Telecom Decision CRTC 2010-160

Ottawa, 17 March 2010

Bell Aliant Regional Communications, Limited Partnership, Bell Canada, and Télébec, Limited Partnership – Effects of deflation on price cap mechanics

File number: 8678-B54-200915663

The Commission denies Bell Canada et al.'s application to set the inflation measure to zero for the 2010 price cap year. However, the Commission sets outs its determinations regarding the specific inflation measure that should apply to the large and small incumbent local exchange carriers, and Northwestel.

Introduction

1. The Commission received an application by Bell Aliant Regional Communications, Limited Partnership (Bell Aliant), Bell Canada, and Télébec, Limited Partnership (Télébec) [Bell Canada et al.], dated 17 November 2009, requesting that the Commission confirm that if the inflation measure used for price cap purposes ("I") is negative for the 2010 price cap year, the value of this factor will be set to zero for purposes of, among other things, updating the price cap parameters.[1]

2. Bell Canada et al. noted that since the introduction of the price cap regime, "I" has always been positive. They also noted that for the 2010 price cap year, "I" was expected to be negative.[2]

3. Specifically, Bell Canada et al. requested that the Commission confirm that, if "I" is negative for the 2010 price cap year,

   a) the incumbent local exchange carriers (ILECs) will not be required to reduce prices for the regulated retail services that are subject to either a service basket limit (SBL), or a rate element constraint of "I"; and

   b) costs (as used in determining the rates for the Category I competitor services that are subject to the inflation minus productivity offset, or "I-X," constraint, and for the total subsidy requirement calculation) will not be deemed to have fallen by more than 3.2 percent, which is the value of the productivity offset (X-factor).

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[1] Under the price cap regime, which began on 1 January 1998, capped services grouped into service baskets are subject to a price cap index (PCI). The PCI includes the annual change in the gross domestic product – price index (GDP-PI) as the inflation measure ("I"), a productivity offset (X-factor), and limited exogenous factors arising from events that are beyond the ILECs' control.

[2] The 2010 price cap year covers the period from 1 June 2010 to 31 May 2011. For the 2010 price cap year, the inflation measure is -1.9331 percent.

4. In their application, Bell Canada et al. submitted a number of arguments to support their view that when “I” is negative for a given year, it would be inappropriate and inconsistent with the price cap framework to reflect deflation in the price cap parameters.

5. In a letter dated 1 December 2009, the Commission noted that the application raised issues of national relevance. It broadened the process to include all those affected by the outcome of this proceeding, including the large ILECs,[3] the competitive local exchange carriers, and the small ILECs.

6. The Commission received comments from the Canadian Independent Telephone Company Joint Task Force (JTF), Distributel Communications Limited, MTS Allstream Inc. (MTS Allstream), Northwestel Inc. (Northwestel), Rogers Communications Inc. (RCI), Saskatchewan Telecommunications (SaskTel), TELUS Communications Company (TCC), the Government of the Northwest Territories (GNWT), the Public Interest Advocacy Centre (PIAC), and TekSavvy Solutions Inc. (TSI). The public record of this proceeding, which closed on 14 January 2010, is available on the Commission's website at www.crtc.gc.ca under "Public Proceedings" or by using the file number provided above.

Would reflecting deflation in the price cap parameters be consistent with the price cap framework?

7. Bell Canada et al. submitted that the Commission had never contemplated negative inflation when it set the price cap parameters. In their view, the assumptions used to set the price cap parameters cannot be assumed to hold in a deflationary environment. They submitted that the ILECs are affected fairly quickly by inflation, but benefit very slowly – if at all – from deflation.

8. Bell Canada et al. noted the Bank of Canada's efforts to ensure that deflation does not take hold in Canada. They submitted that it would be contrary to this policy for the Commission to mandate a price cap parameter that would have a deflationary effect.

9. Bell Canada et al. submitted that Telecom Decision 2007-27, which set out the current price cap framework for large ILECs, reflects the Commission's view that prices in retail markets should not be forced down by a regulatory formula. Bell Canada et al. also submitted that Telecom Decision 2007-27 indicates that mandated rate reductions via a regulatory formula would interfere with the natural development of market forces and would not be in keeping with paragraph 7(*f*) of the *Telecommunications Act* (the Act) and the Governor in Council's *Order Issuing a Direction to the CRTC on Implementing the Canadian Telecommunications Policy Objectives*, P.C. 2006-1534, 14 December 2006 (the Policy Direction).

10. For services in the residential high-cost serving areas (HCSA) basket, Bell Canada et al. submitted that flowing through deflation would be contrary to the Commission's general policy of moving rates closer to costs and contrary to its concern expressed in prior decisions that below-cost rates should not move further away from cost.

[3] In this decision, “the large ILECs” refers to Bell Aliant, Bell Canada, MTS Allstream Inc., Saskatchewan Telecommunications, TELUS Communications Company, and Télébec.

11. SaskTel, TCC, Northwestel, and the JTF supported the application, while TSI and the GNWT opposed it. RCI and MTS Allstream opposed the application as it relates to competitor services and the cost component in the subsidy calculation. PIAC opposed the application as it relates to capped services in non-HCSAs.

12. Parties opposing the application submitted that when “I” is negative, it suggests that the price of all goods, including inputs to the ILECs, have on average been falling. They noted that when “I” is positive, increasing price caps serves to ensure that ILECs earn reasonable profits on their services, and when “I” is negative, lowering price caps serves to prevent ILECs from earning excessive profits. They also submitted that Bell Canada et al.'s argument regarding the Bank of Canada's measures is irrelevant and that neither the objectives of the Act nor the Policy Direction require or permit the Commission to engage in macroeconomic inflation policy.

13. Parties opposing the application as it relates to competitor services submitted that applying negative inflation to the rates for these services would result in unwarranted windfall profits for the ILECs at the expense of their competitors. In relation to Bell Canada et al.'s argument regarding the Bank of Canada's measures, these parties submitted that a reduction in competitor services rates would have no measurable impact on any deflationary trend.

Commission's analysis and determinations

14. The Commission notes that it adopted the annual change in the GDP-PI as the inflation measure in Telecom Decision 97-9 and has used this measure in all subsequent price cap proceedings to reflect the changes in the cost of inputs used by the ILECs.

15. The Commission notes that the inclusion of this inflation measure in the price cap framework was intended to take into account the changes to the input costs incurred by regulated companies. Thus, during inflationary periods, the pricing constraints allow the ILECs to propose price increases to recover increases in their costs, but when inflation is negative, the pricing constraints would result in cost reductions being passed on to customers. In this regard, the Commission notes that most of the ILECs have applied for, and the Commission has approved, various price increases through the years when the inflation measure was positive.

16. With respect to Bell Canada et al.'s submission that the ILECs are affected fairly quickly by inflation, but benefit very slowly – if at all – from deflation, the Commission considers that it is reasonable to assume that the ILECs' input costs decrease when inflation is negative. The Commission notes that the applicants have not provided any evidence demonstrating that the costs of their inputs have not decreased in the last year.

17. With respect to the argument concerning the Bank of Canada's policy, the Commission notes that the applicants have not provided any evidence of a significant direct link between the application of negative inflation to the ILECs' price cap constraints and deflationary pressures in the Canadian economy.

18. With respect to the natural development of market forces, the Commission notes that retail service rates are regulated only where competition is not strong enough to discipline prices. The Commission further notes that the GDP-PI as an economy-wide statistic reflects the prices of all inputs used in the Canadian economy. The Commission considers that applying negative “I” to retail services would not be unfair to competitors and would benefit end-customers.

19. Moreover, the Commission notes that if it were to approve Bell Canada et al.'s application, the ILECs' SBL would no longer be constrained by the GDP-PI, and would allow the ILECs' prices to rise faster than the GDP-PI rate of inflation. This would be contrary to the Commission's determination in Telecom Decision 2007-27 that these prices should be allowed to rise to the same extent as the GDP-PI. Therefore, the Commission considers that it would be appropriate to apply the negative inflation measure to the basket constraints on business services, and on other capped services, as well as to the rate element constraint applicable to Category I competitor services.

20. However, with respect to retail rates in HCSAs, the Commission notes that residential primary exchange service rates in HCSAs continue to be below cost. The Commission's general policy has been to move rates closer to costs. The Commission considers that it would be contrary to this policy to apply negative inflation to residential rates that are still below cost. Therefore, the Commission considers that negative inflation should not be applied to the basket and rate element constraints applicable to residential primary exchange service rates in HCSAs.

21. Further, the Commission considers that the cost component in the subsidy calculation should reflect negative inflation. The Commission notes that this measure will serve to meet its objective of reducing subsidies.

22. Accordingly, the Commission considers that while it is appropriate to flow through positive inflation in the price cap parameters to allow the ILECs to recover increases in the cost of their inputs, it is also appropriate to flow through negative inflation and pass on to customers the reduction in the cost of the ILECs' inputs, except in relation to residential rates in HCSAs.

23. The Commission notes that for the small ILECs and for Northwestel, the inflation measure is relevant in terms of the pricing constraints applicable to the rates for business primary exchange service.

24. In Telecom Regulatory Policy 2009-788, the Commission determined

> ... that the small ILECs may propose increases to the monthly rates for business PES [primary exchange service] by up to $5 in any one year, until a rate of $45.45 is reached. After reaching the $45.45 rate, the small ILECs may propose increases to the monthly rate up to the previous year's rate of inflation.

25. The Commission notes that, as a result of that decision, a small ILEC with a business rate set at $45.45 or above may choose, for the 2010 price cap year, either (i) not to propose a change to that rate or (ii) to apply the negative inflation measure to that rate.

26. In Telecom Decision 2007-5, the Commission determined that it would not require Northwestel to file a rate reduction for a service that is below Phase II costs plus a markup of 25 percent. The Commission noted that Northwestel's business rates are less than Phase II costs plus a markup of 25 percent and considered it appropriate to provide the company with sufficient pricing flexibility should it wish to price its business services at a minimum of Phase II costs plus a 25 percent markup. However, the Commission was concerned that the business market might not be sufficiently competitive to discipline rates in all circumstances. Therefore, the Commission approved an overall constraint of inflation for the Business Services basket and a rate element constraint limiting increases for individual services to 10 percent per year.

27. The Commission notes that Northwestel's business rates are still below Phase II costs plus a markup of 25 percent. Accordingly, the Commission finds it would be contrary to its determination in Telecom Decision 2007-5 to require Northwestel to apply a basket constraint on business services that reflects a negative inflation measure as it would require the company to reduce business rates that are below Phase II costs plus a markup of 25 percent. Accordingly, the Commission considers that it would be appropriate to set the inflation measure for Northwestel equal to zero for 2010.

28. The Commission's determinations in this Decision apply to all large ILECs, including Télébec, as well as to the small ILECs and Northwestel, as specified above.

29. In light of all the above, the Commission

a) **denies** Bell Canada et al.'s application;

b) directs the large ILECs to

- apply the negative inflation measure in setting the basket limits for business services, other capped services, and the rate element constraints applicable to the rates for Category I competitor services;
- set the inflation measure to zero for the basket and rate element constraints applicable to residential rates in HCSAs;
- set “I” to the GDP-PI rate of inflation for “I-X” cost calculations for subsidy purposes;
- submit their subsidy calculations as a result of these rulings within 30 days; and

c) directs Northwestel to set “I” to zero in the basket constraint applicable to business services.

Secretary General

Related documents

- *Regulatory framework for the small incumbent local exchange carriers*, Telecom Regulatory Policy CRTC 2009-788, 17 December 2009

- *Price cap framework for large incumbent local exchange carriers*, Telecom Decision CRTC 2007-27, 30 April 2007

- *Price cap regulation for Northwestel Inc.*, Telecom Decision CRTC 2007-5, 2 February 2007

- *Price Cap Regulation and Related Issues*, Telecom Decision CRTC 97-9, 1 May 1997