Canadian Radio-television and Telecommunications Commission
Conseil de la radiodiffusion et des télécommunications canadiennes

Telecom Decision CRTC 2007-27

Price cap framework for large incumbent local exchange carriers

30 April 2007

Canada

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Reference: 8678-C12-200605553

In this Decision, the Commission establishes a price cap regime that will apply to Bell Aliant Regional Communications, Limited Partnership, Bell Canada, MTS Allstream Inc., Saskatchewan Telecommunications, and TELUS Communications Company (collectively, the ILECs).

The Commission's key determinations in this Decision include the following:

- *basic residential service rates in urban areas are capped at existing levels (i.e. price ceiling);*
- *basic residential service rates in rural areas are not permitted to increase by any more than the lesser of the annual rate of inflation or 5% on an annual basis;*
- *local optional service and bundled service rates are no longer subject to pricing constraints;*
- *the prohibition on further rate de-averaging is removed for local residential, including optional local services;*
- *business and other capped service rate increases are limited to the rate of inflation overall and a maximum increase of 10% per year for individual rates;*
- *pay telephone service rates are permitted to increase to a maximum rate of $0.50 per cash call, and a maximum rate of $1.00 per non-cash call; and*
- *rates for public safety and social services (e.g. 9-1-1 service, Message Relay Service) remain frozen at existing levels.*

The price cap regime is designed to ensure that customers continue to have access to just and reasonable rates while at the same time providing the ILECs with incentives to operate more efficiently and to be more innovative in the provision of services. This regime will apply to those areas which do not qualify for forbearance.

The Commission directs Société en commandite Télébec to show cause, by 30 May 2007, why the determinations made in this Decision should not apply to it.

The dissenting opinion of Commissioner Langford is attached.

Canada

Background

1. Price cap regulation generally places upward constraints on prices that an incumbent local exchange carrier (ILEC) can charge its customers for various telecommunications services. The price cap regime includes other rules which govern the rates charged to residential and business customers. Services subject to price cap regulation account for almost $7 billion in annual revenues collectively for the large ILECs with over 65% derived from the local residential voice market.

2. Price cap regulation is used to constrain market power with respect to service rates and to ensure customer access to just and reasonable rates. In addition to protecting customers, price cap regulation provides the ILECs with incentives to operate more efficiently and to be more innovative in the provision of services.

3. In 2002, the Commission established separate price cap regimes for two groups of large ILECs.[1] These regimes, which are generally similar, include eight baskets or groups of services: residential local services in high-cost serving areas (HCSAs); residential local services in non-HCSAs; business services; other capped services; competitor services; services with frozen rates; payphones; and uncapped services. Each of these baskets or groups of services is subject to constraints tailored to meet the circumstances of the relevant services.

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

5. The current price cap regimes are set to expire in mid-2007. In order to establish the price cap regime that would go into effect in 2007 in the operating territories of the large ILECs, the Commission initiated a proceeding in 2006. In *Review of price cap framework*, Telecom Public Notice CRTC 2006-5, 9 May 2006 (Public Notice 2006-5), the Commission invited comments on what changes, if any, should be made to the price cap regime with respect to the following:

    a) objectives of the regime;
    b) service basket structure and pricing constraints;
    c) components of the price cap formula;
    d) further rate de-averaging within a band; and
    e) other issues including the duration of the next price cap regime.

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[1] The price regulation regime established in *Regulatory framework for second price cap period*, Telecom Decision CRTC 2002-34, 30 May 2002, as amended by Telecom Decision CRTC 2002-34-1, 15 July 2002 (Decision 2002-34) applies to: Aliant Telecom Inc., now known as Bell Aliant Regional Communications, Limited Partnership; Bell Canada; MTS Communications Inc., now known as MTS Allstream Inc; Saskatchewan Telecommunications; and TELUS Communications Inc., now known as TELUS Communications Company. The price cap regime set out in *Implementation of price regulation for Télébec and TELUS Québec*, Telecom Decision CRTC 2002-43, 31 July 2002 (Decision 2002-43) applies to Société en commandite Télébec (Télébec) and TELUS Communications (Québec) Inc. (TELUS Québec) (now part of TELUS Communications Company). All the companies listed in these decisions are referred to as the large ILECs.

The proceeding

6. The Commission received submissions, interrogatory responses, comments and/or arguments from Bell Aliant Regional Communications, Limited Partnership (Bell Aliant), Bell Canada, and Saskatchewan Telecommunications (SaskTel) (collectively, the Companies); Bragg Communications Inc., carrying on business as EastLink; the British Columbia Public Interest Advocacy Centre (BCOAPO et al.); the City of Calgary; Cogeco Cable Canada Inc., Rogers Communications Inc., and Shaw Communications Inc. (collectively, the Competitors); the Public Interest Law Centre representing the Manitoba Branch of the Consumers' Association of Canada and the Manitoba Society of Seniors and Manitoba Keewatinook Ininew Okimowin (collectively, PILC); MTS Allstream Inc. (MTS Allstream); the Public Interest Advocacy Centre on behalf of the Consumers' Association of Canada and the National Anti-Poverty Organization) (PIAC); Quebecor Media Inc. (including its affiliate Vidéotron Ltd.) (QMI); TELUS Communications Company (TELUS); and l'Union des consommateurs (UC).

7. An oral hearing was held from 10 to 18 October 2006 before Vice-Chairman Richard French (chairman of the hearing) and Commissioners Helen del Val, Elizabeth Duncan, Stuart Langford, and Andrée Noël. Final written arguments were filed on 26 October 2006 and the record of the proceeding closed with reply arguments filed on 6 November 2006.

8. In this Decision, the Commission will address the issues set out in Public Notice 2006-5, as listed above. While the positions of parties have necessarily been summarized in this Decision, the Commission has carefully reviewed and considered the submissions of all parties.[2]

Overview of the current regulatory environment

9. After the close of record of this proceeding, the government announced two initiatives that will have an impact on the manner in which the Commission will regulate the telecommunications industry.

10. The first of these initiatives is a direction, *Order Issuing a Direction to the CRTC on Implementing the Canadian Telecommunications Policy Objectives* (the Policy Direction), issued by the Governor in Council to the Commission. The Policy Direction came into effect on 14 December 2006.

11. The Policy Direction requires, among other things, that the Commission rely on market forces to the maximum extent feasible and regulate where there is still a need to do so, in a manner that interferes with market forces to the minimum extent necessary to meet the policy objectives of the *Telecommunications Act* (the Act). Although the Policy Direction does not apply to this particular proceeding,[3] the Commission has taken the Policy Direction into account in making its determinations in this Decision.

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[2] Where BCOAPO et al., PIAC, PILC, and UC took the same position on an issue, the Commission refers to them collectively as the Consumer Groups in this Decision.

[3] In accordance with subsection 11(2) of the Act, policy directions may apply in respect of matters pending before the Commission. However, in accordance with subsection 11(3) of the Act, a policy direction does not apply in respect of a matter pending before the Commission if final submissions were filed during the year prior to the direction coming into effect.

12. The second initiative was a change to the Commission's forbearance test set out in *Forbearance from the regulation of local retail services*, Telecom Decision CRTC 2006-15, 6 April 2006 (Decision 2006-15). *Order varying Telecom Decision CRTC 2006-15*, Order in Council P.C. 2007-532, issued 5 April 2007 (the Forbearance Order), among other things, replaced the Commission's forbearance test based on market share loss with one that emphasizes the presence of competitive infrastructure. The Commission anticipates a significant portion of the regulated telecommunications market could be forborne in the near future. However, in those areas where a facilities-based competitive market does not exist, the Commission's regulatory oversight, including price cap regulation, will remain in place.

13. In those areas which do not qualify for forbearance, the ILECs will continue to have significant market power and customers will have limited competitive alternatives. The ILECs would have both the incentive and ability to raise and control prices. In light of these circumstances, the next price cap regime is designed to protect the interests of customers in those areas that will not be forborne from the regulation of local exchange services to ensure such customers have just and reasonable rates.

14. The Commission notes that applications have been filed by some ILECs requesting forbearance from the regulation of local services in certain exchanges within their operating territories. These applications have been filed pursuant to the Forbearance Order. The Commission notes that until rulings are made to approve these applications, the price cap regime set out in this Decision will continue to apply in these exchanges.

A. The objectives of the price cap regime

15. The price cap regimes set out in Decisions 2002-34 and 2002-43 were designed to achieve the following objectives:

    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.

16. The Commission notes that BCOAPO et al., the City of Calgary, and the Competitors generally agreed with the objectives set out in Decisions 2002-34 and 2002-43, while the Companies, MTS Allstream, QMI, TELUS, and UC proposed alternative objectives.

17. Section 7 of the Act sets out the following telecommunications policy objectives:

    (*a*) to facilitate the orderly development throughout Canada of a telecommunications system that serves to safeguard, enrich and strengthen the social and economic fabric of Canada and its regions;

    (*b*) to render reliable and affordable telecommunications services of high quality accessible to Canadians in both urban and rural areas in all regions of Canada;

    (*c*) to enhance the efficiency and competitiveness, at the national and international levels, of Canadian telecommunications;

    (*d*) to promote the ownership and control of Canadian carriers by Canadians;

    (*e*) to promote the use of Canadian transmission facilities for telecommunications within Canada and between Canada and points outside Canada;

    (*f*) to foster increased reliance on market forces for the provision of telecommunications services and to ensure that regulation, where required, is efficient and effective;

    (*g*) to stimulate research and development in Canada in the field of telecommunications and to encourage innovation in the provision of telecommunications services;

    (*h*) to respond to the economic and social requirements of users of telecommunications services: and

    (*i*) to contribute to the protection of the privacy of persons.

18. The Commission notes that some of the objectives set out in Decisions 2002-34 and 2002-43 are not explicitly reflected in section 7 of the Act. The Commission recognizes that most of the objectives proposed by the parties are consistent with the telecommunications policy objectives in the Act, in particular paragraphs (*a*), (*b*), (*c*), (*f*) and (*h*).

19. As stated earlier, the Policy Direction does not apply to this proceeding. However, the Commission notes that the Policy Direction emphasizes certain objectives of the Act, including the use of efficient and effective regulation. The Commission also notes that some parties proposed objectives which are consistent with the Policy Direction.

20. The Commission considers that the formulation of a distinct set of objectives specifically applicable to the price cap regime is no longer necessary. Instead, the Commission finds that section 7 of the Act sets out the appropriate objectives for the next price cap regime.

21. The Commission has taken these objectives into consideration and has made reference to them, as applicable, in developing the parameters of the next price cap regime. The Policy Direction has also provided guidance in this regard.

B. Service basket structure and pricing constraints

22. As stated earlier, the current price cap basket structure and pricing constraints were established in Decisions 2002-34 and 2002-43. In general, the Commission determined that two different types of constraints would be in effect for the price cap period. Firstly, a basket constraint was applied to the revenues derived from the basket or sub-basket of the ILECs' services. Secondly, in many cases, a rate element constraint was imposed on the price of a specific service.

23. The basket structure and key pricing constraints were established as follows:

    a) *Residential Services in Non-HCSAs*: This basket was divided into two sub-baskets: basic residential services and residential optional services. The basket was subject to a constraint of inflation (I) less a productivity offset (X-factor). 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 was subject to a deferral account[4] mechanism.

       In order to provide additional pricing protection to customers, the sub-basket of basic residential services in non-HCSAs was subject to a constraint of inflation less a productivity offset (I-X) provided that productivity did not exceed inflation. If productivity exceeded inflation, the constraint would be set at zero. Services in this sub-basket were also subject to a rate element constraint which limited increases in any service rate element to 5% per year.

       The second sub-basket, residential optional services in non-HCSAs, was not subject to a basket constraint. However, some services in this sub-basket were subject to a constraint which limited price increases to $1 per feature per year.

    b) *Residential Services in HCSAs*: As was the case for residential local services in non-HCSAs, the identical sub-basket structure and associated constraints were established for these services except that no constraint was imposed on the basket overall.

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[4] In Decision 2002-34, the Commission imposed a pricing constraint equal to inflation less a productivity offset of 3.5% on residential local services in non-HCSAs. However, in order to avoid an adverse impact on local competition, the Commission required that all incumbent telephone companies that were subject to the determinations in Decision 2002-34 create a deferral account where they placed amounts equal to the revenue reductions that would otherwise have resulted from an application of the price cap formula. Deferral accounts were subsequently established for Télébec and TELUS Québec in Decision 2002-43.

c) *Business Services*: The basket was subject to a constraint set at inflation. No productivity offset was imposed. These services were also subject to a rate element constraint limiting individual rate increases to 10% per year.

d) *Other Capped Services*: This basket was subject to a constraint of inflation less a productivity offset. In addition, these services were subject to a rate element constraint limiting rate increases to 10% per year.

e) *Services With Frozen Rate Treatment*: Rates for these services (e.g. 9-1-1 service and Message Relay Service) were frozen at existing rate levels.

f) *Payphones*: Rates for these services (e.g. public and semi-public pay telephones) were frozen at existing rate levels.

g) *Competitor Services*: This group of services was divided into two service groups: Category I Competitor Services (i.e. services in the nature of an essential service)[5] and Category II Competitor Services (i.e. other competitor services).

Services in the Category I Competitor Services group were generally to be priced at Phase II costs plus a 15% mark-up. With certain exceptions, they were also subject to a rate element constraint of I-X.

The rates for Category II Competitor Services were either mandated or market-based and were based on considerations in addition to or other than Phase II costs. The rates for these services were capped at existing levels and were reviewed as required on a case-by-case basis.

h) *Uncapped Services* included all tariffed services not in one of the previous baskets or service groups and were not subject to any upward pricing constraints.

Positions of parties

The Companies

24. The Companies submitted that the current market conditions supported a more liberal price cap regime. They argued that regulation had a legitimate role in the protection of customers' interests. However, where market forces were sufficient to perform this role,

[5] As described in paragraph 167 of Decision 2002-34, Category I Competitor Services are in the nature of essential services and comprise interconnection and ancillary services, including essential services as defined in *Local competition*, Telecom Decision CRTC 97-8, 1 May 1997, which are critical inputs required by competitors in light of the very limited competitive supply of the services.

regulation could actually interfere to the detriment of consumer welfare. The Companies' proposed basket structure included pricing constraints as well as market indicia to determine when it was time to rely on market forces rather than on regulatory pricing constraints.

25. The Companies proposed five service baskets: connectivity services; emergency, public safety and social protection services; competitor services; discretionary services; and bundles.

Connectivity services

26. The Companies' proposed connectivity services basket included any service that connected a customer to a network or other location. The Companies submitted that the services assigned to this basket had the same characteristics as essential services[6] and required some form of regulatory oversight to discipline prices in the absence of competitive market forces.

27. The Companies proposed that these services be capped, on average, at existing rate levels, except for: (1) pay telephone services; (2) services for which pricing constraints would be redundant; and (3) business services whose prices were below cost. The Companies also proposed that residential connectivity services be subject to a basket constraint of zero and an individual rate element constraint of 5% per year. Business connectivity services should be subject to a basket constraint of zero, and an individual rate element constraint of 10% per year. The Companies submitted that the individual rate element constraints would ensure the continued affordability of each of these connectivity services. The Companies also argued that prices in a capped basket could not increase, on average, which would be more restrictive than if prices were allowed to increase by applying an inflationary constraint.

28. Regarding the exceptions above, the Companies requested the flexibility to increase the local coin pay telephone rate from $0.25 to $0.50 per call. The Companies also requested that Bell Canada be provided the flexibility to increase the rate for local calls placed with collect, third number, calling card, or commercial credit cards from $0.75 up to a maximum of $1.00 per call.

29. In addition, the Companies proposed uncapping services such as Centrex, Internet Protocol services, special facility tariffs and late payment charges since there were regulatory constraints of some form already established for these services. Finally, the Companies proposed that business service prices be allowed to increase if a company could demonstrate that the prices of the services were below the underlying costs.

Emergency, public safety and social protection services

30. The Companies proposed that this basket include those services that have already been deemed by the Commission to have a value in protecting safety, privacy, and other socially desirable goals and that the treatment of them need not be reconsidered. For these services, which include 9-1-1, Call Display Blocking and Message Relay Service, the Companies proposed that prices should remain unchanged over the next price cap period.

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[6] The Companies considered that essential services were typically defined as services of such importance to the economic and social welfare of the citizenry that universal access to such services at affordable rates remained a key element of public policy.

Competitor services

31. The Companies submitted that an adjustment of inflation less productivity (i.e. I-X) should not be applied to Category I Competitor Service rates and that these rates should be frozen pending the conclusion of the proceeding initiated by Public Notice 2006-14,[7] given the likelihood that the proceeding would result in changes to the regulatory framework for competitor services. If the Commission were to impose a productivity offset (i.e. X-factor) for Category I Competitor Services, the Companies submitted that -0.5% would be an appropriate level for 2007 and 2008.

32. For Category II Competitor Services, the Companies proposed that the current rules be retained, whereby any changes in prices would be assessed on a case-by-case basis.

Discretionary services

33. The Companies proposed that all other regulated services be classified as discretionary. The Companies proposed that these services be uncapped, since they were not used to connect the individual to society in general, and typically only a small fraction of customers took these services.

34. The Companies argued that discretionary services differed from connectivity services in terms of positive externalities. The Companies submitted that the benefits of connectivity services went beyond the customer actually purchasing the services, and accrued to others, and thus to society as a whole. The Companies argued that, by contrast, discretionary services had few, if any, externalities. Rather, discretionary services resembled other categories of goods and services, in that the bargain struck between the customer and the supplier had little impact on, or interest for, third parties. As a result, the same concerns as to pricing did not arise, and there was no special reason to impose price caps or similar mechanisms on discretionary services. The Companies submitted that customers had recourse if they became dissatisfied with the ILECs' prices by going to an alternative provider, or by dropping the service. The Companies submitted that market forces would discipline the ILECs' pricing of these services.

Bundles

35. The Companies submitted that bundles were made up of individual service components, which were either subject to their own price cap constraint, or were forborne from regulation, or were an unregulated non-telecommunications service. As such, the customer's protection against high prices, for regulated components of the bundle, would be provided through the constraints that apply to the prices of stand-alone components.

TELUS

36. TELUS submitted that it had designed its proposed price cap framework to reflect prevailing and expected market conditions.

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[7] In the proceeding initiated by *Review of regulatory framework for wholesale services and definition of essential service*, Telecom Public Notice CRTC 2006-14, 9 November 2006, as amended by Telecom Public Notices CRTC 2006-14-1, 2006-14-2, 2006-14-3 and 2006-14-4 (Public Notice 2006-14), the Commission is considering various matters, including a revised definition of "essential service".

37. TELUS proposed five service baskets: residential services, business services, services with frozen rate treatment, payphone services, and competitor services.

38. TELUS also proposed that the prices of residential and business service bundles and optional services be uncapped.

Residential services

39. TELUS proposed that the residential non-HCSA and HCSA services sub-baskets be amalgamated and that prices for these services be capped, on average, at existing levels during the next price cap regime. TELUS proposed, as a further safeguard, an individual rate element constraint of 5% per year on all stand-alone residential primary exchange services (PES), whether or not they were included in the residential services basket. TELUS submitted that, under this basket structure, optional local services and bundles would not be included, but rather would be uncapped.

40. TELUS argued that competitive alternatives, such as cable telephony, wireless service and access-independent voice over Internet Protocol (VoIP) services, would discipline the ILECs' residential service pricing decisions. TELUS argued that competition was exerting increasingly powerful constraints on the upper bound of prices for residential services.

Business services

41. TELUS proposed a new business services basket that would comprise the services that were assigned to the Business Services and Other Capped Services baskets in Decision 2002-34. TELUS argued that as a result of the significant increases in service alternatives and the general price-disciplining power of competitive market forces, there was no longer a reason to maintain separate service baskets. TELUS proposed that a 10% rate element constraint per year apply for services assigned to this basket.

Services with frozen rate treatment

42. TELUS proposed that no changes be made to the basket of services with frozen rate treatment and that their rates remain frozen over the next price cap period, except in cases where an ILEC elected to average rates for these services among its serving territories on a revenue-neutral basis as allowed by the Commission in Decision 2002-34.

Payphone services

43. TELUS proposed that prices for the services in this basket remain frozen at current levels[8] during the next price cap period.

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[8] TELUS charges $0.35 per call for local coin pay telephone service.

Competitor services

44. TELUS submitted that I-X should not be applied to Category I Competitor Service rates and that these rates should be frozen pending the conclusion of the Public Notice 2006-14 proceeding. TELUS further submitted that the Phase II review[9] should also be completed before making further changes to the price cap regime for Category I Competitor Services.

45. TELUS submitted that once these proceedings were completed and prices for Category I Competitor Services established, the next step would be to determine how to change those prices over time, one method being an I-X adjustment. TELUS argued that Commission-approved Phase II costs had resulted in rates that were too low for many Category I Competitor Services and that the continued application of the I-X constraint would exacerbate this situation.

46. TELUS submitted that the current treatment for Category II Competitor Services should be maintained.

Service bundles and optional services

47. TELUS argued that customers did not need the existing protection with respect to bundled services since the stand-alone components of the bundle would be protected with a 5% rate element constraint on residential PES. A customer that was dissatisfied with the bundle price could opt to purchase the same services on a stand-alone basis. In addition, TELUS argued that including the revenues from bundles in the residential services basket would provide the ILECs with the opportunity to create headroom to increase prices for some residential PES in the basket, as the bundled rate declined. TELUS argued that competition for bundles was strong and prices would be disciplined by market forces.

48. TELUS proposed that optional services should be uncapped since they were not essential, were discretionary and were available from cable, wireless and other suppliers.

MTS Allstream

49. MTS Allstream proposed minor modifications to the basket structure and associated pricing constraints established in Decision 2002-34. MTS Allstream submitted that in developing its proposal it had been guided by the fact that local competition had only recently begun to emerge within the residential local services market. MTS Allstream also submitted that the basket structure and associated pricing constraints should protect customers in areas where competitive alternatives were limited or non-existent.

50. MTS Allstream proposed that the distinction between basic residential services in HCSAs and non-HCSAs be eliminated and that the service basket constraint be inflation minus productivity when inflation exceeded productivity, and zero otherwise. MTS Allstream argued that this would not result in mandated rate reductions for basic local service, which could stifle the pace and extent of competitive entry.

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[9] In the proceeding initiated by *Review of certain Phase II issues*, Telecom Public Notice CRTC 2007-4, 30 March 2007 (Public Notice 2007-4), the Commission is reviewing certain Phase II costing issues.

51. MTS Allstream submitted that with competition emerging in the residential segment of the retail local services market, there was no longer any need or justification for including optional services in the Residential Services basket. MTS Allstream further submitted that these services were discretionary in nature and typically formed part of a bundled offering. As competition for retail services continued to increase, the availability and pricing of these services would be dictated by market forces. Where optional services formed part of a bundle, MTS Allstream proposed that the existing bundling and price floor rules still apply.

52. MTS Allstream proposed that no changes be made to the Business Services basket. For the Other Capped Services basket, MTS Allstream proposed a basket constraint of inflation minus productivity, when inflation exceeded productivity, and zero otherwise, on these services. In addition, MTS Allstream proposed that the existing 10% individual rate element constraint continue to apply for these services.

53. MTS Allstream also proposed that the current rate treatment of services with frozen rate treatment and pay telephones remain unchanged. MTS Allstream submitted that requests for changes to these service rates should be considered on a case-by-case basis.

54. MTS Allstream argued that there was no basis to change the existing price cap treatment for Category I and II Competitor Services until the conclusion of the Public Notice 2006-14 proceeding.

The Competitors

55. The Competitors proposed that, except as noted below, the Commission retain the basket structure and pricing constraints established in Decision 2002-34, as well as the assignment of services to those baskets. The Competitors submitted that the pricing constraints established for those baskets would be appropriate on a going-forward basis in order to protect consumers.

56. The Competitors proposed to remove the productivity offset on the Residential Services and Other Capped Services baskets. The Competitors submitted that eliminating the explicit productivity offset on these baskets would be consistent with the Commission's approach to business local services in Decisions 2002-34 and 2002-43.

57. The Competitors proposed that the current treatment for Category I and Category II Competitor Services be retained since there were few, if any, competitive alternatives for these services. The Competitors submitted that the residential market should benefit from lower Category I Competitor Service rates since lower rates would assist competitors in providing more robust, lower cost services to their residential customers.

Consumer Groups

58. The Consumer Groups proposed retaining the basket structure established in Decision 2002-34, with minor modifications to the rate element constraints, arguing that residential consumers were still facing ILEC monopoly power.

59. The Consumer Groups proposed that rate increases for the basic residential service sub-basket be limited to the rate of inflation, or 5%, whichever was lower. For the residential optional services sub-basket, the Consumer Groups proposed that rate increases be limited to the rate of inflation plus 3%.

60. In applying a productivity factor, the Consumer Groups argued that the Commission should recognize the expected productivity gains resulting from shared inputs and scope economies in a competitive market. The Consumer Groups argued that firms experiencing scope economies in competitive markets should not have the ability to arbitrarily award all productivity gains to a single product or service. The Consumer Groups argued that if the productivity gains were not shared with basic service customers, then the ILECs would be able to cross-subsidize the operations to which they allocate productivity gains, potentially harming competition.

61. The Consumer Groups also submitted an alternate price cap model that proposed to cap all existing tariffed rates, so that rates could go down but not up. In support, the Consumer Groups argued that the ILECs would then bear all the risk of inflation during the price cap period and no group of customers would face increases to pay for price discounts to consumers elsewhere.

Comments on proposals

The Companies' views on proposals from other parties

62. The Companies did not object to TELUS' price cap proposal. The Companies noted that, although TELUS' proposal was not identical to their own in every respect, there was no material incongruity of approach.

63. The Companies were opposed to MTS Allstream's and the Competitors' proposals on the grounds that these proposals did not incorporate a mechanism to allow regulation to keep pace with market conditions, as would be the case with a test for the uncapping of services.

64. The Companies were critical of the Consumer Groups' proposal in that rather than letting market forces dictate market outcomes where they are capable of doing so, the Consumer Groups suggested that the Commission guess what would happen in a competitive market, and then impose pricing rules intended to put those guesses into effect. The Companies were of the view that the Consumer Groups' initial proposal of an I-X pricing constraint was not supported by any credible evidence.

TELUS' views on proposals from other parties

65. TELUS considered that the Companies' proposed uncapping test for business services triggered by the presence of alternative facilities was unnecessary. TELUS argued that there was significant competition throughout its serving territory for business customers of all sizes, and that this competition would continue to intensify and expand. TELUS noted that the Commission itself had previously recognized the relatively greater degree of competition for business services when it determined not to impose a productivity offset on business exchange services.

66. TELUS noted that MTS Allstream proposed a unified residential basket for all exchanges. TELUS criticized this approach since it would permit an ILEC to offset price decreases in more competitive exchanges with price increases in less competitive exchanges. For example, TELUS noted that under MTS Allstream's proposed single basket, it would leave an ILEC free to offset rate decreases in more competitive exchanges with price increases in less competitive exchanges, provided the ILEC's prices met the overall basket constraint.

67. TELUS noted the Consumer Groups' alternative proposal, which did not involve the adoption of an explicit X-factor and, to that extent, represented a major concession. While TELUS considered it helpful to know that the Consumer Groups' principal concerns could be met without adopting an explicit X-factor, the principal concerns of the ILECs would not be met, as suggested by these groups. TELUS considered unacceptable the Consumer Groups' proposal that any increase to individual rates should be prohibited. Moreover, TELUS noted that under its proposal no increase in aggregate rates would be permitted for services in the Residential Services basket.

The Competitors' views on the proposals from the Companies and TELUS

68. Although the Competitors did not provide specific comment on the basket structure and pricing constraint proposals, they noted that the proposals made by the Companies and TELUS failed to protect consumers from the ILECs' exercising their market power in areas where competitive options are weak or unavailable. In addition, the Competitors considered the design of the ILECs' proposals would enable them to prevent competitors from growing their businesses in areas where competition is emerging.

Consumer Groups' views on the proposals from the Companies and TELUS

69. The Consumer Groups were of the view that the ILECs' proposals were inappropriate in relation to protecting the interests of consumers and that they should be rejected in favour of Consumer Groups alternate proposal of capping tariffed rates at existing levels.

70. The Consumer Groups were of the view that the Companies and TELUS confused the promise of real competition with its actual arrival. The confusion was then exacerbated by the premise that since competition was on the way, the Commission could be less concerned with the rigor of setting a price cap to ensure just and reasonable rates. The Consumer Groups noted that it considered the record was insufficient to support the ILECs' premise that consumer price protection was interfering with the development of competition.

Commission's analysis and determinations

General conclusions on the basket structure

71. The Commission notes that the proposals from the Companies and TELUS supported a more liberal price cap regime. In particular, these proposals suggested that the Commission rely more heavily on market forces to discipline prices.

72. As noted earlier, the Forbearance Order set out the criteria to forbear from the regulation of local services based on the presence of competitive infrastructure. The Commission notes that

price cap regulation only applies to non-forborne markets. In those areas which do not qualify for forbearance, the ILECs will continue to have significant market power and customers will have limited competitive alternatives. The Commission considers that in these circumstances, a reliance on market forces, as set out in paragraph 7(*f*) of the Act, to discipline prices would not be appropriate. The Commission therefore considers the proposals made by the Companies and TELUS to be unsuitable.

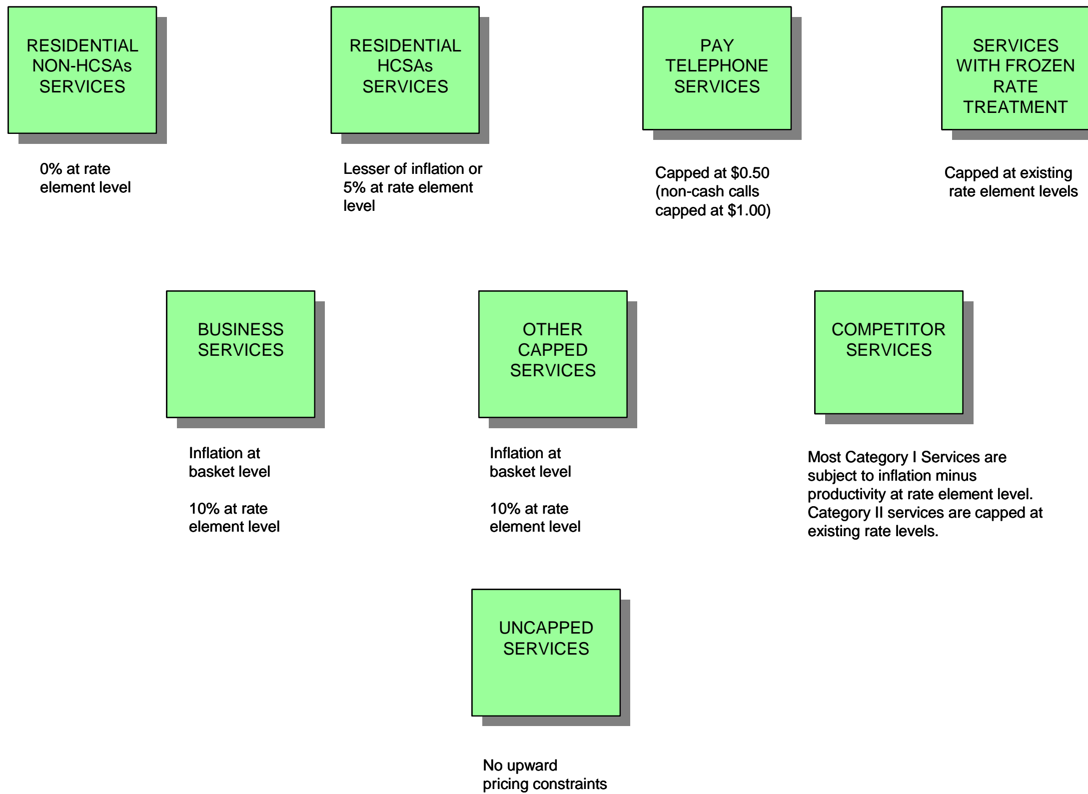
73. The Commission notes that the Consumer Groups initially put forward a basket structure based on pricing constraints that were more restrictive than those set out in Decisions 2002-34 and 2002-43. The Commission considers that, while the Consumer Groups' proposal would provide apparent protection for consumers, it would unnecessarily limit the ILECs' pricing flexibility with respect to residential services. In addition, the Commission considers that the Consumer Groups' proposal to mandate residential rate reductions resulting from an I-X adjustment would interfere with the natural development of market forces. The Commission therefore declines to adopt the Consumer Groups' initial proposal.

74. As an alternate proposal, the Consumer Groups recommended in final argument that the Commission simply cap all existing tariffed rates on a going-forward basis. The Commission considers that the Consumer Groups' proposal may have merit in certain circumstances; however, it would not provide the ILECs with the opportunity or flexibility to increase rates where services are provided below cost.

75. The Commission notes that, while a variety of pricing constraints for various groups of services were proposed by the parties, the majority generally supported the current basket structure and assignment of services to the baskets. The Commission notes that the assignment of services to baskets in Decisions 2002-34 and 2002-43 was generally based on the homogeneity of the services offered. As evidenced by this proceeding and the ILECs' general tariffs, the ILECs' delivery of these services has generally not changed over the last several years.

76. In light of the above, the Commission concludes that the current assignment of services to baskets as established in Decisions 2002-34 and 2002-43, with the exception of moving optional services to the Uncapped Services basket, remains appropriate for the next price cap regime. The Commission has also decided to make some specific changes to the basket and rate element constraints. The modifications to the price cap framework are discussed in detail below. The overall scheme of the framework is illustrated in Figure 1.

FIGURE 1



Changes to basket and rate element constraints

a) Productivity offset for retail services

77. In the current price cap regime, a productivity offset, or X factor, is applied to most retail services at the basket or rate element level, except for the Business Services basket.

78. The Commission notes that applying a productivity offset to revenues from retail services may result in mandated rate reductions. The Commission considers that mandated rate reductions through the application of an X-factor, could interfere with the natural development of market forces. In addition, the Commission notes that mandated rate reductions would not be in keeping with the paragraph 7(*f*) of the Act (i.e. efficient and effective regulation) and the Policy Direction (i.e. use measures that are minimally intrusive and minimally onerous).

79. The Commission notes that with respect to most residential PES in HCSAs, rates are generally below cost. In these circumstances, the Commission considers that applying an X-factor to the revenues associated with these services would not be appropriate.

80. Regarding the Business Services basket, the Commission notes that no parties proposed that a productivity offset should be applied to the services in this basket. The Commission considers this practice continues to be appropriate.

81. Regarding the services assigned to the Other Capped Services basket, the Commission notes that 1) several of the services are becoming obsolete, making it difficult to find replacement parts, and 2) certain legacy services are being replaced by new services offering additional features and benefits. The Commission considers that the ILECs are facing a declining market with respect to several of the services currently assigned to this basket. As such, the Commission considers that the ILECs' ability to achieve productivity and efficiency gains in respect of these services in the next several years would be limited.

82. Accordingly, the Commission finds it appropriate not to subject retail services to a productivity offset (i.e. X-factor) in the next price cap regime. Consequently, the Commission has not applied a productivity offset to the Residential Services (non-HCSA and HCSA sub-baskets), Business Services and the Other Capped Services baskets.

b) Residential local optional services

83. The Commission considers that as residential optional local services are discretionary in nature, the demand would tend to be more sensitive to prices. As a result of price increases, a customer could choose to explore other alternatives or to drop the service entirely.

84. The Commission notes that during the current price cap regime, the ILECs have generally not proposed any rate increases to their residential local optional services. The Commission considers that the ILECs have generally established maximum prices for these services on an individual basis and that any further rate increases would likely lead to a decrease in demand.

85. The Commission also considers that assigning optional services to the Uncapped Services basket would reduce the number of sub-baskets for residential services, and simplify the price cap regime and its associated annual price cap filing requirements. The Commission notes that this would be consistent with the objective of efficient and effective regulation (i.e. paragraph 7(*f*) of the Act).

86. Accordingly, the Commission considers it appropriate to assign residential optional local services to the Uncapped Services basket. Consequently, these residential optional local services rates will no longer be subject to any upper pricing constraints.

c) Modifications to the Residential Services baskets

87. In Decisions 2002-34 and 2002-43, noting the significantly different circumstances in non-HCSAs and HCSAs, the Commission established two baskets for residential local services: a sub-basket of residential local services in non-HCSAs and a sub-basket of residential local services in HCSAs.

88. The Commission notes parties' views varied on whether to retain separate baskets for non-HCSAs and HCSAs. However, all parties proposed that the same rate element constraint be applied to both non-HCSA and HCSA customers.

89. The Commission considers that there is no evidence to suggest that circumstances in non-HCSAs and HCSAs have changed and the application of different constraints for residential PES in non-HCSAs and HCSAs remains appropriate. Accordingly, the Commission maintains separate baskets for residential PES in non-HCSAs and HCSAs.

90. The Commission sets out the pricing constraints for residential PES in non-HCSAs and HCSAs below. The Commission was mindful of paragraph 7(*b*) of the Act (i.e. affordable telecommunications services in both urban and rural areas) in establishing these constraints.

Residential Non-HCSAs Services basket

91. In establishing the local forbearance framework in Decision 2006-15, the Commission considered it important to ensure that the affordability of essential residential PES not be compromised in a forborne market. The Commission was concerned that vulnerable and uncontested residential consumers may not have access to stand-alone PES at affordable rates in a forborne environment without a pricing safeguard. Consequently, the Commission determined that in a forborne market, a price ceiling would apply to the most recently approved rates at the time of forbearance for stand-alone PES, including touch-tone, primary directory listing, and connection charges.

92. The Commission notes that there will be consumers in non-HCSAs who will not have sufficient competitive alternatives for residential PES. The Commission considers that consumers in non-HCSAs face similar circumstances as those uncontested customers identified in Decision 2006-15.

93. The Commission considers that a price ceiling on residential rates in non-HCSAs would provide customers with a safeguard against unreasonable rate increases. The Commission notes that the treatment of these services would be consistent with the Consumer Groups' alternate proposal to cap rates at existing levels and would be similar to the proposals made by the Companies and TELUS to cap, on average, residential rates. The Commission also considers that maintaining residential PES rates in non-HCSAs at the same level will likely provide an incentive for the ILECs to be more cost-efficient.

94. Accordingly, except for the possible rate adjustments resulting from the consideration of the matter noted below, the Commission finds it reasonable to cap the ILECs' residential PES rates in non-HCSAs at existing levels and to apply a rate element constraint of 0% for residential PES in non-HCSAs.

95. In *Elimination of service connection charge applicable to Residential Primary Exchange Service customers*, Telecom Public Notice CRTC 2006-11, 11 August 2006, as amended by Telecom Public Notice CRTC 2006-11-1, the Commission invited comments on applications received from Bell Aliant, Bell Canada and TELUS to eliminate the residential service connection charge and to increase residential PES rates. The Commission will consider the issues associated with the elimination of the residential service connection charge and the increase to residential PES rates subsequent to this decision.

96. As set out later in this Decision, the Commission is allowing the ILECs to propose exogenous factor adjustments during the next price cap regime. The Commission considers that, in these circumstances, rate element constraints should apply to the Residential Non-HCSAs Services basket. Accordingly, rate increases to the services in this basket will be capped at 5% per year per rate element.

97. The Commission notes that the current price cap regime incorporates a deferral account mechanism. In each year of the price cap period, the ILECs are required to assign to the deferral account an amount equal to any revenue reduction that would otherwise be required under the I-X constraint for the Residential Non-HCSAs Services basket.

98. The Commission notes that based on the basket structure and pricing constraints set out in this Decision, a deferral account is no longer required. Accordingly, the Commission concludes that the deferral account mechanism will not form part of the next price cap regime.

99. In Decisions 2002-34 and 2002-43, the Commission determined that the revenues derived from service bundles that included a residential local exchange service or a residential optional local service component must be included in the Residential Services basket when calculating the revenues subject to the deferral account.

100. As noted above, the Commission is eliminating the requirement for a deferral account in the next price cap regime. Accordingly, it is no longer necessary to require that the Residential Services basket include revenues derived from service bundles with a residential local exchange service or a residential optional local service component.

Residential HCSAs Services basket

101. In Decisions 2002-34 and 2002-43, the Commission did not impose any basket constraints on residential PES in HCSAs given that rates were generally below costs. The Commission notes that residential PES rates in HCSAs generally continue to be below costs.

102. The Commission notes that its general policy is to move rates closer to costs provided these rates remain just and reasonable. The Commission considers that allowing ILEC residential rates to increase in HCSAs would move rates closer to costs and reduce the amount of the National Contribution Fund.[10]

103. The Commission determines that it would be reasonable to allow the ILECs to increase residential PES rates in HCSAs by the annual rate of inflation. To protect against any unexpected rise in the rate of inflation, a rate element constraint equal to the lesser of the annual rate of inflation or 5% will apply to the services in the Residential HCSAs Services basket.

104. As set out later in this Decision, the Commission is allowing the ILECs to propose exogenous factor adjustments during the next price cap regime. The Commission considers that, in these circumstances, rate increases to the services in this basket will be capped at 5% per year per rate element.

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[10] In *Changes to the contribution regime*, Decision CRTC 2000-745, 30 November 2000, the Commission introduced, effective 1 January 2001, the National Contribution Fund to subsidize the high cost of local service in rural and remote areas where rates are below costs. In that Decision, the Commission also established a new national contribution mechanism based on revenues from telecommunications service providers (i.e. revenue percent charge).

d) Business and Other Capped Services baskets

105. As noted above, the Business Services basket is currently subject to an overall basket constraint of inflation and a rate element constraint of 10%. No party proposed changes to the constraints for this basket.

106. The Commission determines that it would be appropriate to maintain the current basket constraint of inflation and the rate element constraint of 10%.

107. Regarding the Other Capped Services basket, as discussed earlier in this Decision, the services in this basket will not be subject to a productivity offset in the next price cap regime. The Commission considers that customers of services in this basket will require protection against unreasonable rate increases.

108. Accordingly, the Commission concludes that the Other Capped Services basket be subjected to an overall basket constraint of inflation and a rate element constraint of 10%.

e) Pay telephone services basket

Pay telephone services rates

109. In Decisions 2002-34 and 2002-43, the Commission concluded that public and semi-public pay telephone services be assigned to a separate basket and that the rates for these services be capped at the then current levels. As noted above, the Companies requested flexibility to increase pay telephone rates during the next price cap regime.

110. The Consumer Groups submitted that the Companies remained dominant in the local pay telephone markets. The Consumer Groups argued that information related to the cost and revenues for pay telephone services had not been provided and there had been no opportunity to adequately evaluate the real need for a rate increase.

111. The Consumer Groups pointed out that in *Access to pay telephone service*, Telecom Decision CRTC 2004-47, 15 July 2004 (Decision 2004-47), the Commission considered pay telephone service to be an important public service that wireless services had not rendered obsolete. The Consumer Groups also stated that Decision 2004-47 provided the Companies with a relatively free hand to make decisions concerning removal of unprofitable pay telephones or relocation of pay telephones to more profitable venues.

112. The Commission recognizes that pay telephone rates have not increased for most ILECs for almost 25 years. The Commission considers reasonable the position of the Companies that the costs of providing pay telephone services have increased since the last increase in rates in 1981.

113. In Decision 2004-47, the Commission re-affirmed the ILEC's right to remove and/or relocate pay telephones, with the only restriction being proper notification when the last pay telephone in a community was to be removed. The Commission continues to consider pay telephone service a necessary and valuable public service. The Commission considers that without the flexibility to increase pay telephone rates, the ILECs may remove unprofitable pay telephones which would result in consumers having reduced access to the service.

114. Accordingly, the Commission approves the flexibility for all ILECs to increase the local call charge for a cash call up to a maximum rate of $0.50, and to increase collect, third number, Calling Card or commercial credit card charges up to a maximum rate of $1.00.

Pay telephone local directory assistance charges

115. Charges for calls to Local Directory Assistance (LDA) are currently included in the Other Capped Services basket and vary by ILEC territory. However, LDA calls originating from pay telephones are exempt from incurring these charges.

116. The Companies, on behalf of Bell Canada, requested that the exemption for LDA calls made from pay telephones be removed and a new charge of $0.25 be established in Bell Canada's territory. The Companies argued that rates charged to access directory assistance by the major competitors in Canada vary from $0.25 to $1.00.

117. The Consumer Groups did not support this request, arguing that the social policy issues associated with directories at pay telephone locations had not changed and that pay telephone locations were frequently without directories.

118. The Commission considers that the Companies' request did not adequately address any of the public or social policy issues raised by the Consumer Groups. The Commission considers that the record of this proceeding is insufficient to make a determination on this issue. Accordingly, the Commission denies the Companies' proposal to remove the exemption from charges for local directory assistance calls placed from semi-public and public pay telephones at this time.

f) Competitor Services

119. With respect to TELUS' submission that applying I-X would exacerbate what it characterized as rates for Category I Competitor Services that are too low, the Commission notes that the issue of Category I Competitor Service rate levels is not within the scope of this proceeding. With respect to the suggestion made by the Companies and TELUS that the Commission should also suspend its practice of reviewing costs associated with Category I Competitor Services as part of a freeze on the rates for these services, the Commission notes that the review of costs is not a price cap matter.

120. The Commission notes that the Companies and TELUS referred to other Commission proceedings in support of their proposals to freeze rates for Category I Competitor Services. However, the Commission also notes that the large ILECs are required to provide a service as a Category I Competitor Service if the Commission finds that the service is in the nature of an essential facility.

121. The Commission considers that Category I Competitor Services are not subject to competitive market forces sufficient to ensure the sharing of productivity gains with users of those services. The Commission also considers that the ILECs will continue to experience productivity gains in respect of these services.

122. Accordingly, the Commission determines that an annual I-X adjustment should continue to apply to Category I Competitor Services whose rates were not exempted from the application of this factor in Decisions 2002-34 and 2002-43.

123. The Commission notes that no parties proposed changes to the price cap treatment of Category II Competitor Services established in Decisions 2002-34 and 2002-43. The Commission determines that this treatment should continue to apply.

g) Test to uncap certain services

124. Both the Companies and TELUS proposed a competitive presence test for the uncapping of certain services in areas where alternative facilities were in place. In support of their proposed uncapping test, the Companies cited the need to rely on market forces to the greatest extent possible while ensuring that regulatory constraints were imposed only as necessary to achieve the objectives of regulation. TELUS cited the need for ILECs to have greater flexibility to respond to competitive pressures and that competition would ultimately protect consumers.

125. The other parties to this proceeding disagreed with the uncapping tests proposed by the Companies and TELUS. MTS Allstream, the Competitors and the City of Calgary argued that the tests would not demonstrate diminishing market power and that such market power could be abused. MTS Allstream and BCOAPO et al. argued that the pricing flexibility afforded by such tests prior to forbearance could have undesirable effects on both consumers and competitors, with the possibility of lowered rates where the ILECs faced competition and higher rates elsewhere. BCOAPO et al. and the City of Calgary objected to TELUS' inclusion of wireless service as an alternative in its uncapping test, arguing that wireless service was not a suitable alternative to local wireline service. A number of parties submitted that the proposed uncapping tests were simply alternative tests to forbearance.

126. As noted above, in those areas which do not qualify for forbearance, the ILECs will continue to have significant market power and customers will have limited competitive alternatives. The ILECs would have both the incentive and ability to raise and control prices. The Commission considers that even in areas where there may be competitive alternatives, the ILECs do not require the flexibility to increase prices in those circumstances.

127. The Commission notes that this price cap regime applies only to non-forborne markets. The Commission also notes that ILECs can apply for forbearance in areas where the forbearance criteria are met.

128. Accordingly, the Commission finds that the uncapping tests proposed by the Companies and TELUS are inappropriate and unnecessary.

C. Components of the price cap formula

129. In Decisions 2002-34 and 2002-43, the Commission established the individual basket constraints which relied on an inflation factor, a productivity factor and an exogenous factor, as appropriate. As noted above, the Commission invited comments in this proceeding on what changes, if any, should be made to these components of the price cap formula.

1. Inflation factor

130. In Decisions 2002-34 and 2002-43, the Commission considered it appropriate to use the annual chain-weighted national Gross Domestic Product – Price Index (GDP-PI) as the measure of inflation in the current price cap regime. The GDP-PI is a measure of the national output price change published by Statistics Canada.

131. Both the Companies and TELUS submitted they would support the retention of the GDP-PI as the measure of inflation for the next price cap period in the event that the Commission considered it appropriate to use an explicit measure of inflation. Other parties who commented on the inflation factor also supported the continued use of the GDP-PI.

132. The Commission determines that the measure of inflation for the next price cap regime is the annual chain-weighted GDP-PI published by Statistics Canada.

2. Productivity offset

133. In Decisions 2002-34 and 2002-43, the Commission set the productivity offset (i.e. X-factor) at 3.5% based on a marginal cost approach. This marginal cost approach examined the change in the ILECs' unit costs over time. The X-factor value of 3.5% was developed based on analysis of the ILECs' unit cost changes for residential PES.

134. The Commission notes that several approaches were proposed by the parties in this proceeding to calculate a productivity offset. The Commission will address each of these approaches below.

a) Marginal cost approach

135. The Companies and TELUS proposed that a marginal cost approach be used to establish a productivity offset if the Commission determined that there was a need for an X-factor in the next price cap regime.

136. The Companies proposed an X-factor of -0.5% based on a marginal cost approach for the next price cap regime. The Companies estimated the X-factors for each of the years 2006 to 2008 to be -1.0%, -0.9% and -0.1%, and averaged the forecasted X-factors for the years 2007 and 2008 to arrive at their X-factor of -0.5%.

137. The Companies submitted that they conducted their analysis in three steps. First, the historical trend in Bell Canada's unit costs for residential PES from 1988 to 2005 was estimated using a consistent costing methodology throughout that period. The result of this analysis showed that the unit costs declined at an average rate of 1.04% per year over that period.

138. Second, the Companies combined that information with the average annual economy-wide inflation of 2.16% (based on Statistics Canada's chain-weighted GDP-PI series) for the same period. An average historic value of the X-factor, over the period from 1988 to 2005, was estimated to be 3.2% per year.

139. Third, the Companies adjusted the X-factor value of 3.2% downwards for the years 2006 to 2008, based on three factors related to their expected demand loss associated with the residential PES due to competition. The Companies identified these three factors as: (a) lower average working fill factor (utilization of copper plant), (b) loss of more customers in lower-cost bands relative to high-cost bands, and (c) increased spending on customer retention activities.

140. TELUS proposed an X-factor value in the range of 0.3% to 1.8% based on a marginal cost approach for areas that did not pass its competitive presence test for residential PES. TELUS submitted that the appropriate value would depend on the specific assumptions made about

the extent of competitive losses. TELUS argued that demand reductions from increased facilities-based competition were reducing the scale of TELUS' operations, thereby increasing unit costs and decreasing productivity growth.

141. TELUS estimated that, based on an assumed annual reduction of 3.0% in its primary residential lines, its average annual unit cost change would be 1.7% for the years 2007 to 2011. TELUS calculated an inflation rate of 2.0% based on a historical annual average rate from 1995 to 2005. TELUS then calculated an X-factor of 0.3% based on these figures. Using the same methodology, TELUS also submitted X-factors of 1.1% and 1.8%, assuming percent decline in residential lines of 2.0% and 1.0%, respectively.

b) Total Factor Productivity (TFP) Approach

142. The Consumer Groups' methodology for calculating the productivity offset was based on a TFP approach that examined a firm's or an industry's use of inputs relative to its production of outputs. The Consumer Groups submitted that when economies of scope expanded, firms were able to produce more outputs without a proportional increase of inputs; therefore, expanding scope economies would result in increased productivity.

143. The Consumer Groups proposed that the productivity offset be set at 6.0% for the next price cap regime. This productivity offset level included (1) an industry TFP growth of 4.2% based on data from 1988 to 1995, (2) an economy-wide TFP adjustment of -1.06% from 1995 to 2004, (3) an input price differential of 2.0% to reflect the difference between industry and economy-wide input price growth rates,[11] and (4) a stretch-factor of 1.0% to reflect economies of scope.

144. The Consumer Groups stated that the major problem with using a service-specific marginal cost approach for calculating productivity was that it excluded economies of scope. The Consumer Groups submitted that due to new technologies, such as digital subscriber line (DSL), the recovery of costs associated with loop plant, interoffice facilities, customer support and marketing, and billing could be spread over more services to create economies of scope.

145. The Consumer Groups submitted that a stretch factor of up to 1.0% should be added to the productivity offset because the historical data in the ILECs' service specific marginal cost studies were unlikely to reflect economies of scope.

146. While the City of Calgary supported the Consumer Groups' proposed X-factor value of 6.0%, the Companies, MTS Allstream and TELUS opposed it.

147. The Companies submitted that the TFP approach proposed by the Consumer Groups was inferior to an approach based on the analysis of trends in service-specific unit costs for residential services. TELUS and MTS Allstream submitted that the TFP approach incorrectly measured productivity across all services, rather than specific services that were subject to regulation. The Companies submitted that setting a productivity target for regulated services

[11] The Consumer Groups calculated an input price differential of 2.0% based on a study of U.S. price inflation over the years 1995 to 2004.

based on productivity for services that were not regulated would blunt incentives for efficiency in both service areas because neither sector would bear the complete consequences of what occurred.

148. Regarding the source data used by the Consumer Groups in their X-factor calculation, the Companies submitted that the starting point of 4.2% as an estimate for TFP was flawed because it was based on all the operations of a company instead of only regulated services. Additionally, the Companies and TELUS submitted that the Consumer Groups' source data was significantly outdated and thus it was unclear whether the TFP would be close to 4.2%, if measured with more recent data.

149. The Companies and TELUS submitted that because the Consumer Groups used different time periods when comparing economy-wide TFP (1995 to 2004) and industry TFP (1988 to 1995), the results were inconsistent and therefore unreliable. The Companies and TELUS also submitted that the Consumer Groups' use of U.S. data, instead of Canadian data, to calculate an input price differential of 2.0% provided doubtful comparisons.

150. Regarding the Consumer Groups' proposed stretch factor, the Companies submitted that this adjustment was conceptually flawed. The Companies submitted that the presence of other services would not change the cost of providing a local loop and that the use of the loop, for whatever purpose, was included when a customer purchases PES. Thus, the incremental costs of providing PES to a customer must include an entire local loop and the entire cost of the loop must be included as part of the unit costs for PES.

151. TELUS submitted that its marginal cost approach to calculating productivity captured economies of scope and referred specifically to the inclusion of changes in various other outputs on residential PES costs, including the effect of DSL output on PES costs.

152. MTS Allstream submitted that the potential existence of economies of scope in the provision of telecommunications was not a new phenomenon and that while the introduction of new services had likely contributed to the industry's productivity growth to some degree, there were no estimates, if any, of the precise contribution.

153. MTS Allstream argued that under the existing marginal cost-based approach, there was no need or rationale to include a stretch factor to reflect economies of scope since, to the extent that they have influenced the cost of provisioning PES over time, they would already be reflected in the marginal cost trends.

c) Modified approach

154. MTS Allstream submitted that the X-factor for the next price cap period should be re-set independent of any individual ILEC's actual productivity performance under the current regime, and that it should be based on market conditions that are expected to prevail.

155. MTS Allstream argued that scale economies were the most significant factor explaining historical TFP growth in the telecommunications industry, and the X-factor should be based on the expected impact of scale economies over the next price cap period. MTS Allstream submitted that, on average, scale economies accounted for 60% to 80% of Canadian telecommunications industry historical TFP growth.

156. MTS Allstream submitted that because ILEC Network Access Services (NAS) counts were declining on a yearly basis and given the importance of scale economies on productivity growth, the current X-factor value of 3.5% should be reduced by 60%, thereby arriving at a new X-factor value of 1.5%.

Commission's analysis and determinations

157. Regarding the Consumer Groups' approach to calculating the X-factor, the Commission considers that the vintage of the industry TFP growth data used by the Consumer Groups is not sufficiently recent to calculate an appropriate X-factor value for the next price cap regime. The Commission agrees with the Companies' and TELUS' submissions that the use of different time periods for economy-wide TFP and industry TFP is inappropriate. The Commission also considers that U.S. data cannot be relied on to estimate trends in Canadian input prices.

158. Regarding the Consumer Groups' proposed stretch factor, the Commission acknowledges that the advent of technologies such as DSL could potentially contribute to additional economies of scope given that more than one service could be provided over the same local loop. While such economies of scope could potentially impact the value of the X-factor, the Commission considers that the Consumer Groups' evidence submitted in this proceeding is insufficient to estimate this impact, specifically with respect to the Canadian telecommunications industry.

159. In light of the above, the Commission rejects the Consumer Groups' proposal for an X-factor value based on the TFP approach.

160. The Commission notes that while the Companies, MTS Allstream, and TELUS proposed different methodologies for the determination of the X-factor value, each was based at least in part on a marginal cost approach.

161. Regarding MTS Allstream's X-factor calculation, the Commission considers it inappropriate to calculate this value by combining results from a marginal cost approach and a TFP approach. Consequently, the Commission rejects MTS Allstream's proposal.

162. The Commission notes that both the Companies and TELUS based their proposed X-factor on their forecast demand loss from competition in the local residential PES market. As stated above, the Commission is applying a productivity offset to competitor services and to the calculation of the subsidy for residential services in HCSAs. Since these services are subject to limited competition, the Commission considers that the adjustment for demand loss from competition in the residential PES market would not apply in these circumstances. Consequently, the Commission concludes that it would not be appropriate to include forecast data provided by the Companies and TELUS in the determination of the value for the X-factor.

163. The Commission considers that the Companies' residential PES marginal cost data provides the most appropriate basis on which to calculate the productivity offset since it was based on historical unit costs dating back to 1988. Therefore, the Commission has used the updated marginal cost information filed by the Companies in this proceeding to calculate the X-factor for the next price cap regime.

164. In light of the above, the Commission adopts a productivity offset (i.e. X-factor) of 3.2%.

165. As set out in this Decision, the productivity offset will be applied to certain Category I Competitor Services and to the residential high-cost subsidy calculation. The Commission considers that while the residential PES marginal cost data used to calculate the productivity offset of 3.2% does not specifically relate to competitor services, it provides a better approximation of marginal cost trends of competitor services than other data available in this proceeding.

3. Exogenous factor

166. In Decisions 2002-34 and 2002-43, the Commission set out its criteria for exogenous factor adjustments. Events or initiatives which satisfy all of the following criteria are considered to be exogenous adjustments:

- they are legislative, judicial or administrative actions which are beyond the control of the company;
- they are addressed specifically to the telecommunications industry; and
- they have a material impact on the company.

167. Each exogenous event is reviewed on an individual basis, taking into consideration the particular circumstances of each event, and the assignment to the various price cap baskets is determined on a case-by-case basis.

168. Exogenous factors are not assigned to the Services with Frozen Rate Treatment and the Competitor Services baskets. ILECs 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 are to notify the Commission as soon as possible after they learn of the relevant facts.

169. The Competitors, MTS Allstream, and TELUS submitted that the requirement to treat an event or initiative as exogenous had not changed since the time of the last price cap review proceeding, and that the existing process had worked effectively.

170. The Companies submitted that there should be no requirement for exogenous adjustments. The Companies submitted that if the Commission were to establish a new regulatory obligation that imposed a material cost on the regulated company, it should address the possibility of cost recovery in the proceeding that established the new obligation.

171. The Commission notes that exogenous adjustments in the past have included instances beyond that of a new regulatory obligation, such as a reduction to Bell Canada's Ontario Gross Receipts Tax and MTS Allstream's recovery of income tax expense.

172. The Commission considers that the ILECs would unfairly be required to bear the risk associated with events beyond their control that increase their costs to a significant extent. The Commission also considers that consumers and competitors using the ILECs' services would not benefit from cost savings that could be passed on to them through exogenous adjustments.

173. The Commission concludes that an application of an exogenous factor adjustment, as set out in Decisions 2002-34 and 2002-43, remains appropriate for the next price cap regime.

D. Rate de-averaging

174. In Decision 2002-34, the Commission explicitly prohibited any further rate de-averaging within a rate band for residential services, single and multi-line business local exchange services, and other capped services. As a result of the Commission's prohibition on further rate de-averaging, ILECs cannot lower a rate for these services in one part of a rate band without lowering the rate across the entire band. For uncapped services, the Commission indicated that an ILEC seeking to further de-average rates was to provide supporting rationale with its application.

175. In this proceeding, the Commission invited comments on what changes, if any, should be made to its current policy on rate de-averaging within a band.

Positions of parties

176. The Companies and TELUS were in favour of further rate de-averaging within rate bands while MTS Allstream, the Competitors, and the Consumer Groups were against it.

177. The Companies submitted that uniform pricing led to economic inefficiencies and inhibited efficient pricing decisions. Different marks-ups for different types of customers reduced the intensity of competition in various sub-markets and created an ILEC price umbrella that protected new entrants. The Companies argued that the restriction on further rate de-averaging harmed customers by keeping prices higher than they would be if the ILEC were able to meet competition where it existed.

178. The Companies submitted that as the telecommunications industry continued to evolve, it was unlikely that the rate de-averaging prohibition would ensure just and reasonable rates or the continued development of competition.

179. TELUS argued that the existing rate de-averaging prohibition interfered with market forces and had negative consequences for consumers, entrants, incumbents and the natural evolution of competition. TELUS argued that it needed further rate de-averaging across geographical markets that straddled exchanges and bands in order to have the flexibility to create and implement uniform pricing strategies across large geographical areas.

180. TELUS submitted that eliminating the prohibition on rate de-averaging would provide the company with a reasonable opportunity to begin adjusting its rates to better reflect the underlying cost of providing PES.

181. TELUS submitted that, based on its proposal, de-averaging within bands and exchanges would be limited by both upward and downward pricing constraints. Business or residential PES rates would not be permitted to fall below the Commission's imputation test level. TELUS submitted that as long as de-averaged rates did not increase by more than the rate element constraint, rates would not be unjustly discriminatory. TELUS was of the view that the Commission would continue to have the power to review rate changes to ensure that they were not unjustly discriminatory.

182. In support of its position to maintain the current restriction on rate de-averaging within a rate band, MTS Allstream submitted that local competition was still very limited or non-existent in many parts of the country and that removing the prohibition would only serve to undermine the limited degree of competition that had developed.

183. MTS Allstream argued that where market power persisted in non-forborne markets, upward price controls must be retained. MTS Allstream submitted that the combined effect of removing the prohibition against de-averaging and uncapping services would undercut the local forbearance criteria and damage the development of competition.

184. MTS Allstream also submitted that de-averaging was all about making targeted price reductions available only to those customers who had competitive options and that this was inappropriate in a non-forborne market because the ILECs had a captive customer base to fund this targeting.

185. The Competitors submitted that while they supported rate de-averaging between provinces, rate de-averaging within a rate band within a province should not be permitted because not all locations within a rate band faced competition. As a transitional measure, the Competitors proposed that, once market share loss reached a 20% threshold in a specific local forbearance region (LFR), the same rate could be charged to all customers within this LFR.

186. The Competitors further submitted that where competition was still weak or non existent, the Commission must protect consumers from the ILEC's ability to raise prices to unreasonable levels.

187. The Competitors argued that, as competition generally benefited consumers, the role of a regulator was to foster the development of a competitive market. The Competitors submitted that allowing rate de-averaging would permit the ILECs to reduce rates where they faced competition while maintaining them at higher levels where they did not. The Competitors submitted that allowing the ILECs to reduce prices down to their underlying costs in a selective manner would deny competitors the ability to expand their operations, while the ILECs would sustain their own operations in other market segments where they retained market power.

188. The Consumer Groups argued that the current rate structure in the residential market provided the ILECs with a significant level of rate de-averaging and the level of competitive activity was too low to allow further rate de-averaging. The Consumer Groups submitted that rate de-averaging could be allowed for the business market segment because it already enjoyed rate de-averaging through individual case basis pricing.

189. The Consumer Groups stated that there was little reason to expose customers in markets that were not yet and may never be competitive to the risks of rate increases due to the ILEC's desire to reduce prices to attract customers in other areas. In citing the low level of competitive presence in the residential market segment, UC submitted that rate de-averaging within a rate band would require a high level of regulatory oversight.

Commission's analysis and determinations

190. The Commission's approach to rate de-averaging has always been guided by subsections 27(1), (2) and (4) of the Act which state:

> (1) Every rate charged by a Canadian carrier for a telecommunications service shall be just and reasonable;
>
> (2) No Canadian carrier shall, in relation to the provision of a telecommunications service or the charging of a rate for it, unjustly discriminate or give an undue or unreasonable preference toward any person, including itself, or subject any person to an undue or unreasonable disadvantage; and
>
> (4) The burden of establishing before the Commission that any discrimination is not unjust or that any preference or disadvantage is not undue or unreasonable is on the Canadian carrier that discriminates, gives the preference or subjects the person to the disadvantage.

191. As recently as 2005, the Commission considered that allowing further rate de-averaging was inappropriate as it would allow for a degree of targeted pricing which could subject other customers in the rate band to an undue disadvantage, result in rates that were not just and reasonable, and slow the development of fair and sustainable competition. This view is reflected in *Review of price floor safeguards for retail tariffed services and related issues*, Telecom Decision CRTC 2005-27, 29 April 2005 (Decision 2005-27) in which the Commission denied the Companies' and TELUS' requests to further de-average rates within a rate band to meet existing or anticipated competition.

192. The Commission notes that parties provided very few comments and little evidence on the issue of removing the prohibition on further rate de-averaging for pay telephone and business services. As a result, the Commission considers that the record of this proceeding is insufficient to determine whether the prohibition on further rate de-averaging for pay telephones and business services should be removed at this time.

193. The Commission notes that much of the focus during the proceeding related to how the prohibition on rate de-averaging affected the natural development of competition in the residential markets and its ultimate impact on residential consumers.

194. The Commission finds that much has changed in the residential markets since the determinations in Decision 2005-27. The Commission's determinations were largely based on market conditions as outlined in the Commission's 2003 and 2004 Monitoring Reports. The Commission notes that the facilities-based cable competitors are well positioned to enter the residential market because of their existing infrastructure and their ability to bundle telephony services with their existing suite of services.

195. The Commission recognizes that the Policy Direction requires that the Commission, when relying on regulation of an economic nature, use measures that neither deter economically efficient competitive entry into the market nor promote economically inefficient entry.

The Policy Direction also requires that when relying on regulation, the Commission use measures that are efficient and proportionate to their purpose.

196. In light of the above background and in light of its statutory obligation under section 27 of the Act, the Commission has examined whether its prohibition on further rate de-averaging remains necessary to ensure that residential rates are just and reasonable and to deter unjust discrimination or undue preference in the charging of these rates.

197. As part of the new price cap framework, the Commission has put in place and/or maintained a number of upward and downward constraints on residential services.

198. For example, the Commission is capping the rates for stand-alone residential services in non-HCSAs. For HCSAs, the Commission is allowing rates to increase at the lesser of the rate of inflation or 5%. As a result, removal of the prohibition on further rate de-averaging would not lead to a significant increase in rates for residential HCSA subscribers given the pricing constraints established for residential services baskets. The Commission considers that these constraints will ensure that residential PES rates do not rise to unreasonable or unjust levels.

199. The Commission also notes that downward constraints are in place. Specifically, any proposal to reduce rates for residential services, including optional local services, must generally be accompanied by supporting rationale that demonstrates the proposed rates continue to pass an imputation test. These safeguards deter anti-competitive pricing strategies for services offered by ILECs.

200. The Commission considers that removing the prohibition for residential services would foster economic efficiency in those areas where the ILEC remains the dominant service provider. For example, TELUS noted during its testimony that if rate de-averaging is allowed, it would have the pricing flexibility to offer a bundled service across a very large geographical area. As a result, TELUS would be able to pass these benefits to consumers through either rate reductions or bundled service offerings to meet various sub-market requirements across their operating territory.

201. In light of the above, the Commission considers that the rates for residential services, including optional local services, subject to regulation would remain just and reasonable under the next price cap regime.

202. Removal of the prohibition would not entail the abdication of all regulatory oversight over the pricing strategies of the ILEC. The Commission retains the ability on a case-by-case basis, to determine whether the particular pricing strategies of the ILEC lead to discrimination that is unjust or confer a preference or disadvantage that is undue or unreasonable. To this effect, the Commission notes that subsection 27(4) of the Act places the onus on the Canadian carrier to demonstrate that any discrimination is not unjust or that any preference or disadvantage is not undue or unreasonable.

203. Accordingly, the Commission concludes that it is appropriate to remove the prohibition on further rate de-averaging for residential services, including optional local services. The Commission will allow price de-averaging down to the individual subscriber.

204. Regarding pay telephone and business services, the Commission will conduct a follow-up proceeding to consider whether the prohibition on further rate de-averaging should be removed for these services.

205. The Commission notes that in *Rate ranges for services other than voice over Internet Protocol services*, Telecom Decision CRTC 2006-75, 23 November 2006, the Commission determined that rate ranges would generally be appropriate for local exchange and related services. However, the Commission decided to defer its determinations on the range-within-a-range proposal until a determination was rendered on the rate de-averaging issue. In light of the Commission's determinations on rate de-averaging in this Decision, the Commission will rule on the range-within-a-range proposal shortly in a separate decision.

E. Other issues

206. In the following section, the Commission will consider issues related to a) contribution, b) implementation of the price cap regime, and c) follow-up processes.

a) Contribution issues

i) Adjustment to PES costs

207. In Decisions 2002-34 and 2002-43, the Commission determined that an I-X adjustment would be applied annually to the PES cost component of the ILECs' subsidy calculations.

Positions of parties

208. The Companies submitted that the cost component of the subsidy requirement formula should be fixed at current levels throughout the price cap period. The Companies argued that if its estimated productivity factor of -0.5% was applied, the amount of subsidy would increase each year, which would be an inappropriate result from a public policy perspective.

209. TELUS proposed that the Commission freeze the subsidy per residential NAS amounts for HCSAs at the current levels until the Commission completed its review of the Phase II costing methodology. TELUS was concerned that the current Phase II calculations for contribution underestimated the amount of contribution per line that was required and that the application of the annual I-X adjustment had likely exacerbated the underestimation problem.

Commission's analysis and determinations

210. The Commission is not persuaded by the request to freeze the subsidy per residential NAS amounts since there is no evidence on the record of this proceeding that the current HCSA residential PES costs are underestimated.

211. The Commission notes that the I-X adjustment to the PES cost component was established in Decisions 2002-34 and 2002-43 to reflect the expected cost changes for residential local exchange services in HCSAs. The Commission considers that the ILECs will continue to experience productivity gains in respect of these services. The Commission also considers

that since residential PES in HCSAs are generally not subject to competitive market forces, it would not be appropriate for the ILECs to keep all the productivity gains associated with these services.

212. The Commission determines that the annual I-X adjustment applied to the PES cost component of the ILECs' subsidy calculations continues to be appropriate. The Commission directs that when the I-X adjustments are being applied, each individual calculation should be rounded to the nearest whole cent. The ILECs' 31 December 2006 residential PES costs to be used in their 2007 Total Subsidy Requirement calculations are as follows:

ILEC Territory	Band E	Band F	Band G
Bell Aliant – New Brunswick	$28.40	$22.81	not applicable
Bell Aliant – Newfoundland	$30.47	$30.56	$35.05
Bell Aliant – Nova Scotia	$26.95	$25.93	not applicable
Bell Aliant – Ontario/Quebec	$27.67	$26.00	$42.22
Bell Aliant – P.E.I.	$29.96	$31.14	not applicable
Bell Canada	$27.67	$26.00	$42.22
MTS Allstream	$42.63	$36.54	$81.68
SaskTel	$44.94	$37.93	$52.44
TELUS – Alberta	$34.19	$30.55	$33.65
TELUS – B.C.	$47.30	$36.48	$44.83
TELUS – Quebec	$37.85	$27.74	$66.78

213. In *Changes to the contribution regime*, Decision CRTC 2000-745, 30 November 2000, the Commission determined that the ILECs would be allowed a 4.5% exogenous adjustment in their 2001 price cap filings to recover the costs associated with the contribution revenue-percent charge applicable to their capped services.

214. In Decisions 2002-34 and 2002-43, the Commission determined that the ILECs could recover the cost of the revenue-percent charge on their HCSA residential local rates from the National Contribution Fund. However, the ILECs had to reduce their HCSA residential local rates in their subsidy calculations by 4.5% before the cost recovery amount was calculated.

215. Given that the ILECs will have the flexibility to increase residential local rates in HCSAs as a result of the determinations in this Decision, the Commission considers that the 4.5% reduction to average HCSA residential local rates in the subsidy calculation is no longer required. Accordingly, the Commission directs the ILECs to use their actual band-average HCSA residential local rates in their subsidy calculations.

ii) HCSA residential local rates for subsidy calculation purposes

216. In this proceeding, parties were requested to comment on the appropriateness of mandated HCSA residential local rate increases in order to reduce the National Subsidy Requirement and the contribution collection revenue-percent charge.

Positions of parties

217. The Companies submitted that such a proposal touched on a variety of complex issues that would best be addressed in a separate proceeding. For example, mandating an ILEC to increase HCSA residential local rates, but not other parties offering such services in the same market, would distort the competitive outcome and have impacts on the contribution regime.

218. MTS Allstream submitted that mandated HCSA residential local rate increases would have the effect of significantly reducing the National Subsidy Requirement, but it would also substantially increase the price of basic local services for subscribers in rural and remote areas of the country.

219. SaskTel submitted that any consideration of taking specific rate action to reduce the subsidy requirement should be addressed in a proceeding specifically designed to examine the continuing need for subsidies. SaskTel also submitted that the current subsidy mechanism achieved the policy objectives in section 7 of the Act and there were no sound policy reasons for reducing the National Subsidy Requirement through mandated HCSA rate increases.

220. TELUS submitted that mandating a series of residential local rate increases to reduce the National Subsidy Requirement could be accommodated by allowing rate de-averaging at the same time. TELUS submitted that, regardless, mandated local rate increases should be treated, for price cap index purposes, in the same way as an exogenous adjustment. TELUS also submitted that, as a general approach, a maximum affordable rate should be determined and rates be adjusted to that level over time, while reducing the subsidy per line amounts at the same time. TELUS agreed with other parties that, in order for such a plan to be adopted, another proceeding would be required.

221. The Competitors submitted that mandated cross-subsidy mechanisms such as the National Subsidy Requirement reduce economic efficiency by distorting price signals to both consumers and producers of telecommunications services. They supported the gradual elimination of the National Subsidy Requirement through annual HCSA residential local rate increases where rates were below cost.

222. The Consumer Groups did not support mandated residential local rate increases. The Consumer Groups submitted that without access to competitive alternatives, vulnerable and captive HCSA customers would be forced to pay higher rates to maintain this essential service, which would be inconsistent with the objectives of the price cap regime. The Consumer Groups also submitted that consideration must be given to broader issues such as affordability, quality of service, rate shock, remoteness, the legislative obligations imposed on the Commission, and policy considerations.

Commission's analysis and determinations

223. As set out in this Decision, the Commission will allow the ILECs' the flexibility to increase, on an annual basis, residential PES rates in HCSAs by the lesser of the annual rate of inflation or 5%. The Commission notes that if it were to mandate these local rate increases, the contribution requirement would be reduced.

224. The Commission considers that the decision whether to increase HCSA residential local rates resides with the ILECs. However, under the current subsidy regime, the Commission notes that there is little incentive for the ILECs to increase HCSA residential local rates since any rate increase would be entirely offset by a corresponding decrease in subsidy payments.

225. If the Commission were to impute for subsidy calculation purposes any local rate increases in HCSAs permitted by the price cap constraints, regardless of whether the ILEC actually increases its rates, the resultant reduction in the National Subsidy Requirement would be passed on to those telecommunications service providers who pay into the National Contribution Fund through a lower revenue-percent charge. The Commission notes that a similar approach was used for the small ILECs in *Regulatory framework for the small incumbent telephone companies*, Decision CRTC 2001-756, 14 December 2001.

226. The Commission considers that a target residential local rate for subsidy calculation purposes should be established to ensure that any imputed local rate increases would not result in residential local rates going beyond just and reasonable levels. The Commission notes that the ILECs' current subsidy band-average residential local rates are at or below $25, except for TELUS in Alberta. Given that the approved residential local rates in some HCSAs are already in excess of $30, the Commission considers that a target HCSA residential local rate of $30 would not be unreasonable, particularly given that these rates are below cost.

227. The Commission considers that the imputed local rate increases should only apply to those bands that receive subsidy because once a band stops receiving subsidy, it would be considered to be at cost for subsidy purposes. For individual residential line rates that are above $30, while no imputed increase would be applied, if the ILEC increases the rate, then the increased local rate should be used to determine the band-average rate for subsidy calculation purposes.

228. Accordingly, the Commission determines that, for subsidy calculation purposes:

    i) For those bands that receive subsidy where the individual residential local rate is below $30, the ILECs are to impute individual residential local rate increases, effective 1 June of each year, based upon the HCSA residential rate element constraint, to each individual HCSA residential local rate used in the subsidy band-average rate calculation, regardless of whether the ILEC actually increases rates; and

ii) For those bands where the subsidy per residential NAS amount has been reduced to zero or the individual residential local rate is above $30, the ILECs are not required to impute any rate increase. However, the individual residential local rates used to determine the subsidy band-average rates must include any rate increases actually taken by the ILEC.

229. In Decisions 2002-34 and 2002-43, the Commission determined that the ILECs should use their band-average actual residential local rates calculated at 31 December of the preceding year, in their subsidy calculations. As a result of this Decision, local rate increases will be imputed effective 1 June of each year. In calculating band-average residential local rates for subsidy calculation purposes, the Commission directs the ILECs to take into account the impact of (a) any imputed local rate increases that would be effective 1 June, and (b) any non-imputed actual local rate increases that would be effective the date of their implementation.

230. The ILECs are required to file their subsidy per residential NAS calculations by 31 March of each year, except for their 2007 filing which is required by **30 May 2007**.

b) Implementation of the price cap regime

i) Price cap period

231. In Decisions 2002-34 and 2002-43, the Commission determined that the duration of the price cap regimes would be four years. The length of the regimes was later extended by one year.[12]

Positions of parties

232. The Companies argued for a price cap period not to exceed two years. The Companies submitted that it would not be consistent with the notion of promoting a dynamic industry, especially in the current environment of significant change, to establish pricing restrictions for an extended period of time. The Companies submitted that the pricing constraints in their own proposal would be too inflexible if the price regulation period were in excess of two years.

233. TELUS proposed that the next price regime be open ended, with the option for the Commission to initiate a review of any aspect of the regime, after a period of four years. TELUS submitted that a review could be initiated by the Commission on its own motion or on application by an ILEC or by another party. TELUS further proposed that, to simplify the process and to recognize the differences in market conditions in different regions of the country, any further reviews should generally be restricted to the price constraints attached to a specific company.

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[12] In *Extension of the price regulation regime for Aliant Telecom Inc., Bell Canada, MTS Allstream Inc., Saskatchewan Telecommunications and TELUS Communications Inc.*, Telecom Decision CRTC 2005-69, 15 December 2005, the Commission extended the current price cap regime without changes for Aliant Telecom, Bell Canada, MTS Allstream, SaskTel and TELUS for a period of one year, to 31 May 2007. In *Extension of the price regulation regime for Société en commandite Télébec and TELUS Communications (Québec) Inc.*, Telecom Decision CRTC 2005-70, 16 December 2005, the Commission extended the current price cap regime without changes for Télébec and TELUS Québec for a period of one year, to 31 July 2007.

TELUS argued that limiting future price cap reviews to company-specific issues would account for the likelihood that competition would develop in different ways and in different degrees across the country.

234. The City of Calgary, the Consumer Groups, and MTS Allstream all proposed a four-year price cap regime. The Consumer Groups predicated its four-year proposal on the assumption that the Commission would establish a reasonable inflation offset.

235. The Competitors proposed that the period for the next price cap regime be five years, noting that during this time a number of telephone services in specific geographical locations would be forborne from rate regulation.

Commission's analysis and determination

236. The Commission notes that in those areas which do not qualify for forbearance, an ILEC will continue to have significant market power and the price cap regime will continue to apply. The Commission also notes that when the ILEC considers that it no longer has market power in a relevant market, the ILEC can apply for forbearance from regulation as set out in the Forbearance Order. The Commission considers that with established criteria for forbearance, a fixed price cap period and a scheduled review date for the next price cap regime are not required.

237. The Commission determines that the next price cap regime will not have a fixed duration.

ii) Amalgamation of TELUS' price cap indices

238. The price cap regime for the services provided by TELUS in the province of Quebec is currently scheduled to expire on 31 July 2007, as opposed to 31 May 2007 for TELUS in Alberta and British Columbia. TELUS requested that the price cap regime for the services it provides in its operating territory in Quebec be fully integrated into the overall basket structure proposed for TELUS with an effective date of 1 June 2007. This request would be independent of the structure of the general tariffs for the individual operating territories.

239. The Commission considers that, in establishing a price cap regime that would apply on a going-forward basis, it would be reasonable to allow TELUS to amalgamate the price cap indices for its operating territories into one price cap regime that incorporates all of its capped services. The Commission approves TELUS' request to integrate the price cap regime for the services it provides in its operating territories.

240. The Commission notes that, with the application of the I-X adjustment on 1 August of each year, the former TELUS Communications (Québec) Inc. (TELUS Québec) has different subsidy per residential NAS amounts for the periods (a) January to July and (b) August to December, of each year.

241. The Commission determines that, in order to streamline reporting processes, the effective date for the former TELUS Québec calculation of its subsidy per residential NAS amounts should be changed to 1 January of each year starting in 2008. For its serving territory in Quebec, the Commission directs TELUS to apply only 5/12's of the August 2007 I-X adjustment, to cover the period August to December 2007, with the full 2008 I-X adjustment being applied effective 1 January 2008.

iii) Timing of annual price cap filings

242. Under the current price cap regime, the ILEC must file, by 31 March of each year, a submission demonstrating compliance with the applicable pricing constraints by comparing a price index of actual price changes with a price index of allowable price changes. The allowable average price changes are reflected through a service band limit (SBL) while the Actual average price changes are reflected through a service band index (SBI).

243. Based on the basket structure and associated pricing constraints in this Decision, the Commission considers that it would be appropriate to continue with 31 March for the annual update of the price indices. In addition, the Commission concludes that the SBLs and SBIs should be set at 100 effective 31 May 2007.

244. Accordingly, the Commission directs:

   i) for the year 2007, each ILEC to file the SBL and SBI with supporting calculations, formulae and spreadsheets, for each basket of capped services, as applicable, on **30 May 2007**;

   ii) for subsequent years on an annual basis on 31 March, each ILEC to file updates to the SBL and SBI, with supporting calculations, formulae and spreadsheets, for each basket of capped services, as applicable; and

   iii) each ILEC to issue tariff pages reflecting the application of the I-X constraint on rates for Category I Competitor Services effective 1 June of each year.

c) Follow-up processes

i) Price ceiling when forbearance is granted

245. In Decision 2006-15, the Commission determined that residential local rates would be capped at the approved tariff rate when forbearance was granted. In HCSAs, if an ILEC's residential local rates are set below the tariffed rate applicable at the time forbearance is granted, the tariffed rate at the time of forbearance would be used to determine the ILEC's average residential rate for subsidy calculation purposes.

246. The Commission notes that the determinations made in this Decision may have an impact on the determinations made in Decision 2006-15 with respect to the cap for residential PES rates in HCSAs and on the subsidy calculation. The Commission's preliminary view on these issues is as follows:

   i) change the cap at the time forbearance is granted from the tariffed rate to the rate being imputed for subsidy calculation purposes; and

   ii) continue to impute HCSA local rate increases for the ILECs after forbearance is granted until the band no longer receives subsidy or the $30 target is reached.

The Commission notes that these modifications could result in local rate increases in HCSAs after forbearance has been granted and would move rates closer to cost.

247. Accordingly, parties are requested to provide their comments on the Commission's preliminary view by **30 May 2007**, serving a copy on all interested parties to this proceeding. Parties may file reply comments by **11 June 2007**, serving a copy on all parties.

ii) Application of the price cap regime to Société en commandite Télébec

248. Société en commandite Télébec (Télébec) proposed that subsequent to a decision in this proceeding it would file a submission with the Commission indicating whether the regime set out was appropriate to the company going forward, noting any changes it would prefer. In Public Notice 2006-5, the Commission stated that it would request Télébec to indicate why the regime set out in this Decision should not apply to it.

249. The Commission directs Télébec to show cause by **30 May 2007**, serving a copy on all interested parties to this proceeding, as to why the determinations made in this Decision should not apply to it. Parties may file reply comments by **14 June 2007**, serving a copy on Télébec and all parties. Télébec may file final reply comments, serving a copy on all parties, by **29 June 2007**.

250. As part of this show cause proceeding, Télébec is also requested to comment on, starting in 2008, changing the effective date of the subsidy per residential NAS amounts to 1 January and changing the price cap filing dates to those set out in this Decision.

251. In order to allow for a timely decision with respect to the final 2007 revenue-percent charge, Télébec is to file its 2007 subsidy per residential NAS calculations, based upon the effective date it will propose in the show cause proceeding, by **30 May 2007**.

252. Since a decision on this show cause process will be issued after 1 June 2007, the Commission concludes that Télébec is not required to impute any residential local rate increases in 2007 for subsidy calculation purposes. Rather, this determination will only apply to Télébec starting in 2008.

253. The dissenting opinion of Commissioner Langford is attached.

Secretary General

This document is available in alternative format upon request, and may also be examined in PDF format or in HTML at the following Internet site: http://www.crtc.gc.ca

Dissenting opinion of Commissioner Stuart Langford

I disagree with a good many of the positions taken by the majority, and in the paragraphs that follow I explain why and offer alternatives. By way of general introduction, I am of the view that the majority, in formulating those elements of a third Price cap regime (Price cap 3) that apply to residential subscribers in non-forborne, non-high cost service areas (non-HCSAs), has lost sight of the purpose of such schemes. In its quest for administrative efficiency, the majority appears to have abandoned its responsibilities to balance the interests of all stakeholders: customers, competitors and incumbent telephone companies.

A fundamental error:

The result is a regime which I believe will fail on any number of fronts. Vulnerable consumers will find themselves stripped of many of the protections built into both competitive marketplaces and properly constructed price cap schemes. Competitors will be left with little or no incentive to expand into unopened markets because the majority decision equips incumbent telephone companies with pricing and marketing tools powerful enough to halt dead in its tracks any future roll-out of competition in their territories. Finally, incumbent telephone companies could also lose. Should inflation drive up the cost of providing service, they may find themselves subsidizing residential stand-alone primary exchange service (PES).

Perhaps in its desire to capture the spirit of two Government initiatives, the December 14th, 2006 Policy Direction (the Direction) favouring reliance on market forces, and the April 5th, 2007 Order-in-Council (the Order) regarding the staged deregulation of telecommunications services in Canada, the majority appears to have made a fundamental error. It seems to have overlooked the fact that market forces cannot be relied upon to protect consumer interests in places where little or no competition exists.

Price cap 3 will only apply to these areas, areas where neither the letter nor the spirit of the Government's Direction or Order is applicable, where market forces and the prospect of deregulation do not exist. We are talking here about parts of Canada where incumbent telephone companies, for all intents and purposes, remain monopolies or near-monopolies and where regulation remains necessary if consumer interests are to be protected.

The need for a price cap scheme:

Broadly speaking, the purpose of establishing a price cap scheme in such places is twofold: to imitate and to stimulate. Properly constructed, such a regime will protect consumers in the short term by imitating the effects of a rivalrous marketplace, and in the long term by helping to establish conditions conducive to stimulating competitive entry. In my opinion, the majority decision fails on both fronts. It deprives consumers of the key benefit of competition, lower prices, and provides incumbent telephone companies with excessive powers, powers that can only frustrate the roll-out of competition in their territories. Neither consequence is in the public interest.

As revised by the Government in the Order, the test used to determine whether a market is sufficiently competitive to no longer require price regulation by the Commission has become both straightforward and easy to meet. Under its terms, services provided to most of Canada's

residential non-HCSA subscribers will soon be forborne. Except in extraordinary circumstances, consumer buying choices, not regulatory oversight, will be the sole methods of disciplining future telecommunications service offerings and prices in forborne areas. Hopefully, that approach will work.

In non-HCSAs that do not meet the Order's simple test, consumer protection from monopolistic and near-monopolistic service providers and the job of creating market conditions attractive to competitive entry, will remain largely in the hands of the Commission. In my opinion, the changes to the majority decision I set out in the following paragraphs would make it far more likely that those two goals will be achieved.

Pricing residential services:

For customers in the non-forborne, non-HCSA markets that will be regulated by Price cap 3, the majority has replaced most of the consumer-oriented pricing constraints included in the last price cap regime (Price cap 2) with one safeguard. Going forward, prices for basic, no-frills, no-extras service will remain capped at today's levels. So, if you are paying $25 per month for basic service today, in theory, as long as you remain in a regulated area, you will never pay more. That's the theory. In reality, other circumstances could see basic service prices climb.

For everything else, notably, optional services like "caller identification" and bundles of basic and optional services, the majority has cancelled all upward pricing restrictions. Incumbent phone companies can charge whatever they like; the sky's the limit. Consumers are left with two choices: pay or do without. That does not sound like the regulatory bargain that the Minister of Industry, The Hon. Maxime Bernier, anticipated when on February 19th, 2007, he made the following statement before the Standing Committee on Industry, Science and Technology:

> "The rural areas – and this is an important point – have not been deregulated. They still benefit from CRTC regulations and standards that are currently in effect. It's the *status quo*."

What was "currently in effect" when the Minister made this statement was the Price cap 2 regime, and in my view, the Price cap 2 approach was fairer to consumers than the Price cap 3 regime set out in the majority decision. With certain modifications, I would continue it.

If the decision were mine alone to make, residential phone services in non-forborne non-HCSAs would be price-controlled as follows: each year incumbent telephone companies would be allowed to raise prices for residential services as a whole the equivalent of that year's inflation level less a productivity factor of 3.2% and an "economies-of-scope" factor of 1%, though the price of no single service element or service bundle could be raised more than 5%. Price rises for optional services would be treated differently. Any of them could be raised a maximum of $1 per year.

A few examples:

So, if inflation in a given year were, say, 6%, prices for all residential services in non-forborne non-HCSAs could be raised 6% minus 3.2% minus 1%. That is, a total of 1.8%. No optional service could be raised more than a dollar, and no other single element making up residential

service could be raised more than 5%. On the other hand, if inflation were, for example, 3%, the effect would be the following: 3% – 3.2% – 1% = minus 1.2%. At year-end, consumers would receive a credit on their bill of 1.2% of what they had paid that year for residential services.

More complicated, but fairer:

I believe that though this system seems more complicated than the majority's selective price freeze, it is much fairer. Here is why:

First, it imitates a competitive marketplace. Competition forces suppliers to be more productive and to pass on the benefits of those productivity gains to their customers, if they wish to keep them as customers, in the form of lower prices. The majority decision fails to try to duplicate this phenomenon. It enables incumbent telephone companies to deprive their captive customers of the benefits of productivity, distributing all such gains to their shareholders in the form of dividends and to their executives in the form of annual bonuses.

Second, an economies-of-scope factor of 1% recognizes that the infrastructure telephone companies use to deliver local residential telephone service is also used by them to deliver other services like long distance, internet, home security systems and television. Prices for these services are not regulated. The companies can charge anything customers are willing to pay. Yet, all of the cost for a good deal of that infrastructure is treated as though local phone services are the incumbent telephone companies' only products. Telephone users making local calls are subsidizing those who buy other services. How fair is that?

Third, my formula treats everyone equally. Both consumers and suppliers are positioned to benefit, depending on the state of the economy. If inflation is below 4.2% (the sum total of the 3.2% productivity factor and the 1% economies-of-scope factor), consumers benefit. If the inflation rate goes above 4.2%, the companies get to raise prices. Why shouldn't they? Where is it written that commercial companies, even monopolies or near-monopolies, must subsidize their customers' purchases?

Three cheers for equality:

And while on the subject of equality, there are two other aspects of the majority decision which I regard as likely to favour telephone service providers over telephone service users. The first deals with what are called "exogenous" factors, explained by the majority in paragraph 166. In certain circumstances under the Price cap 3 regime, when they are hit by a particular type of unexpected expense, incumbent telephone companies will be allowed to raise basic rates. Those are the rates that are supposed to be frozen. That's fair, though knowing this could happen, in my opinion, makes the majority's categorization of basic service as capped or frozen misleading.

When an exogenous event occurs, for example, the Commission orders telephone companies to add a service like 911 or special telephones for consumers with disabilities, the companies affected are given permission to raise rates to recover the costs of following those orders.
To be fair, the majority decision will also force telephone companies in areas regulated by Price cap 3 to lower rates if an exogenous factor, say a reduction in taxes on phone revenues, ends up saving them money. The cloth cuts both ways, but experience demonstrates that most

of the cutting goes in one direction. A review of exogenous claims over the past nine years of price cap regulation reveals that with only one exception (see the majority decision, paragraph 171), Commission decisions on exogenous matters resulted in money flowing into company coffers, not into the hands of customers. Expect those "frozen" basic service prices to thaw and rise.

The second strange case in the majority decision of what I regard as uneven treatment is that it applies the benefits of a productivity factor to competitive telephone service providers but not to the incumbent telephone company's customers. Rates charged to competitor companies for most Category I services (see the majority decision, paragraph 165) are subject to an inflation minus 3.2% pricing formula. The majority forces incumbent telephone companies to share the benefits of productivity gains with their competitors but not with their own customers. My approach to pricing as set out above would see all users benefit.

Rate de-averaging:

Traditionally, incumbent telephone companies have been restricted as to the price offerings they can make to consumers. Their territories have been divided into what are called rate bands. Typically, an "A" band is in a city's downtown core, "B" bands cover the city's residential areas, and bands "C" and higher cover ever more rural areas containing decreasing population densities. The rule has been that any rate offered to one resident in any band has to be made available to all the residents in that band. If Bell, for example, offers Mr. Smith in band "B" a rate of $20 per month for basic service, it has to give everyone else in band "B" the same price.

The majority decision drastically changes that rule. In fact, it does away with it entirely. Under Price cap 3, as the majority has devised the regime, incumbent telephone companies can offer different prices to each and every one of the people living in non-forborne areas, just as it can in forborne or deregulated areas. Five or ten or a hundred people all living on the same street in the same city might all find themselves paying different prices for the same services. Why?

Remember the fundamentals:

De-averaging rates in deregulated areas makes sense. The incumbent telephone companies are competing against other service providers like cable companies who are not subject to the rule against de-averaging. It isn't fair to give one equally strong competitor an advantage over another in an area where market forces are powerful enough to ensure that no service provider can become a monopoly. But the Price cap 3 regime does not apply in such areas. To repeat the fundamental point I made at the beginning of this dissenting opinion, the whole reason for developing a price cap scheme lies in the fact that it will apply only in areas where competitive forces are weak or non-existent.

Fairness forgotten:

Rate de-averaging in price cap regulated areas can have only two effects. Both are negative. First, it is anti-competitive. It enables an established telephone company to slash a particular customer's rates the instant it learns that customer is planning to switch to another service provider. Let us say, for example, that Primus, a non-facilities based phone company, attracts a customer away from the incumbent telephone company, say Bell Canada. Primus contacts

Bell and says, "Please switch Mrs. Jones' service to us." Using the majority's de-averaging rules, Bell can immediately phone Mrs. Jones and say: "We didn't know you were unhappy with us. We want to keep you as a customer. We will beat any offer Primus has made and throw in 3 optional services and free long distance. Come on back to Bell."

If she accepts Bell's offer, Primus loses Mrs. Jones and all the money it spent to attract her as a customer. From a consumer fairness perspective, the fallout is equally negative. The other subscribers in Mrs. Jones' rate band continue paying the old prices with no freebies, thereby subsidizing Bell's efforts to crush competition. How can that further the interests of fairness? More particularly, how does it further Parliament's direction to the Commission (see paragraph 7(*f*) of the *Telecommunications Act*) to make best efforts "to foster increased reliance on market forces"? It is hard to imagine why entrepreneurs would invest the huge sums required to start phone businesses in price cap regulated areas where the Commission has given incumbent phone companies so much power to crush competition before it even gets started.

Pay phones:

It is equally hard to imagine why the majority has taken the position it has on the pricing of pay telephone services. The majority has granted incumbent telephone companies in non-forborne areas the freedom to increase rates to a maximum of 50 cents per cash local call and a maximum of $1 for local calls paid by way of collect billing, third number, calling card or commercial credit card (non-cash). This is precisely what Bell Canada, Bell Aliant and SaskTel requested.

At first blush, these increases may seem reasonable. After all, Bell Canada, to take one example, has been charging 25 cents for a cash-paid local pay phone call since 1981, and who can deny that costs have gone up over the past 26 years. But there is another revealing piece of evidence on the record of this proceeding. TELUS has been charging 35 cents for cash and 75 cents for non-cash calls since 1998, and it did not ask for increases in either rate. It seems logical to assume, then, that the 35/75 formula is more than compensatory if Canada's second largest incumbent telephone company is happy with it. For that reason, I would have adopted the TELUS price structure.

What's the difference?

After analyzing the majority decision, a fundamental question remains unanswered: Why did it bother devising Price cap 3? What's the difference between deregulation, forbearance in other words, and Price cap 3? For consumers, the answer will be, very little. In fact, in the future, consumers living in forborne regions will be better protected. At least they'll have competition to rely on. Under Price cap 3, the only consumers protected are those that subscribe exclusively to basic, no-frills, no-options service. For them, prices are theoretically frozen. Big deal! Basic service subscribers in forborne areas will enjoy the same protection.

As I understand the positions espoused by representatives speaking on behalf of some of Canada's former monopoly service providers, though they will no doubt be delighted by the majority decision which gives them practically carte blanche when it comes to pricing, they

certainly did not expect anything like it. What they, like Minister Bernier, seemed to have anticipated was a continuation of the consumer protections offered by Price cap 2. Here are examples of what incumbent telephone company representatives promised the Standing Committee on Industry, Science and Technology when they appeared before it on February 14th, 2007:

> Mr. Denis Henry, speaking for Bell Aliant: "There's no doubt that there will be some rural communities where there is no choice, and the current regime will apply in that case. There will be full price regulation."
>
> Ms Janet Yale, speaking for TELUS: "I don't believe that in the absence of competition there is any threat at all to customers, because they are completely protected under the regulatory umbrella today."

The majority decision takes away consumers' umbrellas. For that reason, I cannot support it.