Office of the Director of
Telecommunications
Regulation

CONSULTATION PAPER

Review of the Price Cap on Certain Telecommunications Services – Consultation II

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1 Introduction

The Director of Telecommunications Regulation ('The Director') issued a consultation document on 1st March 2002 entitled "Review of the Price Cap on Certain Telecommunications Services" (the "March Consultation Paper").[1] That document sought comments from interested parties on the objectives for the price cap; on which services should be subject to a price cap; and on how a price cap should be set, if the Director considers any to be necessary.

The Director would like to thank all the organisations that responded to the Consultation Paper. Their comments have been carefully considered and have helped the Director to progress her price cap review. Responses were received from the following organisations:

- Conduit Europe;
- Digifone MMO2;
- Eircom;
- Esat Telecommunications (joint submission with Ocean Telecommunications);
- IBEC Telecommunications and Internet Federation;
- Nevada Tele.com;
- NTL;
- Swiftcall;
- Vodafone; and
- Worldcom.

These responses are available for inspection at the Office of the Director of Telecommunications Regulation's (ODTR's) office, excluding confidential material that respondents specifically asked to be withheld.

This document summarises the substantive issues raised by respondents, identifying the arguments and evidence that the Director considers most relevant to making decisions about future price cap control in Irish communications markets. Where different organisations held markedly different views, this is noted. This document also sets out the Director's preliminary view on which services should be subject to a price cap, drawing on the views expressed by respondents to the Consultation Paper and a review of competition in the fixed line telephony markets. National Economic Research Associates (NERA) carried out this review on behalf of the ODTR.

This document also forms the second of a series of three consultation documents planned for the Director's price cap review. It outlines the methodology that the Director intends to use

[1] Document No. 02/21

to set the level of the price caps for the relevant services and interested parties are encouraged to offer their comments on the proposed approach.

The ODTR intends to issue the third consultation paper in mid-September. This will consult on the level and structure of any price caps to be applied and will also include a draft tariff regulation amendment order. This consultation will be followed by a statutory two-month consultation period. Once the responses to the September Consultation Paper have been considered, a final tariff regulation amendment order will be issued. The Director's intention is to implement any necessary changes by 1 January 2003. If however there are delays in the collection of adequate data for the purposes of setting a price cap, the new controls may not be introduced until 31st March 2003. The Director will take a final decision on this point in September.

The remainder of this paper is structured as follows:

- Section 2 records relevant developments since the publication of the March Consultation Paper;
- Section 3 – 5 provide an account of the responses to the March Consultation Paper and the Director's response to these. The summary of responses received have been grouped as they appeared in the March Consultation Paper, with successive sections on:
    - objectives for the price cap review;
    - the scope of the review; and
    - setting the price cap.
- Section 6 provides further details of the Director's proposed approach to setting price cap controls; and
- Section 7 provides interested parties with details of how and when comments should be submitted.

To summarise, this paper explains why the Director takes the view that further price cap control is necessary for at least some of the retail services provided by eircom. The paper also provides further information on the steps the Director proposes to take to set the proposed price cap, in terms of building a financial model, conducting an efficiency study and estimating eircom's cost of capital.

2 Developments since the publication of the consultation paper

Several developments since the publication of the March Consultation Paper are relevant to the development of competition and regulation for the services discussed here. The main ODTR documents are outlined below.

Consumer awareness of mobile roaming: A report by the ODTR, part of a joint ODTR/Oftel study on mobile roaming (ODTR 02/33).

This report presents consumer awareness, usage and satisfaction results relating to consumers' use of mobile phones abroad. It is based on surveys carried out in February 2002 for the ODTR and Oftel. The main results were that Irish consumers tend to use their mobile phone abroad more frequently than consumers in Great Britain and Northern Ireland; there appears to be relatively low awareness among Irish consumers on international roaming costs and options to reduce them; consumers in Great Britain and Northern Ireland tend to make greater use of options to reduce roaming costs than those in Ireland; Irish consumers (as well as those in Great Britain and Northern Ireland) are generally dissatisfied with their international roaming service and in particular the costs of receiving incoming calls whilst abroad.

Future Regulation of Electronic Communications Networks and Services: Future Authorisations, Consultation Paper (ODTR 02/22)

This document provided information about the new EU Framework on the regulation of electronic communications networks. It also invited views from interested parties on how the new framework should be implemented, in particular on the transition from a scheme of licenses to general authorisations as required by the Authorisation Directive. The deadline for responses was 12th April 2002.

The European Commission published draft guidelines on market analysis and the calculation of significant market power under the new framework in March 2001. Delays in the publication of the Commission's draft Recommendation on market definitions mean that this Recommendation[2] is not expected to be finalised until later in the summer.

eircom's Reference Interconnection Offer: Consultation Paper (ODTR02/27)

This consultation paper was the ODTR's third major review of eircom's Reference Interconnect Offer (RIO), the last operational review of which took place in April 2000. The issues addressed related to incremental change and development of the transit regime arising from dissatisfaction with the detailed operation of current procedures, lack of transparency in the communication of details of *eircom*'s RIO, and a desire to improve upon the status quo.

[2] To be issued in accordance with Article 15 of the forthcoming Framework Directive.

Comments were due by 26th April, and a report on the consultation will be published in June 2002.

eircom's Reference Interconnection Offer: Miscellaneous Issues, Response to Consultation Paper, Decision Notice and Further Consultation (ODTR 02/30)

This document, published on 25th March, sought to address and summarise the views of the respondents on a range of issues relating to financial aspects of eircom's Reference Interconnection Offer and to provide the reasoning behind the decisions taken. Comments were due by 26th April.

Local Loop Unbundling: Review of eircom's Access Reference Offer (ODTR 02/36)

This review was published on 17th April 2002 and marked the conclusion of discussions on a range of issues relating to LLU pricing. In this Decision Notice, the Director accepted eircom's Access Reference Offer, and used this to set the final prices for the period 1 January 2001 until 31 March 2002 and for the period 1 April 2002 until 31 March 2003 subject to further review of certain aspects detailed in the notice.

Eircom's Wholesale Bitstream Reference Offer: Information Notice (ODTR 02/37)

This Information Notice announced that the Director was satisfied with eircom's new pricing structure relating to bitstream services. There were a small number of operational issues which the Director urged eircom to finalise. In addition the Director noted an assurance by eircom that backhaul would be put in place in time for access seekers wishing to make use of the wholesale bitstream service and the special arrangements in place for the submission of build orders for the launch period.

Interconnection rates in the Irish Telecommunications Sector: Information Notice (ODTR 02/38)

This Information Notice provided a status report to the market on the interconnection rates contained in eircom's RIO. It welcomed eircom's decision to discontinue its legal proceedings against Decision Note D7/01. The key positions and actions being adopted were the finalisation of interconnection rates for the 4 month period from 1 December 1999 to 31 March 2000 and for the 12 month period from 1 April 2000 to 31 March 2001.

Interconnection rates in the Irish telecommunication sector: Decision Notice D6/02 on rates to apply from 1 April 2000 – 31 March 2001 (ODTR 02/40)

This Decision Notice determined the final rates that should apply for the period 1 April 2000 until 31 March 2001 following eircom's proposed reduction in the interim rates. It also noted eircom's intention to discontinue its legal proceedings against Decision Notice D7/01.

CPS Call Quality Summary Report (ODTR 02/41)

The ODTR commissioned Mason Communications to conduct a quantitative analysis of Carrier Pre Select (CPS) call quality in Ireland. The aim was to test whether there was any difference in the quality of telephony service experienced by customers using eircom direct and those using the CPS service from an OLO. Esat Telecom, Worldcom (both OLOs) and eircom participated in the tests and Mason Communications did not find any evidence to suggest that there is any difference in the processing of voice calls whether the service is offered by eircom or via an OLO using CPS.

Carrier Pre-Selection in Ireland: Consultation Paper (ODTR 02/47)

This Consultation Paper is part of a comprehensive review of CPS that the ODTR is currently undertaking, now that CPS services have been available for over 2 years. Four main issues were addressed in this consultation paper: the possibility of a single bill for CPS customers; the inclusion of additional call categories in the ‘All Calls’ CPS option; provision of call barring and other ancillary services to CPS customers; and a CPS Code of Practice focussing on complaint and enquiry handling, customer contact and “win-back”. The deadline for comments was Friday 7th June.

3 Objectives for the Price cap review (section 3 of the consultation paper)

3.1 Objectives for the price cap

There was general support for the three objectives ODTR put forward and strong continuing support for the use of price caps for services where the operator faces no competition or is dominant. In terms of the relative importance of the ODTR's proposed objectives, responses fell into two main groups:

- those arguing that the ODTR's main objective should be to encourage the rapid development of effective competition; and
- those arguing that the primary objective should be to ensure that prices (both wholesale and retail) set by dominant operators should be close to competitive and therefore cost-based prices.

In addition, one respondent suggested that the ODTR might include an additional objective of "encouraging sustainable investment in infrastructure and innovation."

The Director welcomes respondents' support for the ODTR's proposed objectives and will ensure that these are borne firmly in mind when decisions are taken in relation to price cap controls. The Director recognises the importance of investment and innovation when providing telecommunications services, and these are factors that she will take into account when seeking to ensure that the principal objectives do not endanger the continuing provision of high quality telecommunications services to customers.

To conclude, the principal objectives for the ODTR's price cap review are as follows:

- to ensure that the prices charged by dominant operators to all customers are brought closer to competitive prices than they would be in the absence of price controls;
- where appropriate to ensure affordable access to a universal services and in particular to address the needs of specific vulnerable social groups; and
- to encourage the rapid development of effective competition in the supply of telecommunications services.

The Director will aim to meet these objectives in such a way that they:

- do not endanger the continuing provision of high quality telecommunications services to customers;
- do not distort or restrict competition, including the development of future competition;
- encourage efficient provision of telecommunications services;
- ensure that there is no discrimination in the treatment of undertakings in the market.

3.2 Ensuring affordable access

The March Consultation Paper invited interested parties to comment on how protection for vulnerable users could best be delivered. In this context in particular, the Director notes with regret that the consultation failed to attract responses from any interested parties other than operators. Reference was made to the different measures of protection currently in place, which include:

- the obligations placed on designated USO providers;
- the Department of Social, Community and Family Affairs' (DSCFA's) Free Telephone Rental Allowance (FTRA); and
- within the price cap regime, sub-cap controls on line rental and the lower quartile bill.

This issue attracted relatively few comments. eircom argued that only DSCFA's scheme should be used to protect vulnerable customers. Other schemes such as the sub-cap on the lower quartile bill and low user tariffs were ineffective because customers with low expenditure on fixed line telephony services with the incumbent operator may not have low incomes. They may, for example, use indirect access operators or mobile phones to place their calls instead.

However, several other respondents supported the use of tariff control (e.g. through a sub-cap on line rental) and bill control (e.g. through the use of a sub-cap on a group such as the lower quartile bill). A couple of these suggested that a review should be conducted to determine the relevant customer group(s) that should be targeted for protection. In addition, one other respondent argued that a competitively neutral Universal Service scheme be set up and that this scheme should be quantified, justified and accessible to all carriers equally.

The Director notes that the FTRA scheme is not designed, on its own, to protect all low income customers and that the existing cap on the lower quartile bill may protect some customers who are not vulnerable. The coverage of these measures will be reviewed by the Director over the coming months, and may be subject to further consultation.

3.3 The New Regulatory Framework

Although the current price cap review is being carried out in the context of Irish Legislation, the Director notes the fact that the office has taken the utmost account of the new EU Framework on the regulation of electronic communications networks in Europe. In particular the Director is satisfied that work carried out, up until and beyond now, under Irish Legislation has been and will be consistent with the objectives of the Framework and USO Directives of the new telecom's package which will be transposed into Irish law over the next 15 months.

4 The Scope of the Review

4.1 Fixed line and Mobile Markets

The Director has powers to impose a price cap on services in both fixed line and mobile telephony markets, but only where there is no competition or where an operator is dominant. Previously a price cap has been applied only to certain fixed line services. Respondents' views on whether mobile markets should be price capped were mixed. Three respondents believed that international roaming prices should be price capped, whilst two did not. Only one respondent believed that other mobile retail calls – such as calls to other mobiles or to fixed lines should be regulated, whilst three respondents believed that these markets were already sufficiently competitive so that regulation was unnecessary. There was more consensus on mobile call origination and call termination services, where several respondents suggested that price regulation was necessary.

There have been a number of developments in mobile markets since the March Consultation Paper. Both of the mobile operators currently with SMP status, Vodafone and 02, have recently announced reductions in their mobile termination rates (MTR). MTRs are the rates that a mobile operator charges other operators (both fixed and mobile) for terminating their calls on its network. The new average rate for Vodafone is 12.6 cents per minute and 12 cents for 0_2, with effective dates of 1st June and 1st July respectively. The average rate in the EU is currently 16 cents. Irish rates are therefore currently favourable compared to those in other EU countries. In addition, there is already evidence that fixed line consumers will benefit from these new lower charges for termination on mobile networks. Both SMP mobile operators will be working constructively with the ODTR in developing separated accounts and costing models over the next few months.

In preparation for the introduction of the new EU framework legislation for the regulation of electronic communications markets, the ODTR will be reviewing the level of competition in mobile telecommunications markets early in 2003. If the Director finds that one or more mobile operators in Ireland are dominant in any mobile markets the Director will consider the most appropriate form of regulation, if any. Next year, the Director will have the benefit of more detailed information on mobile operators' costs and, where necessary, will be able to use this as an input to any decision on the most appropriate form of price control. This may include a price cap. In the event that the Director does decide to impose one or more price caps on mobile operators, the Tariff Regulation Order would need to be amended again later in 2003.

Given that there is already a fixed line price cap, the Director proposes to give priority to the review of the fixed line markets. The Director has reviewed the level of competition in fixed line markets, the outcome of which is summarised in Section 5.

4.2 Market Definition

Respondents to the March Consultation Paper supported the ODTR's overall approach to defining markets, which is in line with current Irish telecommunications and competition legislation and is also the standard approach adopted in many other jurisdictions. Some respondents indicated where they thought the emphasis should lie. For example, one argued that the approach should be forward-looking and focus on the dynamic aspects of markets, give supply side considerations the same weight as demand side considerations and take into account demand-side interdependencies as well. On the other hand another respondent considered that demand side substitution should be the primary consideration.

As noted in the March Consultation Paper, the Director takes into account both demand and supply side substitutes when assessing market definition and agrees that a dynamic approach is needed, particularly in fast changing markets.

The March Consultation Paper contained a list of possible markets and respondents were asked to comment on that list, and to indicate whether there were other markets that should be considered or whether the markets should be fragmented any further.

There was general agreement that the different fixed line wholesale services formed separate markets but views on the remaining relevant markets were mixed. Four respondents agreed that the services on ODTR's list all constituted separate relevant markets, whilst the following main points were put forward by other respondents:

- there is a single retail market for access to PSTN/ISDN lines (this would include connection, rental and takeover);
- all mobile services should be treated as a single market because mobile phone customers purchase a bundle of services when joining a network. This bundle of services includes 2G and 3G services (and is therefore technologically neutral); and
- there is substitution between fixed and mobile services (on a call by call and access basis) and a wider web of substitutes for calls from mobiles that together offer a competitive constraint on mobile calls (e-mails, SMS, voicemail, call retiming, call back, calls to a different number).

Interested parties were also asked to comment on whether further fragmentation of markets would be reasonable (e.g. business/residential; peak/off-peak etc). The general view was that further fragmentation would not be appropriate, except perhaps for leased lines where there may be separate relevant markets for different bandwidths and lengths. In addition, one respondent argued that it may be appropriate to define international call markets on a route by route basis and another argued that the wholesale market should be further fragmented to include a market for interconnect specific services such as POIs, GNP and access operator services etc.

Suggestions for additional relevant markets that had not been included in the ODTR's list were fixed to mobile termination for calls originating abroad and international freephone numbers.

All those that commented on geographic market definition believed that the markets should be defined as national in scope, because this was the area for which operators typically held licenses and because, with respect to fixed line services, eircom has to offer geographically averaged prices.

There was little in the way of comment on the impact of removing international calls from the price cap. Eircom believed that subsequent price reductions and its fall in market share have shown that international services do not need to be price capped whilst two other respondents believed that these services should still be subject to a price cap.

The Director's view is provided in Section 5.

4.3 Assessing effective competition

On the whole respondents were supportive of the ODTR's proposed approach to assessing competition, although one respondent was concerned that the ODTR appeared to be using a test of "no effective competition" rather than "no competition" or "dominance" (the terms used in Irish legislation). As explained in the March Consultation Paper, the term "no effective competition" in the Consultation was being used as shorthand to cover both "no competition" and "dominance." Hence the test that is being used is that of "no competition" or "dominance" as set out in Irish legislation.

As noted before, a finding that there is dominance or no competition does not mean that the Director will necessarily seek to apply a price cap. The Director will consider a range of factors to enable her to reach a view on the desirability (or otherwise) of setting a price cap.
ODTR asked for views on the level of competition in the list of possible markets contained in the March Consultation Paper. Specifically, respondents were asked to use one of the following categories to describe each potential market:

- **a** - the market is sufficiently competitive now so that price controls are unnecessary
- **b** – the market is likely to be sufficiently competitive by 2005 so that price controls will be unnecessary
- **c** – the market is likely to be sufficiently competitive by 2007 so that price controls will be unnecessary
- **d** – the market is unlikely to be sufficiently competitive by 2007
- **e** – the market is sufficiently managed by other forms of regulation so that price control in the form of a price cap is unnecessary

The following table provides a summary of the responses received, with each 'x' denoting a categorisation received from a respondent.

Table 4.1:
Summary of respondents view on level of competition

ODTR's original list of potential markets	a	b	c	d	e
Provision of telephone exchange lines – Retail and wholesale (unbundled local access including bitstream access)	x[2]	x	x[3]	x	
Provision of Integrated Services Digital Network (ISDN) lines		x		xxx	
Telephone exchange line connection and takeover		x		xx	
Integrated Services Digital Network (ISDN) line connection and takeover		x		xxx	
National Leased Lines	x[4]	x[5]		xxx	
International leased lines	xx			xx	
Local Dialled Calls	x	x		xx	
Trunk Dialled calls	x	x		xx	
International dialled calls		x		xx	
Operator calls	x			xx	
Directory Enquiry calls	x			xx	x
Payphone calls	x			xx	
Fixed to mobile calls	x			xx	
Internet calls	x			xx	
International roaming services	xx			xxx	
On net mobile to mobile calls	xxx			x	
Off-net mobile to mobile calls	xxx			x	
Off-net mobile to fixed calls	xxx			x	
Fixed call origination				xxxx	
Fixed call termination				xxxx	
Transit	x			xx	
Interconnection of leased lines	x			xxx	
Mobile call origination				xxx	
Mobile call termination				xx	

Note 1: each 'x' denotes a categorisation by a respondent.
Note 2: bitstream access.
Note 3: unbundled local access.
Note 4: narrowband only.
Note 5: Broadband only.

As Table 4.1 illustrates, respondents' views on the level of competition for the above services were very mixed. Indeed, for many services there were respondents with views at either end of the spectrum, with some indicating that there was sufficient competition for a service (to render price controls unnecessary) whilst others took the view that there was unlikely to be sufficient competition for the same service by 2007. It is worth noting however, that in most cases where operators were either the largest/most active in a particular market, the prevailing view of such operators was that these markets were already sufficiently competitive so as to render a price cap unnecessary. The only services for which respondents appeared to be in agreement were fixed call origination and termination, for which the view was that competition, would not be sufficient by 2007 to avoid the need for regulation.

The March Consultation Paper also invited comments on which services should be subject to some form of price control. A number of respondents strongly advocated the removal of eircom's existing retail price cap and the setting of a new price cap for eircom's wholesale services, together with active application of a price squeeze test. These respondents were concerned that the current retail price cap was effectively a cap on *all* operators, reducing their incentives to invest in new products and services. It is worth noting that eircom itself also supported the introduction of a price cap for a number of wholesale services, namely fixed call origination and termination, private partial circuits, and unbundled local access. Several other operators advocated the use of price caps to control leased line interconnection and mobile call termination.

The Director's view is presented in Section 5.

4.4 Other Factors

Where the Director finds that an operator faces either no competition or is dominant in a particular market, she will consider how appropriate a price cap might be, taking into account factors such as the prospects for an increase in competition; the scope and effects of existing regulation; and the potential impact of a price cap on the development of competition.

Three respondents indicated that they supported this approach and the factors put forward by the Director. In addition, eircom believed that the likely administrative costs involved in setting price caps should be taken into account. The Director agrees that when deciding whether or not to impose a price cap, due consideration should be given to the level of administrative costs that are likely to be involved, though in most cases these costs are unlikely to be high relative to the potential gains or losses from regulation.

5 Director's view on relevant markets and level of competition

Since the March Consultation Paper, the ODTR has conducted a review of relevant markets for fixed line telephony services and an assessment of competition in those markets, taking into account respondents' views on these issues. Other sources of information have included responses to the ODTR's SMP questionnaires, which are sent to all licensed operators, and the consumer surveys that are regularly conducted by the ODTR.

5.1 Retail markets

5.1.1 Access

In terms of access, PSTN and ISDN lines are likely to be in the same relevant economic market. In Ireland, PSTN and ISDN lines are used for similar services and charges are broadly similar when translated into an equivalent cost per line. Whilst connection and takeover are clearly not substitutes on either the demand or the supply side, competitive conditions are similar for these products because they are currently both provided by the operator providing the fixed line.

The Director therefore considers that it may be appropriate to define a single fixed line access market, which encompasses the provision of both PSTN and ISDN lines, connection and takeover. In Ireland, eircom currently provides about 99% of fixed lines and in view of the high barriers to entry (other operators would need to build out a fixed network of their own), the Director concludes that eircom is dominant in this market and is likely to remain dominant for at least the next 3 –5 years and these services should be subject to a price cap.[3]

5.1.2 Local, national and fixed to mobile calls

The Director does not believe that calls from a mobile are in the same market as calls from a fixed line, nor are they likely to become part of the same market in the near future. The price of calling from mobiles is still far in excess of the price of calls from a fixed line and consequently it is not plausible that a 5-10 per cent rise in the price of fixed calls would lead to sufficient customers switching calls to a mobile for the price rise to be unprofitable. This could change in the longer term if there is greater price convergence.

Calls made by business and residential customers appear to be in separate markets because these types of customer differ in their usage of fixed line services (both in terms of quantity and time of day) and in their choice of operator. They can also face different prices, in particular larger businesses may face substantially different prices compared with other customers due to their buyer power. Therefore the Director considers that it may be appropriate to treat them as separate markets.

Residential customers can choose to place their calls with eircom, indirect access operators and in some areas cable operators. Where indirect access (IA) operators are used, most customers choose the "all calls" option and so place their local, national, international and

[3] Note: no proposals for the structure of any overall price cap basket or for the need for separate caps or sub-caps are made in this Consultation Paper. Proposals on these matters will be made in the next price cap consultation in September.

fixed to mobile calls with the same operator. As a result, the main competitive conditions are the same in each of these markets. Consequently, it could be argued that a single market should be defined for all of these services, although for the purposes of the current review, the Director continues to define them as separate markets (in practice it makes little difference because of the similarity in competitive conditions for these services).

The evidence on the level of competition for these residential call services is mixed. On the one hand prices have been declining substantially and customers have appeared willing to switch between different operators in response to price changes. When CPS was first introduced a large number of customers moved to the new entrant providers. Few difficulties were experienced when customers changed suppliers. eircom has subsequently won back a number of these customers, through a mixture of marketing, billing and new discount offerings. There is evidence that eircom may be subject to price competition.

However, there are other aspects of the call markets which give rise to some concerns. In particular, the exit of Spirit last year means that there is one less potentially significant competitor in the market place. In addition, eircom appears to have been very effective in winning back customers so that the number of residential CPS subscribers has fallen by 20 per cent over the past year. ODTR research has found that the majority of CPS subscribers who returned to eircom have done so following a direct approach by eircom. These approaches may be assisted by eircom’s position as the access operator, which means that it is aware of the identity and location of all CPS customers. Whilst these direct approaches may have benefited those customers who have switched back to eircom, it has also meant that alternative operators have found it more difficult to become established. Until the Director is satisfied that the other operators have become more firmly established, the Director will continue to view eircom as dominant in the supply of local, national and fixed to mobile calls. The Director proposes that a price cap be retained on eircom’s local and national calls. She will consider whether a price cap should be introduced for fixed to mobile calls.

The picture for business customers is broadly similar to that for residential customers, though there appears to be stronger competition for larger business customers. Larger business customers are likely to have buyer power and are therefore less in need of protection. Customer research has also revealed that eircom’s share of the market for large businesses, though high, is significantly lower than its shares of the residential and other business markets. This indicates that other operators are more likely to be established competitors to eircom for large businesses and that eircom is less likely to be dominant in providing service to these larger customers. Whether it is practical to treat this group separately for price cap purposes would need further review.

5.1.3 International calls

As with the other call markets described above, the evidence on the competitive situation in international calls is mixed. On the one hand, despite the absence of any price control on international calls, the cost of calling the two main international markets (UK and USA) fell substantially over the period. Given that there was no regulatory requirement for eircom to reduce its international call prices, this is evidence of effective competition to eircom.

Iinternational calls are not subject to a price cap at present, having been removed from the cap in 1999. Since then prices have continued to fall, and there is still some prospect of this market becoming competitive in the near future. The Director therefore proposes not to reintroduce a price cap at this stage. However given recent developments on CPS and the position eircom holds in this market place the Director will monitor developments in international call markets closely with a view to reintroducing a price cap if it becomes clear that there is no competitive constraint on eircom's pricing.

5.1.4 Other call markets

Operator Assisted (OA) calls are likely to be in a separate market to direct dialled calls. The significant price premium charged for OA calls suggests that customers would only place such calls as a last resort. Other operators are unable to provide OA calls to the majority of customers because to do so they would need control of the fixed line network for example, to be able to test an individual line.[4] Eircom is currently the only provider of OA calls. In view of the high barriers to entry and the fact that the OA market is a very small and declining market, the Director believes that eircom is the monopoly provider and is likely to remain dominant for the foreseeable future. The Director therefore proposes to continue to include eircom's OA calls in a retail price cap.

The Director considers that directory enquiry (DQ) calls are in a separate market to other products providing similar information, such as the telephone directory, Golden Pages etc, which are available at a significantly lower cost to customers. Whilst DQ call prices have risen by 75 per cent since 1999, there has been no fall in customer volume, indicating that DQ prices are not constrained by the price of these alternatives. There are currently five providers of directory enquiry calls. One of these, Conduit, is not a network provider but is nonetheless an established competitor, which appears to be actively competing in the market. The Director considers that the directory enquiry market is a prospectively competitive market and proposes to remove these calls from the price cap basket. She will continue to monitor developments in this market.

5.1.5 Public Payphones

Anomalies in the data currently available to the Director from operators mean that the Director has not yet been able to complete her review of payphone markets. The Director will seek to clarify these anomalies in the coming weeks and the relevant markets, the level of competition and whether there is a need for price control for payphones will be discussed in the next price cap consultation paper in September.

5.1.6 Leased Lines

Leased lines can either be analogue or digital. The Director considers that analogue leased lines are a separate market from digital leased lines because switching to a digital leased line would not be a cost effective substitute for the vast majority of users. Eircom is currently the only provider of analogue leased lines and, given the barriers to entry coupled to the lack of entry incentive to invest in these traditional networks, the Director concludes that eircom is dominant and likely to remain dominant for the foreseeable future.

The Director has considered whether it is appropriate to subdivide digital leased lines according to bandwidth, for example narrowband and broadband, but has taken the view that

[4] On this basis, it is arguable that OA calls should be part of the market for access. In practice, market definition makes little difference in this case and for the purpose of the price cap review the Director intends to define a separate market.

such a distinction would be largely artificial. This is for two main reasons. First, there is to some extent a chain of substitution for the different bandwidths. Secondly, competitive conditions appear to be broadly similar across bandwidths, as regardless of the bandwidth chosen eircom is the dominant operator with few other competitors. At this stage, other types of services are not considered to provide an adequate competitive constraint on leased line prices, but the ODTR will be monitoring the evolution of new infrastructure, such as IP networks and xDSL, that might provide a close substitute. Eircom is by far the largest supplier of leased lines and while other operators have entered the market, the capacity to expand quickly is low given the costs and complexities associated with market entry in this area. The alternative would be for an operator to build its own connection to the customer, the costs of which can be high, in addition to which planning permission to build the connection from local planning authorities can be difficult to obtain. The Director therefore concludes that eircom is dominant and is likely to remain so for the next 3 – 5 years.

The ODTR is currently working with eircom to develop cost models for leased line provision. Consequently, the Director believes that it would be premature to place a cap on retail or wholesale leased lines this year. An appropriate form of price control, if necessary, and including the possibility of a price cap, will be considered during 2003.

5.1.7 Summary

The following table (Table 5.1:~~Table 5.1:~~) summarises the Director's proposals in relation to the retail services that should be subject to a price cap.

Table 5.1:
Proposals on price control of fixed line retail services

Service	Director's proposal
Fixed line access (provision of PSTN and ISDN lines, connection and takeover)	Eircom is dominant and price cap should be retained.
Local, national and fixed to mobile residential calls	Eircom is dominant and price cap should apply.
Local, national and fixed to mobile business calls	Eircom dominant for provision of services to small to medium sized businesses, but competitive pressures evident for provision of services to large companies. The Director will consider further the most appropriate approach to price control.
International residential calls	Eircom is dominant but the prospect of competition means that these calls should be kept out of price cap and monitored by the ODTR.
International business calls	Eircom dominant for provision of services to SMEs, but competitive pressures evident for provision of services to large companies. The prospect of competition means that these calls should remain out of price cap and monitored by the ODTR.
Operator Assisted calls	Eircom is dominant and price cap should be retained.
Directory Enquiry calls	This market is prospectively competitive and should not be subject to price cap controls.
Public Payphone calls	Further information is needed before a decision can be taken.
Analogue Leased Lines	Eircom is dominant but price cap is not considered appropriate at present, when the ODTR is developing leased line cost models.
Digital Leased Lines	Eircom is dominant but price cap is not considered appropriate at present, when

	the ODTR is developing leased line cost models.

Q1: Views are invited on the Director's proposals in relation to fixed line telephony retail markets and underlying analysis, as summarised in Section 5.1.

5.2 Wholesale markets

The Director considers that **fixed line call origination and termination** are separate markets because of the lack of effective demand or supply side substitutes. As the key provider of fixed access lines, eircom supplies the vast majority of such services in Ireland. Barriers to entry are also very high, because a new entrant would need to build its own local loop to offer these services in competition with eircom. As a result the Director considers that eircom is currently dominant in the provision of fixed line call origination and termination services and is likely to remain dominant for at least the next 3 – 5 years.

Transit involves the conveyance of a call from one network to another. Whilst it is possible to sub-divide transit, for example into local, single or double transit, eircom is currently the only provider of these services. Even if another operator were to enter during the next few years, it is likely to take time to become an established competitor. Therefore the Director considers that eircom is dominant in the provision of transit services and is likely to remain dominant over the next 3 to 5 years.

Wholesale **bitstream** services and **unbundled local loops (ULLs)** have only very recently become available (there is also potential for a new wholesale line rental product coming on stream pending the outcome of a separate consultation). Assessing the competitiveness of markets that are so new is to some degree speculative but the Director will continue to monitor developments in these new markets.

The Director considers that most **wholesale leased line** customers will have no choice but to purchase a leased line from eircom, the alternative of building a new connection in most cases being unlikely to be cost-effective. Eircom is therefore dominant, and likely to continue to be dominant. Although the future introduction of partial private circuits may affect the market for wholesale leased lines, it is too early to predict the impact that this may have. The Director does not propose to impose a price cap on eircom's wholesale leased lines for the same reasons that are outlined in the discussion of retail leased lines above. The prices of wholesale leased lines are currently regulated through a link with the price of retail leased lines.

If and when **partial private circuits** (interconnection of leased lines) are introduced, it seems likely that eircom will be the only operator that can cost-effectively provide the service in the majority of areas. Eircom may therefore be dominant, however at present it is too early to make such an assessment.

A number of respondents, including eircom, said they would welcome a price cap on wholesale fixed services. An increased level of certainty about prices looking forward was cited among the reasons for advocating such a move. Price controls on eircom's wholesale services already exist in the form of the annual setting of prices in arrears. The issue of whether or not to change the current price controls on wholesale fixed services to a price cap that sets prices in advance over one or more years is a significant long term strategic question for the office. The Director considers that there may be potential benefits from shifting the approach to wholesale price control from the current mechanism to a price cap. However, the Director believes that such a change could not happen within the timescale of the current price cap. The recent and ongoing shift from historic cost based prices to prices based on long run incremental costs in the core and access networks, has led to a significant decline in rates. There are still a significant number of issues for the Office to work through with eircom following this change which may lead to further significant changes in rates over the next year or so. Once these issues are worked through and wholesale rates have stabilised the Director considers that it would be appropriate to review the scope for changing to a price control based on a price cap. This review may be feasible in the latter half of 2003, but is more likely in 2004.

Q2 Views are invited on the Director's initial conclusions in relation to fixed line wholesale services, and the underlying analysis as summarised in section 5.2.

6 Setting the price cap (Section 5 of the consultation paper)

6.1 Start date for any new control

The Director currently intends to introduce any new controls and any changes to existing controls on 1st January 2003, rather than align the price controls with the financial year of the relevant price-capped operator. This view was supported by the responses received, none of which argued for alignment with the financial year. A couple of respondents argued for immediate introduction of any changes, whilst others emphasised the need for further consultation and adequate notice before new controls were introduced. However, whilst the office will be continuing to focus on meeting the year-end deadline delays that have arisen in the collection of adequate data for the purposes of setting the price cap may lead to some slippage The Director will take a final decision on this point in September.

The Director would like to reassure respondents that she fully intends to give interested parties further opportunity to comment including the two month consultation period that is required by the relevant legislation before any changes are introduced. As noted in Section 1, the ODTR will issue another consultation paper, (targeted for mid-September), which will summarise responses to the issues raised in this June Consultation Paper and present the Director's final proposals for price caps. The September Consultation Paper will offer interested parties a further period of two months to provide the ODTR with their comments.

6.2 Duration of controls

In the March Consultation Paper, the Director noted that although price caps have often been set for a five year period by regulators elsewhere, three years might still be appropriate for the Irish telecommunications sector because of greater uncertainty about future technical and competitive development.

In its response, eircom emphasised the desirability of having a clearly defined review period for controls and indicated that the *maximum* duration for any price cap should be 5 years, beyond which forecasts can be subject to considerable uncertainty. Other respondents had mixed views, some favouring a review after three years and others five years to maximise efficiency incentives.

The Director does not intend to take a final decision on the duration until the financial price cap model has been built (see Section 7.1) which should provide a clearer picture of the likely evolution of the Irish communications markets over the next few years. The proposed duration will be presented in the ODTR's September Consultation Paper.

As noted in the discussion of mobile markets in Section 4.1 above, any amendment to the current Tariff Regulation Order this year will relate to fixed line markets only. The ODTR will review next year whether any amendments relating to mobile markets would be appropriate.

6.3 Carryover

Of those respondents that commented, all but two were in favour of carryover during a price cap control period, recognising the benefit of allowing the price-controlled operator a greater degree of pricing flexibility. The two respondents that were against carryover were concerned that this additional flexibility could give the price-controlled operator sufficient scope to abuse its market power. Only eircom was in favour of allowing carryover from one price cap regime to the next.

The Director agrees with the majority of respondents that allowing the price capped operator a greater degree of pricing flexibility than a strict annual application of the price cap can bring benefits, particularly if carryover encourages the operator to bring forward additional price reductions. The Director is in favour of only allowing carryover on a *discretionary* rather than an *automatic* basis. A discretionary approach, whereby the operator has to seek agreement from the ODTR before making use of a carryover facility, should minimise any scope that the operator would otherwise have to use this facility to abuse its market power. The Director agrees that operators should not be able to carry over unmade price increases or additional price reductions from one price cap to the next. Indeed, it would not be practical to incorporate carryover from one price cap regime into an entirely new one, which may be set on a different basis to the previous one.

The Director intends to make her decision on whether carryover is permitted for the whole basket of services and/or individual sub-caps when the detailed specification of the price cap has been decided.

6.4 Level and Structure of the Control

Two main questions were raised in this section of the March Consultation Paper. One was whether interested parties agreed with the ODTR's proposed approach to setting price caps and the second was whether they saw a continuing need for sub-caps.

Most of those that commented supported the ODTR's proposed approach, one adding that international trends could also be considered. An alternative two-stage approach put forward for regulating wholesale prices was as follows:

- first adjust all prices so that they are equal to cost; and then
- apply a price cap to the cost of the service.

The Director is pleased to note the general support for her overall approach to setting price caps, further details of which are provided in Section 7 of this document. The Director will decide which level to apply the price cap to once the financial price cap model has been prepared.

All but one respondent supported the use of sub-caps. Two went so far as to argue that there should be no basket price cap for wholesale services and instead the services should all be subject to individual price caps.

The Director has noted the respondents' views on sub-caps. She will not take any decisions on the use of sub-caps until after the financial model has been produced. Any proposals for the inclusion of sub-caps will be outlined in the ODTR's September Consultation Paper.

7 Proposed methodology for setting price caps

Where the Director decides that the price cap should be maintained or that a new price cap is necessary, a financial analysis will contribute to the determination of the appropriate level of X for use in the CPI – X formula. As part and parcel of this approach, efficiency and cost of capital studies will be conducted, the results of which will feed into a financial model.

For some markets, competitive pressures may exist, even if the Director considers that they are not yet strong enough to counteract eircom's dominance. In these cases the Director will carefully consider the impact that a price cap might have on prospective competition before setting any cap. One option might be to introduce a less stringent cap in order to provide a safety net for consumers whilst allowing more freedom for competition to develop further.

7.1 The financial model

The setting of a price cap requires an estimate of the revenue that would be needed to finance the business, including an adequate return to shareholders but also taking into account scope for efficiency improvements. This entails estimating the likely level of operating costs, capital expenditure and the level of return that an efficient company would incur over the period for which the price control will apply, all of which are forecast within the financial model. An understanding of the impact of key macroeconomic factors affecting the level of expected growth in the Irish telecommunications market in general is required, in addition to the likely impact of microeconomic factors relevant to the operator's business. Specifically, calculation of an appropriate price cap will involve an assessment of the following issues in the context of the Irish communications sector:

- how price changes affect volumes sold and hence revenues;
- likely revenue growth taking account of both macro and microeconomic factors;
- the operator's market share and how it is likely to change over time;
- the likely impact of this growth on costs and capital expenditure;
- likely changes in factor input prices (including wages);
- potential for efficiency improvements; and
- cost of capital.

The following table (Table 7.1~~Table 7.1~~) outlines the proposed approach for forecasting revenues and costs in the financial model.

Table 7.1

Key Items to be Forecast	Outline Approach
(i) Revenue	
- market volumes	Start with current market volumes for services that are to be price capped. Use forecasts of likely changes in demand drivers and combine with estimates of elasticities to forecast changes in overall market volumes for those services.
- market shares	Start with current market shares for each service and forecast future market shares taking into account past trends; likely relative prices; operator projections; and where relevant and possible, trends in other countries.
- prices	Forecast likely prices for each price-capped service, taking into account past trends; operator projections; value of X; and where relevant, trends in other countries.
(ii) Operating costs	Start with current operating costs (including payments to other operators) and estimate additional costs required to support volume growth using cost volume elasticities and likely increases in wages and input prices and redundancy costs. Take into account scope for reductions in operating costs through efficiency improvements.
(iii) Capital employed	Start with capital currently employed and estimate additional capital employed (investment) needed to satisfy volume growth. Estimate the value of replacement investment and retired equipment. Take into account scope for efficiency improvements.

Q3: Do you agree with the overall approach taken? If not, why not?

7.2 Efficiency study

The Director intends to consider two main approaches to measuring the relative efficiency of an operator:

- total factor productivity, an approach which has been used by regulators setting price caps in the United States; and
- statistical and mathematical programming techniques, such as ordinary least squares regression analysis, panel data and data envelopment analysis, which have been used by other regulators as part of the process of setting price caps.

The main group of comparator companies will be local exchange carriers (LECs) in the United States (although the ODTR intends to investigate the scope for including other European operators in the TFP analysis). A significant amount of detailed cost data is publicly available for the LECs and these are regarded as providing a good international benchmark for efficiency.

The ODTR's overall approach will be to review available comparable data and assess efficiency using a range of alternative techniques. A view on the scope for efficiency improvements will then be taken based on this review and any further data and/or cost savings plans that the operator in question is able to supply to the ODTR within the time frame necessary for completing the review of the price cap before 1 January 2003.

Q4: Does the respondent agree that by taking the above approaches the Director will have a reasonable *overall* picture of an operator's relative efficiency, which can then be taken into consideration when setting the price cap? Please explain your answer.

7.3 Cost of capital

- ODTR Decision Notice D7/00 stated that the weighted average cost of capital (WACC) methodology should be used to estimate the cost of capital and that the Capital Asset Pricing Methodology (CAPM) should be used as the model for estimating the cost of equity. The Director continues to believe that the WACC and CAPM approaches should be used to calculate the cost of capital for interconnection services and also for retail telecommunication services.

Q5: Do you agree that the above approach is reasonable? Please explain your answer.

8 Submitting Comments

The consultation period will run until 31st July 2002 by which time written comments on any of the issues raised in this paper will be welcome. It would be appreciated if comments were referenced to the relevant question numbers from this document, because this would make the task of analysing responses more straightforward.

Once ODTR has analysed and considered the comments received, it will publish a report in September that will, amongst other things, summarise the responses and present the Directors' views on price caps. In order to promote further openness and transparency, the ODTR will publish the names of all respondents and make responses to the consultation available at her Offices.

The Director appreciates that respondents may wish to provide confidential information to ensure that their comments are meaningful. Where this is the case, respondents are requested to clearly identify confidential material and if possible to include it in a separate Annex to the response. Such information would be treated as strictly confidential.

All responses to this consultation should be clearly marked "Reference: ODTR Price Cap Consultation 02/57" and sent by post, facsimile or e-mail to:Carol Donohue-donohuec@odtr.ie