



Telecom Regulatory Policy CRTC 2009-80

Route reference: Telecom Public Notice 2008-5

Ottawa, 19 February 2009

Review of the price floor test and certain wholesale costing methodologies

Reference: 8661-C12-200807779

In this decision, the Commission determines that, subject to minor modifications, the current price floor test (previously referred to as the imputation test) remains appropriate and necessary in light of the Policy Direction.

Introduction

1. In Telecom Decision 2007-51, the Commission released an action plan for reviewing existing regulatory measures in light of the Governor in Council's *Order Issuing a Direction to the CRTC on Implementing the Canadian Policy objectives*, P.C. 2006-1534, 14 December 2006 (the Policy Direction). As part of the action plan, the Commission identified the price floor test¹ as a matter to be reviewed.
2. In Telecom Public Notice 2008-5, the Commission invited parties to comment on the continued appropriateness of the price floor test for retail services, as well as the continued appropriateness of various wholesale costing methodologies.
3. The Commission received submissions from Bell Aliant Regional Communications, Limited Partnership, Bell Canada, and Saskatchewan Telecommunications (collectively, Bell Canada et al.); MTS Allstream Inc. (MTS Allstream); Primus Telecommunications Canada Inc. (Primus); the Public Interest Advocacy Centre (PIAC); Rogers Communications Inc. (RCI); and TELUS Communications Company (TCC).
4. The public record of this proceeding, which closed on 18 August 2008, is available on the Commission's website at www.crtc.gc.ca under "Public Proceedings."

Issues

5. In order to determine whether the price floor test continues to be appropriate in light of the Policy Direction, the Commission will consider the following:
 - What is the purpose of the current price floor test and what are the telecommunications policy objectives (the policy objectives) that are relevant to this purpose?

¹ In previous decisions, the price floor test was referred to as the imputation test.

- Can market forces be relied on to achieve the policy objectives?
6. If the Commission determines that market forces cannot be relied on to achieve the policy objectives, it will then address the following, as required:
- Is the current price floor test efficient and proportionate to its purpose?
 - Does it interfere with the operation of competitive market forces to the minimum extent necessary to meet the policy objectives?
 - Does it deter economically efficient competitive entry into a market or promote economically inefficient entry?
 - Is the associated tariff mechanism as minimally intrusive and as minimally onerous as possible?
7. In addition, the Commission will address the following:
- How should the price floor test be adapted to reflect the revised wholesale service classifications in Telecom Decision 2008-17?
 - Are the other wholesale costing methodologies still appropriate?

Background

8. In Telecom Decision 94-13, the Commission established a price floor test as a safeguard to ensure that retail tariff applications made by incumbent local exchange carriers (ILECs) for long distance rate reductions and new long distance services were not anti-competitive. In Telecom Decision 97-8, the Commission extended the price floor test to ILECs' retail local exchange services. The price floor test for ILECs' retail local exchange services and other retail services has been reviewed and modified on an ongoing basis in subsequent decisions, orders, and directives to reflect, among other things, changes in the Commission's other regulatory frameworks.
9. The price floor is calculated using tariffed rates for certain wholesale services, and incremental costs or acquisition costs for other service inputs. The price floor test methodology varies by type of tariffed retail service.

What is the purpose of the current price floor test and what are the policy objectives that are relevant to this purpose?

10. All parties submitted that the price floor test is intended to address the potential for anti-competitive pricing by ILECs, although the parties disagreed as to what constituted anti-competitive pricing.

11. Bell Canada et al. identified the relevant policy objectives as being those set out in paragraphs 7(c) and (f) of the *Telecommunications Act* (the Act), while MTS Allstream additionally identified paragraphs 7(a) and (h) of the Act.²

Commission's analysis and determinations

12. The Commission concludes that the price floor test establishes a minimum price threshold to ensure that rates are just and reasonable and not unjustly discriminatory. The Commission also concludes that the price floor test guards against certain anti-competitive pricing, in order to facilitate the development of sustainable competition.
13. The Commission considers that the policy objective set out in paragraph 7(a) of the Act is too general to be relevant to the purposes determined above. The Commission concludes that the policy objectives set out in paragraphs 7(c), (f), and (h) of the Act are relevant to the identified purposes.

Can market forces be relied on to achieve the policy objectives?

14. Bell Canada et al. and TCC submitted that market forces could generally be relied on to achieve the policy objectives because the risk of anti-competitive behaviour on the part of ILECs was very low. While Bell Canada et al. generally supported retaining the price floor test as a component of its alternate proposal, TCC proposed that the Commission eliminate the price floor test.
15. MTS Allstream, PIAC, and Primus submitted that regulated services are, by definition, not subject to market forces sufficient to protect the interests of users, otherwise those services would be forborne. These parties generally argued in support of retaining the price floor test.

Commission's analysis and determinations

16. The Commission considers that TCC's proposal to eliminate the price floor test, on the basis that market forces can be relied upon, is not appropriate because the test applies only to services in non-forborne markets, where competition has not yet developed or has not sufficiently developed.

² The cited policy objectives of the Act are
(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;
(c) to enhance the efficiency and competitiveness, at the national and international levels, of Canadian telecommunications;
(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; and
(h) to respond to the economic and social requirements of users of telecommunications services.

17. The Commission therefore concludes that market forces cannot be relied on to achieve the policy objectives of the Act, as they relate to the price floor test. Accordingly, it is necessary to assess the price floor test against the other criteria specified in the Policy Direction.

Is the current price floor test efficient and proportionate to its purpose? Does it interfere with the operation of competitive market forces to the minimum extent necessary to meet the policy objectives? Does it deter economically efficient competitive entry into a market or promote economically inefficient entry? Is the tariff approval mechanism as minimally intrusive and as minimally onerous as possible?

18. Bell Canada et al. and TCC argued that the current price floor test is not efficient and proportionate to its purpose, does not interfere with the operation of competitive market forces to the minimum extent necessary, deters economically efficient competitive entry into a market or promotes economically inefficient entry, and is not as minimally intrusive and as minimally onerous as possible. Both of these parties proposed changes to the price floor test that, in their view, would result in a regulatory measure more compliant with the Policy Direction.
19. Bell Canada et al. and TCC submitted that, in order to ensure that an appropriate price floor was established, avoidable costs³ should be used in lieu of Phase II costs in the price floor calculation, which would result in a lower price floor. In addition, TCC submitted that the price floor should be further reduced by adjusting the price floor calculation to reflect the concepts of facilities-based competitor market share⁴ and competitive displacement in the downstream market.⁵
20. Bell Canada et al. and TCC also argued that the application of the price floor test on an *ex ante* basis⁶ was inappropriate given that it prevented all pricing below the price floor without any evidence that such pricing was necessarily anti-competitive, effectively undermining price competition in non-forborne markets. These parties also submitted that the price floor test requires a resource-intensive process on the part of the industry resulting in regulatory delay.

³ Avoidable costs refer to all prospective incremental costs that could have been avoided by a firm had it chosen not to sell the service in question.

⁴ TCC indicated that a facilities-based provider will generally rely on its own facilities, and use few, if any, wholesale inputs from the ILECs to provide competing retail services. Hence, the ILEC's price floor should be adjusted downward to reflect the wholesale service input at cost, not at tariff, with respect to a facilities-based competitor's market share.

⁵ TCC asserted that the current test assumes that the sale of a unit of an ILEC's retail service displaces one unit of a competitor's competing service. In TCC's view, since this competitor displacement does not always occur, the wholesale service input for service units that do not result in competitor displacement should be included at cost and not imputed at tariff rate.

⁶ In this context, *ex ante* basis (i.e. before the fact) means that an ILEC cannot bill customers the proposed rate until the Commission has found that the price floor test has been satisfied and the Commission has approved the attendant tariff setting out the proposed rate.

21. Bell Canada et al. submitted that it would be more appropriate to apply the price floor test on an *ex post* basis,⁷ using competition law principles, in order to examine allegations of ILEC anti-competitive pricing. Under Bell Canada et al.'s proposal, on an *ex post* basis, the existing price floor test would be used as a preliminary screen to determine if an anti-competitive complaint had any merit and warranted further assessment. TCC supported the application of the price floor test on an *ex post* basis, in the event that the Commission chose to retain the regulatory measure.
22. MTS Allstream, PIAC, and Primus argued that the price floor test is compliant with the Policy Direction to the extent feasible in light of the requirements of the Act. These parties argued that the test (1) is required only under specific circumstances (e.g. new services, rate reductions), (2) has been standardized and refined over time, and (3) is well known by the industry.
23. MTS Allstream and Primus argued that applying the price floor test on an *ex post* basis would be contrary to the Act which requires the Commission to determine, *ex ante*, whether rates are consistent with subsections 27(1) and (2) of the Act.⁸ MTS Allstream also argued that an examination using competition law would be complex, prolonged, and resource intensive.

Commission's analysis and determinations

24. The Commission considers that the price floor test is standardized, based on available data, and well understood by the industry. The Commission notes that the price floor test is required only in specific circumstances, notably the introduction of new retail services and certain rate reductions to existing services. The Commission further notes that, as a result, the test is only required for a small percentage of retail tariff filings. The Commission also notes that the ILECs have considerable pricing flexibility for retail services, such as certain service bundles, and short-term promotions and market trials.⁹
25. With respect to the use of avoidable costs in the price floor test for tariffed retail services, TCC argued that there are certain Phase II costs such as network costs that are sunk and not avoidable at the time of sale and therefore the price floor based on Phase II costs is too high. The Commission agrees with TCC that if prospective incremental costs are assessed by using the avoidable costs over a short time period, certain costs, such as network costs, may not be avoidable at the time of sale and hence the avoidable costs in this scenario would be lower than the Phase II costs.

⁷ In this context, *ex post* basis (i.e. after the fact) means that the Commission would determine whether the price floor test has been satisfied subsequent to the implementation of the proposed rate and, generally, on a complaint basis only.

⁸ The cited subsections of the Act are
27(1) Every rate charged by a Canadian carrier for a telecommunications service shall be just and reasonable; and
27(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.

⁹ For example, ILECs are no longer required to submit tariffs or price floor test results for market trials, or for service bundles that meet the criteria set out in Telecom Decisions 2007-117 and 2007-74, or for promotions that meet the criteria set out in Telecom Decision 2008-41.

26. However, the Commission notes that tariffed telecommunications services such as primary exchange services are typically offered on a long-term basis. The use of the associated network(s) by these services will generally impact the capacity of that network and cause the ILEC to augment that capacity and incur additional network costs over the long term.
27. The Commission also notes that, in Telecom Decision 2008-17, it established the regulatory framework under which competitors have access to the ILECs' wholesale services. Under this framework, Phase II costs, not avoidable costs, provide the basis for developing rates for ILECs' wholesale services.
28. In light of the above, the Commission considers that Phase II costs, which estimate a service's prospective incremental costs including the associated network costs over the duration of the service, are the appropriate costs for establishing tariffed service rates.
29. The Commission disagrees with TCC's submission that the price floor should be adjusted downwards to reflect a facilities-based competitor's market share. The current price floor test works with the regulatory framework established in Telecom Decision 2008-17 whereby mandated wholesale services are to be provided by ILECs at regulated rates to facilitate the development of sustainable competition. The Commission considers that, under this framework, it is appropriate to include the tariffed rate for certain wholesale service inputs in the price floor, regardless of whether a competitor requires these wholesale service inputs in the provision of competitive retail services.
30. The Commission further considers that TCC's submission that the price floor should be adjusted downwards to reflect competitive displacement has little merit as, in a competitive market, it is reasonable to expect that over time competitors will offer services that are similar to the ILECs'.
31. The Commission therefore considers that allowing these proposed price floor adjustments would deter economically efficient entry by competitors that rely on mandated wholesale services. Furthermore, the Commission considers that TCC's proposals would consume significantly more resources for both the Commission and the ILECs compared to the current price floor calculation, with a minimum impact on the level of the price floor.
32. With respect to Bell Canada et al.'s proposal that the price floor test be applied on an *ex post* basis, the Commission considers that this approach would be more appropriate and effective if it had the statutory authority to impose meaningful administrative monetary penalties (AMPs)¹⁰ in circumstances of non-compliance with the price floor test. The Commission considers that, if it had such an AMP power,¹¹ it would, in principle, be prepared to apply the price floor test on an *ex post* basis.

¹⁰ AMPs are monetary penalties imposed in the context of a regulatory scheme for infringements of the relevant legislation, regulations and/or requirements of the regulator.

¹¹ Under the Act, AMPs may only be imposed for a contravention of any prohibition or requirement of the Commission under section 41 of the Act, i.e., unsolicited telecommunications such as telemarketing.

33. Notwithstanding the above, the Commission considers that the filing requirements associated with the price floor test could be further streamlined.¹²
34. The Commission notes that, pursuant to Telecom Order 90-779, any retail service that is expected to have ten or fewer customers and monthly revenues of less than \$2,000 (or the equivalent) is exempt from the requirement to file a cost study and therefore exempt from the requirement of filing a price floor test.
35. While no party commented on this revenue threshold, the Commission considers it appropriate to update the above-noted revenue threshold, in order to better reflect current market conditions and the requirements of the Policy Direction.
36. Accordingly, the Commission modifies the price floor test filing requirements such that a retail service that is expected to have ten or fewer customers and monthly revenues of less than \$10,000 (or an equivalent revenue over the relevant time period) is exempt from the price floor test requirement. The Commission directs each ILEC to update its Regulatory Economic Studies Manual in accordance with the procedures set out in section 4.2 of that Manual.
37. In view of all the above, the Commission concludes that the price floor test, as modified above, remains appropriate and necessary in light of the Policy Direction.

How should the price floor test be adapted to reflect the revised wholesale classifications in Telecom Decision 2008-17?

38. In Telecom Decision 2008-17, the Commission set out the following six categories of wholesale services: essential, conditional essential, conditional mandated non-essential, public good, interconnection, and non-essential subject to phase-out. In Telecom Public Notice 2008-5, the Commission invited parties to comment on which wholesale service categories should be imputed at tariff and which wholesale service categories should be included at Phase II cost in the price floor test.
39. Bell Canada et al., MTS Allstream, Primus, and TCC submitted that essential, interconnection, and public good wholesale services should be imputed at tariffed rates in the price floor test. While the first three parties submitted that conditional essential services should be imputed at tariffed rates, TCC argued that these services should be included at the relevant incremental costs or market-based prices as they can be duplicated.

¹² The Commission notes that it recently streamlined the filing requirements associated with the price floor test in Telecom Decision 2007-74 with respect to certain customer-specific arrangements, in Telecom Decision 2007-117 with respect to certain service bundles, and in Telecom Decision 2008-74 with respect to certain tariff filings.

40. Primus submitted that conditional mandated non-essential wholesale services should be imputed at tariffed rates in the price floor test. MTS Allstream submitted that these services should be included at Phase II cost plus some allowable range of mark-ups. Bell Canada et al. submitted that these services should be included at Phase II cost, and TCC submitted that they should be included at the relevant incremental costs or market-based prices.
41. Bell Canada et al. and MTS Allstream submitted that non-essential subject to phase-out services should be included in the price floor test at Phase II cost. TCC submitted that these services should be included at the relevant incremental costs or market-based prices while Primus submitted that tariffed rates should be used for these services.

Commission's analysis and determinations

42. The Commission agrees with parties that essential, interconnection, and public good services are to be imputed in the price floor test at their tariffed rates.
43. With respect to the treatment of conditional essential services, the Commission notes that while it stated in Telecom Decision 2008-17 that there may be functionally equivalent wholesale alternatives to conditional essential services in the future, services presently classified in this category meet the essential service criteria. The Commission therefore finds that conditional essential services are to be imputed in the price floor test at their tariffed rates.
44. With respect to conditional mandated non-essential services and non-essential subject to phase-out services, the Commission notes that it found, in Telecom Decision 2008-17, that these wholesale services are non-essential services. The Commission therefore finds that conditional mandated non-essential services and non-essential subject to phase-out services are to be included in the price floor test at their Phase II cost.
45. The Commission directs each ILEC to update its Regulatory Economic Studies Manual in accordance with the procedures set out in section 4.2 of that Manual.

Are the other wholesale costing methodologies still appropriate?

All-carriers approach

46. Wholesale tariffed service rates are typically established based on the prospective incremental costs plus a mark-up. For certain wholesale services,¹³ the Commission develops prospective incremental costs using what it terms the “all-carriers approach.”¹⁴ Under this approach, prospective incremental costs associated with certain wholesale services are developed based on the combined demand of the ILECs and competitors, rather than based on competitor demand only.

¹³ Examples include certain equal access and other bottleneck services established in Telecom Decision 97-6, and various unbundled network elements established in Telecom Decision 97-8.

¹⁴ The all-carriers approach was first mandated by the Commission in Telecom Decision 97-6.

47. Bell Canada et al. and TCC proposed that the use of the all-carriers approach be discontinued, submitting that it caused the ILECs to bear a disproportionate amount of costs incurred in providing the wholesale service.
48. RCI submitted that the all-carriers approach appropriately recognizes that both the ILEC and competitors make use of the same inputs in the provisioning of their retail services and hence is competitively neutral.

Commission's analysis and determinations

49. The Commission notes that the wholesale services that are subject to the all-carriers approach are typically services that cannot be practically or feasibly duplicated by a reasonably efficient competitor. These wholesale services represent ILEC facilities or functionalities that both ILECs and competitors require to provide their retail services.
50. The Commission considers that, in these circumstances, the use of the all-carriers approach to develop certain wholesale service rates places ILECs and competitors on an equal footing with respect to the use of these services as inputs in the provision of retail services. The Commission is also of the view that the use of the all-carriers approach provides a disincentive for ILECs to engage in shifting costs to competitors, thus serving as a competitive safeguard and resulting in a reduced need for regulatory oversight.
51. In view of the above, the Commission finds that the continued use of the all-carriers approach is appropriate and necessary to determine the costs of certain wholesale services and is consistent with the Policy Direction.

Regulatory process to ensure competitor service rates reflect costs

52. MTS Allstream submitted that there is a lack of regulatory process to ensure that wholesale service prices reflect current and declining costs on an ongoing basis. MTS Allstream did not, however, propose specific revisions to the current process.
53. The Commission notes that certain wholesale service rates are adjusted annually to approximate the reduction in costs, net of inflation. The Commission also notes that the review of wholesale service rates and costs can be addressed through the existing Part VII application process. Therefore, the Commission considers that its current process is appropriate to address issues with respect to cost changes for wholesale services.

Operating and maintenance expenses

54. TCC requested that the Commission allow ILECs to use actual company-specific functional operating expenses and maintenance expenses for residential exchange service and unbundled loops in the determination of the total Phase II costs for these services, instead of using the capped values established in Decision 2001-238.

55. The Commission notes that TCC's request was made prior to the issuance of Telecom Order 2008-237. In that order, the Commission determined that ILECs may now use company-specific expenses in regulatory economic studies. Therefore, the capping of expenses is no longer required for residential exchange service and unbundled loops. In view of this, the Commission considers that this issue has been resolved.

Other issues

56. The Commission notes that parties raised several other issues related to the pricing of wholesale services. These issues included wholesale pricing mark-ups, transition to negotiated pricing, de-averaged prices within a band, risk premiums related to short-term contracts, and proposed adjustments to the level of wholesale rates for non-essential subject to phase-out services. The Commission considers that these matters are beyond the scope of this proceeding, and therefore are not addressed in this decision.
57. The Commission notes that Bell Canada et al. and TCC proposed modifications to two additional costing methodologies: the use of company-specific working fill factors and the recovery of past introduction costs not fully recovered. These issues are being addressed in a separate process pursuant to the Commission's letter dated 10 October 2008.

Secretary General

Related documents

- *Regulatory Economic Studies Manuals – Follow-up proceeding to Telecom Decision 2008-14*, Telecom Order CRTC 2008-237, 25 August 2008
- *Approval mechanisms for retail and CLEC tariffs*, Telecom Decision CRTC 2008-74, 21 August 2008
- *Review of regulatory requirements pertaining to the imputation test for retail services and to costing methodologies for wholesale services*, Telecom Public Notice CRTC 2008-5, 5 June 2008
- *Forbearance from the regulation of promotions for retail residential and business local wireline services*, Telecom Decision CRTC 2008-41, 22 May 2008
- *Revised regulatory framework for wholesale services and definition of essential service*, Telecom Decision CRTC 2008-17, 3 March 2008
- *Review of general tariff bundling rules and requirements for market trials*, Telecom Decision CRTC 2007-117, 23 November 2007
- *Bell Canada – Application to modify the rules for mixed Type 2 customer-specific arrangements*, Telecom Decision CRTC 2007-74, 17 August 2007

- *Action plan for the review of Commission regulatory measures in light of Order in Council P.C. 2006-1534*, Telecom Decision CRTC 2007-51, 11 July 2007
- *Restructured bands, revised loop rates and related issues*, Decision CRTC 2001-238, 27 April 2001, as amended by Decision CRTC 2001-238-1, 28 May 2001, and Decision CRTC 2001-238-2, 7 August 2001
- *Local competition*, Telecom Decision CRTC 97-8, 1 May 1997
- *Unbundled rates to provide equal access*, Telecom Decision CRTC 97-6, 10 April 1997, as amended by Telecom Decision CRTC 97-6-1, 24 April 1997
- *Review of regulatory framework – Targeted pricing, anti-competitive pricing and imputation test for telephone company toll filings*, Telecom Decision CRTC 94-13, 13 July 1994
- Telecom Order CRTC 90-779, 24 July 1990

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>