the company added a flotation adjustment for financial flexibility.

a) Risk-free rate

475. TELUS Québec used a risk-free rate of 6.0% in its measure of equity risk premium. In arriving at the 6.0% figure, TELUS Québec used a combination of consensus economic forecasts 3-months forward and 12-months forward of 10-year long-term Canada (LTC) bond yields, longer term forecasts of these bonds from 2002 to 2006, and forecasts of the 30-year U.S. treasury bond. TELUS Québec then compared its results to the rate used by the Commission in Decision 98-2 to ensure consistency over time.

476. ARC et al. also used a risk-free rate of 6.0% in its calculation of the equity risk premium.

477. The Commission notes that both parties that addressed this issue used a 6.0% LTC bond rate. The Commission considers this to be an appropriate measure of the long term risk-free rate.

b) Market risk premium

478. The primary approach to estimating the required risk premium involves measuring the risk premium for the entire stock market derived from an analysis of achieved market risk premiums. Those market risk premiums are then adjusted to reflect the risk of the benchmark company relative to the market as a whole. This is accomplished through the use of a beta factor. The elements of this approach are discussed in the following sections on holding periods, U.S. data and use of historical and forward-looking data.

i) Holding periods

479. TELUS Québec provided data on both a compound and arithmetic holding period basis, using a combination of both in arriving at its proposed estimate. It submitted that consideration of the arithmetic average was appropriate as it recognized market uncertainty, whereas the compound average tended to smooth out any uncertainty over time.

480. The Commission notes that in previous decisions it has not used the arithmetic average on the grounds that it could give undue emphasis to short term variations in the market. The Commission has held that it was appropriate to take a longer term perspective when establishing the equity risk premium. In the Commission's view, TELUS Québec did not justify any modification to this approach. Accordingly, the Commission continues to consider it appropriate to rely on the compound average when calculating the equity risk premium.

ii) U.S. data

481. TELUS Québec submitted that the historical risk premiums should not be limited to the Canadian experience but should include an international weighting to reflect the increasing globalization of capital markets. TELUS Québec also submitted that Canadian and international markets should both be utilized as Canadian investors were increasingly concerned with the mediocre performance of the Canadian equity market. TELUS Québec used a weighting of 70% for Canadian and 30% for U.S. data based on the fact that investment in registered retirement savings plans (RRSPs) was limited to 30% foreign content.

482. TELUS Québec submitted evidence indicating that Canadians were increasing their foreign investment, and that there were factors specific to the historical Canadian risk premiums which cast doubt on the premise that historical data was a proxy for investor expectations. In TELUS Québec's submission, these factors included the increasing recognition of the under-performance of the Canadian market, the fact that the market had undergone significant structural changes and the fact that the Canadian market remained significantly less diversified than the U.S. market.

483. ARC et al. submitted that international data might be of use, but that the Commission should not place too much reliance on it as the United States had different monetary and tax policies, both of which affected rates of return.

484. The Commission agrees that markets are becoming global in nature, and that a level of reliance on international data is appropriate. The Commission has used a methodology based on the concept of foreign content within RRSPs in previous decisions, and considers that a split of 70% Canadian and 30% U.S. is appropriate.

iii) Use of historical and forward-looking data

485. In developing the MRP, TELUS Québec used measures of both historical and forward-looking risk premiums. In TELUS Québec's submission, consideration of both measures was required to ensure that the resulting estimate would be compatible with current market expectations.

486. ARC et al. submitted that TELUS Québec had used only one source of historical data instead of the three sources that were used in the evidence filed in Decision 98-2. ARC et al. argued that this had increased the value of the historical MRP estimates, as compared to the evidence filed in Decision 98-2, given that the source used by TELUS Québec contained the largest risk premium estimates of the three possible sources.

487. In defence of its approach, TELUS Québec indicated that the other two sources of data had not been updated since Decision 98-2.

488. With respect to the forward-looking measure, TELUS Québec indicated that this was used primarily as a check on historical estimates. TELUS Québec submitted that investment analysts' forecasts had been optimistic, were not sustainable over the longer term, and that these forward-looking risk premiums confirmed that historical averages were likely to understate current investor expectations. TELUS Québec calculated the MRP using these estimates at 8.5% and acknowledged that the estimates were optimistic. Nonetheless, TELUS Québec did not consider it appropriate to adjust them downward.

489. ARC et al. submitted that TELUS Québec's forward-looking estimates were in the magnitude of 6.0% too high and suggested that the Commission disregard these as they were optimistic.

490. The Commission concludes that TELUS Québec's forward-looking data was based on estimates that were optimistic and, therefore, the Commission has placed minimal reliance on this data.

iv) Conclusions regarding the Market Risk Premium

491. By way of summary, TELUS Québec calculated its proposed MRP using an average of compound and arithmetic holding periods, weighted 70% to 30% for Canadian and U.S. data, based on historical returns for the timeframe from 1947 to 2000. The result of this calculation was then compared to the calculation using forward-looking data for reasonableness. In the end, TELUS Québec proposed an MRP of 6.5% to 7.5%.

492. ARC et al. submitted that an MRP of 3.5% would be appropriate on a forward-looking basis and that a 5.0% MRP would be appropriate on a historical basis.

493. In accordance with the conclusions set out above, the Commission is of the view that the MRP should be calculated using a compound average holding period, based predominantly on historical data using a 70/30 split between the Canadian and U.S. experience. The Commission has made adjustments to the calculations submitted by both

ARC et al. and TELUS Québec to reflect this approach. On the basis of these adjustments, the Commission concludes that an appropriate range for the MRP would be 6.0% to 6.5%.

c) Beta

494. The beta serves to adjust the MRP to reflect the risk of a benchmark company relative to the market. It indicates the change in the rate of return on a stock associated with a one percentage point change in the rate of return on the market.

495. The beta is measured in two ways – raw or adjusted. The raw (or unadjusted) beta represents the calculated beta using market data, without adjustment. The adjusted beta effectively gives a two-thirds weighting to the raw beta and a one-third weighting to the market beta of 1.0.

496. TELUS Québec proposed that the relative risk recognize total market risk as measured by the adjusted beta. TELUS Québec submitted that this was the most appropriate measure of beta as it was more consistent with relative standard deviations of market returns and the explicit consideration of telephone company (telco) common equity shares' interest rate sensitivity.

497. TELUS Québec proposed an adjusted beta of 0.80 to 0.85 which equates to a raw beta of 0.75 to 0.80. TELUS Québec indicated that its beta was based on Canadian telephone company betas for three five-year periods ending in 1998, 1999 and 2000.

498. ARC et al. submitted that the higher beta estimates provided by TELUS Québec should be disregarded as they were calculated using data which reflected BCE Inc.'s ownership of Nortel Networks Corporation (Nortel) and, hence, did not properly capture the relative risk of telecommunications carriers. ARC et al. also submitted that the beta estimate used by TELUS Québec was too high as it took into consideration the period in which there was vigorous long distance competition and limited local competition. In the view of ARC et al., the period prior to the one used by TELUS Québec would be more appropriate, resulting in a lower beta of 0.60.

499. The Commission has ruled in previous decisions, including Decision 98-2, that raw betas are appropriate given that, in the Commission's view, there is no basis in theory for the use of an adjusted beta. In the present proceeding, TELUS Québec has provided no new evidence or arguments that would justify using an adjusted beta. The Commission therefore concludes that, consistent with its previous decisions, it is appropriate to use the raw beta.

500. The Commission notes that betas measured using the Toronto Stock Exchange (TSE) Telco Index have been used in past decisions. The Commission agrees with ARC et al. that the use of the Telco Index, including BCE Inc., is not appropriate as it would skew the results due to the impact of the ownership of Nortel. The Commission is of the view that the Telco Index (less BCE Inc.) is the best basis for determining the beta. The

Commission is also of the view that a five-year average (1996 to 2000) is an appropriate measure as it encompasses a period that is long enough to smooth out any distortions in the data that may occur. Using this data results in a beta of 0.72 to 0.76.

d) Flotation costs

501. TELUS Québec submitted that an adjustment for financing flexibility was required to permit a company to recover all costs that would be incurred to issue additional stock, if necessary, without harming its existing shareholders. TELUS Québec also submitted that its proposed adjustment of 50 to 75 basis points would compensate for flotation costs plus two additional considerations – a margin for unanticipated capital market conditions and a recognition that regulation continued to be a surrogate for competition.

502. Other parties did not comment on this issue.

503. The Commission is of the view that firms should only be able to recover legitimate flotation costs that are a necessary cost of doing business. In past decisions, the Commission allowed a flotation cost adjustment of between 20 to 30 basis points to recognize these costs. The Commission considers that this level of recovery is still appropriate and, consequently, does not accept TELUS Québec's proposed higher range.

3) Direct estimates of risk premium

504. An alternative approach used to estimate the equity risk premium develops the risk premium for a particular stock or industry directly, either by reference to the stock's or the industry's market performance or by reference to a series of DCF studies. DCF-based estimates of the equity risk premium rely on the projected dividend yield plus investor expectations of long-term growth.

505. TELUS Québec calculated direct estimates using both of the methods described in the previous paragraph.

506. First, TELUS Québec estimated the equity risk premium by using a direct measure of telco risk premium. This was accomplished by measuring the historical risk premium using (1) the TSE 300 Telco Index (2) the TSE 300 Utility Index and (3) the TSE 300 Gas and Electric Index. TELUS Québec submitted that the results obtained through this measure of risk premium were in line with its proposed amount.

507. Second, TELUS Québec provided a DCF estimate that consisted of the forecast dividend yield plus expected growth. TELUS Québec submitted that the results of this method further supported its proposal.

508. With respect to TELUS Québec's DCF estimate, ARC et al. submitted that TELUS Québec had based its dividend yield on an inappropriate timeframe and that the dividend yield should have been 2.0%, not the 5.4% that TELUS Québec used. ARC et al. argued that this correction would result in a cost of equity for the market as a whole of 9.0% (made up of a dividend yield of 2.0% and a growth rate of 7.0%).

509. The Commission is of the view that TELUS Québec's direct measure of the telco risk premium should be discounted as it relied predominantly on stock market indices of other industries whose overall risk exposure would be different from that of the incumbent telephone companies. The Commission also notes that TELUS Québec's DCF estimate was put forward solely to support or confirm the results of other tests. Accordingly, the Commission has placed minimal reliance on this direct approach to estimate the company's equity risk premium.

4) Risk assessment

510. Business risk encompasses the basic operating characteristics of a firm which can lead to variations in operating income or affect the ability of the firm to recover and obtain a return on capital investment. Financial risk is the additional risk exposure resulting from the use of leverage, which to the common shareholder includes both preferred stock and debt. Business and financial risk are factors which are generally considered when assessing the cost of equity.

511. TELUS Québec submitted that the business risk of its Utility Segment was not materially different from the total risk faced by the other large ILECs. The company based this conclusion on a large number of factors.

512. According to TELUS Québec, its Utility Segment had a lesser ability to expand demand than either toll or full service providers. At the same time, it had greater capital intensity and operating leverage than toll networks, but less ability to offset market share loss than toll providers. TELUS Québec also argued that its Utility Segment faced a high risk of obsolescence and a lack of risk-reducing benefits as among technologies and services compared to a larger, more integrated telephone company. In TELUS Québec's view, it faced strong potential competitors in the new converged market for services.

513. On the question of financial risk, TELUS Québec submitted that its financial risk had been similar to that of Aliant Telecom, Bell Canada and TELUS over the last five years. In arriving at this conclusion, TELUS Québec indicated that its debt rating was investment grade, its capital structure was forecast for 2001 at 55.8% common equity (approximately at the level of 55.0% deemed by the Commission to be acceptable for the other large ILECs), and its interest coverage ratios were within an acceptable range.

514. None of the other parties to this proceeding commented on the risk evidence filed by TELUS Québec.

515. The Commission agrees with TELUS Québec's assessment of the business and financial risks faced by the company.

Conclusion on cost of equity for TELUS Québec

516. In light of the foregoing, the Commission concludes that a going-in Utility Segment ROE of 11.0% is appropriate for TELUS Québec. This ROE is based on a risk-free rate of 6.0%, an MRP of 6.0%-6.5%, a beta of 0.72 to 0.76 and a flotation adjustment of 20 to 30 basis points. The Commission has also determined that no adjustment to this ROE is required as a result of the risk assessment set out above.

Risk differentials between the Companies

517. The final issue considered by the Commission relating to the cost of equity was whether Télébec and TELUS Québec faced different risks and, hence, should have different costs of equity.

518. In Decision 97-21, the Commission set the current ROE ranges for Télébec and TELUS Québec. These were based on the same risk-free premium and the same business risk premium for each company. The overall range for Télébec was slightly higher due to a higher financial risk premium for this company.

519. In PN 2001-36, the Commission proposed to use the same Utility Segment ROE for both Télébec and TELUS Québec, namely the 11% ROE used for the other large ILECs in Decision 98-2.

520. In the present proceeding, Télébec submitted that the going-in Utility Segment ROE of 11% proposed by the Commission would be appropriate. The Commission has determined above that the going-in Utility Segment ROE for TELUS Québec should be 11%. Accordingly, the Commission concludes that there is no basis for setting different going-in ROEs for Télébec and TELUS Québec.

Conclusions on cost of equity

521. In light of the above, the Commission determines that the going-in Utility Segment ROE for both Télébec and TELUS Québec should be 11.0%. The Commission has calculated the Companies' going-in revenue requirement on this basis.

Net annualized revenue impacts of pending and planned tariff items

522. As discussed above, in PN 2001-36 the Commission directed Télébec and TELUS Québec, when calculating their going-in revenue requirements, to include the net annualized revenue impacts of any pending and planned tariff items as one of the required incremental adjustments to their final 2001 contribution requirements.

523. Télébec and TELUS Québec have included $0.6 million and $1.1 million, respectively, in the calculation of their going-in revenue requirements to reflect the net annualized revenue impacts of any pending and planned tariff items.

524. Other parties to this proceeding did not comment on this issue.

525. In the Commission's view, Télébec and TELUS Québec have properly included the net annualized revenues arising from any pending and planned tariff filings as part of their going-in revenue requirement calculations.

526. Accordingly, in setting the Companies' going-in revenue requirements, the Commission has accepted Télébec's and TELUS Québec's proposed net annualized revenue impacts of pending and planned tariff items of $0.6 million and $1.1 million, respectively.

Amortization of deferral accounts

Background

527. In PN 2001-36, the Commission directed Télébec and TELUS Québec to include in their proposed going-in revenue requirement any adjustment that might arise in connection with proposed changes to the amortization of their respective deferral accounts.

528. Télébec's deferral account resulted from two related Commission orders, one in 2000 and another in 2001. In *Télébec ltée – Rate restructuring*, Order CRTC 2000-531, 9 June 2000 (Order 2000-531), the Commission approved, effective 1 July 2000, a residential rate restructuring proposal of Télébec. In *CRTC approves an application to review and vary Order CRTC 2001-531 – Télébec ltée – Rate restructuring*, Telecom Order CRTC 2001-216, 14 March 2001 (Order 2001-216), the Commission directed that the rate restructuring approved in Order 2000-531 be maintained, but that as of 1 July 2000, funds generated by this residential rate restructuring be placed in a deferral account to be used for the benefit of Télébec's residential subscribers to mitigate future rate increases that would have otherwise been approved by the Commission.

529. In Decision 97-21, the Commission directed TELUS Québec to place excess earnings in a deferral account should the Utility Segment achieve earnings above the upper limit of the allowed rate of return on average equity range during the split rate base regime. In the proceeding leading to *Québec-Téléphone 1999 final contribution rate approved*, Order CRTC 2000-860, 19 September 2000 (Order 2000-860), TELUS Québec reported excess earnings in 1998 that were placed in a deferral account. In Order 2000-860, the Commission stated that it would use the deferral account to mitigate any future residential local rate increases during the transition period or at the start of the price cap regime.

Positions of parties

530. Télébec proposed to withdraw the $5.1 million balance in its deferral account in 2002 ($4.9 million principal plus interest accumulated in 2002). The company also submitted that it should no longer be required to place $3.2 million per year (i.e., the annual revenue associated with the residential rate restructuring approved in Order 2000-531 as of 1 January 2002) in the deferral account. The resulting total decrease in Télébec's proposed revenue requirement would be $8.3 million for 2002 and $3.2 million annually for subsequent years.

531. In response to an interrogatory from the Commission, Télébec disagreed with the idea of amortizing the balance of the deferral account equally over the entire price cap period. Télébec argued that if this approach were adopted, its average basic local residential rate would be approximately $33.65 per month for the four years of the price cap regime. The company noted that this would be less than its proposed maximum rate of $34.43. Télébec also submitted that the average rate should increase, in any case, at the end of the four-year period because the deferral account would be depleted.

532. TELUS Québec proposed to withdraw $7.3 million from the deferral account in 2002 and $1.6 million in 2003.

533. In response to an interrogatory from the Commission, TELUS Québec disagreed with the idea of amortizing the balance of the deferral account equally over the entire price cap period. TELUS Québec submitted that amortizing the deferral account in this manner would require it to increase rates in its non-HCSA rate bands. The company argued that this could result in an unfavourable positioning of its residential rates compared with those of Bell Canada. For that reason, TELUS Québec preferred its proposal to amortize the deferral account primarily at the start of the price cap regime.

534. With respect to Télébec, ARC et al. noted that during the public hearing, Télébec stated that the majority of its residential rates were compensatory before the rate increase approved by the Commission in Order 2000-531. ARC et al. submitted that the company's going-in rates should be set at a level where they would be compensatory (i.e., the same as the rates in effect before the increase approved in Order 2000-531). ARC et al. also argued that Télébec's deferral account should be used to mitigate rate increases only in the areas where rates were not compensatory.

535. Other parties did not file comments on TELUS Québec's proposed use of its deferral account.

Conclusions

536. The Commission notes that Télébec's proposal to stop placing $3.2 million in the deferral account would reduce the company's going-in revenue requirement by the same amount. These additional revenues would mitigate the need for further residential rate increases, which would be in accordance with the determinations in Order 2001-216. Accordingly, the Commission directs Télébec to stop placing the annual rate restructuring revenues of $3.2 million in the deferral account, effective 1 August 2002.

537. With respect to the funds currently in the deferral accounts of Télébec and TELUS Québec, the Commission is of the view that it is generally preferable to amortize a large amount over a longer period of time in order to maintain rate stability. Using all or almost all of the balance of the deferral account in the first year would distort the Companies' first year revenues and could lead to a situation where substantial rate

increases would be required in the second year to compensate for the elimination of a non-recurring item (i.e., the draw down of the deferral account). This type of rate increase during the price regulation period would run counter to the overall scheme and purpose of price regulation and, in the Commission's view, should be avoided if possible.

538. In order to minimize fluctuations in local rates and maintain the integrity and uniformity of the price regulation regime, the Commission has decided, for the purposes of establishing the going-in revenue requirements of the Companies, to amortize their deferral accounts equally over the price regulation period of four years. The Commission notes that it has taken into account the accumulation of interest and, in the case of Télébec, any amounts placed in the deferral account after the filing of its materials in this proceeding but prior to the release of this Decision.

Local number portability and local competition start-up costs

Background

539. In the present proceeding, the question arose whether there was a need to take into account the start-up costs associated with local number portability (LNP) and local competition when determining the going-in revenue requirements of Télébec and TELUS Québec.

540. In *Local Competition,* Telecom Decision CRTC 97-8, 1 May 1997 (Decision 97-8) and in *Responsibility for Carrier Specific costs for the provision of Local Number Portability,* Telecom Order CRTC 97-591, 1 May 1997, the Commission determined that LNP and local competition start-up costs incurred by the other large ILECs should not be recovered from interconnecting carriers, but that each carrier should be responsible for recovering its own costs.

541. In Decision 98-2, the Commission decided that the contribution payments made by toll service providers should not be used to fund the other large ILECs' LNP and local competition start-up costs. As a result, these costs were excluded from their expense forecasts in establishing their going-in contribution requirement and going-in rates. In addition, the Commission stated that it would initiate a proceeding to determine whether any LNP and local competition start-up costs should be recovered from subscribers.

542. In *Local Competition Start-up Costs Proceeding*, Telecom Order CRTC 99-239, 12 March 1999 (Order 99-239), the Commission determined that the other large ILECs' LNP and local competition start-up costs should be calculated on a revenue requirement basis. Under the revenue requirement approach, the capital costs would be recovered through an annual depreciation expense. The Commission also concluded that these costs should be allocated among Capped and Uncapped services on the basis of retail switched exchange service NAS, with non-residence NAS weighted by a factor of 1.5. The recovery of costs allocated to capped Utility Segment services would be by way of an exogenous factor.

543. In Order 2001-761, the Commission determined that Télébec and TELUS Québec would each be responsible for recovering its own LNP and local competition start-up costs and that such costs would not be recovered from the NCF. In addition, in order to control the magnitude of these costs, the Commission determined that both Companies should incur expenses only when and if required.

Positions of parties

544. Télébec initially proposed to recover its anticipated expenses of $2.6 million for the implementation of LNP and local competition directly from the NCF. The company submitted that it had already incurred some start-up costs related to the introduction of local competition. Télébec stated that to enable local competition, the costs to modify systems and procedures were necessary before competition was permitted. In addition, Télébec submitted that one competitor had indicated that it planned to provide services in Télébec's territory.

545. Upon the release of Order 2001-761, and in response to the Commission's interrogatories, Télébec altered its proposal and suggested instead that LNP and local competition start-up costs be recovered through an exogenous factor in the price regulation regime.

546. Télébec submitted that its proposed method of recovery would be consistent with the Order 99-239 methodology, except with respect to the allocation of costs to business services in high-cost bands. In this regard, Télébec did not agree with the application of the 1.5 weighting factor for business NAS in those bands. In Télébec's view, the expectation of profit in high-cost bands was more risky due to lower density and higher costs. Consequently, Télébec argued that in high-cost bands the benefits of competition to business subscribers would be the same as for residential subscribers. On that basis, the company submitted that the allocation of costs for business NAS should carry the same weight as for residential NAS. That is, a factor of 1.0 should be used for both residential NAS and business NAS in high-cost bands.

547. TELUS Québec initially proposed to include its LNP and local competition start-up costs in its going-in revenue requirement. The company forecast these costs at $2.6 million. The company also submitted that it would require six months to prepare its network so that it could provide service to competitors.

548. Upon the release of Order 2001-761, TELUS Québec altered its proposal. Instead of including the start-up costs in its revenue requirement, the company proposed to set aside $2.6 million of its deferral account to recover those costs when incurred.

549. In response to Télébec's proposal, ARC et al. noted that in Order 2001-761, the Commission determined that the Companies should incur expenses to implement LNP and local competition only as required. ARC et al. submitted that this approach was necessary so as to ensure that consumers would not pay, through residential rates, for the cost of facilities that would not be needed for several years. ARC et al. also stated that it was surprised Télébec had incurred start-up costs before the Commission allowed

competition in the company's serving territory, while acknowledging that competition in its territory might not actually start on 1 September 2002. In ARC et al.'s submission, incurring start-up costs before permitted or necessary was disrespectful of Order 2001-761.

550. ARC et al. proposed that the Commission require competitors to register before providing local services in the Companies' territories. ARC et al. argued that this would help ensure that the Companies comply with Order 2001-761 by incurring start-up costs for LNP and local competition only when services are required by competitors.

Conclusions

551. In Order 2001-761, the Commission concluded that Télébec and TELUS Québec should incur LNP and local competition start-up costs only as and when required. In the present proceeding, the Companies provided estimates of their anticipated start-up costs.

552. In the Commission's view, it is not possible to properly assess the reasonableness of the Companies' anticipated costs in advance of the implementation of LNP and the start-up of local competition. Consequently, it would be premature to allow recovery of such costs at this time.

553. The Commission also considers that LNP and local competition start-up costs should not be included in the going-in revenue requirement as this would result in permanent increases to rates, despite the fact that some of these costs are non-recurring costs that, once recovered, should be removed from rates.

554. In light of these considerations, and in keeping with the approach adopted in Order 99-239, the Commission has decided that the Companies should recover LNP and local competition start-up costs by means of an exogenous factor which they may apply for when the relevant costs are incurred.

555. On a preliminary basis, the Commission also considers that the methodology used for the recovery of LNP and local competition start-up costs by the other large ILECs, as set out in Order 99-239, would be appropriate for Télébec and TELUS Québec. Accordingly, in their filings for an exogenous factor, the Companies should include the amount of LNP and local competition start-up costs, as well as the method of recovery, calculated using the methodology set out in Order 99-239. In addition, the Companies should distinguish between recurring and non-recurring costs.

556. The Commission notes that Télébec argued that the cost allocation methodology of Order 99-239 should be modified in respect of business services in high-cost bands since, in its view, business and residential customers in these bands would benefit in a comparable manner from local competition.

557. Generally, the Commission assigns costs on the basis of causality. Under this approach, the services or customer groups that expect to use the services or facilities are assigned the costs. In the case of high-cost bands in Télébec's territory, the Commission is not convinced that local competition would develop in these areas in a significantly different manner from non-HCSAs.

558. Consequently, the Commission reiterates its preliminary view that when Télébec and TELUS Québec file for an exogenous factor, they should allocate their LNP and local competition start-up costs on the basis of retail switched exchange service NAS, with non-residence NAS weighted by a factor of 1.5 and residence NAS by a factor of 1.0 as described in Order 99-239.

559. The Commission notes that TELUS Québec proposed to set aside $2.6 million of funds in its deferral account that would be drawn down as LNP and local competition start-up costs were incurred. In light of the Commission's view that such costs should be recovered, after they have been incurred, within the parameters of the price regulation regime (i.e., by means of an exogenous factor), the Commission does not consider TELUS Québec's proposal to be appropriate.

560. The Commission also notes that TELUS Québec included $2.6 million for LNP and local competition start-up costs in its proposed going-in revenue requirement. The Commission has removed this amount from the determination of the company's going-in revenue requirement.

561. Finally, the Commission notes that, as set out in Decision 97-8 and Order 2001-761, CLECs must register with the Commission before they are eligible to operate in the territory of the Companies or of the other large ILECs. They must also update their registration information whenever they intend to serve new areas not already identified in their registration materials.

562. In the Commission's view, it would be inappropriate to require, as a precondition of the Companies incurring LNP or local competition start-up costs, a further registration from a CLEC, which has complied with the requirements noted in the preceding paragraph, and decides to actually commence offering services in Télébec's or TELUS Québec's territory. The Commission believes that the current registration and updating requirements continue to be adequate.

Amortization of TELUS Québec employee benefits

563. In Order 2001-641, the Commission approved TELUS Québec's final 2001 contribution rate. The analysis of revenues and expenses showed that TELUS Québec had followed the new accounting standards of the Canadian Institute of Chartered Accountants (CICA) relating to the treatment of employee benefits on a prospective basis, and had selected reasonable amortization periods for the various benefits, based on their nature. The annual amortization expense for the total benefits liability for the Utility Segment was $1.3 million for 2001.

564. In the present proceeding, TELUS Québec proposed to change the amortization period associated with employee benefits. Specifically, TELUS Québec proposed to amortize this liability over the four-year price cap period proposed by the company.

565. This change would reduce the amortization period for medical expenses and life, accident and disability insurance by 17 years (i.e., from 21 to four years). It would also reduce the amortization period for the Annuities Readjustment and the Regulatory Derestriction from 10 years to four. These proposed changes would increase the going-in revenue requirement of the company's Utility Segment by $2.3 million.

566. In support of its proposal, TELUS Québec argued that the existence of the employee benefits transitional liability meant that past contributions to the plans had not been as high as necessary. As a result, in the company's view, subscribers benefited from lower than normal rates. TELUS Québec also noted that, for accounting purposes, it had retroactively charged the entire liability against its earnings in the year in which the liability was recognized. The company submitted that, for regulatory purposes, it would be appropriate to amortize the liability prospectively over four years so as to prevent too great a rate shock to its customers.

567. Other parties did not file comments on this issue.

568. The Commission notes that when it approved the company's 2001 contribution requirement and contribution rate in Order 2001-641, amortization periods were set for the employee benefits in accordance with the CICA's new accounting standards and were determined based on the specific nature of the various benefits.

569. In the Commission's view, TELUS Québec has provided no compelling reasons for decreasing, for regulatory purposes, the amortization periods of the employee benefits in the manner proposed. The Commission notes that if the company's proposal were accepted, rather than preventing rate shock as suggested by TELUS Québec, it would result in a $2.3 million increase in the company's going-in revenue requirement which would, in turn, increase the potential need to raise rates.

570. The Commission concludes that, for regulatory purposes, the approved CICA-based amortization periods for the different employee benefits should be maintained. Consequently, the Commission has not accepted TELUS Québec's proposal to amend the amortization period for the company's employee benefits transitional liability. As a result, the $2.3 million associated with the amortization of the liability has been removed from the calculation of the company's going-in revenue requirement.

Non-existent assets

571. TELUS Québec proposed to write off $1.7 million in assets, and charge that amount directly as an expense for purposes of calculating the going-in revenue requirement. The company submitted that such treatment would comply with regulatory accounting principles, which stipulate that written-off assets should be considered fully depreciated.

572. TELUS Québec stated that when a new accounting system was implemented, assets were categorized according to a new accounting structure, and that some assets from the old accounting system could not be categorized under the new structure. Despite efforts to identify those assets, the company indicated that they still represented unidentified residual assets. TELUS Québec estimated the value of these assets, as of 31 January 2001, at $2.5 million, $1.7 million of which represented the Utility Segment portion. In response to an interrogatory, TELUS Québec stated that the assets in question were investments made in the internal network, and were unidentifiable or "non-existent" network components.

573. Other parties did not comment on this issue.

574. The Commission notes that TELUS Québec was unable to provide more detail on the nature of the assets in question. The Commission also notes that if it were to allow TELUS Québec to expense the $1.7 million, the going-in revenue requirement would be higher, which, in turn, would likely result in higher rates.

575. The Commission recognizes that, for accounting purposes, it may be appropriate to expense non-existing assets when there are no more assets remaining in a class of assets and there is still a net book value. However, the Commission also notes that, under the Phase I Directives, any remaining net book value in an asset class would normally not be expensed, but would instead be depreciated over the remaining useful life of that class.

576. Given the uncertainty as to the nature of the assets at issue in the present case, the Commission is concerned that the costs relating to those assets may have been included in other asset classes and could either still be in use or may already have been fully depreciated. In these circumstances, the Commission is of the view that the write-off of non-existent assets should not be included in the calculation of the going-in revenue requirement. Accordingly, TELUS Québec's going-in revenue requirement, as proposed by the company, has been reduced by $1.7 million.

Contribution payment to the national contribution fund

Background

577. In order to determine the going-in revenue requirements of Télébec and TELUS Québec, it is necessary to establish the contribution payments these companies will be required to make to the NCF. In accordance with the Commission's determinations in Decision 2000-745, the Companies' contribution payments must be calculated by multiplying the applicable revenue-percent charge times the amount of contribution-eligible Utility Segment revenues.

578. In the 2001 contribution requirement proceeding for Télébec and TELUS Québec, the Companies calculated their respective contribution payments to the NCF using the interim revenue-percent charge of 4.5%. Subsequently, in Decision 2001-238, the Commission determined that, based on a preliminary calculation, the revenue-percent charge for 2002 should be 1.5%. More recently, in *Interim 2002 revenue-percent charge,*

national subsidy requirement and procedures for the revenue based contribution regime, Order CRTC 2001-876, 14 December 2001 (Order 2001-876), the Commission determined that an interim revenue-percent charge of 1.4% should be used effective 1 January 2002.

Positions of parties

579. Télébec proposed a reduction in its contribution payment to the NCF of $2.8 million based on the reduction in Decision 2001-238 of the revenue-percent charge from 4.5% to 1.5%.

580. Télébec also proposed to include in its going-in revenue requirement an additional contribution payment of $141,000 to the NCF based on $9.4 million of additional contribution-eligible revenues and a revenue-percent charge of 1.5%. Télébec indicated that these additional revenues comprised the annualized revenues from pending and planned tariff filings, the additional revenues from the rate restructuring in Order 2001-216 that would no longer accrue in the deferral account and the revenues from the proposed rate increases for 2002 and 2003.

581. As a result of these two adjustments, the net reduction of the contribution payment to the NCF proposed by Télébec was $2.7 million.

582. TELUS Québec calculated the reduction of its contribution payment to the NCF by using the estimated Utility Segment contribution-eligible revenues for 2002 and the interim applicable revenue-percent charge of 1.5% approved in Decision 2001-238. On that basis, TELUS Québec calculated in a supporting schedule that the reduction of its contribution payment to the NCF should be $4.3 million. However, in the calculation of its proposed going-in revenue requirement, the company included a reduction of $4.1 million instead of the $4.3 million set out in the supporting schedule.

583. Other parties did not comment on this issue.

Conclusions

584. Based on the interim revenue-percent charge of 1.4% set out in Order 2001-876, the Commission has determined that the reduction in Télébec's contribution payments to the NCF is $2.9 million, instead of the $2.8 million proposed by the company. This constitutes a further reduction of $0.1 million.

585. The Commission also notes that in Part IX of this Decision it has denied Télébec's proposed rate increases for 2002 and 2003. Consequently, the additional contribution-eligible revenues only comprise the additional revenues from pending and planned tariff filings and the additional revenues from not accruing the revenues from Order 2001-216 in the deferral account. In total, these additional contribution-eligible revenues are $3.8 million. Applying the 1.4% revenue-percent charge, established in Order 2001-876, to the $5.6 million reduction in revenues results in a further reduction to the contribution payment to the NCF of $0.1 million.

586. Combining the two adjustments set out above, the Commission has reduced Télébec's going-in revenue requirement by $0.2 million.

587. With respect to TELUS Québec, the Commission notes that the company included in its contribution-eligible revenue base additional revenues from proposed going-in rate increases and excluded certain revenues for telecommunications services that had been included in the base for calculating the contribution expense as part of the 2001 contribution requirement.

588. The Commission has determined that the company's contribution-eligible revenues should be calculated as the sum of the 2001 revenues used to calculate the NCF expense for the 2001 contribution requirement, plus the additional revenues from pending and planned tariffs filings. Using the contribution-eligible revenue base used for 2001, the additional $1.1 million in revenues from the 2001 pending and planned tariff filings and applying the revenue-percent charge of 1.4% approved in Order 2001-876, the Commission has determined that TELUS Québec's contribution payment to the NCF should be reduced by $4.4 million rather than the $4.3 million proposed by the company. The Commission has also corrected for the discrepancy of $0.2 million introduced by the company when it used $4.1 million in its going-in revenue requirement calculation, instead of the $4.3 million set out in its supporting schedule. Taken together, these two adjustments result in a reduction of $0.3 million in TELUS Québec's proposed revenue requirement.

Total subsidy requirement to serve the high-cost residential bands

Background

589. The Utility Segment revenues of Télébec and TELUS Québec include the subsidy they receive from the NCF in respect of their high-cost residential bands. In order to determine the Companies' going-in revenue requirements, it is therefore necessary to determine for each company its TSR.

590. In Decision 2000-745, the Commission determined that the subsidy for residential NAS in each high-cost band was the Phase II cost plus an appropriate mark-up, less the sum of the primary exchange residential service revenues and the annual target implicit contribution from other local services. The subsidy for each high-cost band was determined by multiplying the subsidy requirement per residential NAS by the number of residential NAS in that band. The TSR for a telephone company was the sum of the total subsidies required in each high-cost band.

591. In a letter dated 30 May 2001, the Commission asked Télébec and TELUS Québec to determine the TSR that they would receive from the NCF using the formula established in Decision 2000-745. In addition, the Companies were given, on an interim basis, the choice of either using their costs developed using the Phase II methodology, or using the national average of Phase II costs established in Decision 2001-238.

592. The banding structure and the Phase II costs for Télébec and TELUS Québec are currently being considered in the proceedings initiated by PN 2001-69.

Positions of parties

593. Télébec calculated its TSR using both the formula established in Decision 2000-745 and the national average of Phase II costs established in Decision 2001-238. Using its proposed rates for 2003, the company estimated that its TSR for determining its going-in revenue requirement would be $5.9 million.

594. TELUS Québec also used the methodology established in Decision 2000-745 to calculate its proposed TSR of $13.7 million. However, in its calculation, the company used its 2001 effective rates rather than its proposed going-in rates. In light of the fact that its proposed rate increases in high-cost bands would reduce its TSR, TELUS Québec included an expense of $1.4 million in its proposed going-in revenue requirement to reflect this revenue impact.

595. Other parties did not comment on this issue.

Conclusions

596. In the Commission's view, the TSR for 2002, used to estimate the Companies' going-in revenue requirements, should be calculated using the proxy national Phase II costs, the associated band structure and the Companies' average going-in rates, including the implicit optional local service revenues for the NAS in each of the high-cost bands eligible for subsidy.

597. The going-in rates approved by the Commission in Part IX of this Decision for Télébec are $3.33 lower than those proposed by Télébec for 2003 and used by the company for calculating its TSR for 2002. Using the approved going-in rates, the Commission has determined that Télébec's TSR to be approximately $8.1 million for 2002, or $2.3 million more than that proposed by Télébec as part of its going-in revenue requirement. The Commission has adjusted the company's going-in revenue requirement by the same amount.

598. As far as TELUS Québec is concerned, in Part IX of this Decision, the Commission has denied the rate increases proposed by the company. Consequently, the TSR as calculated by the company is correct. However, there is no basis for TELUS Québec's proposed adjustment of $1.4 million as there will be no TSR reduction from rate increases. Accordingly, the Commission has excluded the proposed expense for the reduction of the TSR from the company's going-in revenue requirement.

Additional uncollectible revenues

599. Télébec included in its proposed going-in revenue requirement an expense to reflect uncollectible revenues. Based on its proposed rate increases for 2002 and 2003, Télébec estimated that it would receive additional going-in revenues of $9.4 million. Using the uncollectible ratio of 0.55%, Télébec then estimated additional uncollectible revenues of $52,000.

600. Other parties did not comment on this issue.

601. In Part IX of this Decision, the Commission has denied the rate increases proposed by Télébec for 2002 and 2003. Consequently, the company's additional uncollectible expense should be based solely on the forecast revenues from the annualized impact of the 2001 planned and pending tariff filings and the residential rate restructuring revenues deferred by Order 2001-216. On this basis, the Commission determines that Télébec's additional uncollectible expense should be $20,700, a reduction of $31,300 from the company's proposed $52,000. The company's going-in revenue requirement has been adjusted accordingly.

Termination of integrality adjustment

602. Under rate base/rate of return regulation, the Commission generally treated the earnings of affiliates that provided directory services as if they were earnings of the regulated company pursuant to section 33 of the *Telecommunications Act*. In *Québec-Téléphone – Development plan for 1995-1999 and revenue requirement for 1995*, Telecom Decision CRTC 95-1, 25 January 1995, the Commission made such a finding with respect to Québec-Téléphone and its affiliate, Les Annuaires du Québec Enr. (LAQ).

603. As a result of TELUS' acquisition of Québec-Téléphone in 2000, TELUS Québec is no longer affiliated to LAQ. The company, therefore, proposed to eliminate the regulatory adjustment used to treat the earnings of the directory affiliate as if they were earnings of the company.

604. Other parties did not comment on this issue.

605. The Commission considers that TELUS Québec's proposed removal of the integrality adjustment of $0.4 million is appropriate and has reflected this adjustment in its determination of the company's going-in revenue requirement.

Going-in revenue requirements

606. The basic calculations to determine the going-in revenue requirements of Télébec and TELUS Québec are set out below in Table 1 and Table 2, respectively.

607. The starting point for the going-in revenue requirement calculation is the approved "2001 contribution requirement (Phase III)" as shown at Line A in the Tables. The incremental revenue requirement is then calculated by adding a number of incremental

financial adjustments, including the adjustments to expenses, the full year impact of rate initiatives proposed or implemented during 2001, the disposition of the deferral account, and the estimated impact of any rate proposals implemented at the initiation of the price cap method of regulation (Line B). The difference between the 2001 contribution requirement (Phase III) and the incremental revenue requirement is the going-in revenue requirement before the subsidy for the high-cost bands (Line C). The TSR that will be paid from the NCF is then deducted from the going-in revenue requirement (Line D). The difference is the residual going-in revenue requirement shortfall or surplus (Line E).

608. The financial adjustments resulting from the Commission determinations discussed in the various sections of this Decision are listed under the "Commission adjustments" column of the Tables and the going-in revenue requirement impacts are listed under the "Commission's view" column.

609. Télébec proposed a residual going-in revenue requirement shortfall of $12.3 million that would be recovered from the NCF for each year of the four-year price cap period. On the basis of determinations made in this Decision, the Commission has calculated a residual going-in revenue requirement shortfall of $7.6 million for Télébec. In light of the magnitude of this shortfall, the Commission concludes that regulatory action is required to permit its recovery by the company. The method of recovery of Télébec's residual revenue requirement shortfall is discussed in Part X of this Decision.

610. TELUS Québec proposed a residual going-in revenue requirement shortfall of $2.4 million that could be funded from the NCF, funds in the deferral account or from further rate increases. On the basis of determinations made in this Decision, the Commission calculated a residual going-in revenue requirement surplus of approximately $0.1 million for TELUS Québec. Given that the surplus is very small, the Commission concludes that no further action is required to eliminate the surplus.

Table 1

Télébec
Going-in revenue requirement
($ million)

			Company's proposal	Commission adjustments	Commission's view
A	**2001 Contribution requirement (Phase III)**		**27.3**		**27.3**
	Incremental revenue requirement impact				
	Service improvement plan (SIP)	(1)	0.0		0.0
	Additional depreciation expense		3.8	(6.0)	(2.2)
	ROE reduction from 11.3% to 11%		(0.7)		(0.7)
	Pending and planned tariff filings		(0.6)		(0.6)
	Amortization of deferral account		(5.1)	3.3	(1.9)
	Contribution payment to the NCF		(2.7)	(0.2)	(2.9)
	Uncollectible revenues		0.1	(0.1)	0.0
	Redirection of funds from deferral account (Order 2001-216)		(3.2)		(3.2)
	Advertisement and information system expense reductions		(0.2)		(0.2)
	Incremental revenue requirement impact before proposed rates		**(8.5)**	**(3.1)**	**(11.6)**
	Proposed rate increases 2002		(0.5)	0.5	0.0
B	**Incremental revenue requirement after proposed rates**		**(9.0)**	**(2.6)**	**(11.6)**
C	**Going-in revenue requirement (A+B)**		**18.3**	**(2.6)**	**15.7**
D	**Contribution from Central Fund**		**(5.9)**	**(2.3)**	**(8.1)**
E	**Residual going-in revenue requirement (C+D)**		**12.3**	**(4.7)**	**7.6**

Figures may not add due to rounding

(1) $0.036 million.

Table 2

TELUS Québec
Going-in revenue requirement
($ million)

		Company's proposal	Commission adjustments	Commission's view
	Contribution amount	30.5		30.5
	Withdrawal from deferral account	2.1		2.1
A	**2001 Contribution requirement (Phase III)**	**32.6**		**32.6**
	Incremental revenue requirement impact			
	Service improvement plan (SIP) and the network improvement	1.0		1.0
	Reduction to depreciation expense	(12.3)		(12.3)
	ROE increase from 11.3% to 12.0%	1.3		(1.3)
	ROE reduction from 12% to11%		(1.9)	(1.9)
	Pending and planned tariff filings	(1.1)		(1.1)
	Amortization of deferral account	(7.3)	5.1	(2.2)
	Local number portability	0.8	(0.8)	
	Local competition start-up	1.8	(1.8)	
	Amortization of employees benefits	2.3	(2.3)	
	Non-existent asset write-off	1.7	(1.7)	
	Removal of directory integrality	0.4		0.4
	Reduction in subsidies for band C	1.4	(1.4)	
	Contribution payment to the NCF	(4.1)	(0.3)	(4.4)
	Consulting services	0.2		0.2
	Incremental revenue requirement before proposed rates	**(13.9)**	**(5.1)**	**(19.0)**
	Proposed ($0.95) residential rate increases 2002	(2.5)	2.5	
	Proposed business rates for band C	(0.1)	0.1	
B	**Incremental revenue requirement after proposed rates**	**(16.5)**	**(2.5)**	**(19.0)**
C	**Going-in revenue requirement (A+B)**	**16.1**	**(2.5)**	**13.6**
D	**Contribution from Central Fund**	**(13.7)**		**(13.7)**
E	**Residual going-in revenue requirement (C+D)**	**2.4**	**(2.5)**	**(0.1)**

Figures may not add due to rounding

IX Setting 2002 going-in rates

Introduction

611. In PN 2001-36, the Commission indicated that as part of the present proceeding it would set going-in rates coincident with the implementation of price cap regulation.

612. Télébec and TELUS Québec each filed proposals seeking rate increases in order to meet their proposed going-in revenue requirements.

613. Télébec proposed to increase its residential local service rates in stages over the price cap period. The company also proposed to restructure its business rates at the commencement of the period in order to achieve greater uniformity and simplicity in its rate structure.

614. TELUS Québec proposed to increase its residential local service rates in stages over the price cap period. It also proposed to increase its single-line business rates in band C.

Télébec's residential rate proposals

615. Télébec proposed to increase its residential rates as follows:

a) in 2002, a $4.17 and $3.52 monthly rate increase to residential individual line rate in rate bands N1 and N2, respectively; and

b) in 2003, a $3.33 monthly rate increase to residential individual line rate in rate bands N1, N2 and N4.

616. In addition, Télébec indicated that it would expect to apply for further rate increases in 2004 and 2005 as a result of the Commission's decision in the PN 2001-69 proceeding related to the classification and identification of high-cost serving areas and the establishment of bands.

617. Télébec submitted that its proposed residential rate increases, along with those it proposed for business services, were essential for a harmonious introduction of a price cap regime.

618. In Télébec's view, the residential rate increases it proposed for 2002 and 2003 were necessary in order to bring rates closer to costs.

619. Télébec noted that, under its proposal, only a limited number of customers would face rate increases. According to Télébec, 90% of its residential customer base would not face any rate increase in 2002, while only 10.7% of its residential customers would face a rate increase in 2003.

620. Télébec argued that the additional revenues generated by its proposed rate increases would reduce the special subsidy it would require. Télébec submitted that, in 2002, the company's proposed residential rate increases would generate $0.5 million and that, in 2003, the next proposed rate increase would generate an additional $5.1 million. According to Télébec, from a revenue requirement perspective, the additional 2003 revenues were necessary to replace the revenues Télébec proposed to draw down in 2002 from its deferral account.

621. ARC et al. emphasized that Télébec customers were already paying the highest rates in Canada for basic residential telephone service. ARC et al. argued that it would be inappropriate for the Commission to allow Télébec to increase residential monthly rates over the next four years. ARC et al. submitted that at least 40% of Télébec's customer base lived in areas that the company identified as non-HCSAs. According to ARC et al., rates in these areas were already compensatory and should not be raised.

622. ARC et al. also opposed Télébec's proposed rate increases on the grounds that they would be significant, up to 10.7% in some cases, and would involve rate shock to consumers.

623. ARC et al. noted that one of Télébec's reasons for its proposed rate increases was to establish a uniform rate of $34.43 per month in 2003 for all its residential individual line customers. ARC et al. submitted that a uniform rate should not be a Commission priority since rates would not reflect true costs. ARC et al. concluded that Télébec's goal of a uniform rate did not justify its proposed rate increases.

624. ARC et al. submitted that Télébec's rate proposals were improper since they were developed using a 2001 ROE of 11.2% and Télébec's calculation excluded the monies currently held in a deferral account. ARC et al. also argued that the funds in the deferral account should be used to offset potential rate increases in those areas where rates were not compensatory.

625. A number of Télébec subscribers commented on Télébec's proposed residential rate increases. All were opposed to any residential rate increases. They emphasized that Télébec's residential subscribers had seen their rates significantly increase over the last few years, and several subscribers noted that these increases had been much greater than the rate of inflation over the past several years, up to 11 times the rate of inflation in some cases. They also noted that Télébec customers were already paying the highest rates in Canada and that the proposed rate increases were significant.

Commission determinations regarding Télébec's residential rate proposals

626. In the Commission's view, Télébec's residential rate proposal would mix elements of traditional earnings regulation with price regulation and thereby diminish the benefits of the latter approach. Consequently, the Commission has determined that it would be inappropriate to approve any rate increases for 2003 at this time. Télébec can, of course, apply for residential rate increases in the future, provided they are within the parameters of the price regulation regime established by the Commission in this Decision.

627. With respect to the proposed residential rate increases for 2002, the Commission notes that Télébec's residential monthly rates increased from $16.89 in 1994 to $31.00 in 2000. Further, on 1 July 2000, residential subscribers experienced monthly basic rate increases ranging from $0.47 to $4.00.

628. The Commission considers that Télébec's subscribers should not be subject to further increases at this time, in light of the significant rate increases which have been approved in recent years and the current level of Télébec's rates. The Commission also notes that the additional revenues generated by the proposed increases would not significantly diminish Télébec's going-in revenue requirement shortfall. The method of recovery of Télébec's residual going-in revenue requirement shortfall is discussed in Part X of this Decision.

629. Accordingly, the Commission does not approve Télébec's proposed residential rates. Instead, the Commission sets Télébec's going-in residential rates at their current level.

Télébec's business rate proposals

630. Télébec proposed to restructure business service rates as follows:

a) a single-line business rate restructuring that involves monthly rate changes ranging from a reduction of $14.35 to an increase of $20.35 resulting in a uniform monthly rate of $60.08;

b) a multi-line business rate restructuring that involves monthly rate changes ranging from a reduction of $46.95 to an increase of $13.95 resulting in a uniform monthly rate of $75.08;

c) a Centrex "Forfait affaire de base" rate restructuring that involves monthly rate changes ranging from a reduction of $23.01 to an increase of $16.98 resulting in a uniform monthly rate of $72.48;

d) a Centrex "Forfait A" rate restructuring that involves monthly rate changes ranging from a reduction of $17.86 to an increase of $27.25 resulting in a uniform monthly rate of $77.08;

e) a Centrex "Forfait B" rate restructuring that involves monthly rate changes ranging from a reduction of $29.20 to an increase of $21.11 resulting in a uniform monthly rate of $84.78;

f) a Centrex "Forfait C" rate restructuring that involves monthly rate changes ranging from a reduction of $30.85 to an increase of $24.37 resulting in a uniform monthly rate of $92.48; and

g) a Megalink service rate restructuring that involves monthly rate changes ranging from a reduction of $16.64 to an increase of $22.56 resulting in a uniform monthly rate of $60.08.

631. In support of its proposed business rate restructuring, Télébec argued that the business tariff modifications, along with those it proposed for its residential services, were essential for a harmonious introduction of a price cap regime.

632. Télébec submitted that its business rate restructuring proposal was effectively revenue neutral, as it would result in a minimal increase in revenues. Accordingly, the company submitted that its proposal was comparable to other revenue neutral proposals approved by the Commission in the past and should be considered appropriate as it would introduce a more uniform rate structure without affecting revenues.

633. Other parties did not comment on Télébec's proposed business rate restructuring.

634. The Commission agrees with Télébec that its proposed business rate restructuring is effectively revenue neutral and, therefore, would have no impact on the going-in revenue requirement. The Commission considers that Télébec's proposal would introduce greater business rate uniformity, as well as increase administrative simplicity.

635. In light of the above, the Commission considers Télébec's proposed business rate restructuring appropriate and approves the proposed rates, effective 31 July 2002. The Commission is therefore setting Télébec's going-in business rates in accordance with Télébec's proposal. The Commission directs Télébec to issue tariff pages by 30 August 2002.

TELUS Québec's residential rate proposals

636. TELUS Québec proposed the following residential rate increases:

a) in 2002, a $0.95 monthly rate increase to its basic residential service in rate bands C, D, E, F and G (i.e., those bands TELUS Québec considers high cost);

b) in 2003, a $2.50 monthly rate increase to its basic residential service in rate bands D, E, F, and G;

c) in 2004, a $2.25 monthly rate increase to its basic residential service in rate bands D, E, F, and G; and

d) in 2005, a $1.40 monthly rate increase to its basic residential service in rate bands E, F, and G and a $0.55 monthly rate increase to its basic residential service in rate band D.

637. TELUS Québec submitted that its residential rate proposal would ensure that basic local service would remain accessible to all residents of its territory at an adequate quality of service level. The company also argued that its proposed graduated rate increases would minimize any rate shock to its customers.

638. TELUS Québec justified its proposed residential rate increases on the basis of the revenue and expense adjustments it estimated for each year of the four-year price cap period.

639. ARC et al. opposed TELUS Québec's proposed residential rate increases on the grounds that consumers had already seen rates increase from $14.00 in 1995 to the current rate of $23.50.

640. The Commission also received two letters from subscribers opposing TELUS Québec's proposed residential rate increases.

Commission determinations regarding TELUS Québec's residential rate proposals

641. In the Commission's view, TELUS Québec's proposal for residential rate increases would mix earnings regulation and price regulation in much the same manner as Télébec's residential rate proposal and it would give rise to the same concerns. In particular, this approach would undermine the incentives for increased efficiency and innovation under price regulation.

642. Under the price regulation regime established by the Commission for TELUS Québec in this Decision, once going-in rates are set, rates for individual services may increase or decrease provided that they conform with all of the applicable pricing constraints. Consequently, the Commission does not consider it appropriate to approve any rate increases for 2003, 2004 or 2005. If TELUS Québec wishes to implement residential rate increases in 2003, 2004 or 2005, it must do so within the parameters of the price regulation regime.

643. As far as TELUS Québec's proposed residential rate increase for 2002 is concerned, the Commission concludes that TELUS Québec does not require any increase to its current residential rates since, as determined in Part VIII of this Decision, the company has a negligible going-in revenue requirement surplus based on existing rates.

644. Accordingly, the Commission denies TELUS Québec's proposed residential rate increases in 2002. The Commission is therefore setting TELUS Québec's going-in residential rates at their current levels.

TELUS Québec's business rate proposal

645. TELUS Québec proposed to increase its single-line business band C monthly rate from $55.90 to $58.00. The company submitted that this proposed change would generate approximate $0.1 million in additional annual revenues.

646. TELUS Québec did not provide any specific rationale in support of its proposed rate increase. TELUS Québec did indicate that it expects local competition to develop in its serving territory over the four-year price cap period, particularly in the business market.

647. Other parties did not comment on TELUS Québec's business rate proposal.

648. The Commission has determined that TELUS Québec does not require any adjustments to its business rates in order to meet its going-in revenue requirement.

649. Accordingly, the Commission denies TELUS Québec's proposed increase of $2.10 to its business band C rate. The Commission sets TELUS Québec's going-in business rates at their current levels.

X Recovery of Télébec's residual going-in revenue requirement shortfall

Background

650. As a result of the Commission's conclusions in Parts VIII and IX of this Decision, Télébec has a residual going-in revenue requirement shortfall of $7.6 million.

651. This shortfall is based, in part, on the use of Phase II cost proxies in the TSR calculation that will be finalized in the PN 2001-69 proceeding. In PN 2001-69, the Commission stated that it would review, among other things, the rate band structure, the definition and the identification of high-cost serving areas, the local loop rates per band and associated costs for Télébec and TELUS Québec.

652. In Decision 2000-745, the Commission indicated a transition period might be required to permit the small ILECs to adjust to the new contribution mechanism. In *Regulatory framework for the small incumbent telephone companies*, Decision CRTC 2001-756, 14 December 2001, the Commission determined that the small ILECs who received a lower subsidy under the Phase II methodology would have a four-year transition period.

Positions of parties

653. Télébec calculated its price cap proposal using a proxy subsidy per NAS based on the criteria established in Decision 2001-238. Based on this proxy subsidy, as well as the other adjustments it proposed, Télébec estimated a residual going-in revenue requirement shortfall of $12.3 million.

654. To fund its shortfall, Télébec proposed a recurring annual special subsidy of $12.3 million to be funded from the NCF for the duration of the price cap period. Télébec indicated that its special subsidy requirement would decrease once the review of its bands and Phase II costs is completed under PN 2001-69.

655. In response to a Commission question at the oral hearing, Télébec indicated that it would not object to the application of a price cap formula (I-X) to the entire Utility Segment revenues in order to eliminate its special subsidy over time. Télébec was concerned, however, that it would not be able to adjust its rates, other than in HCSAs, until the special subsidy was completely eliminated.

656. In its final argument, Télébec reiterated its view that its going-in revenue shortfall should be funded from the NCF to allow the company to maintain its financial integrity while avoiding rate shock for its customers. Télébec also argued that the special subsidy was necessary to permit the company to maintain its quality of service and to foster socio-economic development in its regions through telecommunications.

657. In its final argument, ARC et al. noted that, in Decision 2000-745, the Commission determined that the NCF would be used solely to subsidize HCSAs and that the amount of the subsidy a telephone company would receive would be based on its Phase II costs. ARC et al. was of the view that the Commission's intent in Decision 2000-745 was to create an incentive for the telephone companies to reduce their costs.

658. ARC et al. submitted that a special subsidy for Télébec would not be appropriate, unless it could be justified for public policy reasons. In ARC et al.'s view, if the Commission were to determine that a residual going-in revenue requirement shortfall existed for Télébec, a special subsidy could be justified, as long as it declined over time.

Conclusions

Funding Options

659. In the present proceeding, several options were considered to allow Télébec to recover its residual going-in revenue requirement shortfall of $7.6 million. These funding options included rate increases, a recurring annual subsidy from the NCF, or a declining transitional subsidy from the NCF.

660. The Commission decided in Part IX of this Decision not to permit Télébec to raise its residential local service rates to fund the residual going-in revenue requirement shortfall since it would have required significant rate increases for Télébec customers. Amongst other considerations, the Commission concluded that such increases would not be appropriate given their magnitude and the fact that significant rate increases have been approved for Télébec in recent years.

661. In the Commission's view, Télébec's residual going-in revenue requirement shortfall should be funded by means of a subsidy from the NCF. However, the Commission shares ARC et al.'s view that any such subsidy should not be constant but, instead, should decline over time.

662. As noted above, the small ILECs were given four years to make the transition to their lower subsidy level. The Commission is of the view that Télébec, with its larger revenue base, should be able to make the transition to its lower subsidy level more quickly.

663. Accordingly, the Commission concludes that Télébec's residual going-in revenue requirement shortfall of $7.6 million will be funded through a transitional subsidy from the NCF.

664. As stated earlier, Télébec agreed that if the company had a residual going-in revenue requirement shortfall, the Commission could apply an I-X constraint to the company's going-in revenue requirement in order to reduce the shortfall for regulatory purposes. In this way, any transitional subsidy would be gradually phased out. The Commission concludes that this is an appropriate approach.

The inflation factor and productivity offset

665. With respect to the inflation factor, in Part IV of this Decision, the Commission decided to use the chain-weighed GDP-PI in the TSR calculation and in the pricing constraints applicable to the Companies. The Commission considers it appropriate to also use this factor in the transitional subsidy mechanism discussed below.

666. With respect to the productivity offset, in response to a Commission interrogatory, Télébec provided an estimated productivity offset of 2.9% using the TFP approach. The company indicated, however, that it did not have historical data on TFP.

667. As stated in Part IV of this Decision, ARC et al. submitted that a TFP approach would provide a good indicator of Utility Segment productivity gains. ARC et al. recommended that an industry-wide TFP-based productivity offset be set at a level greater than 4.5%.

668. The Commission notes that Télébec's residual going-in revenue requirement shortfall was derived from the Utility Segment. The Commission considers that the productivity offset to be used in the transitional subsidy mechanism should reflect the productivity gains achievable by the services formerly classified as being in Télébec's Utility Segment. In this regard, a TFP-based productivity offset is more comprehensive than a productivity offset based on marginal costs trends which is more suitable for individual capped baskets. The Commission also notes that, in Decision 97-9, a company-wide TFP approach was found to be an appropriate proxy for the Utility Segment productivity.

669. As noted above, Télébec indicated that it did not have historical data on TFP. In the circumstances, the Commission considers Télébec's 2.9% estimate to be of limited value.

670. The Commission notes that in the PN 2001-37 proceeding, historical TFP information was provided by the other large ILECs. This information was for the period 1988 to 2000 and was the only historical TFP data available. On the basis of this information, the Commission has derived an industry-wide TFP productivity offset of 4.7%.

671. In light of the above, the Commission has decided to use a productivity offset of 4.7% for the purpose of phasing out Télébec's transitional subsidy of $7.6 million.

The transitional subsidy mechanism

672. The Commission has decided that Télébec will receive a transitional subsidy from the NCF to fund its residual going-in revenue requirement shortfall. In order to implement the transitional subsidy mechanism, the Commission is suspending the application of the I-X constraint to the baskets of Residential services in non-HCSAs and the Other capped services. The rate element constraints applicable to these baskets will remain in force. The application of the I-X constraint on rates for certain Competitor Services is also suspended. All other basket constraints and rate element constraints remain in place.

673. The Commission has also decided that the annual adjustment of inflation less a productivity offset to residential local exchange costs in HCSAs for the annual TSR calculation will not be applied for Télébec until the transitional subsidy is eliminated.

674. The effect of the suspension of the I-X basket constraints will be to permit the company to retain productivity gains with respect to the services in these baskets in order to reduce the transitional subsidy. The transitional subsidy will decline annually based on three types of adjustments discussed below.

675. First, a basic adjustment will be calculated by applying the I-X formula to a fixed going-in revenue base, where the inflation will be the chain-weighted GDP-PI for the previous year and the X-factor will be 4.7%. The I-X adjustment will be applied to a revenue base to determine the amount by which the transitional subsidy must be reduced for the current year.

676. The Commission has determined that the appropriate fixed going-in revenue base will be Télébec's 2001 Utility Segment revenue of $127.1 million, less the total incremental revenue requirement adjustments of $11.6 million, for a net amount of $115.5 million.

677. Second, the transitional subsidy will be reduced by means of revenues derived from rate increases which Télébec may introduce in accordance with the transitional price regulation regime discussed above. Any additional revenues generated as a result of rate increases for services within the baskets identified above will be applied directly to the reduction of the transitional subsidy.

678. Third, the Commission anticipates that the decision arising from the PN 2001-69 proceeding will likely affect Télébec's revenues and subsidy entitlements. The Commission will make any appropriate adjustments to the transitional subsidy when that decision is released.

679. Once the transitional subsidy is completely eliminated, the special measures identified above will cease to apply. In particular, the I-X basket constraints will be reinstated for the baskets of Residential services in non-HCSAs and the Other capped services. The I-X constraint on Competitor Services rates will also be reinstated. Similarly, the I-X adjustment will be reintroduced in the TSR calculation for Télébec.

680. In order to monitor the level of the transitional subsidy, the Commission directs Télébec to indicate the amount of the transitional subsidy, including supporting calculations, as part of the annual contribution filing calculations (i.e., on 31 March each year until the transitional subsidy is eliminated).

XI Other issues

Reporting requirements

681. In Decision 97-21, the Commission established a revised regulatory regime that segmented the Companies' operations into a Utility Segment and a Competitive Segment. In connection with this change, the Commission introduced new reporting requirements. Specifically, Phase III/SRB reports were introduced to provide the Companies' Income Statement, Average Net Investment Base, Capitalization Report and Return on Average Common Equity Report results separated into the two segments.

682. The current reporting requirements for Télébec and TELUS Québec include:

- filing of annual audited historical Phase III/SRB results on or before 31 October of the following year;

- filing of Phase III/SRB manual updates, along with any changes to Accounting Manuals, annually on 31 March, with such updates considered approved after 60 days from filing, unless the Commission indicates otherwise;

- filing of actual non-audited year-to-date financial results for the Utility and Competitive Segments on a quarterly basis, 45 days after the end of the quarter;

- filing of current quarterly intercorporate transaction reports;

- filing of capital plans for the Utility Segment on an annual basis; and

- filing of changes to depreciation life characteristics.

683. Both Télébec and TELUS Québec submitted that the price cap regime should result in a streamlined form of regulation. The Companies proposed to eliminate the requirement to file:

- audited Phase III/SRB results;
- capital plans;
- changes in depreciation life characteristics;
- updates to the accounting guide manual; and
- intercorporate transaction reports.

684. Both Télébec and TELUS Québec submitted that they would have a residual going-in revenue requirement shortfall and, therefore, should receive a special subsidy from the NCF. As a result, the Companies proposed to continue filing annual Phase III/SRB results in order to allow the Commission to monitor and control the evolution of their special subsidy requirement. However, to lighten their regulatory burden, Télébec proposed to file non-audited annual Phase III/SRB results instead of audited Phase III/SRB results.

685. ARC et al. submitted that without the discipline inherent in robust competition, continued regulation was a necessity, and that for effective regulation, some minimum level of reporting was required for the Commission to be satisfied that rates were just and reasonable. ARC et al. also submitted that such reporting was needed to assess the reasonableness and effectiveness of the price cap regime. ARC et al. noted that company-wide results, while broadly indicative of performance under price caps, included revenues and costs related to non-regulated services. ARC et al. argued that, given the absence of competition for much of the Utility Segment services, the Phase III/SRB results should be maintained since they can be tied to the Companies' audited financial statements.

686. ARC et al. also submitted that it would be important for the Commission to be able to monitor the Companies' financial performance throughout the price cap period. Consequently, ARC et al. proposed that existing reporting requirements should be continued.

687. ARC et al. also proposed new reports on the nature and extent of competition as well as achieved productivity gains in order to measure the success of price cap regulation.

688. The Commission considers that the concept of a Utility Segment no longer has relevance. This is due, in part, to the introduction of a Phase II-based determination of the subsidy requirement starting in 2002. Previously, the contribution requirement was based on a Phase III Utility Segment shortfall calculation. As well, as discussed in Part III of this Decision, the Commission has determined that the price cap framework will be extended to non-forborne services currently in the Competitive Segment.

689. The Commission also considers that the distinction between the Utility Segment and Competitive Segment is no longer relevant. The meaningful distinction in the price regulation regime is between tariffed services and forborne services.

690. In light of this regulatory framework, there is no longer a need for Phase III/SRB inputs on a going-forward basis. Therefore, the Commission determines that the requirement for Télébec and TELUS Québec to report their financial results on a Phase III/SRB basis is eliminated effective immediately.

691. The Commission recognizes that the financial results for Télébec and TELUS Québec will need to be available for the purpose of the review of this price cap regime. Sufficient information must be reported to allow the Commission to gauge the financial state of the Companies in order to ensure that the objectives of the price cap regime are being met.

692. The Commission notes that the information provided by all telecommunications companies as part of the Commission's annual monitoring process includes, among other things, financial data.

693. With respect to intercorporate transaction reporting, the Commission notes that the existing reporting requirements were introduced when the Companies were under rate of return regulation to reduce the incentive to overstate the amount of Utility Segment intercorporate transactions, and thus reduce Utility Segment earnings.

694. The Commission considers that under the structure of the price cap regime, the incentive to overstate intercorporate transactions is reduced. Accordingly, the Commission has determined that the current intercorporate transaction reports for Télébec and TELUS Québec are no longer required, effective immediately.

695. In addition, the Commission agrees with Télébec and TELUS Québec that the following reports are no longer required, effective immediately:

- Annual Capital/Construction Program;
- Changes in Depreciation life characteristics; and
- Updates to accounting guides.

696. The Commission does not consider that the new reports proposed by ARC et al. are required. All information necessary to permit a full review of the Companies' price regulation regime will be available either from the ongoing monitoring reports which the Companies are required to file or from information to be obtained during the review process.

Contribution issues

Background

697. In Decision 2000-745, the Commission introduced a new national contribution collection mechanism to subsidize the high cost of local service in rural and remote areas. Under the new mechanism, effective 1 January 2001, a revenue-percent charge is levied on revenues from eligible telecommunications service providers (TSPs).

698. In Decision 2000-745, the Commission also introduced a new subsidy requirement calculation that would establish the appropriate amount of subsidy payable to local exchange carriers which provide service in HCSAs. In brief, the subsidy requirement consists of the sum of the average annual residential PES revenue and an annual implicit contribution target amount of $60.00 less the average annual PES costs, established on the basis of Phase II costs with an approved mark-up, per residence NAS in each high-cost band. The TSR for each of the Companies is the total of the annual subsidy requirements for all residential NAS in all high-cost bands. This TSR calculation methodology became effective 1 January 2002.

699. In PN 2001-36, the Commission indicated that a number of TSR-related issues associated with the implementation of a price cap regime for Télébec and TELUS Québec would be determined in the present proceeding.

700. In Decision 2002-34, the Commission resolved a number of similar issues involving the TSR and price regulation regime for the other large ILECs.

Calculation of the TSR

701. In Part IV of this Decision, the Commission directed Télébec and TELUS Québec to apply a 3.5% productivity factor and an inflation factor based on the chain-weighted GDP-PI annually in the TSR formula.

702. In calculating the appropriate cost adjustments for the TSR, the Commission considers that the adjustment for the revenue-percent charge should be the net change in the revenue-percent charge from year to year. The Commission notes that this will eliminate the cumulative effect of adding the annual revenue-percent charge directly to the base average PES cost each year.

703. In Order 2001-876, the Commission approved an interim revenue-percent charge of 1.4%, effective 1 January 2002.

704. In Decision 2002-34, the Commission adjusted the 2002 TSR calculation for the other large ILECs in order to reflect the change to the revenue-percent charge from 4.5% to 1.4% as follows:

- assume a 4.5% reduction in the average revenue per NAS;
- calculate 1.4% of the reduced revenue; and
- add that amount to the average PES cost per NAS.

705. The Commission considers that the same approach should apply to Télébec and TELUS Québec. Accordingly, these adjustments have been made in Part VIII of this Decision in setting the Companies' going-in revenue requirements. The Commission notes that, in subsequent year adjustments, Télébec and TELUS Québec should use a similar approach.

706. In keeping with the Commission's conclusion in Decision 2002-34, in general, the PES costs used in the TSR formula are to be adjusted in the following sequence:

- the base average PES costs will be adjusted by inflation minus the annual productivity offset of 3.5%;
- the 15% mark-up, established in Decision 2000-745, will then be applied to the adjusted average PES costs; and
- the net cost adjustment related to the revenue-percent charge will be included.

For Télébec, the Commission has concluded in Part X of this Decision that the annual adjustment of inflation less a productivity offset to be applied to average PES costs in the TSR formula will be suspended until Télébec's transitional subsidy is no longer required.

Timing of annual updates to the TSR

707. In Decision 2000-745, the Commission determined that certain information is to be filed annually with the Commission, by 31 March of each year, by all TSPs or groups of related service providers. Updated TSRs and NAS counts by band are also required from the ILECs on the same date. This allows the Commission to verify the contribution amounts remitted the previous year, review the calculation of contribution-eligible revenues, determine which companies will be required to pay contribution and calculate the revenue-percentage charge for the current year.

708. Parties did not comment on this issue.

709. In Decision 2002-34, the Commission upheld the 1 January effective date for the annual revenue-percent charge and the 31 March date for the annual filing of revenue information by all TSPs. The Commission considers that these requirements also remain valid for Télébec and TELUS Québec.

710. The Commission directs Télébec and TELUS Québec to file revised 2002 total subsidy requirements and associated monthly amounts by 30 August 2002 to take into account the Commission's determination in this Decision. The calculation is to reconcile amounts already received from the central fund administrator pursuant to Order 2001-876. Télébec and TELUS Québec are to identify separately the adjustments resulting from the application of the inflation factor and productivity offset to their base subsidy amount as determined in Part VIII of this Decision. Télébec is also required to identify separately the special subsidy requirement as determined in Part X of this Decision.

Secretary General

This document is available in alternative format upon request and may also be examined at the following Internet site: http://www.crtc.gc.ca

Rebate Plan for Retail Quality of Service

1. Total amounts available for rebate are based on 5% of total annual local revenues subject to the price cap, referred to as the Total Maximum Adjustment Value.

2. The interim plan will be based on results for the following 13 indicators:

   - Indicator 1.1A/B: Provisioning Interval – Urban and Rural
   - Indicator 1.2A/B: Installation Appointments Met – Urban and Rural
   - Indicator 1.3A/B: Held Orders per 100 NAS Inward Movement – Urban and Rural
   - Indicator 1.5: Access to Business Office
   - Indicator 1.7: On-Time Activation of PICs for Alternate Providers of Long Distance Service
   - Indicator 2.1A/B: Out-of-Service Trouble Reports Cleared within 24 Hours – Urban and Rural
   - Indicator 2.2A/B: Repair Appointments Met – Urban and Rural
   - Indicator 2.3A/B: Initial Customer Trouble Reports per 100 NAS – Urban and Rural
   - Indicator 2.5: Access to Repair Bureau
   - Indicator 3.1: Dial Tone Delay
   - Indicator 4.1: Directory Accuracy
   - Indicator 4.2: Access to Directory Assistance
   - Indicator 4.3: Directory Assistance – Accuracy

3. Each of the 13 indicators are given equal weighting in calculating the rebate amount. The maximum adjustment value for each indicator is calculated by dividing the total maximum adjustment value by the number of indicators included in the rebate plan (e.g., TMAV / 13).

4. Annual Average Performance (AAP) is the actual performance in percentage terms of an indicator over one year. Note that the quality of service standard associated with each indicator is stated in percentage terms.

5. Annual Average Performance Ratio (AAPR) describes the extent to which the indicator's performance fell short of its standard (portrayed in terms of the maximum 10 point value that an indicator can achieve to escape any rate adjustment).

6. To reach the full 10 points for an indicator, the ILEC must achieve an annual average performance which is equal to or better than the standard established for that indicator by the Commission. When the annual average performance falls below the standard, the ILEC calculates the percentage deterioration in performance as compared to the standard, multiplying this result by the maximum 10 point value for the indicator to develop the specific AAPR for the indicator. The AAPR may range from 0 to 10 based on the quality of service results. Where standards are expressed in terms of "x% or less",

both the AAP and the standard are to be expressed in terms of "x% or more" in order to calculate the AAPR. In order to accomplish this, the standard and the AAP values are each subtracted from 100% and the resulting values used to calculate the AAPR (See example in Step 4 of Worksheet 3).

7. The Quality of Service Adjustment calculation displays the relationship (for a single indicator) between AAP Ratios and the rebate amounts that would apply. Once the AAPR is calculated, the ratio is read into the Standard Adjustment Table, and the corresponding percentage value reflected in the table is applied to the maximum adjustment value for the indicator. Where urban and rural results are reported for a single indicator, the maximum adjustment value is divided by two in calculating the Quality of Service adjustment for the indicator.

Retail Quality of Service Adjustment Plan
Report
(to be filed with the Commission with Q of S results)

Date: ___/____/_____
dd / mm/ yyyy

Company: ____
(Full Corporate Name)

Contact Name: ____

Contact Address: ____

Contact Phone: ____ - ____ - _____ **Contact Facsimile:** ____ - ____- _____

Certification: (insert statutory declaration language, include knowledge that Q of S results are subject to random audits by the CRTC or its agent)

Retail Quality of Service Adjustment Plan
Worksheet 1

Step 1: Calculate the Total Maximum Adjustment Value (TMAV)
TOTAL ANNUAL LOCAL REVENUES $_______________ * 5% = ___________(A)

Step 2: Calculate the Maximum Adjustment Value (MAV) per required Q of S indicator TMAV (A) ___________ / total number of required Quality of Service Indicators _____ = _________(B)
Transfer to Worksheet 3 – MAV Column
(For this calculation only: Q of S Indicator reported as rural and urban, count as one required indicator when calculating MAV).

Step 3: Calculate Annual Average Performance (AAP) for each Quality of Service Indicator. (Worksheet 2)

Add Monthly results for each indicator / 12 (where required and not reported = 0%).

Step 4: Calculate the AAP Ratio (AAPR) for each indicator compared to the Q of S standard (Worksheet 2)
AAPR = (AAP / Q of S standard) * 10 or (100-AAP) / (100-Q of S standard) * 10
[Note: maximum AAPR = 10]

Step 5: Calculate the Quality of Service Adjustment (QSA) (Worksheet 3)
QSA = Standard Adjustment (SA) percent * MAV

The standard adjustment is determined by reading the AAPR into the AAPR to Standard Adjustment conversion table

Step 6: Calculate the Total Annual Quality of Service Adjustment (Worksheet 2)

Retail Quality of Service Adjustment Plan
Worksheet 2

Q o S Indicator	QoS Standard (QoSS)	QUALITY OF SERVICE RESULTS REPORTED												Sum 1-12	TOTAL / 12	AAP / QoSS *10	Work-sheet 3
		MONTHLY ACTUALS												TOTAL	AAP	AAPR	QSA
		1	2	3	4	5	6	7	8	9	10	11	12				

TOTAL ANNUAL QUALITY OF SERVICE ADJUSTMENT $_______________

Retail Quality of Service Adjustment Plan
Worksheet 3
Including
Illustrative Calculations

Step 1 Calculate the Total Maximum Adjustment Value (TMAV)
TMAV = Total Annual Local Revenues * 5 %

EXAMPLE	$168,250,000.00	*	5.00%	(A)
				$8,412,500.00

Step 2 Calculate the Maximum Adjustment Value (MAV) per required Q of S indicator
MAV = TMAV (A) / number of required Quality of Service Indicators

EXAMPLE	$8,412,500.00	/	13	(B)
				$647,115.38

** Where rural and urban indicators are reported, count as one service category

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Step 3 Calculate Annual Average Performance (AAP) for each Quality of Service Indicator
Add Monthly results for each indicator / 12 (where not reported = 0%)

EXAMPLE				(C)
INDICATOR 1	1035.6	/	12	86.30
INDICATOR 2	955.4	/	12	79.62
INDICATOR 3	1114.5	/	12	92.88
INDICATOR 4	1095.2	/	12	91.27
INDICATOR 5	828.5	/	12	69.04
INDICATOR 6	922.6	/	12	76.88
INDICATOR 7	45.6	/	12	3.8
INDICATOR 8	48.0	/	12	4.8

Retail Quality of Service Adjustment Plan
Worksheet 3
Including
Illustrative Calculations (cont'd)

Step 4 Calculate the AAP Ratio (AAPR) for each indicator compared to the Q of S standard

AAPR = (AAP / Q of S standard) * 10 [Note: maximum AAPR = 10]

EXAMPLE	AAP (C)		Standard	*10	AAP Ratio (D)
INDICATOR 1	86.30	/	90	*10	9.59
INDICATOR 2	79.62	/	80	*10	9.59
INDICATOR 3	92.88	/	90	*10	10
INDICATOR 4	91.27	/	90	*10	10
INDICATOR 5	69.04	/	90	*10	7.67
INDICATOR 6	76.88	/	80	*10	9.61
OR					
STANDARD >3.3	(100-3.8)= 96.2	/	(100-3.3)=96.7	*10	9.95
STANDARD >5.5	(100-5.2) = 94.8	/	(100-5.5)=94.5	*10	10

Retail Quality of Service Adjustment Plan
Worksheet 3
Including
Illustrative Calculations (cont'd)

Step 5 Calculate the Quality of Service Adjustment (QSA) for each indicator per table below. The Standard Adjustment value is based on the Annual Average Performance Ratio calculated for each indicator, which is read into the AAPR to SA conversion table below.

EXAMPLE
AAPR per table = SA per table.
SA * MAV from Step 2 = QSA

AAPR TO SA CONVERSION TABLE AAP Ratio (D)	=	SA (E)	*	(B) MAV $647,115.38	QSA (F)
10	=	0%	*	MAV	$0.00
9.50-9.99	=	25%	*	MAV	$161,778.85
9.00-9.49	=	30%	*	MAV	$194,134.61
8.50-8.99	=	35%	*	MAV	$226,490.38
8.00-8.49	=	40%	*	MAV	$258,846.15
7.75-7.99	=	45%	*	MAV	$291,201.92
7.50-7.74	=	50%	*	MAV	$323,557.69
7.25-7.49	=	60%	*	MAV	$388,269.23
7.00-7.24	=	70%	*	MAV	$452,980.77
6.50-6.99	=	80%	*	MAV	$517,692.30
6.00-6.49	=	90%	*	MAV	$582,403.84
5.50-5.99	=	92%	*	MAV	$595,346.15
5.00-5.59	=	94%	*	MAV	$608,288.46
4.50-4.99	=	96%	*	MAV	$621,230.76
4.00-4.49	=	98%	*	MAV	$634,173.07
3.00-3.99	=	100%	*	MAV	$647,115.38
2.00-2.99	=	100%	*	MAV	$647,115.38
1.00-1.99	=	100%	*	MAV	$647,115.38
0	=	100%	*	MAV	$647,115.38

Retail Quality of Service Adjustment Plan
Worksheet 3
Including
Illustrative Calculations (cont'd)

Step 5a For Rural and Urban, apply 50% of Maximum Adjustment Value to each AAP
(AAP = SA) * (MAV/2)

EXAMPLE	(AAP = SA)	*	(MAV/2)	(C)
Rural	(7.75 = 45%)	*	$323,577.69	$145,600.96
Urban	(9.92 = 25%)	*	$323,577.69	$ 80,889.42

Step 6 Add all QSA results for all indicators for the year

Competitor Quality of Service Adjustment Plan

The rate adjustment plan is based on the following criteria, as applicable:

1) the rate a CLEC is paying for the service that does not meet the indicator's standard; or

2) the rate a CLEC is paying for the service that is affected by an indicator whose standard is not met; or

3) ILEC prices for business exchange services, as a proxy for the market advantage to the ILEC of the substandard indicator, where the indicator whose standard is not met does not apply to or affect a particular competitor service.

The specific formulae for the plan are:

For case (1) above: (mandated percentage standard – achieved percentage) x (CLEC-specific total tariffed charges applied for the month for the specific rate element(s) in question)

For case (2) above: (mandated percentage standard – achieved percentage) x (CLEC-specific total tariffed charges applied for the month for the service in question)

For case (3) above: (mandated percentage standard – achieved percentage) x (CLEC's specific demand for the month for the activity in question) x (CRTC mandated adjustment amount per event)

Competitor Quality of Service Adjustment Plan (cont'd)

CLEC (ABC)			Achieved performance in %			Adjustment amount in $ payable to CLEC (ABC)			Applicable Formula
Indicator #	Standard	Title	Month/ Year	Month/ Year	Month/ Year	Month/Year	Month/Year	Month/Year	
1.8 Final	90% or more	New Unbundled Type A and B Loop Order Service Intervals Met	**P(1.8)*i***	**P(1.8)*j***	**P(1.8)*k***	**[90%-P(1.8)*i*]*(CLEC-specific total tariffed charges for the month for the specific rate element)**	**[90%-P(1.8)*j*]*(CLEC-specific total tariffed charges for the month for the specific rate element)**	**[90%-P(1.8)*k*]*(CLEC-specific total tariffed charges for the month for the specific rate element)**	**Formula #1**
1.9 Final	90% or more	Migrated Unbundled Type A and B Loop Order Service Intervals Met	**P(1.9)*i***	**P(1.9)*j***	**P(1.9)*k***	**[90%-P(1.9)*i*]*(CLEC-specific total tariffed charges for the month for the specific rate element)**	**[90%-P(1.9)*j*]*(CLEC-specific total tariffed charges for the month for the specific rate element)**	**[90%-P(1.9)*k*]*(CLEC-specific total tariffed charges for the month for the specific rate element)**	**Formula #1**
1.10 Final	90% or more	Local Number Portability (LNP) Order (Standalone) Service Interval Met	**P(1.10)*i***	**P(1.10)*j***	**P(1.10)*k***	**[90%-P(1.10)*i*]*(CLEC-specific demand for the month) * (CRTC mandated adjustment amount per event)**	**[90%-P(1.10)*j*]*(CLEC-specific demand for the month) * (CRTC mandated adjustment amount per event)**	**[90%-P(1.10)*k*]*(CLEC-specific demand for the month) * (CRTC mandated adjustment amount per event)**	**Not applicable for the interim regime**
1.11 Final	90% or more	Competitor Interconnection Trunk Order Service Interval Met	**P(1.11)*i***	**P(1.11)*j***	**P(1.11)*k***	**[90%-P(1.11)*i*]*(CLEC-specific demand for the month) * (CRTC mandated adjustment amount per event)**	**[90%-P(1.11)*j*]*(CLEC-specific demand for the month) * (CRTC mandated adjustment amount per event)**	**[90%-P(1.11)*k*]*(CLEC-specific demand for the month) * (CRTC mandated adjustment amount per event)**	**Not applicable for the interim regime**
2.7 Final	80% or more	Competitor Out-of-Service Trouble Reports Cleared within 24 Hours	**P(2.7)*i***	**P(2.7)*j***	**P(2.7)*k***	**[80%-P(2.7)*i*]*(CLEC-specific total tariffed charges for the month for the service in question)**	**[80%-P(2.7)*j*]*(CLEC-specific total tariffed charges for the month for the service in question)**	**[80%-P(2.7)*k*]*(CLEC-specific total tariffed charges for the month for the service in question)**	**Formula #2**
2.8 Final	90% or more	Migrated Local Loop Completion Notices to Competitors	**P(2.8)*i***	**P(2.8)*j***	**P(2.8)*k***	**[90%-P(2.8)*i*]*(CLEC-specific total tariffed charges for the month for the specific rate element)**	**[90%-P(2.8)*j*]*(CLEC-specific total tariffed charges for the month for the specific rate elements)**	**[90%-P(2.8)*k*]*(CLEC-specific total tariffed charges for the month for the specific rate elements)**	**Formula #1**

Competitor Quality of Service Adjustment Plan (cont'd)

P(Indicator # x.y)*i,j,k* = Performance for indicator x.y relative to month *i,j* or *k*

Formula #1: This formula applies in the case where the indicator is associated with a specific service or services for which a rate is paid by the CLEC.

Formula #2: This formula applies in the case where the indicator is associated with an activity for which no specific rate is paid by the CLEC but affects a service or services for which the CLEC pays a rate.

Indicators 1.10 and 1.11: The applicable formula for these indicators, both associated with an activity for which no specific rate is paid by the CLEC, requires the use of a mandated amount per event that will be developed in a follow up proceeding. Therefore, rate adjustments for these indicators will not be applied during the interim regime.

Notes:

Competitor Quality of Service results are to be filed quarterly. Rebates will be calculated and issued quarterly.

Any adjustments owing to a CLEC are to be provided to the CLEC within 45 calendar days following the end of each quarter (due date).

For purposes of determining rebates that are applicable for substandard service quality, the remedy is predicated on the rate paid by the entrant for the activity covered by the indicator.

Indicators 1.8, 1.9, and 2.8 are subject to formula #1 (case 1) so that the rate elements for the activities concerned would be non-recurring charges. Indicator 2.7, however, does not describe an activity for which a specific rate (or rates) is (are) paid. Rather, this would be a formula #2 (case 2) situation in which the service quality of one or more services would be affected by a substandard performance of Indicator 2.7. Thus, the monthly recurring rate of the affected service or services would be applicable for adjustment purposes.

Application of Rate Adjustment Plan for Competitors Examples

(Note: Examples use Bell Canada's rates since rates for the Companies are not available)

1) Indicator 1.8 (New Unbundled Type A and B Loop Order Service Intervals Met)

The set standard is 90%.

Example:

- The CLEC orders for a given month 540 new Type A loops and 210 new Type B loops all in band A
- The ILEC performance for indicator 1.8 was 84%
- The set objective was then missed by: 90% - 84% = 6%
- When the CLEC receives the bill for these loops (those delivered on time and those that were delayed), the following will be shown:

a) One time charges for the Type A and B loops:

Total charges (service charge per order) (assuming a total of 550 orders and all orders were for Business): 550 * $46.50 = $25,575.00

b) Total charges (service charge per loop): (540+210) * $27.00 = $20,250.00

- The rate adjustment plan for that given month, excluding taxes, will then be applied as follows: (90%-84%) * ($25,575 + $20,250) = 6% * $45,825 = **$2,749.50**

2) Indicator 1.9 (Migrated Unbundled Type A and B Loop Order Service Intervals Met)

The set standard is 90%.

The calculation of the rate adjustment is the same as for new loops in the example above.

Application of Rate Adjustment Plan for Competitors Examples (cont'd)

3) Indicator 2.7 (Competitor Out of Service Trouble Reports Cleared within 24 Hours)

The set standard is 80%.

Example:

- The CLEC has sustained in a given month troubles for 200 Type A loops and 10 Type B loops, all in band A.
- The performance of the ILEC for indicator 2.7 was 70%
- The set objective was missed by: 80% - 70% = 10%
- The calculation of the rate adjustment will be as follows:

Monthly rate for a Type A loop in band A: $9.24
Monthly rate for a Type B loop in band A: $11.59

ILEC revenue for the loops for which a trouble report was issued that month:
200 * $9.24 + 10 * $11.59 = $1,848.00 + $115.90 = $1,963.90

Adjustment for missed standard (for trouble reports for Type A and Type B loops not cleared within 24 hours): (80% - 70%) * $1,963.90 = **$196.39**

Application of Rate Adjustment Plan for Competitors
Examples (cont'd)

4) Indicator 2.8 (Migrated Local Loop Completion Notices to Competitors)

The set standard is 90%

The definition of the indicator is:

> The total number of migrations of local loops and the number of notifications given on time by the incumbent telephone company to the competitors, notifying that the local loop migration is complete at the facilities of the incumbent telephone company, with the percentage of notifications given on time relative to this total.
>
> The indicator measures the completions of migrated local loops and the notifications given on time are sorted to determine the actual numbers and the percentage of notifications given on time.

Note: The unit to be adopted to calculate a rate adjustment in this case is the service charge for the local loops to be migrated and for which a completion notification was not given on time.

Example:

- The CLEC has sent 20 orders for the migration of 250 loops (200 Type A and 50 Type B all in band A) for business customers.
- The performance of the ILEC with regard to this indicator was 84%
- The service charges for the loops to be migrated is calculated as follows:

  a) Total charge for service charge per order: $46.50 * 20 = $930.00
  b) Total charge for service charge per loop: (200 + 50) * $27.00 = $6,750.00

- The rate adjustment plan for that given month will then be applied as follows: (90%-84%) * ($930.00 + $6,750.00) = 6% * $7,680.00 = **$460.80**