

**Canadian Radio-television and Telecommunications
Commission**

**Pursuant to Telecom Public Notice CRTC 2006-5
Review of price cap framework**

Evidence of

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Prepared on behalf of

The City of Calgary

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Executive Summary

1. The purpose of this proceeding is to adjust the existing price cap regime, as necessary within the issues specified by the Commission.
2. Telecom Public Notice CRTC 2006-5 identified the objectives from the second generation of price cap briefly as:
 - (i) Service that is reliable, affordable, of high quality and is accessible;
 - (ii) Balancing the interests for the three main stakeholders;
 - (iii) Fostering facilities based competition;
 - (iv) Incentives to incumbents for efficiency and innovation; and
 - (v) Minimized regulatory burden compatible with other objectives.
3. It was understood that the price cap mechanism would evolve in the context of these objectives based on the dynamics and limitations in the marketplace and the behaviours in response.
4. Experience shows that the price cap has fallen short of its goals. Price cap regulation is intended to replicate the discipline that market forces would impose on the regulated firm if they were present. However, price cap regime has not resulted in profitability levels that are reflective of a competitive industry in the first price cap period. If the second price cap period suffers from the high returns experienced in the first price cap period, there will have been an extended period of extranormal profits.
5. Extranormal profits or excessive returns was not an objective of price cap. Their existence under price cap would tend to violate the objective of balancing the interests of the stakeholders.
6. Over the nine years of price cap, some competitors have struggled and only gained a small foothold, particularly in the residential retail local exchange market in Alberta and BC.
7. Extranormal profits in the ILECs combined with their market dominance would be a strong indicator that the price cap regime has permitted the interests of the ILECs to be realized at the cost of the interests of the affected customers and competitors.
8. There is a requirement for data from the ILECs for the second price cap period and going forward, it is essential the Commission require further data to assist it in making a proper assessment of its price cap regime and to make the appropriate adjustments.
9. The Commission has, at its disposal, at least two mechanisms in the current price cap formula to correct for extranormal profits and to assist it in finding balance in the price cap regulation.

1.0 Background and Context

1. In Telecom Decision CRTC 97-9, *Price cap regulation and related issues* (“Decision 97-9”) the Commission introduced price cap regulation under a four year regime¹ for the major incumbent local exchange carriers (“ILECs”). Subsequently, the Commission reviewed the initial price cap regime and made certain amendments to it for a second four year price cap period² in Telecom Decision CRTC 2002-34, *Regulatory Framework for second price cap period* (“Decision 2002-34”). That second period was extended for one year³ under Telecom Decision CRTC 2005-69, *Extension of price regulation for Aliant Telecom Inc. [“Aliant”], Bell Canada, MTS Allstream Inc., Saskatchewan Telecommunications and TELUS Communications Inc [“Telus”]*, (“Decision 2005-69”)⁴. Essentially, once the current extension expires, price cap regimes for the ILECS will have been in place for nine years.
2. As noted by the Commission in its Telecom Public Notice CRTC 2006-5 (“PN 2005-5”), also of relevance are its findings with respect to forbearance in Telecom Decision CRTC 2006-15 *Forbearance from the regulation of retail local exchange services* (“Decision 2006-15”)⁵ wherein the Commission set out the criteria for forbearance and denied Aliant’s application for local forbearance as it did not meet the criteria.
3. It appears that the most recent price cap decision considered the ILEC’s achieved equity returns as an essential ingredient in assessing this type of regulatory regime. However, it is not clear how the Commission used the information in its deliberations in that decision.
4. In PN 2006-5 the Commission set out the scope for establishing a price cap regime to go into effect in 2007. The Commission does not appear to be prepared to consider other forms of regulation (eg. earnings overlay) or “re-initialization” of prices at the start of the next regime⁶. This determination limits the opportunities to correct for what may be having a significant impact on the realization of the Commission’s objectives set out in its last price cap decision and in its current public notice.

¹ Decision 97-9, paragraph 204

² Decision 2002-34, paragraph 107

³ Decision 2005-69, paragraph 52

⁴ All references to the second price cap period in this evidence assumes and includes the one year extension determined under Decision 2005-69.

⁵ PN 2006-5, paragraph 23

⁶ PN 2005-5, paragraph 24

5. This evidence will focus on a general assessment of price cap from the perspective of competitive and regulated markets and why the Commission may consider amending the current price cap regime. It will not, to any great degree, delve into the existing elements of the price cap formula, basket structure or deferral accounts. While the scope of this evidence has applicability to the general price cap structure and the ILECs, the context tends to be focused on that of Telus and its Alberta and BC ILEC service territory.
6. From a review of the criteria for forbearance, and if one were to look at the circumstances of Telus, it would appear, like Aliant, that Telus would also not qualify for local forbearance. This would, in large part, be due to its dominance, particularly in the residential segment of local exchange services. While there may be competition at the margin, essentially there does not exist a workably competitive market in the Alberta or in BC in this local segment. The absence of such a market continues to require regulation of certain of Telus' services, and therefore no forbearance, and moreover, this market climate has implications in the assessment of the current price cap regime.
7. This evidence will not include the recommendation of another form of regulation or "re-initialization" of prices at the start of the next regime. Rather, the focus will be on the assessment of achieved results, the indicators that demonstrate that changes should be made and how the Commission should approach those influencing factors. The evidence will recommend an alternative of dealing with extranormal profits of the ILECs, if any, in the context of price cap and given the Commission's defined scope. Finally, the evidence will comment on how reporting can be enhanced to allow the Commission to better ensure the discipline of a competitive market on tariffed services.

2.0 Fundamentals and Principles

8. At the outset it would be useful to set out the fundamentals associated with price cap regulation.
9. A workably competitive market which is relied on to set terms of trade in businesses is absent in the case of monopolies or where there is monopoly power.
10. Where there is a monopoly or monopoly power or the absence of adequate competition, there is an inherent need for regulation of prices, profits and service quality.
11. Clearly, the economics of a monopoly are expected to differ from those of a competitive business.

12. The essential purpose of regulation is to achieve the results of competition in the form of reasonable prices, reasonable profits and adequate service quality.
13. Typically, a distinguishing characteristic of monopolies is that they often provide an essential service or exist as natural monopolies.
14. Extranormal profits are profits which are greater than those that would be achieved in competitive market over the long run. As noted in the regulatory literature:

A primary effect of market forces is to limit the rate of growth of a firm's profit.

...

Indeed, in a perfectly competitive industry, extranormal profit is eliminated in the long run.⁷

15. The above fundamentals and principles are reflective of a contrast between the competitive market and monopolies or markets with monopoly power. While the ILECs are not necessarily 100% monopolies, they continue to dominate their respective markets as near monopolies or, more importantly, having monopoly power. This will be discussed further in Section 4.0, Applicability to Local Telecom Service.

3.0 Purpose of Price Cap

16. The purpose of price cap has received much attention worldwide. One of the original architects of price cap regulation, Steven Littlechild, referred to price cap in the following manner:

It 'holds the fort' until competition arrives, and is inappropriate if competition is not expected to emerge.⁸

17. The Commission's stated objectives of the initial price cap regime were as follows:

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

⁷ Bernstein, Jeffrey I., and David E. M. Sappington. "Setting the X Factor in Price-Cap Regulation Plans." Vol. 16, no. 1 (July 1999): 5-26, page 8

⁸ Beesely, M.E., and S.C. Littlechild. 1986 "Privatization: Principles, Problems and Priorities." *Privatization and Regulation – The UK Experience*. Ed. J. Kay. Oxford: Clarendon Press

- b) to foster competition in the Canadian telecommunications markets;
- c) to provide incumbents with incentives to increase efficiencies and to be more innovative, and with a reasonable opportunity to earn a fair return for their Utility Segments; and
- d) to implement a price cap regime that is simple, straightforward, easy to understand and reduces the regulatory burden to the greatest extent possible.⁹

18. In its review of price cap leading to Decision 2002-34, the Commission modified the objectives of the regulatory framework to be 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.¹⁰

19. The more significant changes in the Commission's objectives are as follows:

- (i) In the second price cap regime, the Commission decided to add an objective to balance the interests of the three main stakeholders;
- (ii) The term "fostering competition" was amended to be "fostering facilities based competition";
- (iii) While the ILECs still had the objectives of increasing efficiencies and to be more innovative, in the second price cap regime "the opportunity to earn a fair return in the Utility Segment" was removed; and
- (iv) The regulatory approach was amended from "a price cap regime that is simple, straightforward, easy to understand and reduces the regulatory burden to the greatest extent possible" to "adopt regulatory approaches that impose the minimum regulatory burden compatible with the achievement of the previous four objectives".

⁹ Decision 2002-34, paragraph 5

¹⁰ Decision 2002-34, paragraph 99

20. All of these changes are notable as they have implications for assessing the existing price cap regime and assisting in identifying appropriate changes.
21. Balancing the interests among stakeholders suggests that if one party was achieving a greater advantage than the other or greater than was anticipated or intended, then measures would be taken to bring the structure and its effects back into balance so that the interests of all parties are brought into line with the Commission's objectives. This evidence identifies the factors that may be out of balance and the actions the Commission should take in response.
22. Since the beginning of the price cap regime, it has been the intention of the Commission to find ways to encourage competition. Competition at the local exchange level continues to remain an area of slow growth and in some cases negative growth¹¹ whether facilities-based or otherwise. In any event, the competitor entry has been sluggish over the price cap periods.
23. Of significance, the Commission released the ILECs from reporting on the rate of return on the Utility Segment. It appears that the regulated or tariffed services are no longer gathered under a regulated segment reporting mechanism, *per se*. As will be discussed in greater detail below, this change could adversely affect how the Commission and stakeholders assess the impact of price cap on the desired balance among the stakeholders. Extranormal profits and potentially excessive returns¹² could significantly tilt the balance of interests away from customers and competitors in favour of the ILECS. It is notable that it is not now, nor was it previously an objective of price cap that ILECs earn extranormal profits or excessive returns from tariffed services. Therefore, it is fair to assume that such returns or profits should be considered in the assessment of price cap.
24. Clearly, there was a marked variation in the set of objectives from the second price cap period relative to those of the first price cap period. Tied to the objective regarding regulatory approach seems to be the relaxation of reporting requirements for return on equity. The change appears to be predicated on the proposition that regulatory approaches should minimize burden so long as it achieves the other objectives. Since the time of the first price cap period, it would appear that there has been a shortfall in realizing other objectives – most notably the objectives of
- (i) balance among stakeholders, and
 - (ii) fostering competition, let alone facilities based competition.

¹¹ CRTC Report to the Governor in Council *Status of Competition in Canadian Telecommunications Markets*, October 2005, Tables 4.3.9 and 4.3.10

¹² The terms "returns" or "cost of capital" will be considered as the combined effect of rate of return on equity and equity layer or the equity ratio as both should be considered when assessing impact.

That shortfall may have been adversely influenced by the release from the obligation to report on equity returns and changes should be considered.

25. Littlechild's words above, regarding the purpose of price cap, may have been more prophetic than intended. While all good intentions of existing price cap structure are to foster competition, it may be that this mechanism is limited in what it can contribute to encouraging competition and that objective may need to be reassessed for emphasis.
26. In the context of some of the objectives including: (i) balancing the interests of the stakeholders; (ii) fostering facilities based competition and (iii) minimizing regulatory burden compatible with the other objectives, the equity return data from the first price cap and hopefully available for the current assessment of the second price cap may indicate that there is a need to reinstate some type of achieved earnings assessment.

4.0 Applicability to Local Telecom Service

27. Under the current price cap regime tariffed services are subject to price caps. Price caps are imposed on these services since, at the time of its last price cap decision, the Commission determined that it did not consider that market forces would be sufficient to discipline the ILEC's prices for residential local exchange and optional local services during the most recent price cap period.¹³

28. The Commission's finding is consistent with the regulatory literature where it is commonly stated:

The purpose of price-cap regulation, like many forms of regulation, is to replicate the discipline that market forces would impose on the regulated firm if they were present.¹⁴

29. Price cap is a set of rules that are intended to achieve the more general purpose expressed above by Littlechild, Bernstein and Sappington and the more specific objectives articulated by the Commission. What seems to be acknowledged is that the rules evolve based on dynamics and limitations in the market and experience of behaviours in response to those dynamics and limitations. Perhaps the Commission can take this opportunity to seriously reflect on the experiences of both price cap periods.

¹³ Decision 2002-34, para 402

¹⁴ Bernstein, Jeffrey I., and David E. M. Sappington. "Setting the X Factor in Price-Cap Regulation Plans." Vol. 16, no. 1 (July 1999): 5-26, page 8

30. Currently, an element of the rules that appears to be missing is a measure of the fundamentals of monopoly power and regulation – i.e. the absence of market forces to sufficiently discipline the ILEC's prices. The methodology in the current regime does not appear to be applying the discipline that would be present in a competitive market. That has historically manifested in extranormal profits.
31. The Commission set out criteria for forbearance from regulation of existing tariffed services in the retail local exchange services. Similarly, the Commission could adopt criteria or limits for dealing with extranormal profits under its price cap structure.
32. It could be said that in industries dominated by monopolies, despite good intentions, it may not be the case that price cap can, indeed, fully replicate competitive market conditions. In competitive markets, inefficient participants will likely fail. In the regulated monopoly environment, regulators and policy makers may be reluctant to allow a monopoly to fail, even in the face of poor management decisions. Largely, that is due to the essential nature of its services. As a result there is a possibility of an inherent asymmetry where the negative market consequences are not applied in a regulated environment with the same rigour as they would be in a competitive market. A regulated monopoly is insulated, to some degree, from this downside risk.
33. If, in the face of market dominance, the ILECs continue to earn extranormal profits or excessive returns, then balancing of stakeholder interests will be at significant risk of not being achieved. It would effectively suggest that ILECs' interests have been treated more favourably in that they were allowed to continue to dominate this market segment while achieving those extranormal profits or excessive returns.
34. One of the Commission's objectives of price cap was to foster competition. The lack of significant development of competition appears to speak for itself. Yes, there have been pockets of market segments where there has been some limited entry. However, with respect to the local exchange market, in the case of Telus in Alberta and BC, residential and business dominance has moved only slightly. In particular, ILEC residential market share has only marginally been reduced from essentially at, or just under 100% prior to price cap to the following according to the Commission's latest report on the status of competition¹⁵:

¹⁵ CRTC Report to the Governor in Council *Status of Competition in Canadian Telecommunications Markets*, October 2005, Tables 4.3.5 and 4.3.6

Table 1

Province and City	Telus Market Share
Alberta (Residential & Business)	92.4%
Calgary (Residential)	93.0%
Edmonton (Residential)	99.7%
BC (Residential & Business)	94.0%
Vancouver (Residential)	95.1%
Victoria (Residential)	99.5%

35. Table 1 shows that, for the provinces Alberta and BC and their major centres, Telus continues to dominate the local retail market share. For the residential market segment which relies so heavily on local service as an essential service, it remains captive to a supplier with market dominance – market power.

36. Over the period of almost a decade since its introduction, it does not appear that price cap has served as effective a mechanism as hoped for to foster competition in the local exchange market, particularly in residential segment. Meanwhile, it appears that the ILECs are not suffering financially under the price cap regime. At least, there does not appear to be any indication of ILEC financial adversity at the hands of price cap being communicated to the investment community. Further, had there been adverse impact of price caps, it might be fair to assume that the ILEC would seek adjustments from the Commission. To date, there do not appear to have been any such adjustments to the mechanism since Decision 2002-34.

37. In the academic regulatory literature, a study on price cap stated that:

...the regulated firm will earn zero [extranormal] profit if the rate at which its output prices rise, on average, is restricted to equal the difference between: (1) the rate at which the firm's input prices rise; and (2) the rate at which the firm's productivity increases. Therefore, if a regulated firm's prices are set initially to ensure zero (extranormal) profit, and if the firm's prices are subsequently required to change at a rate equal to the difference between the rate at which its input prices rise and its productivity increases, then the regulated firm will continue to earn zero extranormal profit, just as it would in a competitive marketplace."¹⁶

38. The ILECs do not face a competitive market for a significant part of their services, in particular residential local exchange services. If an enterprise

¹⁶ Bernstein, Jeffrey I., and David E. M. Sappington. "Setting the X Factor in Price-Cap Regulation Plans." Vol. 16, no. 1 (July 1999): 5-26, page 9

was in a competitive market, it may be hard pressed to achieve extranormal profits for an extended period, such as nine years.

39. By the time the next price cap period becomes effective, there will have been nine years of experience under this type of regulation. Yet, there is still no appreciable change in competitive dominance. On the other hand based on reports from first price cap, there were extranormal profits where equity returns were as high as 27.7%¹⁷. There is no indication, as of yet, from the ILECs that the climate for returns has changed to the disfavour of the ILECs in the second price cap period. If there is almost a decade of extranormal profits, combined with monopoly power, then that would be an indicator that there is a need to amend the price cap regime for rebalancing. While it may have been more difficult to rebase or restructure after the first price cap period, if the trends from that period have continued or have been exacerbated, then with the experience during the timeframe of the two price cap periods¹⁸, there may be an argument for restructuring at this time.

5.0 Returns as a measure

40. First, there is a long established legal and regulatory framework for determining what rate of return is fair.^{19 20} Essentially the fair return was established by the courts to be the return investors could expect on an investment with comparable risk elsewhere in the economy.²¹

41. Second, the academic literature addresses this very issue:

In a normally competitive industry, the forces of competition hold prices down to the costs of production, including a requisite expected return on invested capital.

and,

Over the long run, the expected rate of return will reflect the risks of the industry. The greater the risks confronted by the industry, the greater is the expected rate of return.²²

¹⁷ Evidence of John D. Todd and M. Greg Matwichuk, filed August 20, 2001 pursuant to Telecom Public Notice CRTC 2001-37, Table 1, page 8

¹⁸ Including the extension to the second price cap period

¹⁹ Bonbright, James C., Albert L. Danielsen, and David R. Kamerschen *Principles in Public Utility Rates* Arlington, VA: Public Utility Reports, 1988, page 315

²⁰ Philips, Charles F. Jr., Robert G Brown *The Regulation of Public Utilities: Theory and Practice* Arlington, VA: Public Utility Reports, Inc. 1988, pages 358-61

²¹ Bonbright, *ibid*, page 316

²² Morin, Roger A., Lisa Todd Hillman *Regulatory Finance: Utilities' Cost of Capital*, Arlington, VA, Public Utility Reports, Inc. 1994, pages 2-3

42. In price cap regulation, one should consider, more broadly, the reason for regulation. Because of their dominance in the local exchange market, the ILECs remain regulated. As noted above, the ILECs do not suffer the rigours of the competitive market. Rather regulation must replace pressures of the competitive market.

The objective of regulation is to determine an allowed rate of return in such a way as to emulate the returns for industries in a competitive market. Regulatory commissions act as a substitute for the market, setting allowed rates of return so as to satisfy consumer demand at non-monopolistic prices and ensure good performance.²³

43. While price cap regulation represented a replacement of earnings regulation, one must have some sort of benchmark to assess the newer regime. One of those benchmarks would typically be a reference to the return earned by the ILECs.

44. Generally speaking, for-profit businesses assess their well being and progress with reference to, among other things, a return on equity. Such a measure is used commonly in for-profit entities. More specifically, in the case of the ILECs, they or their parent companies report this figure to their shareholders on a yearly and often on a quarterly basis.

45. The academic literature recognizes that ILEC rate of return is an essential tool in an assessment of price cap regulation:

Even under a pure price cap regime, which represents the most draconian departure from traditional RORR [rate of return regulation], the spectre of rate of return remains. This is because the **validity of the parameters in a price cap plan** can only be assessed by reference to some rate of return benchmark.²⁴ [emphasis added]

46. When price cap was introduced, base rates were established assuming an return on equity of 11.0% on an average common equity base of 55%²⁵. Generally speaking, the return on equity for regulated entities across Canada has been substantially below that. It may be the case that regulated entities with similar risk may be lower or at that same level today as the 11.0%. Under the going in rates the ILECs have been able to achieve much higher returns, at least in the first price cap period, and perhaps the 2nd price cap period as well.

²³ Morin, *ibid*, page 3

²⁴ Morin, *ibid* page 518

²⁵ Decision 98-2, paragraph 305

47. Finally, one can look to the experience in other jurisdictions. In the UK where price cap originated, the Ofcom²⁶ specifically estimates a reasonable rate of return as a key part of its duties in setting price caps. This regulator has attempted to set the price cap formula such that the aim of the price control is to reduce prices so that by the end of the price control period the regulated firm earns its **cost of capital**. The cost of capital is defined as the minimum rate of profit that a company needs in order for it to invest.

6.0 Achieved Returns

48. Generally speaking, the ILECs tend to maximize returns for their public shareholder, and would be incented to appeal to the CRTC to amend the price cap if returns were too low. Naturally, the ILECs are in possession of the information that would determine whether returns are too low. The customers are not, or at least not to a level of detail to properly assess the degree of profitability of the ILECs tariffed services. Since ILECS have not applied to change the mechanism, it may be fair to assume the achieved returns are not too low.

49. Some may argue that price caps are intended to break the link between rates and costs to emulate the competitive market. That may be true to some extent. The ILECs are not in a competitive market for many of their services. As a result, price cap is a regulatory regime intended to overcome the advantages of their market dominances. Therefore, the ILECs are not subject to the rigours of the competitive market. Yet, there still should be some objective measure to determine and periodically check the appropriateness of the allowed rate levels.

50. In terms of excessive returns, one should consider how much is acceptable and how much would be too much? Would the Commission find it acceptable if the ILECs were earning, say 200% per annum in ROE on tariffed services? Obviously, this is an exaggeration, but to make the point: How much is too much? That is a question the Commission should address.

51. If allowed equity returns of regulated entities of similar risk profile were approximately 11%, is it reasonable that rates under the price cap for the ILECs be set to allow returns that are significantly greater? How much more?

52. It has been said that one of the characteristics in a competitive market is that investors expect a fair opportunity to earn a rate of return on investments that

²⁶ Otherwise known as the Office of Communications. Among other things Ofcom regulates UK communications industries.

is just equal to the cost of capital they supply.²⁷ Are recurring equity rates of return of 11%, or perhaps greater, reflective of the cost of capital supplied by investors in a competitive market opportunities of similar risk? The Commission should require the ILECs to produce the necessary data to allow analysis of the achieved returns to determine whether those returns reflect a fair balance for stakeholders

53. In the review of the first price cap period, the issue of extranormal profits appeared to be of concern to the Commission when it stated:

Also, while the ILECs enjoyed significantly improved returns on their Utility Segment services, the financial health of competitors - who relied on ILEC services in order to compete – deteriorated seriously.²⁸

and,

First, when considered together, the increases in residential local service rates, the financial weakness and the limited market penetration of competitors, and **high returns achieved by the ILECs**, raised concerns about whether an appropriate balance had been struck in the initial regime between the interests of the different stakeholders (customers, ILECs and competitors).²⁹ [emphasis added]

The high equity returns arising out of the first price cap regime were apparently an issue of concern to the Commission in reviewing the first price cap period. The Commission apparently used these developments, together with other factors, to make adjustments to the basket structure and pricing constraints³⁰. Currently, there does not appear to be a mechanism to properly examine the equity returns achieved by the ILECs in the second price cap period. That is unfortunate given the existing stated objectives of price cap, the fundamentals around returns in a competitive and regulated market, and the possibility that the ILECs have, once again, achieved extranormal profits through regulated services.

54. An assessment of return on equity will likely assist the Commission to establish whether there need to be changes to factors used to establish the cap, or whether any of the rates need to be “re-initialized”. Given the latter is not within the scope of PN 2005-6, the Commission may wish to focus on other factors such as those in the formula to achieve the appropriate objectives.

²⁷ Kolbe, Lawrence A., William Tye and Stewart C. Myers *Regulatory Risk – Economic Principles and Applications to Natural Gas Pipelines and Other Industries*, Norwell, MA: Kluwer Academic Publishers, 1993, page 116

²⁸ Decision 2002-34, paragraph 65

²⁹ Decision 2002-34, paragraph 66

³⁰ Decision 2002-34, paragraphs 65 - 71

7.0 Indicators

55. Indicators that call for reporting on equity returns would be the combination of apparent significant profitability of the ILECs and continued monopoly power. At this stage, there is a lack of data on the evidentiary record of this proceeding regarding profitability. The continued monopoly power or market dominance is apparent through recent reports of the CRTC on competition where the ILEC market share, by province, is typically 90% or higher and some are as high as 100% of the residential local market many years after regulation was relaxed and competition was encouraged.
56. If there were assurances that, in spite of the high 90%+ type dominance in the market, the tariffed services were only achieving reasonable returns generally equal to the cost of capital, then customers would have difficulty being as concerned. However, those assurances do not appear to be available or forthcoming. The continued level of dominance is an indicator that competitive entry has been and continues to be largely uneconomic. Moreover, that market dominance if coupled with extranormal profits, would be a strong indicator that the Commission's objectives with respect to balancing stakeholder objectives is not being achieved.
57. One could speculate that, at the time of the release of Decision 2002-34, the Commission expected higher market penetration by the competitors would take place by the end of the second price cap period. Given that expectation has not come to fruition, the Commission should reinstate a requirement for financial reporting that would allow it to review achieved returns and assess the need for a ensuing adjustment to the price cap mechanism.
58. If there has been a history of extranormal profits, particularly with the apparent market dominance, then that would be a strong indicator that price caps, to date, have resulted in an asymmetry among stakeholders, that the Commission's objective with respect to balancing stakeholder interests are unrealized and that adjustments may be required to the existing price cap methodology to ensure a proper starting point and fairness to stakeholders going into the next price cap period.

8.0 Reporting

59. As noted above, equity returns are reported on in other major jurisdictions and used assessing price cap. In the UK, for instance, estimates of a reasonable rate of return are an essential ingredient in the Ofcom's duties to set price caps.³¹

³¹ Ofcom's approach to risk in the assessment of the cost of capital, August 2005

60. It is recognized that the Commission has not embraced earnings sharing and is not considering an earnings overlay as another form of regulation mechanism at this time. Nonetheless, that does not detract from the notion that equity returns still play an important role in assessing a price cap regime and, as the regulator, it is essential for the Commission to have an understanding of the returns being earned under its price cap regulation.

61. It would appear that the Commission appreciated the need to follow up on this matter when it stated:

The Commission recognizes that ILEC financial results will need to be available for the purpose of the review of the next regime. Sufficient information must be reported to allow the Commission to gauge the financial state of ILECs in order to ensure that the objectives of the price cap regime are being met.³²

62. What first must be considered is whether this financial data is sufficient to allow for proper determination of rate of return and equity thickness in the capital structure, as they are related to tariffed services. If not, then that data reported should be enhanced and reported on in a manner that would allow the Commission and stakeholders to properly assess it.

63. It is possible to consult the annual reports of the parent companies of the ILECs and perhaps, in some cases, the ILECs themselves. However, due to the ILECs carrying on tariffed and non-tariffed services and activities within the same reporting enterprise, it is not possible to determine return on equity of tariffed services. For every key measure for such entities, there will be distortions arising from activities and operations other than tariffed services.

9.0 Recommendation

64. The following summarizes the issues and recommendations that arise from them..

65. Competition in the local exchange market, particularly the residential segment, has essentially not come to fruition despite almost a decade since the Commission embarked on that objective. The regulatory framework moved away from reporting and assessing reasonable return in spite of the lack of competition. Achieved returns have likely been excessive for an extended period. As a result there is quite possibly a significant imbalance in the interests of the stakeholders, particularly as between the ILECs relative to customers and competitors. As well, the relaxing of the level of regulatory

³² Decision 2002-34, para 995

burden has not likely been compatible with the achievement of at least two of the price cap objectives.

66. If ILECs are earning extranormal profits from tariffed services under price cap, then there should be some factor in the price cap formula to deal with extranormal profits to help achieve balance among stakeholders.
67. One possibility is for the Commission to amend the X factor in a similar fashion as that used in the UK. The X factor would be adjusted to such a degree to allow the ILEC to earn its cost of capital and minimize the risk of situations where extranormal profits are earned under tariffed services subject to the price cap.
68. Another possibility is to adopt another factor, say, an R-Factor that would be added to the price cap formula as a new way to deal with extranormal profits (i.e. R = Excessive Returns) in the ILECs from tariffed services. The effect of this factor would be to reduce the price cap where the ILEC has a history of earning extranormal profits for tariffed services. The factor would be specific to each ILEC.
69. Using either mechanism, customers would not be paying rates that are excessive to the ILECs' costs of capital and avoid extranormal profits derived from tariffed services. As noted above, it is not an objective that ILECs earn extranormal profits or excessive returns from tariffed service under the price cap regime. Nor is it an economic expectation of a competitive market. Therefore, it is reasonable to expect that excessive returns should not be included in the rates determined under price cap.
70. In summary, it is recommended that there be sufficient detailed reporting of achieved returns, rates of returns and their derivations for tariffed services and reconciled to those for non-tariffed services and the financial statements (the latter two filed in confidence with the Commission) for years in the most recent price cap period – to help assess the effectiveness, fairness, etc of the previous price cap period and whether adjustments may need to be made - and similarly for the years going forward in the current price cap period.

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